(continued from front flap)

The period also saw the dominance of fiscal over monetary policy, the breakdown of the Bretton Woods system and the emergence of a new international financial order characterized by floating instead of fixed exchanged rates. The legacy of all three is still with us.

This volume narrates in detail how the RBI coped with the changes that it was required to manage. It is a fascinating story of how policy was actually made during a very trying period in the country's history. The chapters dealing with the management of the external sector are especially revealing since not much has been written about that aspect so far. Researchers of India's economic history will find this volume, as indeed the other two as well, indispensable to their efforts.

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Volume 3
1967–1981

THE RESERVE BANK OF INDIA

THE RESERVE BANK OF INDIA

Volume 3
1967–1981

The Reserve Bank of India (RBI) was set up in 1935, under private ownership. Its charter was to maintain the monetary stability of India. In 1949, it was nationalized. The RBI manages India's monetary and exchange rate policies, and the borrowings of the central and state governments. Regulation of commercial banking is another key responsibility. In 1947, India had a rather rudimentary financial system. Governments sought to promote rapid economic development within a mixed economy framework. This widened the nature and scope of the RBI's responsibilities.

On the banking side, during 1951–66, an effort was made to consolidate commercial banking. There were far too many banks, most of them unviable. The number of commercial banks was therefore brought down sharply, from 566 in 1951 to 91 in 1966. (An account of this process is given in Volume 2.) It was, on the whole, a successful endeavour – by the mid-1960s, Indian banking had become far more viable than it had been ever before. The RBI played a crucial role in this process.

So far, the Reserve Bank of India has published two volumes of its history. The first covered the period 1935–1951 and the second, 1951–67. The present volume begins with the year 1967 and ends with 1981. This was a period that saw major changes in India's financial infrastructure. The nationalization of fourteen banks in July 1969 was the defining economic event of not just the 1960s but the next three decades. Its reverberations have still not died down. It remains, without doubt, the single most important economic decision taken by any government since 1947. Not even the reforms of 1991 are comparable in their consequences – political, social and, of course, economic.

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THE RESERVE BANK OF INDIA

Volume 3

1967–1981

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THE RESERVE BANK OF INDIA
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Contents

Foreword

The Reserve Bank of India, completing 70 eventful years in 2005, has the distinction of being one of the oldest Central Banks of the developing world. The first volume of the Bank's history, published in 1970, covered the beginnings and early evolution of pre-planning and mostly the pre-independence era of 1935–51. The second volume, published in 1998, covering the period up to 1967, focused upon the Bank's pioneering efforts in public policy and institution-building in the first (about) one-and-a-half decades of planned economic development. The period of 1967–81 covered by the present third volume was marked by phenomenal expansion and diversification of the financial sector, and attempts to closely align financial and regulatory policies with plan and development priorities. Aiming at correction of market failures, it was a period of heightened regulation and direction of the Central Bank in every sphere of financial activity.

It needs no reiteration, therefore, that the defining event of the period under study here was the decision by the government, in July 1969, to nationalize fourteen private banks. This decision was taken at the highest policy-making level and, more importantly, it was aimed at promoting the cause of a particular shade of economic policy. As the institution charged with maintaining the financial health of the country, the Bank was at the centre stage of spreading banking from a few urban centres to semi-urban and rural centres including remote parts of the country. This made a significant impact on the overall economic life of the country, by deepening the financial system and through detailed directions shaping the behaviour of banks and financial institutions.

It thus became the Bank's responsibility to ensure that the poor and the vulnerable participated in the huge financial experiments undertaken at that time. As an institution responsible for the conduct of monetary policy, it also had the important task of maintaining price stability. Although dominated by fiscal imperatives and considerations arising out of central planning, the Bank was able to tame intense inflationary pressures twice in the 1970s, which were partly driven by large and unanticipated external shocks. Against the backdrop of chronic shortage of foreign exchange, the Bank made signal contributions to the management of India's external relations.

The experience of the period left behind a powerful legacy, large elements of which were carried forward in the later period and at least some of them are still with us. The Bank's history is, after all, a truthful record of events and decisions evolving in the context of a time and environment, and reflecting, in large part, socio-political realities. I hope this volume will enable readers to assess both the positive and negative consequences in an objective and dispassionate way. While passing judgments with hindsight is easy, I am sure that a discerning reader will keep in mind that the past should not be judged by the standards and wisdom of the present.

The history, as is the case with the previous two volumes, is based on official records and a number of published sources, as well as discussions with persons who were closely involved with different events of the period. The series of volumes, though it represents an institutional history and is sponsored and published by the Bank, should by no means be viewed as an official account since considerable freedom was available to those who worked in choosing the focus and expressing opinions. These efforts should therefore be considered, in some ways, as an exercise in transparency and accountability through an objective and somewhat independent scrutiny, in retrospect, of the functioning of the Bank.

This volume was made possible by contributions coming from a number of Bank officials, including former Governors, and vast expertise also drawn from outside, as our acknowledgements would show. I feel privileged to have been associated with the process of preparation, first as Deputy Governor and later as Governor. This volume also benefited from the advice and guidance of Dr Bimal Jalan, former Governor of the Bank.

Originally, the task of preparing this volume was initiated by the distinguished economic historian, Dr S. Ambirajan. But sadly, due to his sudden demise, we missed the opportunity of his continued involvement. The writing of the history was then entrusted to a team of experts from the Bank headed by Dr A. Vasudevan. Simultaneously, Dr (Ms) C.J. Batliwalla, with her compendious and first-hand knowledge of the external sector, shared the debates, dilemmas and decisions of a most difficult period. Subsequently, Shri T.C.A. Srinivasa Raghavan was given the task of rewriting some parts and editing the draft chapters. I am grateful to Dr A. Vasudevan, Dr (Ms.) Batliwalla and Shri T.C.A. Srinivasa Raghavan for their valuable contributions.

Former Governors Shri M. Narasimham and Dr I.G. Patel also made themselves generously available and the books authored by them too were particularly useful. Discussions with former Union Finance Minister Shri C. Subramaniam, former Deputy Governor Dr K.S. Krishnaswamy, and former Executive Directors Shri W.S. Tambe and V.G. Pendharkar, about some of the events of the period, have made this volume richer.

Thanks are also due to several distinguished central bankers, academicians and bankers who, through their involvement as members of the Advisory Committee at different points of time, guided the effort, including Shri M. Narasimham, S. Venkitaramanan, S.S. Tarapore, M.G. Bhide, the late Dr P.R. Brahmananda, the late Shri R. Janakiraman, Dr T.C.A. Anant and Dr Rakesh Mohan.

Notable contributions were made by officers and staff of the Bank who did the initial drafting, as also those who assisted them with material and ideas. In particular, to be placed on record are the services of the late Shri Y.S.R. Sarma, Shri A.L. Verma, Dr N. Gopalaswamy and above all Dr T.K. Chakrabarty (assisted by Shri Ashok Jangam), who ensured that all the tasks of finalizing and releasing the volume came to fruition. They also coordinated all the academic and administrative activities of the History Cell efficiently.

Overall guidance, all through the preparation of this volume, was provided by Dr C. Rangarajan, Chairman, Advisory Committee. On behalf of the Bank and on my own behalf, I would like to place on record a deep sense of gratitude to him for ungrudgingly sparing his valuable time for this monumental work with his characteristic erudition, dedication and meticulousness.

Finally, I can do no better than to wish the readers, as Professor Paul Samuelson did to the readers of one of Dr Sukhamoy Chakravarty's books: *bon aperitif!*

Mumbai
June 2005

Dr Y.V. Reddy
Governor
Reserve Bank of India

Preface

With the publication of this volume, the history of the Reserve Bank of India has been brought forward to the end of 1981. Very few Central Banks have reached this far in the writing of their histories. The period beyond 1981 is so current that it is better to let some time pass before writing the history of that period.

Institutional histories are important; they show what role institutions have played in moulding the events of the day. They also show how effective and influential they have been. The history of the Reserve Bank of India, for example, is not just the history of an institution. It is part of the economic history of the country. As the apex institution of the financial system of the country, it has played and continues to play a critical role in steering the economy.

The first volume of the history of the Reserve Bank of India dealt with the formative years of the Bank, and the critical issues faced by the country and the Bank in the immediate post-independence period. The second volume dealt with the issues of economic development and management of the financial system in a period marked by several crises of shortages. The third volume covers a period that is marked not only by political and economic upheavals, but also by far-reaching changes in the financial system.

The 'defining event' of the period 1967-81 was nationalization of the major commercial banks. This is surrounded by much controversy. As the present volume has brought out, while the timing might have been political, the decision to nationalize banks was rooted in economic considerations that had been debated over a long time. This decision had a dramatic effect on the banking system which underwent a fundamental change in terms of orientation and operations. The functional and geographical coverage of the system that followed nationalization was truly impressive and unparalleled. In a significant way, sectors which had hitherto been neglected came under credit dispensation. Undoubtedly, it also had an effect on viability and efficiency which showed up, in a stark way, only in the subsequent period. With the emergence of the government as the owner of the major banks, a system of 'dual control' over the banking system emerged. The Reserve Bank had to adjust itself to a new situation, creating sometimes doubts about who was calling the shots, even when there was a congruence of approaches.

This period was beset with many uncertainties. With two oil shocks and the breakdown of the original Bretton Woods system of exchange rates, the external environment was hardly conducive to growth. The Bangladesh war had its impact on the economy. Output growth, more particularly that of agricultural production, was erratic. The price situation went out of control in several years. At the same time, there was a felt compulsion to enlarge the size of the Plan, which, in turn, put pressure on the fiscal system. The Reserve Bank had to act in a situation when the demands of the fiscal system largely guided the course of monetary policy. While monetary policy in conjunction with other measures was actively used to control inflation when it reached alarmingly high levels, during the rest of the period it had to accommodate itself to the dictates of fiscal policy. Monetary management thus became a delicate balancing act between the compulsions of fiscal policy and price stability considerations. This dilemma was not, however, unique to the Reserve Bank of India. However, autonomy of the Central Bank was yet to become an issue to be debated in the open. The banking system operated under a regime of administered interest rates and credit allocation. This also had a bearing both on the scope and the instruments of credit control. These and other aspects of the management of the monetary and credit system constitute the key elements of the third volume.

History is not just a chronicle of events. It goes behind the events and tries to analyse how, by whom and in what circumstances decisions were taken. This is how the task has been broadly conceived in writing these volumes. It is also important that we judge the events in the context of the times in which they happened. It is always easy to be wiser in retrospect!

The eminent economic historian Dr S. Ambirajan was initially entrusted with the work of writing this third volume. He had a great vision that could not be fulfilled. After his sudden demise, Dr A. Vasudevan was given the task. He had literally to start from the scratch and had to design the pattern and content. Independently, Dr Batliwalla was in charge of writing on the issues relating to the external sector. The final task of editing and modifying the chapters fell to Shri T.C.A. Srinivasa Raghavan. Thus, the book bears the imprint of all the three. Besides, the members of the History Cell, initially under the leadership of Shri A.L. Verma and later Dr T.K. Chakrabarty, had to put together the materials, cross-check and verify them, and present them in a coherent manner.

The members of the Advisory Committee offered critical comments on the chapters as they were being drafted. I must record my thanks to all those who have made it possible for this third volume to come out in this year when RBI is celebrating the completion of 70 years.

Finally, let me thank Dr Bimal Jalan who asked me to chair the Advisory Committee, Dr Y.V. Reddy, the present Governor, and Dr Rakesh Mohan, Deputy Governor, for their continuous support and advice.

Delhi
June 2005

Dr C. Rangarajan
Chairman, Advisory Committee

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Names of officials and some associates of the History Cell, RBI, are acknowledged in Appendix 4.

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Introduction

Histories, whether of countries or institutions, necessarily have to be periodicized. But the starting point of each period has its own context. For that reason, it is both important and necessary to bear in mind the context in which the period covered by this volume (1967–81) begins. Unless that is done, much of what happened during the late 1960s and through the 1970s in banking and monetary policy, will appear to suffer from the usual depredations of hindsight.

To get a real flavour of the time, even if only an incomplete one at this distance, one key factor must be kept in view at all times. This is that the 1960s were a decade of several successive shocks—economic, political, military, diplomatic and social. Unless the full magnitude of the impact of these is understood, the period under review in this volume cannot be fully understood. In a space of twenty months, India lost two Prime Ministers, fought two wars with Pakistan that came on top of an earlier one in 1962, and grappled with a major drought that lasted for two years, over 1965 and 1966.

The first shock was military, when, in 1962, China inflicted two severe wounds: the defeat of the Indian army and, therefore, a major dent in the national mood and self-confidence. This was followed by Jawaharlal Nehru's death in 1964. He had been unwell for a few months before, and the old question—after Nehru, who?—had introduced a sense of foreboding and instability. The Congress leadership began to conduct an intense succession battle, and, although Lal Bahadur Shastri became Prime Minister when Nehru passed away, it was clear that he was not in full command.

In the summer and autumn of 1965, Pakistan attacked India twice: once in the Rann of Kutch and again in September, in Kashmir. The resulting war was a stalemate but the toll it took of public finances sealed the Third Plan's fate. The United States and several other western donor nations suspended aid. Then, two-and-a-half months later, in January 1966, Prime Minister

Lal Bahadur Shastri died of a heart attack in Tashkent, where he had gone for peace talks with Pakistan. His successor was Nehru's daughter, Indira Gandhi, but she had to contend with the older and rival power centres in the Congress party. The consequence was a three-year-long struggle for power, which further heightened the sense of drift and chaos. In 1967, the Congress, for the first time, lost in the state assembly elections and this exacerbated the political situation.

On the economic side, the country had to cope with the fiscal consequences of three wars, two droughts, persistent inflation, chronic foreign exchange shortages, and a severe devaluation of the rupee, by 36.5 per cent, in June 1966. As a result, the exchange rate of the rupee per US dollar moved from Rs 4.76 to Rs 7.50. The devaluation was politically unpopular but the policy-makers were led to believe that India would receive large financial support from the multilateral agencies and from aid donors. In the event, this promise was not kept.

Growth slipped and the national mood became very pessimistic. Two-thirds of India was hit by drought in the mid-1960s, which meant that relief works cost the exchequer dear. Food imports grew alarmingly, which meant that the foreign exchange reserves all but vanished. Import controls were in place. Meanwhile, the Americans, fed up with India's policy towards Vietnam, were pushing India around on food shipments.

Most importantly, prices were rising. The economy experienced severe inflationary pressures with the wholesale price index of 'all commodities' and the consumer price index increasing, respectively, by 18.3 per cent and 13.5 per cent, in 1965–66. The prices of the food articles group led the overall price rise. The states were being starved of development funds and the country was in despair. The inflationary situation raised costs and this led to a loss of export competitiveness. The interruption in external aid and the large payments that had to be made for importation of food aggravated the external imbalance.

The increasing burden of external debt servicing and decline in net earnings on account of invisible exports were reflected in a basic disequilibrium in the balance of payments. The setback to agricultural production on account of the severe drought slowed down the rate of growth of industrial production in two ways. First, the raw materials that were needed for agriculture-based industries were in severe short supply, with the result that the prices of raw materials shot up sharply, cutting down the margins required for industries to function viably. Second, agricultural incomes declined owing to low out-turn of farm output, reducing the demand for industrial goods, in particular for cotton textiles, which had a truly all-India market and which provided one of the vital links between agriculture and industry. The drought also resulted in shortage of hydro-based electric power in the late 1960s.

The loss of power of the Congress in one-third of the Indian states intensified the power struggle within the party. All of it came to head in 1969 when Indira Gandhi used the issue of social control of banks versus nationalizing them, in order to project the image of a radical reformer. Mrs Gandhi told a senior official of the Finance Ministry at the time that the decision to nationalize was a political one, and left the details to be worked by the officials in twenty-four hours. Fourteen banks were thus nationalized.

The result of the inner-party conflict was, first, the resignation of the Deputy Prime Minister and Finance Minister Morarji Desai, in March and, second, the nationalization of fourteen in July. Soon after, the Congress party split and Mrs Gandhi's became a minority government dependent on the support of the Communist Party of India (CPI).

Mrs Gandhi took over the Finance portfolio and, for the first time since independence, the budget became an instrument of politics. Until that last day of February in 1970, the budget had been a tool devoted to, and designed for, the economy alone. The idea that it could be used to project the Congress party as a saviour of the poor had never crossed anyone's mind. Politics did intervene from time to time but only tangentially. Nehru had been too honest a politician to allow the budget to be used for political purposes. It was, he made it clear, to be used for gaining purely economic objectives. So, when taxes were raised, the government did not go to town saying it was in order to redistribute wealth or to attack poverty 'directly'. It simply said that higher taxes were necessary to pay for such and such investments in plant and machinery, or for meeting such and such contingent liability. Aware of the implications of introducing issues relating to the redistribution of wealth into the budget, until 1970, governments consciously avoided linking such issues to the budget.

Indira Gandhi changed all that. This is what she said as she presented her first—and only—budget in 1970:

> The provision of adequate employment opportunities is not just a welfare measure. It is a necessary part of the strategy of development in a poor country which can ill afford to keep any resources unutilized or underutilized. Greater attention to dry farming areas is not merely to avoid inequalities in the rural areas. It is also an essential part of any programme to achieve sustained increases in agricultural production. Encouragement to small

enterprises and to new entrepreneurs is vital to build up managerial and entrepreneurial talent which is all too scarce today. Without some restraint on urban land values and individual ownership of urban property, we cannot adequately develop housing and other amenities required to wrest the maximum benefits from the vast productive investments already made in our over-crowded towns and cities. The weakest sections of the society are also the greatest source of potential strength. We cannot provide for all the urgent needs of society with our limited resources. But a balance has to be struck between outlays which may be immediately productive and those which are essential to create and sustain a social and political framework which is conducive to growth in the long run.

I would like to say that in presenting my first Budget to this Honourable House, I have become acutely aware of the challenges as well as the constraints of the contemporary epoch of development of our national economy. I (have) endeavoured to set out the broad framework within which this Budget is cast. That framework, I believe, is consistent with the political, economic and social realities of our country. Convinced as I am of its essential soundness, there is no alternative but to tread a difficult but determined course. If the opportunities for growth which are so much in evidence are to be seized fully, no effort must be spared for raising resources for the purpose. To flinch from this effort at this stage would be to impose even heavier burdens in the years to come. If we allow the present momentum of growth to wane for the sake of some purely temporary advantage, we will deny ourselves the cumulative benefits of a higher rate of growth for all time to come.

If the requirements of growth are urgent, so is the need for some selective measures of social welfare. The fiscal system has also to serve the ends of greater equality of incomes, consumption and wealth, irrespective of any immediate need for resources. At the same time, the needs of those sectors of the economy which require private initiative and investment must also be kept in mind in the interest of growth of the economy as a whole. I can only hope that the proposals I have just presented steer clear of the opposite dangers of venturing too little or attempting too much.

The story of the Reserve Bank of India covered in this volume unfolds in this overall context. It was an intensely political period when old ways were giving way to new ones and when a power shift took place. The retributive ideology favoured by the Left became the dominant policy driver. This gave fiscal policy the pride of place, as a result of which the role that monetary policy could play was drastically curtailed. There were dramatic changes in the institutional setting in which monetary policy was conducted. Not to put too fine a point on it, the Central Bank's freedom to influence the key variable of monetary policy, namely, the interest rate, was severely abridged. This was, instead, a period of directed lending and credit rationing, which sought to replicate the methods of physical planning in the financial sector. The tectonic shift that took place—bank nationalization—was the fundamental driving force as well as the instrument, because public sector banks now had a preponderant share in both bank deposits and bank credit, ranging from 85 to 90 per cent. A number of other financial institutions also came under the jurisdiction of the public sector during the period. Several other institutional mechanisms were also evolved. All this altered the nature of the relationship between the government and the Reserve Bank, which was left with little say in the structure of the financial system.

The Reserve Bank's other objective of promoting price stability was to be addressed by controlling the money supply within certain limits. If there was one basic characteristic of the period, it was the loss of control of the Bank on the sources of change in money stock. This happened because there were no institutional limits on the government for issuing securities and availing of credit from the Bank. The system of issuance of ad hoc treasury bills, which had begun so casually in 1956, virtually became the norm and central variable of monetary policy. These bills were issued on tap at a determined discount rate. The Bank was also required to accommodate the public borrowing programme with suitable policy adjustments. In other words, whatever the government demanded, the Bank was obliged to give. It's was not to reason why.

As mentioned above, the period under study here was marked by turbulence at different levels—political, economic and social, and it posed severe challenges to policy-makers, both in the government and in the Reserve Bank. During this period, there were nine Finance Ministers and eight Governors of the Bank. As a result, the policy regime took nuanced positions at frequencies that would generally be considered unsettling. Operationally, this meant that the Bank had to deploy its skills to reorient financial and credit policies in a manner that was consistent with the economic and institutional aims of the government. But sometimes these aims were not consistent with the principles of sound economic management. The resulting pressures had to be managed without being overtly submissive or confrontational. In a sense, this was the real challenge before the Bank. The credibility and public image of its Governors depended a great deal on how effectively they presented their policies in a style and language that would be perceived by the general public to be easily comprehensible, objective and politically neutral, and yet consistent with the overall real and fiscal policies.

The full force of the government's new determination to launch a 'direct attack on poverty' became evident in the next three budgets. Income taxes were raised to ridiculously high levels—the marginal rate went up to 97 per cent and, along with the wealth tax, to over a 100 per cent. Indirect taxes were also hiked, especially on articles that the government regarded as being luxuries or inessential. Outlays for rural development were increased sharply. Exchange control was tightened, as was industrial licensing. Employment schemes were inaugurated with much fanfare. The newly nationalized banks were asked to go rural, regardless of profitability. Small-scale industry received its share of the largesse as well. It was a complete reversal of the fiscal conservatism of the previous quarter of a century.

As such, it was only a matter of time before a crisis hit. The ingredients were there; all that was needed was a shock to the system. And it came soon enough. In 1972, the monsoon failed and in October 1973 Iran quadrupled oil prices. The fiscal crisis of 1973–74 acted as damper on the redistributive zeal of the government. Fiscal adventurism was quickly given up, and tried and tested methods of restoring order were brought into full play. Inflation was the chief political enemy—as befitted a poor country with low per capita incomes, it was not seen then, and not even now, as an economic problem. It was tamed by inducing savage cuts in aggregate demand. The counterproductive taxation regime was reversed and the marginal tax rate was brought down to a 'mere' 77 per cent. A couple of years later, it was further lowered to 66 per cent, where it stayed for fifteen years. In July 1974, Finance Minister Chavan presented a mini-budget aimed at eliminating inflation, and its main focus was a deep cutting of expenditure, both by direct and indirect means. It finally settled the economic direction. The budget returned to being what it had been before 1970, an instrument of economic policy, not party politics—almost.

But the genie had been let out of the bottle. Indira Gandhi had shown how a budget could be manipulated for political gain. So, even though the tempo of manipulation dropped, the temptations, the possibilities and the practice all remained. Between 1975 and 1979, fiscal conservatism was the rule.

Nevertheless, the budget deficit rose sharply in these years. By serendipity, foreign exchange reserves rose during this period in spite of the policy of slow import liberalization. Mainly, it was the inward remittances from workers in the Gulf that contributed. But exports also grew. The process that Indira Gandhi had begun at the very start of the decade, in 1970, was brought to its culmination in its last year, 1979. In between, a state of 'Emergency' was declared—from June 1975 to March 1977. The Janata government, after an excellent spell, was in its death throes in 1979. Ignoring Prime Minister Morarji Desai's advice, the Finance Minister presented a budget in February 1979 that took the uncovered budget deficit to over Rs 1,000 crore; and, by the end of the fiscal year, it ballooned to Rs 2,700 crore. There was an external shock that year as well—quadrupled oil prices.

By the end of 1979, all the good work of the previous five years had been undone. India was in crisis once again. In January 1980, Indira Gandhi was re-elected as Prime Minister. Inflation was running at 22 per cent. Foreign exchange reserves, thanks to the second oil crisis of 1979–80, had all but vanished. There was an unprecedented drought in the country. The Sixth Five Year Plan had to be finalized and resources had to be found for it.

But the budget had no room for manoeuvre in 1980. So, except for undoing the damage done by Charan Singh as far as income tax rates were concerned—he had raised it to a maximum of 72 per cent, the budget was essentially a fire-fighting one, designed to contain the budget deficit and the deficit on the current account. The latter had gone up from 0.3 per cent of GDP in 1979–80 to 3 per cent of GDP in 1980–81. The revised estimates for 1979–80 showed that the budget deficit had risen to an unprecedented Rs 2,700 crore, double what had been estimated a year earlier. This was thanks mainly to the relief works occasioned by the drought and poor tax collections due to the collapse of governance in the middle half of fiscal 1979.

But any expectations that the fiscal contraction of 1980–81 would resolve the twin crisis of high inflation and a high current account deficit were shortlived. By the time the budget for 1981 came around, it was clear that India was solidly in the middle of a major crisis and that something more would have to be done to tide over it. By October that year, there was only way out left: a loan from the extended financing facility (EFF) of the International Monetary Fund (IMF)—non-conditionality credit lines had already been tapped earlier—in order to insulate the Sixth Plan's investments from debilitating shortage of foreign exchange.

This was arranged for in November of 1981 and, helped by a good monsoon and sensible monetary policies, the crisis was a thing of the past by the beginning of the next financial year. Inflation was down to high single digits, the IMF loan had given some breathing space for imports, exports were starting to pick up and oil prices had stabilized.

The period covered in this volume was thus characterized by highly unsettled politics and policy responses thereto. It was a period of learning, experimentation and mistakes. It was also a period of huge gains, especially in banking, which spread to the far corners of the country. Whether social control would have achieved the same objectives and, if so, at what cost will never be known, and is, in any case, an academic question now.

One issue that has never been properly debated is whether nationalization benefited the country or not. The answer, of course, depends on the point of view of the analyst. But it is worth recording a basic fact here, namely, that at the time of nationalization as many as 617 towns out of 2,700 in the country were not covered by commercial banks. Of these, 444 did not have cooperative banking facilities either. And, even worse, out of about 600,000 villages, hardly 5,000 had banks. The spread, too, was uneven. While the credit–deposit ratio was as high as 89 per cent in centres with a population above 10 lakhs, the declining trend in lower population centres was equally glaring. Centres with population groups of less than 10,000 averaged a credit–deposit ratio of 41 per cent. By 1982, this picture had been completely transformed. Practically the whole country was covered by the banking system. It is impossible not to wonder if this transformation could have been achieved if the banks had not been nationalized. And, as one wonders about that, it is impossible not to be struck by the level of involvement of the government and the Reserve Bank in sorting out problems that had plagued the country for centuries. It was perhaps a period of error; but it was also a period of trial.

An issue directly related to this is credit delivery to the poor, whether in rural or urban areas. The efforts in this direction were truly heroic, if sometimes ham-handed and ill-advised. Although it can be argued, with the benefit of hindsight, that this or that way was wrong or right, there can be no gainsaying the fact that the 1970s saw credit going to the poor. It did not remain a political stick to beat the government with, because actual instruments of credit delivery were devised. Not all of them worked, of course, and, arguably, those that did were not the most efficient. But the fact remained that credit began to flow to the poor, who now had an alternative to the local moneylender. The failures would come later but, for the moment, a sea-change had been achieved in the economic sociology of the country.

Another important issue related to the consequence of nationalization was the diminution in the role of monetary policy. Throughout the 1970s and much of the 1980s, it was fiscal policy that held the centrestage. The government decided upon its borrowing programme often without paying due heed to the consequences of monetization of debt. Inflation was seen as being tolerable till it reached 7 per cent, perhaps because it was at that level that dearness allowance payments began to fall due, and it was only then that efforts to reduce money supply started. But these usually consisted of non-price instruments such as raising the statutory liquidity ratio (SLR) and the cash reserve ratio (CRR). Such changes in interest rates as were made mostly impacted the private sector, which, in any case, was faced with over 200 rates by the middle of the 1980s. The idea of a benchmark rate was known but only as something that other countries had. It was not until the late 1980s that the structure of the rates at the short end began to be unified. Monetary policy thus had a very small role to play in overall economic management. It is tempting to note, in this context, that, at least in this respect, India was doing in the 1970s what China is doing now.

One of the most significant developments of the early 1960s was the establishment of the Industrial Development Bank of India (IDBI) and the Unit Trust of India (UTI) in 1964. The former was intended to provide long-term capital to industry; the latter was designed to provide a safe haven for small savers. The Reserve Bank's initiative in their setting up is discussed in Volume 2 of the history of the Bank (1951–1967). By the end of the 1960s, both institutions had begun to function well; in the 1970s, a certain amount of tension developed between the Bank, these institutions and the government. Coordination was a major irritant and the eventual consequence of this tension was the 'delinking' of IDBI and UTI from the Bank in 1976. There were four areas of relationship between the Bank and the two financial institutions. From the Bank's point of view, these were: management participation, staff and organizational support, financial support and policy support. Of these, the first two areas were not critical; they were expected to be fulfilled because both IDBI and UTI had been, after all, set up by the Bank. It was only in respect of the latter two that the relationship became a little fraught owing to their flexible nature. This happened despite the fact that the Bank's participation at the highest management level of the two institutions differed. The RBI Governor was the ex-officio chairman of the IDBI, and a Deputy Governor acted as the vice chairman. The Bank and the IDBI had an identical board of directors. However, in the case of UTI, although the chairman, the executive trustee and four other trustees were nominated by the Bank, the chairman was not from the RBI. Also, the executive trustee was of the rank of an Executive Director of the Bank. This created some anomalies. The financial and policy support was influenced by the culture that the Bank exported via the secondment of its clerical and officer-level staff.

This was also a period when foreign exchange shortages were endemic and severe. Coping with the uncertainties of the time took a great deal of effort and sagacity, and the Reserve Bank played an important role here, especially in the dealings with the IMF. The abandonment of the Bretton Woods system in 1971 created problems for all countries but for the developing countries these were especially severe. The Bank had to cope with the adjustment challenges in a period of huge uncertainty. Exchange control and exchange rate management are analysed in this volume, in this context. The developing countries were also pressing for the reform of the international monetary system and the Bank made several important contributions to the debate.

Issues of safety and prudence also came to the fore and the Reserve Bank dealt with them in a satisfactory manner. Of late, there has been some criticism that the Bank tended to be overly bureaucratic and process-driven in doing this, with the result that even normal risk-taking in banking was discouraged. There is some truth in this but, before arriving at a judgment, it is important to bear in mind that the country did not really have a very large cadre of trained bankers at the time. In the absence of skills, experience and market knowledge in the required quantities, ruled-based banking was the only option.

During this period, since interest rates were not market-determined and since credit was not easily forthcoming, there was a mushrooming of private deposit-taking, moneylending companies. These were called non-bank finance companies (NBFCs) and were outside the formal purview of the Reserve Bank. But, given the risks that were inherent in their activities, the Bank did try and regulate them, though not with much success. Over time, these companies came to form a powerful political lobby. It was not easy to ward off both political and market pressures at the same time.

Another important feature of this period related to the Governor, and thereby the autonomy of the Bank. During 1951–81, the Bank had as many as eleven Governors.[1] There were two issues involved: one, most Governors

[1] Of these, seven—B. Rama Rao, H.V.R. Iengar, P.C. Bhattacharya, L.K. Jha, S. Jagannathan, K.R. Puri and I.G. Patel—were appointed for regular terms and their initial term of appointment varied from five years to one year, as in the case of K.R. Puri. Rama Rao had the longest tenure, of about seven-and-a-half years. He was originally given a term of five years, which was extended first by one year and then again by two years. K.R. Puri was

were not only chosen from the civil service, but also, they came towards the end of their careers; two, and the more substantive issue, the relationship between the Finance Ministry and the Bank. Where the first was concerned, in 1968, Madhu Limaye raised the issue in Parliament and Morarji Desai, who was the Finance Minister, assured him that in the future civil servants would not be appointed as Governor. But that did not happen and L.K. Jha was succeeded by another civil servant, S. Jagannathan.[2] Even I.G. Patel expressed in an interview that he could not understand why the RBI Governor should nearly always come from within the ranks of Secretaries of the Ministry of Finance: 'Why not a worthy academician or even a successful businessman who has the understanding? I think we need to bring a new spirit.'[3]

Where the second issue is concerned, as we saw in Volume 2 of the history of the Reserve Bank of India how, when the Governor came into

given a term of one year originally, which was extended by two years but he did not complete the extended term. He had a very short tenure, of one year and nine months. H.V.R. Iengar and P.C. Bhattacharyya completed their five-year terms. L.K. Jha was appointed for five years but relinquished office in less than three years to go as India's Ambassador to the United States. Jagannathan and Patel relinquished office a few weeks before the completion of their terms. The remaining four—Ambegaonkar, Adarkar, Sen Gupta and Narasimham—were appointed as pro term till the regular appointments were made. Their terms ranged from forty-two days (Adarkar) to seven months (Narasimham). Ambegaonkar and Adarkar were Deputy Governors when they were elevated to the post of Governor. Sen Gupta and Narasimham came from the Banking Department. Except for Puri, all the Governors were directly or indirectly associated with the RBI. In fact, most of them were on the Bank's Central Board and, therefore, the Bank was not a new institution for them. Puri came from the Life Insurance Corporation (LIC) of India. There was a difference of opinion between the Prime Minister and the Finance Minister over his appointment, which was made at the height of the Emergency: the Finance Minister was not in favour of appointing him but had to bow before the Prime Minister's wishes.

[2] In 1974, during the debate on the Reserve Bank of India (Amendment) Act, 1974, Madhu Limaye reiterated his suggestion regarding the appointment of the Governor. He stated: 'I had suggested several times to Morarji Desai, when he was the Finance Minister, that it was wrong to continue to appoint the ICS officers as Governors of the Reserve Bank. Appoint as Governor only experts who have a sound knowledge of fiscal and monetary policies. However, the government has not so far taken any policy decision in this regard. I would, therefore, request … to clarify on this point also and to state that in future no ICS and IAS officers but only experts will be appointed as Governors of the Reserve Bank.'

[3] Interview to *Business Standard*, 10 December 1993.

conflict with the Finance Minister, it was the latter who won the day.[4]

B.K. Nehru, when he was offered the Governorship in 1967, declined and explained why in his autobiography. 'The reason why I had so far refused was the lack of independence of the Governor. I explained to him that the great battle between TTK and Rama Rao, which the latter lost, had made it clear that the Governor was a subordinate of the Ministry of Finance. Even as Joint Secretary, I used to issue orders to the Reserve Bank. I did not cherish the idea of my juniors ordering me about.' But it is easy to exaggerate the problem. The truth is that, for the most part, the Bank and the Ministry worked well together. Such differences as arose were inevitable and can be seen in all countries.

In the final analysis, it must not be overlooked that throughout this period, the Bank was an important executor of policy as also a key advisor to the Finance Ministry. It is to that story that we turn now.

[4] In 1957, while presenting the Central Budget, the Finance Minister T.T. Krishnamachary levied a charge in the form of higher stamp duty on bills of exchange, which, in effect, amounted to increase in the interest rate. Rama Rao protested against what he regarded as interference by the Finance Minister in the area of his responsibility. TTK ignored the protest. The case went up to the Prime Minister, who put it to the Cabinet at a meeting that the Governor of RBI was invited to attend. Rama Rao apparently had the temerity to put his case to the Cabinet. To this TTK objected, saying he was not a member of the Cabinet, that he had no right to speak at the meeting, and that he had been asked to attend but only to answer specific questions. The Prime Minister, as was expected, supported the Finance Minister. The first result was that, from that day, the Reserve Bank lost even such autonomy as it exercised till then and became a subordinate office of Government of India, taking orders even more than before from the Ministry of Finance. The second result was the resignation of Rama Rao.

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The Defining Event

On 20 July 1969, the Indian government nationalized fourteen private sector banks. By any measure, this was the defining economic event of not just the 1960s but the next three decades. Its reverberations have still not died down. It remains, without doubt, the single most important economic decision taken by any government since 1947. Not even the reforms of 1991 are comparable in their consequences—political, social and, of course, economic.

From 1951 to 1966, in an effort to consolidate commercial banking, which was very fragile, the number of commercial banks was brought down sharply. In 1951, there were 566 banks; by 1967, just 91 were left. (An account of this process is provided in Volume 2 of the history of the Reserve Bank of India.) It was, on the whole, a successful endeavour. By the mid-1960s, Indian banking had become far more viable than it had been ever before.

This did not, however, mean that the spread of banking also reduced. On the contrary, there was an increase in the number of branches—from 4,151 to 7,025 during 1951–67. There was thus a significant and palpable increase in the availability of banking facilities, with the population per branch office declining from 1,36,000 in 1951 to about 75,000 in 1967. But there was one important snag: the expansion of branches was mostly in urban areas, and rural and semi-urban areas continued to go unserved. As a result, a number of economic activities, in sectors ranging from agriculture to small-scale industrial units and the self-employed, did not have proper access to banking facilities.

This led to the widespread political perception that, left to itself, the private sector was not sufficiently aware of its larger responsibilities towards society. The political class became convinced that privately owned banks needed to be informed of the societal requirements of credit. Private banks were seen as being excessively concerned with profit alone, which made them unwilling to diversify their loan portfolios across different scales of operation of economic units, as this would raise transaction costs and reduce profits.

THE ROAD TO 'SOCIAL CONTROL'

The idea of 'social control' of banks, as it first emerged in 1967, was the result of a compromise between two extreme viewpoints on banking held by the political class, then mainly represented by the Congress party. The Economic Programme Committee of the All-India Congress Committee (AICC), in its report submitted in 1948, had strongly recommended that banking and insurance should be nationalized as part of a total package for establishing 'a just social order'. This recommendation was endorsed by the AICC at its meeting held in Bombay in April 1948 and also at the annual session held in Jaipur in December 1948. But there matters rested for a decade and a half.

In March 1963, just after the war with China, which India lost and as a result of which a huge budgetary cost was imposed, the government suddenly found itself short of resources to fund the Third Plan. In the ensuing debates Subhadra Joshi, a senior member of the ruling party, brought a non-official resolution asking for nationalization of private banks. This would mobilize resources for development, she said. T.T. Krishnamachari was Finance Minister then. He responded that nationalization by itself was not likely to provide much additional income to the government.

The events of the next four years are critical to an understanding of the political events that led to the nationalization of banks, and it is worth summarizing them here. As stated above, India was recovering from the disastrous defeat at the hands of the Chinese in October 1962. Its treasury was almost empty, and public and political morale were low. Prices were once again starting to rise, forex reserves were dwindling and there was a mood of general dissatisfaction with the government. Then, on 27 May 1964, Jawaharlal Nehru died. Lal Bahadur Shastri became the Prime Minister even as, internally, the Congress leadership began to conduct an intense succession battle. In June 1965 Pakistan attacked in the Rann of Kutch and was repulsed. Worse still, the monsoon failed. Even before the full enormity of this second disaster had sunk in, Pakistan attacked yet again in September that year, this time in Kashmir. The resulting war was a stalemate but the toll it took of public finances sealed the Third Plan's fate. Then, two and a half months before the fiscal year ended, on 11 January 1966, Prime Minister Lal Bahadur Shastri died of a massive heart attack in Tashkent where he had gone for peace talks with Pakistan. He was succeeded by Indira Gandhi. She owed her position to a 'Syndicate' of senior Congress leaders. Groomed for the job by her father from about 1955 onwards, Indira Gandhi had refused the offer in 1964. It would not look nice, she had told some of her advisors.

Her first year in office was perhaps the worst since Nehru's in 1947, although for very different reasons. In a space of twenty months India had lost two Prime Ministers, fought two wars that came on top of an earlier one in 1962 and was grappling with a major drought. For the next two years, drought persisted. Then a balance of payments crisis broke. By 1966 budgeting became notional. Planning was put on hold for three years. In the 1967 general election, the Congress lost a large number of seats in Parliament. War, famine, political uncertainty, economic distress—the cup of misery was brimming over. Indira Gandhi, resenting the control of the Syndicate and requiring to assert her leadership, restore the authority of the government and rebuild the Congress party, needed a dramatic gesture that would revitalize the hopes of the nation and put her firmly in control.

The objective she chose was the vote and support of the poorest, and the instrument she chose to achieve this was bank nationalization. The election manifesto of the Congress party for the 1967 election declared that while those who held the levers of economic power would also ultimately run the political apparatus, it was necessary to bring most of the 'banking institutions under social control to serve the cause of economic growth more effectively and to make credit available to the producers in all fields where it is needed'.

So, through 1968, Indira Gandhi orchestrated the demand for nationalization; by the start of 1969, it became clear that she and Morarji Desai, her Deputy Prime Minister and Finance Minister who was steadfastly opposed to nationalization, would have to part ways. Soon after presenting the budget for 1969, Morarji Desai resigned. Within a few months, the political crisis that had been brewing for about a year, finally broke.

In July that year, the party split into two factions, one led by Indira Gandhi, projecting herself as a revolutionary saviour of the masses, and the other by the Syndicate, now portrayed as being anti-people and pro-rich. To drive home her point, Indira Gandhi assumed the Finance portfolio, rightly calculating that she could shoot at her targets far more effectively. Just how determined she was to win the political battle was brought home to the nation when she presented the budget for 1970–71 on 28 February 1970. It put India on a course from which it has still not been able to steer away completely.

THE RUN-UP TO NATIONALIZATION

The results of the 1967 general election, in which the Congress lost many seats in Parliament and had to give up office in several key north Indian states, led to sharp introspection. At the Congress Working Committee's meetings held in the second week of May 1967, economic issues came up for serious consideration. Many of the members, who held sharply divergent views, wanted to know exactly what the party's goal of 'democratic socialism' meant and how it was to be achieved. Bank nationalization became a focal issue. Some thought banks should be nationalized without much further ado because, otherwise, it would be impossible to ensure adequate credit facilities for deserving units, whether in the small-scale sector or the large sector. But their opponents said that the Reserve Bank already had enough control over banks and that nationalization would not in any way hasten the process of democratic socialism in the country. A third group played the mid-field, favouring social control of banks and nationalization of general insurance.

After detailed discussions, the Congress Working Committee (CWC), decided to go in for increased participation in banking, foreign trade, insurance and foodgrains distribution. As a first step, the Reserve Bank's control over scheduled banks was proposed to be tightened, and the lending portfolios of banks were to be modified to provide liberal credit facilities to the middle and lower middle sectors of industry, trade and agriculture, and, in particular, to ensure that small farmers, small traders and small industrial units were not starved of credit.

Many senior members pressed for urgent steps towards a take-over of private sector banks. Y.B. Chavan, Jagjivan Ram and K. Kamaraj were for immediate implementation of the promise made in the Congress manifesto regarding social control of banks. Morarji Desai, the Deputy Prime Minister and Finance Minister, conceded that the promise made to the electorate had to be fulfilled but pleaded for adopting a cautious approach. He argued that there was already criticism of the inefficient working of the public sector in general and of the State Bank of India in particular, and, therefore, it would be unwise to burden the administration with the control of 94 private banks in the country, as it would pose enormous problems of integration and fitment of salaries, and efficient running of the banks. He explained that he was behind nobody in progressive thinking and action but proper and effective steps must be taken to achieve this end. Finally, he was able to persuade the members that the socialist goals identified by the CWC could be achieved by greater control of private banks without taking them over, and assured them that preparatory steps would be taken towards reaching the goal envisaged in the election manifesto in a gradual manner. Concurrently, the demand for nationalization was raised in Parliament as well. The government said that it was in agreement with the spirit of the idea but wanted to institute a study first into the nature and extent of power it had over the banking institutions. It also informed the House that the government was examining the resolution of the CWC on control over credit and insurance institutions, and the various methods through which this objective could be achieved. Thus did the Finance Ministry buy time.

V.A. Pai Panandikar, Advisor in the Finance Ministry, was asked to conduct the study required by the CWC's resolution on social control over banks. He was not given any instructions regarding the scope of his work but was to examine all aspects, including nationalization. Indira Gandhi, though not actively participating in the debate, as will be seen, shaped the course of events by silent and skilful planning.

Morarji Desai favoured social control over banks but saw the writing on the wall. He convened a meeting of leading bankers on 18 June 1967, at New Delhi. Among those who attended were Krishnaraj Thackersey, President of the Indian Banks' Association, Kamalnayan Bajaj, A.D. Pai, R.D. Birla and M.P. Birla. This, Morarji hoped, would blunt the edge of the demand for nationalization. He asked the private banks to facilitate the flow of credit into socially desirable sectors and not to fritter away funds by financing speculation in seasonal commodities. He also asked them to take steps to ensure that they had sufficient funds with them at the beginning of the busy season by rationalizing their credit policies during the slack season, so that the return of funds during the busy season was adequate. He suggested that credit facilities for small-scale industries and for small agriculturists should be liberalized, and that banks should accept the technical skills of a promising entrepreneur as sufficient security for accommodation. He gave them six weeks to formulate their suggestions on ways to achieve the objectives outlined by him, and made clear the government's determination to tighten its grip on banks and to attain greater social control. The bankers assured him of their cooperation. A little later, a similar meeting was held in Bombay also.

The bankers, naturally, were concerned about the prospect of 'social control'. The chairman of the Indian Banks' Association (IBA), which did not include the State Bank of India, wrote to Indira Gandhi saying that the powers already vested with the Reserve Bank were 'so extensive and comprehensive' that there was hardly any scope for adding to them or for further extending social control over banks. These powers, he said, included determination of the policy on advances, and directives regarding the purposes for which advances could be made, margins to be kept and the rate of interest to be charged. There were several other ways in which the RBI controlled the banks, he said, including guarantees that might be given on behalf of any one company or individuals by any bank; inspection of a bank thoroughly and without previous notice, and ordering the bank to rectify actions that it considered unsound, unsafe or anti-social; and issuing directives to any bank to safeguard the public interest and the interests of depositors, and to secure proper management and working of the bank.

The IBA was stung by the criticism that the banks were not lending enough to agriculture and small industries. So, in July 1967, it seriously considered proposals to establish two corporations—a Farm Finance Corporation and a Small Industries Finance Corporation. Ultimately, only the Agricultural Finance Corporation was set up. In August 1967, the IBA also placed a series of newspaper advertisements to rebut the arguments advanced in favour of social control. It claimed that 89 per cent of the borrowers were small, each having a limit of less than Rs 50,000. It also said that banks had never been expected to finance agriculture but had nevertheless been assisting agriculture, albeit modestly. The IBA then posed the critical question: if savings account depositors were exposed to reckless risks there might be financial panic and crisis of confidence, and, further, if political or legislative processes precipitated issues and forced hasty, unjustified changes upon banks, the economic future of the country might be jeopardized.

These arguments were just brushed aside. The spirit of the times was against them.[1]

[1] Morarji's unbending stance made the protagonists of nationalization more active. The General Secretary of the Congress Parliamentary Party, Chandrasekhar, commissioned four economists to undertake a study of banking operations in India—H.K. Manmohan Singh, head of the Department of Economics, Punjab University; Dr V.B. Singh, Department of Economics, Lucknow University; Dr S.C. Gupta, Agricultural Economics Research Institute, Delhi University; and Dr S.K. Goyal, Indian Institute of Public Administration, New Delhi. Their report was submitted in the third week of October and said that the demand for take-over was 'purely based on economic and social considerations'.

Their main findings were that bank credit in India had not been utilized for financing projects according to Plan priorities but invested in low priority sectors; that between 1953 and 1965, loans advanced by banks for agriculture declined not only in absolute terms but also as a proportion of the total funds; that easy and cheap availability of credit to a few industrial houses had encouraged the growth of monopolies and concentration of economic power; that the Reserve Bank had been ineffective in preventing this tendency and the Bank

THE PAI PANANDIKAR REPORT

Pai Panandikar submitted his draft report towards the middle of August 1967. He suggested that if existing banking legislation was suitably amended, the objectives of social control envisaged in the ten-point economic programme adopted by the CWC could be achieved. He also said that an important step towards social control of banks would be the setting up of some special institutions to provide credit to certain specified and special sectors. Simultaneously, Morarji Desai also received a report on nationalization of general insurance.

The Panandikar report was not made public but, according to press reports, after a preliminary examination, Morarji Desai concluded that nationalization was not called for and that remedial measures could effectively channelize credit to development needs. Apart from changing the institutional arrangements, more stringent control and supervision were envisaged in the report. One way of exercising control would be to ensure that the government had a voice in the appointment of bank directors. Another suggestion was that a national commission be set up to study the organization and structure of banking. Thus was born the Banking Commission.

After discussions with L.K. Jha, Governor of RBI, the final report was submitted at the end of August. The government wanted to ensure that the boards were not packed with special interests, and that they reflected all sections that had a vital stake in the balanced operation of the credit mechanism for sound economic growth.

B.N. Adarkar, Deputy Governor of the Bank, sent fairly detailed comments on the report to the government within days of its submission. The RBI had serious reservations about the need for establishing the National Credit Council (NCC), presumably because it believed that the Council

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had to be very cautious in exercising its regulatory powers lest public confidence in banks in general might be underestimated. The report also found that a total of 188 persons served as directors of twenty leading banks; these directors also held 1,452 directorships of other companies and the total number of companies under them was 1,100. Similarly, a detailed study of the directorships held by directors of five leading banks revealed that through common directors, these five banks were connected with 33 insurance companies, 6 financial institutions, 25 investment centres, 584 manufacturing and other companies, 26 trading companies and 15 non-profit-making associations.

Chandrasekhar, at a press conference held on 24 October 1967, deprecated attempts to sidetrack basic issues like nationalization of banks and abolition of privy purses. He stated that social control of banks could be secured only through take-over of the banking business by the state.

would eventually undermine the authority of the Bank. It was, however, agreed that social control would suffice in the given economic circumstances. The Bank had disagreements with a number of other recommendations, which need to be elaborated upon.

In September 1967, the supporters of nationalization received a shot in the arm from an unexpected quarter. The report of the Industrial Planning and Licensing Policy Committee that had been set up by the Planning Commission categorically advocated state control of banking.

> At the risk of over-stepping my terms of reference, I should express my doubts about the viability of carrying through the above suggestions so long as many of the major credit institutions are under the direct control and/or influence of those who might suffer under the suggested arrangements. It would be difficult to undertake credit planning unless the link to control of industry and banks in the same hands is snapped by nationalization of banks

said its author, R.K. Hazari. He was then a professor of economics at Bombay University.

But Morarji Desai carried the day. The CWC, at its meeting held in Jabalpur on 27 October, whittled down the controversial elements in the party's ten-point programme and left the basic task of its implementation to the government. The demand raised for nationalization was rejected. The Working Committee neither prescribed the form of social control nor fixed any time limit for its implementation.

The Board of Directors of the RBI had been informally discussing the issue of social control. There had also been an exchange of views between the government and the RBI. This was reflected in Governor Bhattacharyya's letter of 2 June 1967 to Morarji. He argued against nationalization, with the caveat that it was still not practicable 'to issue any rigid or statutory direction' to banks to grant loans to small-scale industries or to agriculture. But he said that he intended to suggest to all the larger banks that they create development departments or cells to cater to small-scale industries. He also said that the banks would be 'in a position to supplement the assistance provided by the cooperative banking structure and by the agricultural credit corporations, by financing certain essential inputs like fertilizers, hybrid or other improved seeds and agricultural machinery and implements'. He thought that it would be of help if an appropriate scheme of guarantee or insurance were formulated.

In July 1967, Bhattacharyya was succeeded by L.K. Jha, who had been

Principal Secretary to Indira Gandhi and had a close working relationship with her. He convened a meeting with the chairmen and chief executives of the leading banks on 31 July. At this meeting, Jha pointed out to the banks that 'what was needed was a positive redirection of credit to priority users. Agriculture and exports were obvious priority sectors; in the industrial sector, industries that helped agriculture or stimulated export—as well as small industries—deserved special attention.' He added: 'It was necessary that the banks should understand and be in tune with these objectives. If such understanding was there, there would be no need for written instructions from the Reserve Bank.' He also announced some liberalization measures to enable the banks to enlarge their assistance to what were regarded as 'priority sectors'.

Meanwhile, as pointed out above, Pai Panandikar's report was causing the Reserve Bank some irritation. Panandikar had stressed the inadequacy of the policies and practices of commercial banks in mobilizing deposits and in channelling funds towards the priority sectors, and gone on to say that the Bank's controls were more of a regulatory nature and did not have a positive directional content. In response, the Bank in a memorandum said that this approach reflected a lack of balance.

> No doubt certain areas like agriculture and small-scale industries have received relatively less attention from banks, but it is not fair to conclude from this, as is sometimes done, that bank credit in India has not served as an instrument of development or that the growth of the banking system since the commencement of planning has not proceeded on the lines of national development needs. . . . Nor is it fair to blame the bank managements for failure to promote certain social objectives which were never recommended to them either by Government or the Reserve Bank in the terms in which they are now envisaged.

Defending itself, the RBI pointed out that following the recommendation of the Committee of Direction of the All India Rural Credit Survey, the policy decision had been taken that further development of rural credit facilities should primarily be through extension and strengthening of the cooperative credit system. Further, the lower order of attention received by the small-scale industries sector was due to the orientation of banks in favour of large-scale industry because of the low unit cost of such lending, and this did not amount to defiance of policy directives given either by the government or the Reserve Bank. It said that the overall insufficiency of bank resources, which was primarily related to the low levels of savings in the economy, was the major hurdle in directing adequate flow of credit into the priority sectors.

What irritated the Bank the most was Pai Panandikar's observation that

> there is some evidence that at least a few major commercial banks have been unduly exclusive in their lending practices. Their internal procedures are often left flexible which vest large discretionary powers in the Boards of Directors who have often acted as sources of patronage in deciding credit matters. Secondly, some of the commercial banks, though they may not have actively aided undesirable social activities, appear to have often connived at such activities. And lastly, the support of the commercial banks seems to have helped to some extent, the concentration of economic power.

The Bank agreed that the preponderance of businessmen on bank boards had afforded them an undue advantage but this did not mean that the banks connived at fostering anti-social practices. It pointed out that the main objectives of its inspections as well as of its selective credit controls were to check such practices, if any. Complete elimination of anti-social practices cannot be achieved by banking control alone, so long as substantial resources continued to be available from the unorganized sector to those indulging in such practices.

Pai Panandikar's report had also observed that the effectiveness of the Bank's 'direct controls' was 'limited only to aggregate advances by the banks. The right of the banks to sanction limits to individuals is not in any way restricted unless it crosses the Rs 1 crore limit. As a result, the Bank often finds that its directives are not as effective as necessary.' The RBI explained that its controls were confined not merely to the aggregate advances of banks, but were also aimed at ensuring that the level of advances of individual banks was reasonable and that the advances portfolio had a balanced distribution.

The report's remarks on the coordination between the Bank and the government were so worded as to create an impression that the RBI had very little authority over the commercial banks. The report observed:

> Although it has taken an active position for developing certain types of financing institutions like the Industrial Finance Corporation and the Agricultural Refinance Corporation, the Reserve Bank did not perceive that it was ever assigned a positive and directive role vis-à-vis the credit policy and practices of

> the commercial banks either by way of the legislation or by various amendments to the Banking Regulation Act. Nor did the Reserve Bank feel that it had either the legal authority or the mandate from Government to play such positive role.

The report added:

> It was also felt that at present there were no clear-cut and established channels of communication between the Reserve Bank and the Government for transmitting on a regular basis national economic policies which needed the attention of the Reserve Bank. More often than not, there was a heavy dependence upon informal channels of communication for securing broad policy guidelines from the Government. While the Reserve Bank took considerable initiative in promotional activities like setting up the long-term financing institutions, agricultural and export refinancing schemes, there was no deliberate design of directing the credit policies and practices of commercial banks towards social objectives.

The RBI refuted the charge that it had not played a positive and direct role vis-à-vis the credit policies and practices of commercial banks. In its defence, it cited the various directives issued by it that had a positive content, and that were intended to ensure that the credit policies and practices of commercial banks were oriented towards the objectives of economic policy set by the government from time to time. Sufficient powers also existed in the Banking Regulation Act for the purpose. The Bank also contended that there had always been close contact between the government and RBI in areas of monetary policy and that it had not experienced any difficulty on account of the stated lack of communication channels.

The fact was that Pai Panandikar's report had put the Bank on the defensive. From then onwards, its relationship with the Finance Ministry would undergo a slow qualitative change, characterized, in the main, by a gradual erosion of its powers and authority.

The busy season credit policy of 1967 gave Jha an opportunity to attempt some liberalization. This included measures such as refinance at a preferential rate of 4.5 per cent per annum in respect of packing credit advances made to exporters of engineering and metallurgical products, subject to the condition that the commercial banks' advances carried a rate not exceeding 6 per cent per annum. Moreover, refinance at the Bank rate in respect of packing credit advances to exporters of other products was proposed, subject to a ceiling rate in regard to commercial bank advances of 8 per cent per annum. These facilities were made available irrespective of the banks' net liquidity ratio (NLR). It was also decided that while computing the NLR, the increase in the banks' advances to specified priority sectors and small-scale industries guaranteed by the credit guarantee organization was not to be taken into account. The RBI also rescinded its directive of October 1966 (requiring that not less than 80 per cent of incremental advances in the busy season should be to industry and against export/import bills), with a view to encouraging unrestricted credit to other sectors.

The Reserve Bank's lead was followed by the Industrial Development Bank of India (IDBI), which, on its part, announced certain relaxations, such as extension of its export credit scheme to seven years (and up to ten years in specially deserving cases) and modification of its industrial bill scheme. Later, for the purpose of assessing the increase in advances to priority sectors, a system of submission of weekly returns to the RBI was introduced.

On the agricultural front, commercial banks were expected to commence direct financing on a large scale. The State Bank of India (SBI) had agreed to finance agriculturists directly with short, medium and long-term loans, in a few districts of Uttar Pradesh. Government of India, on its part, had issued a circular to state governments indicating that in order to enable the SBI and other commercial banks to come into the field of agricultural credit on a vast scale, it will be necessary for the state governments to provide them with certain facilities, such as administrative support for carrying out necessary pre-investment surveys, technical assistance of the agricultural department, and statutory facilities with regard to recovery of dues on the lines of the facilities available to the cooperative credit structure.

These measures, it was widely hoped, would result in quelling the demand for nationalization. But that was not to be. State control over banks continued to evoke interest. There were complaints that the bulk of commercial bank advances tended to be directed towards large and medium-scale industries, and big and established business houses. The complaints grew in strength as the demand for bank credit was accelerating while banks' resources were growing at a relatively slow pace. The clamour for equitable distribution of the available resources assumed an increasingly strident tone. The measures taken so far in this direction were considered piecemeal and inadequate.

By December 1967, the scheme for social control was ready. On 14 December 1967, Morarji Desai made a statement in the Parliament on the scheme. Basically, he agreed that the traditional links of banks with industrial and business houses needed to be snapped, and that credit decisions should conform to the development priorities of meeting the credit needs of priority sectors like agriculture, small-scale industries and exports. But, he said, 'mere acquisition of the banks would severely strain the administrative resources of the government', and the influence of industrial groups or businessmen could be neutralized by changing the board of directors. He also proposed the setting up of the National Credit Council for better planning of credit, and new powers to be conferred on the Bank.

The Reserve Bank and the Finance Ministry had even prepared the required legislation. A note prepared by R.K. Seshadri, Executive Director, on the proposed provisions of the Bill, was discussed in the Governor's room on 4 November 1967. In light of these discussions, a tentative draft of the Banking (Social Control and Miscellaneous Provisions) Bill, as it was initially titled, was submitted by the Bank's Joint Legal Adviser, R.M. Halasyam, on 11 November. The draft, duly revised, was sent to Adarkar on 17 November. In the meantime, on 9 November, Morarji Desai held discussions with officials of the Bank, the government and commercial banks, clarifying certain points as also explaining the major changes proposed under the scheme of social control. This was followed by meetings held by Jha with the representatives of foreign banks on 30 November, explaining the issues further.

In the interregnum, continued interaction between officials of the Bank and the Ministry of Finance at various levels sought to streamline the provisions of the scheme. On 21 November, Seshadri took with him to Delhi a copy of the Bill on social control drafted by the Bank's Legal Department, for further consultations and finalization. Subsequently, on 4 December, the draft Bill prepared by the Law Ministry, incorporating the changes suggested by the Bank, was put up to Jha by Seshadri, with the remark that the same was being redrafted at Delhi by the Law Ministry. The draft Bill, dated 9 December, as finalized after discussions held in Delhi between 6–8 December, was titled 'Banking Laws (Amendment) Bill 1967'.

Certain further changes were made in the printed draft as a result of discussions between the Bank's Joint Legal Adviser and the Law Ministry on 18 December. This marked the culmination of the rather hectic interaction between the Bank and the Ministry, leading to the introduction of the Bill in the Lok Sabha on 23 December. The Bill sought to amend certain provisions of the Banking Regulation Act, 1949, the Reserve Bank of India Act, 1934, and the State Bank of India Act, 1955, for extension of the scheme of social control over banks. Simultaneously, with a view to providing a forum for discussing and assessing credit priorities on an all-India basis, a high-level body called the National Credit Council was set up in terms of Government Resolution dated 22 December, which was published in the Gazette of India extraordinary dated 23 December 1967.

A number of letters seeking clarifications, offering suggestions and registering protests were received both by the government and the Reserve Bank after the introduction of the Bill in the Lok Sabha. In a letter addressed to Morarji Desai on 5 February, Thackersey, who was chairman of IBA, pointed out that although most of the provisions of the Bill were in conformity with the conclusions arrived at during the informal meeting with bankers, the language was in some places at variance with the intentions or objects of the Bill, and different from the conclusions arrived at in the informal meeting. He added that certain provisions of the Bill were such as to cause hardship in genuine cases and went on to furnish details on these points. He also requested that the Bill be referred to a Select Committee for considering these points.

The Select Committee, with G.S. Dhillion as chairman, after initial discussions in Parliament, held its first meeting on 1 April 1968. The meeting decided to call for memoranda from public bodies and associations so as to reach the Parliament Secretariat by 12 April. In a letter addressed to the Governor in this regard, Shiralkar indicated that it would be useful if a representative of the Reserve Bank could be present during the sessions of the Select Committee that were scheduled to take place for about ten days from 15 April onwards. Accordingly, the Bank was represented in these sittings by Seshadri in the initial stages, and later by Adarkar.

The Select Committee examined the various representations and suggestions received, and also recorded the evidence of eight parties including Jha and V.T. Dehejia, chairman of State Bank of India. The Bill, as amended by the Committee, was submitted to the Lok Sabha on 6 May 1968.

The IBA and the banking sector were more concerned about certain provisions of the newly introduced Sections 10A and 10B of the Banking Regulation Act, relating to constitution of the board of directors and appointment of whole-time chairmen, respectively; as also the substitution of Section 20 of the Act, *inter alia*, prohibiting banks from extending loans and advances to their directors or to any firm in which any of their directors were interested as partner, manager, employee, guarantor, etc.

On the other hand, bank employees' associations and other trade union organizations and connected political sympathizers were agitated about the provisions of Section 36AD of the Act, which laid down:

> No person shall:
> obstruct any person from lawfully entering or leaving any office or place of business of a banking company or from carrying on any business there, or hold, within the office or place of business of any banking company, any demonstration which is violent or which prevents, or is calculated to prevent, the transaction of normal business by the banking company or …

Employees' associations/unions registered nation-wide protests against what they perceived as an encroachment on their trade union rights. There were also heated and prolonged discussions on the provisions of this Section in the Lok Sabha.

The Bill, which was passed on 6 August, received the assent of the President of India on 28 December and, in terms of Government Notification dated 13 January 1969, came into force from 1 February 1969.

Some of the more important provisions of the Act were as under.

Banks were required to reconstitute their boards of directors so that not less than 51 per cent of the total number of members were persons having special knowledge of or practical experience in certain fields such as accountancy, agriculture and the rural economy, small-scale industry, co-operation, banking, economics, finance and law. The directors thus constituted should not have substantial interest in or be connected, as employee, manager or managing agent, with large or medium-sized industrial undertakings or trading or commercial concerns. Of these directors, not less than two were to represent agriculture and the rural economy, cooperation and small-scale industry. In consonance with the spirit of these provisions, every foreign bank was also expected to set up an advisory board consisting of Indians (with the exception of the chief executive officer when he was a member), and with a majority of the persons having special knowledge of or practical experience in one or more of the fields mentioned above. Every Indian bank was to have a professional banker and not an industrialist as full-time chairman. The appointment, removal or termination of appointment of the chairman, and the terms to be granted to him, would require the approval of the Reserve Bank.

The grant of any new loans and advances, whether secured or unsecured, to directors or members of any committee or board appointed by the banks in India, or to concerns in which they were interested as partner, director, manager, managing agent, employee or guarantor, or in which they held substantial interest, would be prohibited, except in pursuance of previous commitments. If the director concerned continued to be a member of the bank's board, the loan, even if it was granted because of any previous commitment, would have to be recovered within a period of one year from the commencement of the Act; the Reserve Bank might, however, in special cases, extend the period up to three years. The appointment, reappointment or removal of the auditors of a banking company would require the approval of the Reserve Bank, and the Bank was empowered to direct the auditors to audit any special transactions that it might specify.

The Reserve Bank's powers to appoint directors or observers and to issue directions to banks were amplified. Such directions might hereafter be issued not only in the interests of depositors or proper management of the banking companies, but also in the interest of banking policy.

Banking policy as defined in the Bill meant

> any policy which is specified from time to time by the Reserve Bank in the interest of the banking system or in the interest of monetary stability or sound economic growth, having due regard to the interests of the depositors, the volume of deposits and other resources of the bank and the need for equitable allocation and the efficient use of these deposits and resources.

The government was empowered under the Bill to acquire the business of any bank if it failed more than once to comply with any directions issued to it under Section 21 of the Banking Regulation Act in regard to advances or under Section 35A of that Act in regard to any other matter concerning the affairs of the bank, and if, in addition, the acquisition of the bank was considered necessary in the interests of the depositors or in the public interest or in the interest of banking policy. There was to be payment of compensation in the event of such acquisition.

This provision evolved out of an interesting episode. On 6 December 1967, Jha had written to Morarji Desai that:

> When you decided that a bank which misbehaves should be taken over, it was my impression that you wanted to see such a bank nationalized in the true sense of the term and that Government will take over the shares from the shareholders. The draft which I saw is in the nature of an extension of the existing powers to amalgamate one bank with another; so that nationalization would mean merger with the State Bank.
>
> I do not feel happy about this. The State Bank is already a huge mammoth organization and it would not be very desirable to make it even bigger by merging any large bank with it.

> More important is the consideration that the power to nationalize and therefore the liability to pay compensation must rest with the Government and not with the Reserve Bank. It is one thing for the Reserve Bank to amalgamate a bank which is financially in a bad shape with a bigger bank in order to protect the interests of the depositors and without employing public funds in the operation; it would be quite a different thing for the Reserve Bank to undertake a nationalization operation and provide the resources for compensating the shareholders without Parliamentary scrutiny, control and approval.

Morarji then had the Bill modified.

The meetings the bankers had with Morarji and the Governor prior to the announcement of the scheme for social control had created the atmosphere for speedy implementation. Most banks with deposits of Rs 10 crore and above, and all foreign banks, had reconstituted their boards or constituted advisory boards. Indian banks with deposits of Rs 25 crore or more had appointed whole-time chairmen. On the recommendation of the Bank, which took into consideration certain practical difficulties of comparatively small banks in giving effect to some of the provisions of the Act, the government, on 1 February 1969, exempted banks with deposits of less than Rs 10 crore for a year from the provisions of Section 10A of the Act. Banks with deposits less than Rs 25 crore were exempted from the provisions of Section 10B, which related to the appointment of whole-time chairmen.

NATIONAL CREDIT COUNCIL

The National Credit Council (NCC) was said to have been fashioned on the lines of the French model in order to meet the need for aligning more closely the functioning of the banking and credit system of the country to the objectives and requirements of national economic development. The Council was constituted in terms of Government Resolution dated 1 February 1968, wherein particulars regarding the five permanent members and the names of the remaining twenty members were indicated to assist the Reserve Bank and the government in allocating credit.

The main functions of the Council were to:

- assess the demand for bank credit from various sectors of the economy;
- determine priorities for the grant of loans and advances or for investment, having regard to the availability of resources and requirements of the priority sectors, in particular agriculture, small scale industries and exports;

- coordinate lending and investment policies as between commercial and cooperative banks and specialized agencies to ensure the optimum and efficient use of the overall resources; and
- consider other allied issues as may be referred to it by the chairman or the vice-chairman.

The first meeting of the National Credit Council was held in Bombay on 16 March 1968. It is interesting to note, in retrospect, how many invited Ministers stayed away. They included Jagannath Pahadia and K.C. Pant, who was Minister of State in the Finance Ministry. Professor D.R. Gadgil, Deputy Chairman of the Planning Commission, also could not attend the meeting as the Minister for Food and Agriculture had convened a meeting of Chief Ministers on the same day, to consider prices and other policies regarding rabi foodgrains. But he did send a note for circulation among the members, which dealt mainly with the issue of the appropriate agency for dispensing agricultural and rural credit, and the complementary roles of the commercial and cooperative banking systems in this area. He favoured the cooperative banking system, with the commercial banking structure supporting the efforts by indirectly providing funds through such means as subscribing to debentures of land development banks.

A number of background notes were prepared for the meeting. Among them, the note titled 'Credit Planning: The Issues' by L.K. Jha dealt with the broad principles followed by the central Bank in the past, such as asking banks to conduct their credit operations in such a way that the banking system remained healthy and the depositors' confidence was not impaired; banks being required to see that their resources were not used for commodity hoarding and speculation; and encouraging banks to allocate a reasonable share of their resources for exports, small-scale industries, term finance for agriculture, etc. The note also pointed out that while nearly two-thirds of bank credit was being enjoyed by the industrial sector, the share of bank credit to agriculture was as low as 2 to 3 per cent. It emphasized the dearth of resources in the banking system as the major impediment in meeting the credit demands of various sectors. While specifying agriculture, small-scale industries and exports as areas requiring special attention, Jha wanted the members to identify other deserving sectors.

In his inaugural address, Morarji Desai dealt with the major issues before the NCC, such as stimulating flow of credit in adequate measure to agriculture, small-scale industry and exports; avoiding distortion by way of creation of 'credit gaps' in other sectors like industry and trade while accomplishing the former task; coordination among the different credit agencies, especially in the context of the controversies that were raised regarding the roles of commercial and cooperative banks during this period; placing greater emphasis on mobilization of resources from the savings of the community rather than seeking credit from the Reserve Bank, which would ultimately add to inflationary pressures. Referring to the function of the NCC, Morarji cautioned that 'the guidelines that we frame would have to take into account the needs of all sectors who contribute and have potentialities to contribute to our national product. This involves difficult decisions and informed judgement.' He also indicated that a Commission would be constituted to go into suggestions from the members on specific issues. The proposed Commission, namely, the Banking Commission, was formed much later, and was chaired by R.G. Saraiya.

The ensuing general discussion followed the expected pattern, with each member propounding the strategic and economic importance of the sector represented by him, and pleading for adequate attention in the matter of credit allocation. There were, however, divergent views on the matter of branch expansion. While the commercial bankers sought further relaxations in the branch licensing policy, the cooperative sector tended to resist the banks' increasing presence, which, according to them, was competitive. In this connection, Jha remarked:

> The Reserve Bank sought to keep up pressure on banks to open branches in the rural areas by tying their branch opening in urban areas to their performance in the rural areas. It was true that the Reserve Bank did not wish commercial banks to go into small population centres where cooperative banks were well developed.

Winding up the discussions, the chairman suggested setting up a Standing Committee to go into specific issues and formulate concrete proposals for consideration by the NCC at its next meeting. Accordingly, a Standing Committee consisting of eight members was formed, with the Governor as chairman. The Bank was brought to the centrestage through the Standing Committee, which, as expected, was to drive the agenda of the NCC, keeping in view socio-political considerations.

The second meeting of the NCC was held on 24 July 1968 in New Delhi, under the chairmanship of the Deputy Prime Minister. The deliberations at the meeting mainly centred on the sector-wise estimates arrived at by the Standing Committee. The Council took note of the Committee's suggestion that, in addition to the estimated commercial banks' assistance, banks would be required to deploy a very large proportion of their resources in financing food procurement and allied operations, and also in financing plantations and marketing agricultural products other than food products. This suggestion of the Committee marked the first hint of the RBI agreeing to the commercial banking system taking a more active interest in financing food procurement operations. The Council endorsed the Committee's view that buffer stocks (as distinguished from trading stocks) should be financed out of budgetary appropriations but recognized that the banking system might have to continue to carry this responsibility for some months. On the often-discussed question of coordination and understanding between commercial and cooperative banks, Professor D.R. Gadgil, Deputy Chairman, Planning Commission, agreed with the view that where commercial banks assisted cooperatives, they should pay heed to the need for preserving the internal discipline of the cooperative movement. He also emphasized the importance of adopting an 'area' approach in respect of areas that were neglected by the commercial and cooperative banks.

With regard to small-scale industries, the NCC endorsed the Committee's recommendations for allocating twice the amount of the estimated credit. The Council also felt that the estimated additional credit requirements of large and medium-sized industries could be met, and that there would be no organizational bottlenecks in the extension of such credit.

The third meeting of the NCC was held in New Delhi on 21 March 1969 and was presided over by the Deputy Prime Minister. Out of the five study group set up in the second meeting of the Council, two—viz. the Group on Deposit Mobilization by Commercial and Cooperative Banks and the Group on Credit Facilities for Road Transport Operators—had submitted their reports. The Council agreed with the recommendation of the report of the Study Group on Deposit Mobilization that it was necessary to speed up the process of opening bank branches in semi-urban and rural areas. On the question of differential interest rates as between urban and rural areas, recommended by the Study Group, the Council agreed with the Standing Committee, which had not favoured this idea on the ground that the response to a marginal upward adjustment in interest rates was not likely to be materially significant. The Council, like the Study Group, did not favour subsidization of branch expansion. The area approach suggested for branch expansion, without conferring the privilege of exclusivity to any bank, was endorsed by the Council, on its merits.

As regards the report of the Study Group on Provision of Credit Facilities for Road Transport Operators, the Council supported the view of the Standing Committee—that, rather than relying mainly on hire-purchase financing agencies and lending support to them, as suggested by the Study Group, it would be preferable for the banks themselves to engage in direct financing of the road transport operators. It also agreed that extension of the Credit Guarantee Scheme to small-scale operators and arrangements with insurance companies for covering the risk should facilitate a far more positive role for banks in this field than in the past.

The remaining three study groups submitted their reports after the date of the third meeting of the NCC; one among them became the genesis of a path-breaking innovation in the Indian banking system, viz. the 'Lead Bank Scheme', about which a detailed account is given later in this chapter.

Subsequent to the third meeting of the Council, the suddenness of certain banking developments—the nationalization of fourteen major Indian banks in July 1969 and the setting up of a Banking Department in the Ministry of Finance to monitor them—quietly buried the NCC, as the scheme of social control over banks, to which the Council owed its existence, ceased to be in operation.

NATIONALIZATION[2]

Barely four months after the third meeting of the National Credit Council, on 9 July 1969, Indira Gandhi sent a note to the Congress Working Committee through Fakhruddin Ali Ahmed, who was the Minister for Industrial Development, suggesting the nationalization of major banks. This came as a complete surprise, for the prevalent belief in Congress circles was that

[2] What was most disturbing for the Reserve Bank was the impression that was created in the media that it was opposed to nationalization. This perhaps had to do with the personality of Jha himself, and with the fact that the Bank had striven hard to make a success of the social control experiment. As Vice Chairman of the National Credit Council, Jha ensured that a large number of documents were submitted on different aspects of social control. The Bank had substantial inputs in the work of the groups formed by the Council. It also helped to provide the secretariat for the Council, and to create in March 1969 a cell attached to the Banking Commission. These actions by themselves did not imply that Jha was opposed to nationalization of major Indian banks. All the oral accounts point out that while Jha did not favour bank nationalization, he did not openly articulate his personal view on the subject.

The real issue was summed up by I.G. Patel in his book, *Glimpses of Indian Economic Policy: An Insider's View*: 'For me, one consequence of nationalization was controversy once again about my jurisdiction and that of my department. A new banking department was created in the ministry under A. Bakshi from the RBI, an old leftist and acerbic friend of Haksar who could obviously be more relied upon to run nationalized banks than L.K. or I.G.' (p. 137). As Patel's quote shows, Jha was identified with forces that did not figure in the leftist groups that considered social control as an apology and a dilatory tactic to prevent the state from gaining the commanding heights of Indian finances.

After the legal tangle over nationalization was temporarily sorted out, Jha convened a the issue had been settled in favour of social control. But Indira Gandhi had, by then, decided to confront the Syndicate in what was a bid to wrest control of the party. She needed a dramatic issue and bank nationalization fitted the bill. Accordingly, she decided to precipitate matters. Indeed, hindsight as well as oral evidence from the main dramatis personae suggest that she had already decided upon nationalization. Only the details were left to be worked out by the Finance Ministry.

Mrs Gandhi's note pointed out:

> There is a great feeling in the country regarding the nationalization of private commercial banks. We had taken a decision at an earlier AICC, but perhaps we may review it. Either we can consider the nationalization of the top five or six banks or issue directions that the resources of banks should be reserved to a larger extent for public purposes.

It also dwelt on some of the inadequacies of the scheme of social control over banks:

> Even after the new policy of social control and reconstitution of boards of directors, the former industrialist chairmen of the banks still continue on the board and naturally influence the present chairmen who had previously been general managers. We may examine whether through legislation or otherwise we can prevent these men from continuing on the boards. The chief executive of the banks will not then feel obliged to the former Chairman and may be expected to take an independent line in regard to lendings.

As expected, Morarji Desai opposed the move by pointing out that the legislation on social control had been brought into force barely six months ago, and that the confidence of the public in the banking system would be

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meeting of the custodians of the fourteen nationalized banks and the chairman of the State Bank of India in Bombay on 14 August 1969, to chalk out the immediate steps necessary to implement the objectives of nationalization. The meeting lasted for five hours and discussed the responsibilities of the public sector banks in the new scenario, including the fresh orientation to be given to the banking business, and ways to achieve better distribution of credit, improvement in banking services and profitability. The Governor exhorted the banks to pare their advances to big business houses and examine the scope for contracting large share advances, to aim at better distribution of credit with emphasis on small borrowers, to lay stress on banking operations in the non-urban areas, and to share the SBI's burden of financing the Food Corporation of India's food procurement operations.

shaken if an impression was created that the issue of nationalization was still open. He reiterated that there should be no further talk of nationalization for at least two years. He had the support of the moderates within the party, but another section, known as the 'Young Turks', had been persistently demanding action on issues like nationalization of banks and ceiling on incomes and urban property. They stepped up their demands.

On 10 July, nationalization was discussed in the AICC meeting. The Syndicate, which still controlled the party apparatus, underplayed the resolution on economic and social policy, stressed the ten-point programme, food supply, tenancy security, rural development, science and technology, etc., but made no reference to nationalization of private banks.

But Indira Gandhi had outmanoeuvred them. Her note sent a day earlier sidelined the official draft. She merely asked: 'This is all right as far as it goes. The question is whether it goes far enough?'

Morarji said the objectives of social control and nationalization were the same. In his rejoinder to the specific points raised in the Prime Minister's note, he explained:

> Already the minimum that every bank had to invest in public securities was 25 per cent. Last year this rose to 29 per cent. We could also consider whether this could be raised by 5 per cent to 30 per cent. The National Credit Council which is meeting towards the end of the month will consider it and a decision can be taken.

He also referred to the fear expressed in the Prime Minister's note about former industrialist chairmen of banks continuing to influence the present chairmen and boards of directors of companies, and said that this was being examined. Some steps had been taken to see that such influences did not operate. As a matter of fact, he said, a majority on the boards of companies now were not industrialists but representatives of agriculture, cooperatives, small industries, economists and such people who were not under the influence of industrialists. The government and the Reserve Bank were also keeping in touch to check any pressures or influence.

Y.B. Chavan, who was Home Minister then and who later became a major ally of Indira Gandhi, characterized the note as 'the product of a restless mind' and said 'social control without nationalization is not possible. Similarly nationalization without social control is the greatest fraud.' He indicated that the take-over would only be a matter of time and did not attempt to play down the fact that the party's thinking on economic issues was coloured by political considerations.

Eventually, the resolution on economic policy remained vague about the specific issue of nationalization of banks. It did say, however, that

> the note by the Prime Minister which is appended to this resolution broadly sets out the policies to be pursued and steps to be taken for the purpose of improving the performance of the economy. . . . The AICC welcomes the note and calls upon the Central and state governments to take necessary steps expeditiously to implement the various points mentioned in the note.

It had been widely expected that the Prime Minister's note would cause a storm but, in the event, the Syndicate chose to stage a tactical retreat by virtually endorsing it without going into details.

The political tempo then began to step up. On 12 July, the Congress Parliamentary Board nominated Neelam Sanjiva Reddy, who was the Speaker, as its candidate for President. The vote was four to two, with two abstaining. This was a serious political setback for the Prime Minister, who then sponsored a rival candidate, V.V. Giri, then Vice President. Her Principal Secretary and confidant, P.N. Haksar, urged her to take some bold economic measures for the sake of her political survival, and advocated nationalization. He convinced Mrs Gandhi that the public would support her on the issue. Mrs Gandhi weighed the pros and cons of nationalization by consulting leading economists like K.N. Raj.[3] G.D. Birla and J.R.D. Tata advised her against nationalization.

On 16 July, three days after the AICC session had ended, the Prime Minister surprised everyone by relieving an unwary Morarji of the Finance portfolio, and taking it over herself. *The Economic Times* of 17 July 1969 reported:

> Indira Gandhi has no doubt sent for the Reserve Bank Governor Mr L.K. Jha, who is arriving here tomorrow. It is expected

[3] In his book, *Indira Gandhi, the 'Emergency' and Indian Democracy* (Oxford University Press, New Delhi, 2000), P.N. Dhar, former Secretary to the Prime Minister, wrote about the meeting thus: 'The other meeting, along with K.N. Raj, was at Haksar's house. I learnt later that the second meeting was at the suggestion of the Prime Minister, who was keen to know Raj's views on the subject. Raj was wholeheartedly for nationalization and said it would take at least six months to prepare for it and it should be done as an elaborate but clandestine exercise' (pp. 113–14). Professor Raj later told me that there was nothing 'clandestine' in his espousal and the theoretical framework for advocating nationalization was given in his doctoral work on the *Monetary Policy of the Reserve Bank of India*, published in the late 1940s.

> that she will consult Mr Jha on implementation of the AICC resolution on banks but sources close to her rule out the possibility of her pushing through an ordinance in a day or two in view of the nearness of the Parliament session which is to start on Monday. Mr Jha is also likely to be consulted on a statement on the new economic policy which Mrs Gandhi is reportedly planning to issue.

According to most oral accounts, Mrs Gandhi did not consult Governor Jha, knowing fully well that he was a strong advocate of social control and not in favor of nationalization. It has been recounted by some persons who held senior positions in the government then that when Mrs Gandhi called Jha to go over to New Delhi on 17 July, he went with a comprehensive note in support of social control. She is said to have told him that he could keep the note he was carrying on her table and go to the next room and help in drafting the legislation on nationalization of banks.[4]

We will perhaps never know exactly what happened in those three days but one thing was certain: Mrs Gandhi had decided to go ahead with immediate nationalization. A day before the announcement on 19 July, she informed I.G. Patel, Secretary, Economic Affairs, that she had taken the decision to nationalize banks on 'political' considerations and that he should prepare a speech within the next 72 hours. Patel is said to have offered two suggestions to Mrs Gandhi. One, that foreign banks should not be nationalized. Two, that there was no need to nationalize all banks and it would be better if only the major banks, which accounted for 85–90 per cent of the total banking business, were nationalized.

Mrs Gandhi, it seems, had apprehensions about the support she would receive from officials of the Finance Ministry and Law Ministry. From most oral accounts, it appears that she asked D.N. Ghosh, Deputy Secretary in the Finance Ministry, on 17 July, to draft the legislation within 72 hours. He was helped by R.K. Seshadri, Executive Director, who had had the experience of preparing the draft legislation in 1965 when T.T. Krishnamachari was Finance Minister. Jha oversaw the entire work relating to the drafting, which was done in the Reserve Bank of India building in Delhi.

Many think that only three or four persons were involved in the drafting. In fact, there was a secret noting in the files of the Law Ministry to the effect that S.K. Maitra, Joint Secretary, was also associated with it. Maitra

[4] The oral evidence collected from a number of persons shows that the decision to nationalize a few Indian commercial banks was a political one. However, this view was not shared by left-wing economists of the day.

noted: 'Shri Haksar told me that the Prime Minister has directed that an Ordinance for the nationalization of certain banks should be drafted by me immediately. He also instructed me to keep the matter completely secret and told me that I should not disclose my movements to any one.' He also observed that he had the services of the personal secretary of the Governor of the Reserve Bank and the personal assistant of I.G. Patel. He noted that his first draft was discussed at a meeting in Haksar's room and there were, besides him, L.K. Jha, P.N. Haksar, A. Bakshi, I.G. Patel, B.G. Shiralkar, R.K. Seshadri and D.N. Ghosh. The draft, it would appear from such evidence, went through some changes before it was finalized.

The Banking Companies (Acquisition and Transfer of Undertakings) Ordinance provided for 'the acquisition and transfer of the undertakings of certain banking companies in order to serve better the needs of development of the economy in conformity with national policy and objectives and for matters connected therewith or incidental thereto'. The names of fourteen banking companies having deposits not less than Rs 50 crore as on the last Friday of June 1969, were listed. The chairman of the existing bank or any other person appointed by the central government, if it were necessary to do so, would be the custodian of the corresponding new bank.

An advisory board would be appointed to aid and advise the custodian in discharge of his duties, which would be dissolved on constitution of a board of directors.

In the Second Schedule to the Ordinance it was indicated that the compensation to be paid by the central government to each existing bank for acquisition of the undertaking should be an amount equal to the sum total of the value of the assets of the existing bank as on the commencement of the Ordinance, less the sum total of the computed liabilities and obligations of the existing bank.

On 23 July, the Department of Banking Operations and Development (DBOD) of the Reserve Bank issued a circular to all the fourteen nationalized banks, asking them to consult the Bank before sanctioning any proposal that would normally require the approval of the board of directors. Certain other restrictions were also placed.[5]

[5] Such as proposals that might involve the grant of a fresh loan or advance or the issue of a guarantee, the renewal of a loan or advance granted to, or of a guarantee issued on behalf of any party whose financial position has deteriorated since the loan or advance was granted or last renewed or since the guarantee was issued or last renewed or the conduct of whose account after such grant or renewal had not been satisfactory in any material respect, or the writing off or waiver of any amount due from or grant of any concession to any such party.

These restrictions were meant to be temporary, for taking care of initial and transitional problems. They were withdrawn on 10 September and, simultaneously, the nationalized banks were asked to form internal management committees. These committees were expected to consider loan applications, investments and all other items of business that might normally be brought up before the board of directors. The banks were told that officers of the Reserve Bank would attend the weekly meetings and that a government representative might also attend.

Initially, banks with deposits of Rs 100 crore were listed for nationalization. But then it turned out that some important banks, like Dena Bank, with deposits of Rs 98 crore would be left out. So the limit was lowered to Rs 50 crore. Raghunatha Reddy, a senior Congressman, wanted that Andhra Bank too should be nationalized but its deposit level was below Rs 50 crore and it had to be left out. The criterion of Rs 50 crore deposits was itself based on the then prevalent RBI classification of banks into two categories—banks with deposits of Rs 50 crore and above, and banks having deposits of less than Rs 50 crore.

On Saturday, 19 July 1969, an Ordinance was promulgated to nationalize fourteen major banks with deposits exceeding Rs 50 crore with immediate effect. The Ordinance was signed by the Vice President, V.V. Giri, who was then also the acting President, President Zakir Hussain having died a few months earlier. In a broadcast to the nation that evening, Indira Gandhi said:

> As early as December 1954, Parliament took the decision to frame our plans and policies within a socialist pattern of society. Control over the commanding heights of the economy is necessary, particularly in a poor country where it is extremely difficult to mobilize adequate resources for development and to reduce inequalities between different groups and regions.

She went on to express the 'earnest hope' that nationalization would mark 'a new and more vigorous phase in the implementation of our avowed plans and policies', and assured all sections of industry and trade that their legitimate needs for credit would be safeguarded.

But the main force driving nationalization was fully comprehended by everyone as being political, rather than economic. Indira Gandhi had won the struggle for supremacy within the Congress party and managed to wrest control, decisively and finally. *The Economic Times*, in its editorial the next day, summed it up nicely. It said that nationalization climaxed an unprecedented bout of power politics and feared that the psychological impact might be rather worse because of the take-over of a larger number of banks than was feared. There was speculation that more banks were to be nationalized but the government announced that banks in the private sector would not be automatically nationalized when they achieved the level of deposits of Rs 50 crore.

Trade and industry were unhappy with nationalization but it drew support from Congressmen as well as the Communist parties and the two Socialist parties. Both Kamaraj and Atulya Ghosh, the Syndicate bosses who had opposed Mrs Gandhi tooth and nail, welcomed the measure and pointed out that it had been accepted by the AICC in principle. The Young Turks in the Congress party, led by Chandrasekhar, who had incessantly campaigned for the take-over of banks said, 'We are extremely glad.' Jyoti Basu, who was the Deputy Chief Minister of West Bengal, remarked that the news of acceptance of the resignation of Morarji Desai was good and the news of bank nationalization better still. The Swatantra leader C. Rajagopalachari doubted if nationalization by an ordinance was permissible under the Constitution. The former Reserve Bank Governor and Finance Minister, C.D. Deshmukh, said he favoured social control over banks. H.V.R. Iengar, another former Governor, said that nationalization was a wrong step that was not going to make a great deal of difference to the economic situation of the country. FICCI President Ramnath Poddar called it a 'hasty step' and said that the Prime Minister's explanation in her broadcast failed to convince him that nationalization could achieve anything more than social control measures could not have achieved. T.T. Krishnamachari, former Finance Minister, and G.D. Birla were among those who declined to react. The All-India Bank Employees' Association welcomed the decision. Prabhat Kar, general secretary of the Association, said the step was 'definitely a bold one' but much would depend upon how the nationalized sector would function. Banking circles in Bombay, who were prepared for stricter controls in the wake of the Bangalore meeting's decision on the new economic policy, were taken by surprise.

The RBI, on its part, assured the newly nationalized banks of its unqualified support to them in the unlikely event of a transfer or withdrawal of business. Simultaneously, it told foreign banks not to take advantage of the prevailing situation. The Bank's discussions with the custodians or local representatives of nationalized banks were initiated by B.N. Adarkar on 20 July, in the absence of Jha who was away in Delhi. The representatives of the nationalized banks were specifically told to instruct their staff that no uncertainty should be created in the minds of the customers, that business must proceed as usual and bankmen should endeavour to inspire an atmosphere of confidence. Adarkar told the banks that they should retain their separate identities, advertise competitively for business, and that there was no objection to their going ahead with the branch expansion programme as approved by the Bank.

Monday, 21 July, was the first working day under state ownership and, according to newspaper reports, the banks functioned normally but without the suffix 'Ltd'. The chairmen, who had been telegraphically informed by the Finance Ministry of their new roles as custodians, were considered as public servants.

Financial circles were agog with rumours that as a fall-out of bank nationalization, wide changes were on the cards in the organizational pattern and responsibilities of the Reserve Bank. In particular, the newspapers surmised that as the Governor and a majority of the Deputy Governors were said to have opposed nationalization, some important changes at the top could be expected. But nothing happened. In the last week of July 1969 Mrs Gandhi went to Bombay and addressed a huge rally of bank employees in front of the Reserve Bank of India building, which was marked by a show of great enthusiasm and support by the employees.

On 21 July, when the Lok Sabha met, it was Atal Bihari Vajpayee who raised the issue by asking about the propriety of promulgating an Ordinance of such significance when the Parliament was to meet within two days. The Deputy Speaker permitted a discussion after pointing out that any comments on the merits of the step taken would not be allowed. The Prime Minister sought to justify the haste in promulgation of the Ordinance.

> The House will appreciate that in view of the very nature of the measure, and also to forestall any possibility of manipulations which may not be in public interest, it was essential to make a swift and sudden move which could only be achieved through an ordinance. The fact that speculation about Government's intentions had assumed an acute phase in the last few days rendered it all the more necessary to act without any further loss of time, and in anticipation of the approval of Parliament, which will be sought through a Bill which Government proposes to bring during the current session.

In defence of not bringing foreign banks within the purview of the Ordinance, she stated:

> So far as foreign banks are concerned they provide, by and large,

> business of a specialized nature such as facilitating foreign trade and tourism. The operation of banks of one country in another, subject to the laws of the land, is mainly for such purposes and is part of an international facility. Our Indian banks also maintain their branches in many countries. It has been Government's general policy to confine the opening of new branches of foreign banks to major port towns, where their specialized services are needed.

On the same day, Morarji Desai referred to the circumstances leading to his resignation from the Cabinet and said:

> I came to the conclusion that I can no longer serve in the present Council of Ministers except at the cost of my self-respect and except as a silent spectator to methods that may endanger the basic principles of democracy on which our parliamentary system is established. I came to this conclusion because I was summarily relieved of the Finance Portfolio without even the ordinary courtesy of a prior discussion on this matter being shown to me by the Prime Minister.

The Prime Minister's letter to Mr Desai, dated 16 July 1969, among other things, said that since Mr Desai 'had supported the economic policy resolution at the Bangalore AICC session with reservations', the Prime Minister did not want to strain him with the burden of implementing the economic policy, and that, therefore, she would herself take on the burden of directing finance policy.

The political battle over Mrs Gandhi's populist measure was accompanied by a legal one. Two writ petitions were filed in the Supreme Court by Rustom Cavasjee Cooper, M.R. Masani and another person. On 22 July, the Court gave an interim stay order

> in respect of three matters, namely (i) that the Union of India will not appoint pending the hearing and disposal of these petitions any boards of advisers, (ii) that the Union of India will not remove the Chairmen of the various banks; and (iii) that the Union of India will not give any directions contrary to the provisions of the Banking Laws Act.

(This was actually a reference to the Banking Regulation Act.)

The Prime Minister stated in the Lok Sabha that the essential provisions of the Ordinance for nationalizing banks were not affected by the order.

The ownership of the banks continued to vest in the central government. The former boards of directors also stood dissolved. According to her, as the first direction of the Court related to appointment of advisory boards, the Reserve Bank would, in the interim, advise the banks as appropriate. As regards the second direction, she saw no reason why the order should affect the willingness or ability of chairmen/custodians to perform their duties properly. Under the third direction, she assured that the Reserve Bank would take special care to ensure that nothing was done that was contrary to the public interest or to the interests of the depositors.

The Bill to replace the Ordinance was introduced on 25 July by Govinda Menon, Minister for Law and Social Welfare, seeking acquisition and transfer of the banking companies 'in order to serve better the needs of development of the economy in conformity with national policy and objectives'. During the clause-by-clause discussion on the Bill, the Law Minister explained that the main purpose of the banks' take-over was to ensure credit to small industries, backward areas, farmers and progressive entrepreneurs.

During the discussion on the Bill, it was at one stage suggested that it might be referred to a Select Committee. But this did not happen. However, Mr Madhu Limaye urged for rigid fixation of percentages by statute for extending credit to various sectors of the economy. Mr Menon accepted the proposition in principle but in a flexible manner. Mr Limaye accepted Mr Menon's assurance.

The session also witnessed severe criticism on the discernible shift in the policy approach of the government towards the banking sector vis-à-vis the role of the central Bank of the country. Initially, there was a suggestion to appoint an apex body to exercise overall supervision over the fourteen nationalized banks, which would set broad policies, apportion tasks in functional as well as geographical terms, and look after training. T.A. Pai of the Syndicate Bank was expected to be associated with the apex body. The appointment of the apex body was to be announced in the debate on the Bank Nationalization Bill. *The Economic Times*, in its editorial of 27 July, deplored the move on the ground that any centralized control and direction would not only thwart competition but also kill banking efficiency. It would also result in an inclination on the part of banks to look up to Delhi or the apex body and wait for detailed instructions at every turn. In the new situation, banks would have a complex machinery to contend with, namely, issue of directives from the Reserve Bank, from the Finance Ministry and from the proposed apex body. The government was urged to reconsider this idea.

The controversy was ended by Mrs Gandhi on 29 July, when she said that the government was against setting up any monolithic machinery to control and supervise the fourteen banks that had been nationalized. Intervening in the two-day debate on the Bill to take over these banking institutions, the Prime Minister assured the House that any machinery that was set up would only provide directions on policy and not on special items or specific loans to specific parties. The government wanted to preserve the identity of these banks and also encourage healthy competition.

On 27 July 1969, the Sarvodaya Leader Jayaprakash Narayan described the take-over of banks as 'wrong and unwarranted', while addressing a public meeting in Rajkot. He said the step would not solve the economic ills of the country but would only enhance the power of the present rulers and bureaucrats.

Within the Reserve Bank, the first discussion on nationalization took place on 23 July, at a meeting of the Committee of the Central Board. The proceedings were not recorded except for a cryptic remark: 'There was a brief discussion on the implications of bank nationalization ordinance.'

At the next meeting of the Committee of the Central Board, on 30 July 1969, Governor Jha pointed out that

> the present intention was to preserve the individual identities of the nationalized banks. . . . While Government would be the more appropriate authority to handle issues such as compensation, labour disputes, etc., the Reserve Bank would continue to be responsible for monetary policy and ensuring compliance with its policies by the nationalized banks. The objective of nationalization was that access to credit should be open to a much wider range of people than before; credit gaps had to be identified and areas where banks could and should be involved had to be indicated.

The future set-up of the nationalized banks became clear at the meeting of the Central Board on 18 August. Jha clarified that 'it had been decided not to have a monolithic institution and for the present the separate identities of the fourteen banks were to be preserved'. He also explained that there were practical problems in having one institution. This related to pay scales and seniority. He cited the case of the Life Insurance Corporation, which had not quite yet succeeded in sorting out these problems following the mergers of various insurance companies. There was also the problem of securing the right type of personnel to man the top positions in banks. N.A. Palkhivala, who, incidentally, was involved as an advocate in the writ petitions filed against the Ordinance and the Act, and who was also a member of the Central Board of the Reserve Bank, welcomed the proposal to retain the identities of the banks. Competition, he felt, would be a spur to providing better services.

Towards the end of August, reports began to circulate that the Prime Minister was planning to reorganize the Finance Ministry. She was also reported to be of the view that since the nationalized banks controlled an overwhelming segment of the banking industry, banking should be handled on an exclusive basis instead by the Economic Affairs Department.

On 14 August, the Reserve Bank convened a meeting of the chairman of SBI and the custodians of the fourteen nationalized banks, to chalk out the steps necessary to implement the objectives of nationalization and to discuss the problems that the nationalized banks might face in their operations. The Governor told them that the present intention was to retain the identities of the nationalized banks so that they could compete in matters of service and explore avenues of cooperation among them for increased efficiency, greater economy, higher profitability and better overall performance. The meeting also discussed issues relating to rationalization of branch expansion and coordinated efforts in providing training facilities.

When the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1969, became an Act on 9 August, the Supreme Court's stay order on the Ordinance was still in force, with the hearing on it fixed for 11 August. But once the Act was passed, the Supreme Court vacated the stay order. Subsequently, on the writ petitions filed against the Act, the Supreme Court issued a stay order on 8 September, saying, 'The Court further stays the removal of any custodian during the pendency of these writ petitions and further directs that no direction will be given by the Government of India contrary to the provisions of S.35A of the Banking Regulation Act, 1949, as amended by Act 58 of 1968.' This stay order, however, did not debar the government from appointing advisory boards, unlike the previous order.[6]

[6] There were many writ petitions challenging the Ordinance and the Act. But it was Dr Rustom Cavasjee Cooper, a chartered accountant from Bombay, who emerged as the initiator and main driving force behind these legal proceedings. He was director of the Central Bank of India Ltd and a shareholder in that bank. He also held shares in the Bank of Baroda, the Union Bank of India and the Bank of India. There were rumours of powerful big business/industrial houses financing his cases. So he wrote an article titled 'Why I Moved the Supreme Court' in the *Indian Nation*, published from Patna, on 25 February 1970, saying that the 'main reason why I felt very strongly about bank nationalization was the way in which it was done. I thought that it was done with unreasonable haste, in a totalitarian manner. I also felt that in the great haste in which this was sought to be done, there was a

Operationally, meanwhile, the Finance Ministry, through the newly created Department of Banking, and the Law Ministry had taken charge of commercial banking. The Reserve Bank played a supportive and advisory role, which included collection of financial and other particulars pertaining to the newly nationalized banks, convening meetings of the bankers to chalk out the future course of action, offering comments on various aspects of developments as and when referred to it by the government, and providing clarifications on issues raised by the banks on the provisions of the Nationalization Act.

The Bank did what it was told. It also raised the issues involved in the proposed interim payment of compensation of one half of the paid-up share capital to shareholders under Section 6 of the Act. As such a step would

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clear violation of the sanctity of the Constitution. I have felt that not only certain political parties but even individuals in the highest places in the political sphere have started regarding the Constitution as something which can be easily played about with. My main object in taking this matter to the Supreme Court was to establish the sanctity of the Constitution, the rule of law and the fundamental rights of the individual particularly the small man and the small shareholder. . . . Charges have been made and criticisms levelled that powerful big business interests were financing my case. Insinuations were made to this effect before the Supreme Court during the hearings too. I would like to clarify that not only were there no interests financing this petition but every single person … did it for the love of the matter.'

The issue of the Supreme Court stay order came up for discussion at the meeting of the Committee of the Central Board of the Bank held on 10 September 1969. The relevant part of the minutes read: 'There was some discussion on the implications of the Supreme Court's stay order in the Bank Nationalization case. Director Shri Palkhiwala explained that the plaintiffs had sought the Court's instructions that Government should not give any direction to banks contrary to the provisions of Section 35A of the Banking Regulation Act which stated that such direction could be given in terms of the banking policy, "banking policy" itself having been defined in the 1969 (amending) legislation. The Governor stated his understanding was that while banking legislation had given the Reserve Bank the power to issue directives to the banks in the public interest and in pursuance of banking policy, the Supreme Court had now stated that Government should also be subject to the same discipline in respect of issuing directives to the nationalized banks. He also pointed out that Government had even now the powers to issue directives to the Reserve Bank but whether such powers were exercised or not depended upon the nature of relationship between the Government and the Reserve Bank. Director Shri Mafatlal felt that the situation should not arise where there was dualism of authority and possibility of different interpretations by Government and the Reserve Bank as to what constituted banking policy. Shri Adarkar pointed out that the Reserve Bank under the social control system had exercised its influence through the Chairmen of banks and felt that convention should be established to retain this influence. The Reserve Bank should be the appropriate authority to interpret banking policy.'

amount to reduction in capital, it attracted the relevant constraining provisions of the Companies Act. Madhu Limaye, Socialist MP, contested that the actual amount of total compensation would work out to Rs 150 crore and not Rs 75 crore as given in the financial memorandum of the government. The issue was examined by the RBI after obtaining the necessary data pertaining to the fourteen banks and a detailed note substantiating the stand taken by the government was sent to the Department of Banking on 17 November 1969.

The Bank was actively involved in the discussions for framing the Scheme of Arrangement for nationalized banks, as provided under Section 13 of the Nationalization Act. After one such discussion, R.K. Hazari referred to a sensitive clause in the Scheme (2 January 1970) as follows:

> You might remember that we inserted a clause giving veto power to the government and the Bank nominees on the boards of directors of nationalized banks. I have thought further on this matter and feel that this clause might lead to serious misgivings about the extent of government control over these banks. There is no such clause in the State Bank Act and comparable provisions in respect of government companies have been deleted in recent years or are proposed to be deleted. I wonder if you would like to consider the matter.

Another issue that needed to be sorted out was the powers of the custodians in the absence of a board. These had been left undefined and the matter needed to be rectified. Public interest required that some of the more important transactions of the banks were put through only with prior approval of the Reserve Bank. So directions were issued requiring the custodians to seek prior approval of the Bank before putting through certain transactions.[7]

On 10 February 1970, the Supreme Court upheld the legislative competence of Parliament in the matter of acquisition of the banking companies but struck down the nationalization. Firstly, it said, there had been hostile discrimination against the fourteen banking companies in so far as they

[7] These covered the grant of advances in excess of Rs 25 lakh (with suitable exemptions to ensure that financing of the priority sector was not affected); investments in excess of Rs 1 lakh in shares and debentures of joint stock companies or advances thereagainst above Rs 5 lakh; appointment and extension of service of senior executives, expenditure on land/buildings above specified amounts as also making provisions and appropriations out of profit.

had been debarred from carrying on banking business when other banks were permitted to do so. Secondly, it said that the principles and methods laid down in the Act for determining the quantum of compensation were invalid. And since these provisions were not severable from the main Act, the entire Act was struck down.

However, as against the majority judgement, Justice A.N. Ray gave a dissenting judgement in which he observed:

> The only way in which the exercise of power by the President can be challenged is by establishing bad faith or malafide and corrupt motive. Bad faith will destroy any action. Such bad faith will be a matter to be established by a party propounding bad faith. He should affirm the state of facts. He is not only to allege the same but also to prove it. In the present case there is no allegation of malafide … the petitions fail and are dismissed.

In response to the judgement, and on the same day, the DBOD issued a directive under Section 35A of the Banking Regulation Act, 1949, which was identical in content to the one issued on 22 January, except that the present directive was addressed to the chairmen of the banking companies and not the custodians. Another note submitted by the chief officer of the DBOD on 10 February stated:

> The Supreme Court has today struck down the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969. From the reports available to us, it appears that the Act has been held void mainly on the grounds that it is discriminatory against the fourteen banks which had been nationalized and that the compensation proposed to be paid by government was not fair compensation. As a result of the Supreme Court's decision, the undertakings of the banks have reverted to the corresponding banks. At the moment, we are not aware of the government's intention as to the future course of action to be taken in regard to these and other banks. There is, therefore, uncertainty in the banking system and in the circumstances it is necessary that in the public interest and in order to protect the interests of the depositing public, the Reserve Bank should appoint its officers as directors of these fourteen banks, as also of other banks to which we have been sending observers in terms of section 36(1)(d)(ii) of the Banking Regulation Act, 1949.

This was approved by the Governor on the same day and action was initiated accordingly. A resolution to this effect was passed by the Committee of the Central Board on 11 February.

During the hearing of the writ petitions against the Ordinance and the subsequent Act, officials of the government and the Reserve Bank had attended the proceedings and studied the arguments to ensure that, in case the Ordinance/Act was struck down, the government could issue a new Ordinance keeping in view the observations of the Supreme Court. Eventually, the government issued a fresh Ordinance on 14 February that did not contain the offending provisions of the earlier Act. Under this Ordinance, the government again took over the undertakings of each of these banks with effect from the original date, i.e. 19 July 1969. This Ordinance, unlike the void Act, did not set out any principles for the determination of compensation to be paid to each of the fourteen limited companies whose undertakings were acquired but fixed a specific amount of compensation to each of the nationalized banks, aggregating Rs 8,740 lakh, to be paid within 60 days from the date the banking company applied for it. The banking companies were given three options or any mix of these: in the form of cash, ten-year central government securities at par carrying 4.5 per cent interest per annum, and thirty-year central government securities at par carrying interest at 5.5 per cent per annum. Allahabad Bank and Indian Overseas Bank opted for payment of the entire amount of compensation in cash, ten banks opted for payment entirely in the form of securities, and the remaining two banks opted for payment of compensation partly in cash and partly in government securities. In the case of the first two banks, cash payments were made in instalments, while in the case of the other banks the claims were settled as per their options.

The Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1970, to replace the Ordinance issued on 14 February 1970, was introduced in Parliament on 27 February and was passed without any amendment by both the Houses towards the end of March 1970. The Bill received the assent of the President on 31 March 1970.

The international reaction to bank nationalization in India, as officially recorded in the Reserve Bank, appeared to be passive. A rather nondescript remark on the subject made by Jha, while referring to 'his impressions of views abroad on India', was recorded by Secretary M. Narasimham in the summary of discussions of the Committee meeting held on 22 October 1969: 'The various people he met did not hold any strong views on bank nationalization.' The narration went on to add that from the point of view of international observers, the success of the country in food production had more or less overshadowed all other contemporary developments: 'the picture of a hungry India depending upon the world charity for its essential food supplies had now given way to a new image of an India able to make significant progress on the agricultural front.'

The first phase of nationalization and its aftermath, as revisited by I.G. Patel, offers an interesting picture.

> By all accounts, the nationalization of major banks was a great success initially. Apart from the political dividends for Mrs Gandhi, it greatly increased popular confidence in the banking system and thus increased the mobilization of private savings through banks. The savings so mobilized were also used now for supporting public borrowing as well as for meeting hitherto neglected genuine credit needs. The rot started with the Emergency and what political opportunism started was compounded by bank staff of all grades. With nationalization came the entry of national unions with allegiance to different political parties, mostly the Congress and the Left. Shielded by political support the bank staff proceeded to create for themselves a vast superstructure of perks and privileges under which they could define and limit work, enforce overstaffing and generally encourage indiscipline and incompetence without any fear of being held accountable. Merit went by the board as did customer service; and seniority and closeness to political power held sway.

In 1980, after Indira Gandhi was voted back to power—she had been defeated in the general election of 1977—there was a second round of nationalization. Six banks were taken over, but this was a non-event in comparison with the heightened political drama and legal controversies that had accompanied the first nationalization. Its most important distinguishing feature, perhaps, was that while the Reserve Bank had not been party to the 1969 decision and Governor Jha, as later chronicled by M. Narasimham, 'was clearly unhappy with the decision', in 1980, the initiative came from I.G. Patel, the Governor of RBI. The records in the Bank are not suggestive of any formal correspondence between the Bank and the government on this subject, nor of any discussion having taken place at the meetings of the Central Board of the Bank.

However, I.G. Patel's memoirs provide an insight into the whole affair. 'Such is the irony of life', he writes,

> that one of the first steps I had to recommend to Mrs Gandhi was that she should nationalize another swathe of private banks.

> The Reserve Bank had the responsibility to supervise private banks and to ensure their compliance with social control norms as well as with law. Several small private banks had now grown to respectable size and it was not easy to control their activities in practice. Some of them, like the Punjab and Sind Bank and the Vijaya Bank, had become the personal fiefdoms of individuals who disregarded all rules and advice with impunity. They, with their shady dealings, were offering unfair competition to the nationalized banks. I decided that the only practical way to tackle the problem was to nationalize the banks which had now reached the cut-off point of the 1969 Act. Mrs Gandhi readily accepted the advice—going against her promise of no new wave of nationalization, strictly speaking.

Patel added that the Prime Minister had 'no appetite' for nationalization then and that this particular initiative for the second phase of bank nationalization had come entirely from him as Governor of the Reserve Bank.

The Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1980, was issued on 15 April 1980, under the signature of N. Sanjiva Reddy, President of India, nationalizing six more commercial banks. These were Andhra Bank, Corporation Bank, New Bank of India, Oriental Bank of Commerce, Punjab and Sind Bank, and Vijaya Bank. Their deposits in India, as shown in their returns on 14 March 1980, amounted to not less than Rs 200 crore. The purpose of the nationalization was indicated as 'to further control the heights of the economy, to meet progressively and serve better the needs of the development of the economy, and to promote the welfare of the people in conformity with the policy of the State'.

It was explained that, as on the previous occasion, branches of foreign banks incorporated outside India would remain unaffected by the proposed measure because it was necessary to maintain the *status quo* in the interest of the future of Indian banking abroad. Further, the operations of these banks were limited mainly to port towns and Delhi and largely catered to specialized areas like foreign trade, tourism, etc., and the total deposits of foreign banks in India was less than 4 per cent of the aggregate deposits of all scheduled commercial banks. It was also estimated that with the inclusion of these six banks, the total deposits of public sector banks would be around 91 per cent of the deposits of all scheduled commercial banks.

Indira Gandhi claimed at a news conference that the nationalization of the six banks was meant to help the weaker sections of society. The general opinion among banking circles was that the take-over of the banks was no more than a further step in the government's action of eleven years ago, when it had wanted the large banks to 'fall in line' with its goal of attaining national objectives; in that sense, the decision was seen as long overdue. It was also noted that professionalization in the management of private sector banks had not attained the same heights as in the public sector banks, and that there had been recently a 'whiff of complaints' against some of the private sector banks of interlocking advances that had been made against the other banks too, before nationalization. The Federation of Indian Chambers of Commerce and Industry (FICCI), in a press release, was highly critical of the government's action, which it described as a bad and sad decision. Various associations of bank employees, however, welcomed the step as necessary on account of the several malpractices rampant in these banks, and, more importantly, the harassment of their employees and victimization of trade union activities. The All-India Confederation of Bank Officers Organization said that the decision to nationalize should have been taken earlier because the allegations of mismanagement against most of these banks had been on record for over five years.

The Economic Times wrote, on 17 April, that there was no merit in the second round of bank nationalization. It observed that, with no ideology in place, save for the shopworn Twenty-Point Programme, Mrs Gandhi's government, in its search for character, had sought to play the one card available to regimes the world over for whipping up popularity. It sarcastically commented that what followed from the logic underlying the latest spell of nationalization was that growth and public welfare would be increased manifold by taking over the minority shares held by a few individuals in the SBI.

The draft Bill to replace the Ordinance was referred to the Reserve Bank for suggestions in the last week of April. The necessary notifications for converting the Ordinance into a Bill were communicated to the government on 3 May. The Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1980, was introduced in the Lok Sabha by the Finance Minister, R. Venkataraman, on 12 June. In sharp contrast to the heated exchanges witnessed a decade ago while considering an identical Bill, the discussions on the 1980 Bill were brief. While answering a specific query as to why a Rs 200-crore norm had been fixed for the second phase of nationalization, the Minister explained that the norm enabled the government to practically control 91 per cent of the entire deposits of the country, that it would be difficult to take over all the banks at the same time for nationalization and that the government was not committed to such a principle. He added that when a bank which had Rs 200 crore of demand and time liabilities was nationalized, hypothetically, if there was another bank with Rs 199 crore of deposits, then the Act was likely to be struck down on the ground of improper discrimination. In the extant instance, the next private bank had only about Rs 150 crore of deposits.

The Bill was passed by both Houses of Parliament in June 1980 and it received the President's assent on 11 July 1980.

Mr Inder Malhotra wrote:

> Mrs Gandhi's close friend, Pupul Jayakar, complimented her on the excellent timing of her decision to nationalize the banks. In a revealing reply, Mrs Gandhi said that the timing was not chosen by her but by her adversaries. 'They drove me to the wall and left me with no other option.'

2

Banking Expands

At the beginning of the 1960s, banking in India was concentrated in the cities and major towns. In the rural areas, there was practically nothing. This had led to a growing feeling that the banking system was neither tapping rural savings nor providing credit to agriculture. Bank managements were considered insensitive to the needs of society. These perceptions of the political class led to demands for state intervention. At fist the idea was confined to 'social control', whatever that meant, but soon it gave way to a call for outright nationalization. This gave a strong push to branch expansion, especially in the rural areas.

The push into rural areas had in fact begun earlier. The number of branch offices increased from 5,098 at the end of 1961 to 5,858 by the end of 1964, or by 14.9 per cent. But this was not considered satisfactory. In April 1965 the Reserve Bank responded by liberalizing branch licensing norms. It also decided, as we shall see when we discuss what happened between 1967 and 1969, to focus on rural areas. Those were years when things were hotting up politically and when banking became the focus of political attention. That focus eventually culminated in nationalization but not before the Bank had fought some rearguard action to force commercial banks to expand to poorly served areas.

The first salvo in this direction was publicly fired by Governor Jha in his address to Bombay bankers on 18 August 1967, where he went to the extent of suggesting 'slowing down of branch expansion in urban areas'. The bankers privately told the Governor that they would welcome this so long as their competitors as well as foreign banks were also kept in check. However, foreign banks, as Jha observed, were 'obliged to confine themselves to port towns only' in order to make profits. A week later, in a policy note to Morarji Desai, Jha recommended that more bank offices be opened in smaller places than in urban areas. Morarji Desai was the Deputy Prime Minister and Finance Minister, and a great proponent of social control.

In the context of the 1960s, an enhancement in the geographical coverage of banks implied the opening of additional branch offices in the country. The license for opening of new offices of commercial banks in a particular area is given by the Reserve Bank by virtue of the authority it commands through Section 23 of the Banking Companies Act, 1949 (renamed as the Banking Regulation Act, 1949, in March 1966). The Section prescribes the broad criteria to be followed by the RBI for dealing with applications from commercial banks to open new places of business. These are: (a) the financial condition and the history of the applicant bank; (b) the general character of management; (c) the adequacy of its capital structure; (d) the earning prospects; and (e) the serving of public interest by opening of a new office. The criteria could, however, be applied by the Bank in a flexible manner.

The Reserve Bank had adopted a cautious approach till 1956 in granting licences, with the consideration of applications primarily based on the financial position of the bank concerned. It was only after securing the consolidation of banks in the early 1960s that the focus of attention shifted to extension of banking facilities throughout the country in a phased manner. The guidelines under the branch licensing policy of May 1962 laid stress on opening of offices in 'unbanked' and 'undeveloped' areas, the latter being defined in terms of population per bank office—for example, one lakh population per office, as per the 1962 census.[1] Banks were classified for this purpose into three categories:

(i) all-India banks with deposits of Rs 50 crore and over with branches in at least ten states;

[1] All-India banks could open offices in their own regions at places where the population was over 50,000 (instead of 1 lakh and above hitherto), and at places with lesser population whether within or outside their regions in case no small regional bank had applied for opening of branch offices. All-India banks could also spread to any unbanked centre outside their regions with a population of over 50,000 if no other eligible bank of the region had come forward to open an office. The Reserve Bank also decided that large regional banks with deposits of over Rs 10 crore could open offices in their own regions and in contiguous areas at any place having a population of over 25,000 instead of 50,000 and over hitherto, or where no other bank existed. The large regional banks could also open offices in centres with less than 25,000 people if no small regional bank had applied for bank office licence for operation. The large regional banks were continued to be permitted to open offices in big cities with over 1 million population. The Bank's permission to the remaining banks, i.e. the small regional banks, to open offices at any unbanked/underbanked centres with populations of over 50,000 in their own regions/states was regarded as useful from the point of view both of expansion of banking facilities and of opening up possibilities of competition in the future.

(ii) regional banks with deposits of over Rs 5 crore and a minimum of ten offices;
(iii) small regional banks.

These banks were required to observe a 2:1 ratio between banked and unbanked areas for opening offices within their geographical spheres of operation. This meant that for every branch they opened in a banked area, they had to open two in an unbanked area. The Reserve Bank supplied information to the banks about the centres that were categorized as 'unbanked'. All-India banks were not allowed to open offices in predominantly residential/suburban localities within a distance of 400 metres from an existing office of another bank. An exception was made in the case of the State Bank of India (SBI) and its subsidiaries, since they were expected to open offices to take over cash operations from non-banking treasuries and sub-treasuries.

The branch licensing policy during 1965–67 for 450 offices a year was announced at the Agricultural Credit Department's (ACD) urging. Governor Bhattacharyya explained to the Board in April 1965 that only after the necessary legislation vesting the Reserve Bank with statutory powers of supervision and control over cooperative banks was enacted would the question of coordinating the activities of cooperative banks with the branch expansion of commercial banks be taken up. But, at the prompting of the ACD, the Gujarat State Cooperative Banks' Association drew up a programme for opening branches in rural areas and towns between 1965 and 1967. The Department of Banking Operations and Development (DBOD) responded by saying that any allotment to cooperative banks could be considered only when they were in a position to provide services comparable to those of commercial banks. It also said that since the centres for opening branches of commercial banks for the period had already been approved, the cooperative banks should focus beyond August 1967.

In taking this stand, the DBOD was not being difficult. The fact was that it had asked for a branch expansion programme of cooperative banks for a two-year period beginning August 1967. After that things got stalled in inter-departmental crossfire. The ACD was ready only with twelve states and DBOD said that was not enough. But it also said that it would not hold up everything for ACD to be ready with the data. So it decided to continue in the next programme (1967–69), with the existing practice of not allotting centres with a population of less than 5,000 to commercial banks if the place was not served by a cooperative bank. The Reserve Bank wanted to open only 450 offices a year during 1967–69. But in June 1966 the Board fixed a higher target of 550 branches a year. It also asked all-India banks to pay greater attention to poorly served areas.

The DBOD was quick with its follow-up on Jha's 18 August speech. It suggested that the guidelines for 1967–69 would have to be spelt out and that the selection of centres should be made from the lists already submitted by the banks. The guidelines it suggested were as follows:

(i) All rural areas and unbanked centres will be allotted to the applicant banks, with preference shown for small regional banks.
(ii) A few offices in urban and metropolitan areas will be allotted to banks that were allotted more centres in rural and semi-urban areas.
(iii) There will be preference for allotting centres in underdeveloped states.

Thus, although the 2:1 ratio of banked and unbanked centres, and the 2:1 ratio between offices allowed in developed and underdeveloped states would not be strictly followed, Jha thought this was fine. He asked Deputy Governor Anjaria to discuss the matter with bankers but without committing the RBI to any decision. At the meeting the banks made once again made the point they had been making, namely, it would be disadvantageous to open offices in rural and semi-urban areas unless they were allowed to open some branches in urban areas as well. They clearly needed to cross-subsidize rural operations. Eventually, the allocations were made in such a way that the banks' balance sheets were protected.[2]

The setting up of the National Credit Council (NCC), arising out of the policy of social control, had a bearing on the branch licensing policy and procedures. At its first meeting on 16 March 1968, the NCC suggested certain revisions in the branch licensing policy. Accordingly, the policy was modified in May 1968. Branch expansion henceforth was to have objectives: mobilization of deposits and expansion of credit.

The all-India banks, which had low credit–deposit (CD) ratios in their rural and semi-urban operations, would have to improve the ratios by

[2] The DBOD, after examining the applications received from banks under the branch expansion programme, and keeping in view the Governor's direction, selected 507 centres, of which 279 were in rural and semi-urban areas, 173 were in centres with populations ranging from 50,000 to 5 lakh, and 55 were in large cities with populations of more than 5 lakh, excluding the metropolitan cities of Bombay, Calcutta and Delhi. Of the 279 centres, 212 were unbanked areas and the rest underbanked areas; 78 of them fell in the underdeveloped states of Assam, Bihar, Madhya Pradesh, Orissa, Uttar Pradesh and West Bengal. The distribution of centres was uneven between underdeveloped and developed states. In relation to population, too, the distribution was uneven, since Uttar Pradesh, Bihar and Orissa—the populous states—were to have only a few centres where offices were to be opened.

giving out more credit through their rural and semi-urban branches. Branch expansion was to be not in terms of centres selected in advance but the total number of branches to be opened by each bank with distribution across different states, and across rural, semi-urban and urban areas and cities. At least half the total number of branches had to be in rural and semi-urban areas and half at unbanked centres. However, the criterion for judging the adequacy of banking facilities at a centre, namely, one branch for a population of 10,000, was left unchanged, and the first come, first served principle was instituted. A bank had to take effective steps within six months to open a branch and if it failed to do so, the allotment would be cancelled. Similarly, a bank that did not conform to the distribution of branches between rural and semi-urban and urban areas, and between banked and unbanked centres would be ineligible to avail of the 'first come, first served' principle. There were some other rules as well.

Soon, banks began to complain that the population criterion was resulting in accounts being shifted from one bank to another so that new deposits were not being mobilized as was intended. But closer examination showed that this was not really the case.

There was also the question of branch licensing to foreign banks. In general, foreign banks operated in port towns, and were allowed to open branch offices in cities and metropolitan towns only if the foreign exchange situation was found to be relatively comfortable. This restrictive policy had been adopted in 1962. But the Mercantile Bank Ltd alleged discrimination and the Governor of RBI felt there was some merit in its complaint.

While the issue was under discussion, in January 1967, C.H. Bhabha, chairman, Central Bank of India, wrote to the Governor bringing to his notice a news item in the London *Times* of 23 January. The report said that the Canadian government had turned down a stiff US protest over Canada's refusal to allow the Mercantile Bank of Canada, a US-owned subsidiary, to expand its activities in Canada. The Canadian government said that it wanted the US bank to operate as any Canadian bank was required to. Bhabha argued that 'for peculiar reasons, foreign banking and other service organizations claim it as their birth-right to expand in developing countries like ours. Also, I am afraid, our authorities, without deeper consideration and thought, facilitate that.' The DBOD responded that because of the restrictions on bringing in funds from abroad, foreign banks wanted to open more branches in metropolitan/port cities so that they could augment their resources. The Board, which met in June 1967, did not consider it necessary to suggest any tightening of restrictions on the branch expansion of foreign banks and allowed the existing policy to continue.

But the issue would not go away. In August, Bhabha wrote to Morarji Desai that foreign banks were at a comparative advantage over Indian banks as they were free from the obligation to open branches in rural and semi-urban areas.

> In certain quarters, there is a lurking suspicion as to whether in the matter of issuing licenses to foreign banks for opening branches in India, the general criteria contained in Section 23(2) of the Banking Regulations Act 1949 have been applied as meticulously as in the case of Indian banks or whether there has been any bias in favour of some foreign banks vis-à-vis others.

He wanted the RBI to review the authorizations given in the past few years to foreign banks for opening branches.

By then L.K. Jha had become the Governor, and he responded that foreign banks helped raise foreign exchange for Indian enterprises and must be allowed to increase their activities as the economy developed. He also pointed out that since 1962, against 91 applications from nine foreign banks, the Bank had permitted only 43 offices, while in the same period, the number of new offices opened by Indian banks was 2,367. This showed, in Jha's opinion, that licenses to foreign banks were not given liberally and without scrutiny. Morarji went along with Jha.

THE LEAD BANK SCHEME

But soon all these debates and discussions were to become irrelevant. In July 1969, the government nationalized fourteen major Indian banks and that triggered off a sharp branch expansion drive, especially into rural areas. The name of the game changed completely and banking policy became subservient to political objectives. Access to bank credit was sought to be improved by opening new offices and through allocation of credit to the productive sectors as well as the economically disadvantaged sections. The Lead Bank Scheme had its genesis in this endeavour and it provides a vivid example of how banking became an instrument of social and political policy.

The concept of the Lead Bank Scheme can be traced to the recommendations of the Study Group.[3] Its report became the template for banking

[3] The Study Group was constituted at the end of October 1968 with D.R. Gadgil as chairman, T.A. Pai, B.K. Dutt, M.Y. Ghorpade, A.N. Mafatlal, N.M. Chokshi, P. Natesan and P.N. Damry as members, and B.N. Adarkar as the convener. Damry and Adarkar represented the RBI, while Gadgil was Deputy Chairman of the Planning Commission.

policy after nationalization. The report had addressed itself mainly to the task of identifying the major territorial and functional credit gaps, and making recommendations to fill them. As of April 1969, it said, as many as 617 towns out of 2,700 in the country had not been covered by commercial banks. Of these, 444 did not have cooperative banking facilities either. And, worse still, out of about 6,00,000 villages, hardly 5,000 had banks. The spread, too, was uneven. While the credit–deposit ratio was as high as 89 per cent in centres with populations above 10 lakhs, the declining trend in lower-population centres was equally glaring. Centres with population groups of less than 10,000 averaged a credit–deposit ratio of 41 per cent.

In contrast, cooperative banking had better penetration. The number of villages covered by active primary agricultural credit societies at the end of June 1967 was placed at 82 per cent; and 30 per cent of the rural families were covered. There were, however, regional imbalances in the coverage of the cooperative sector as well. While states like Gujarat, Maharashtra, Punjab and Mysore had done well, Assam, Bihar, Orissa, Rajasthan and Jammu and Kashmir had not. There was also uneven distribution of credit to different economic sectors and virtual non-availability to certain types of borrowers, particularly small borrowers and weaker sections of the community. The sectoral distribution of credit by commercial banks was weighted in favour of large-scale industries, wholesale trade and commerce, rather than agriculture, small-scale industry, retail trade and small borrowers. Agriculture, excluding plantations, accounted for less than 1 per cent of total bank credit, and advances to retail trade accounted for less than 2 per cent. The case studies confirmed that there was potential demand for credit to small borrowers but the non-existence of institutional facilities resulted in their approaching moneylenders, who were found to be charging very high rates of interest. Then there was the problem of collateral as well, and the reluctance of banks to extend credit to small artisans. It just was not worth the banks' time to lend to these people. Nor, indeed, were the banks equipped for credit appraisal. The bulk of their staff was oriented neither to rural living nor to small-scale operations, which require a great deal of examination of detail and exercise of discretion.

So, the Study Group concluded that it was necessary to make detailed plans for the development of credit and banking in the country on the basis of local conditions.

> The first recommendation of the Group, therefore, is for the adoption of an area approach to evolve plans and programmes for the development of banking and credit structure. The area

> approach is inherent in the cooperative system. So far as commercial banks are concerned, the central idea is that depending upon the area of operations and the location, commercial banks should be assigned particular districts in an area where they should act as pace-setters providing integrated banking facilities and in this way, all the districts in the country should be covered.

From this it was an inevitable step to designate a lead bank for each district to carry out the task of expanding credit to hitherto unserved customers. The State Bank of India (SBI) and other nationalized banks were expected to be the torch-bearers. Each district plan was to have three main aspects: one, the establishment of branches; two, the formulation of relationships within a structure or between structures; three, the formulation of proper policies and procedures including the shifting of emphasis from tangible security to operational viability of the schemes. Any subsidy in favour of any category would come from the government.

The Study Group concluded that as a platform for launching the various suggestions,

> the immediate action that is required is to create an apparatus to evolve an action programme for the next one or two years in respect of a district or a zone consisting of one or more districts. For this purpose District or Zonal Committees should be formed within the next one month or so preferably at the initiative of the State Governments concerned, and consisting, among others, of representatives of nationalized commercial banks and cooperative banks, concerned State Government departments such as agriculture, cooperation and small industries.

The first meeting after nationalization of the Governor of RBI with the custodians of the nationalized banks was held on 14 August. Jha had earlier set up a Committee to look into the branch expansion programme of public sector banks. He emphasized that while it was the intention to retain the individual identity of the banks, they were all owned by the government. This opened up the possibilities of cooperation between them and he encouraged them to identify areas that called for special efforts. Jha was anxious to have at least an interim report as early as possible. So, on 8 September, Nariman submitted to the Governor an advance copy of the interim report, which ran to a mere four pages. Nine days later, a fuller interim report was drafted after the Committee had met twice and it was submitted on 17 September to the Governor. The final report was submitted two months later, on 15 November.

It had been agreed at the very first meeting of the Nariman Committee that branch expansion in centres with populations of over 1 million should be left for 'discussions' with the RBI. With this exception, the Committee suggested the concept of a 'lead role' for every identified bank in each district and noted that:

> the primary function of a lead bank would be to undertake a thorough survey—a sort of a techno-economic one—for the development of the district from the angle of branch expansion, intensive financing of agriculture and small-scale sectors, thereby identifying areas of credit gaps and potentialities requiring immediate attention.

But it cautioned that the bank that was assigned the lead role was not expected to enjoy a monopoly in the district but was to act as a consortium leader. The lead banks were to identify, through surveys, areas requiring branch expansion and areas suffering from credit gaps, and invoke the participation of other banks operating in the district for opening branches as well as for meeting credit needs. The process of mutual selection of centres was to be initiated by the lead bank with other banks operating in the district, in order to ensure that a situation such as a lead bank taking high potential centres in the district leaving the other centres for the associate banks was avoided.

This period was important also because it saw the first taste of the relationship that was to develop between the Reserve Bank and the government, leading Adarkar, for example, to protest that 'there seems nothing in writing from Delhi. If the policy is to be modified, this should be preceded by some written comments from Delhi, besides oral advice.'

BRANCH LICENSING POLICY

The immediate provocation was branch licensing policy. The DBOD had proposed that applications for new offices might be considered in the future after assessing the business potential of the particular locality and whether the area was adequately banked. Such an assessment was to be made even in cases where the metropolitan city permitted more bank offices according to the 10,000 population criterion. If the locality applied for qualified for more bank offices, applications, whether of nationalized banks or banks in the private sector, were to be permitted and considered on a 'first come, first served' principle. The DBOD wondered whether, in certain circumstances, banks could go ahead without the Reserve Bank's approval. But eventually it decided against this. In October 1969, Executive Director Seshadri discussed the procedure with Bakshi, who was Secretary in the Department of Banking. Afterwards he recorded a note that set out Bakshi's 'general feelings' on the subject.

These turned out to be that branch expansion was still largely urban-oriented and that the norms of 1:1 for urban and rural areas, and 10 per cent of branches in centres with a population of less than 1 lakh in the seven underbanked states, were probably not relevant any longer because of the sharp emphasis on opening of branches in rural areas and in neglected states. Bakshi also felt that the opening of branches by a nationalized bank in a state or union territory where it did not have a large presence already should be discouraged because of the difficulties arising from language barriers and the unfamiliarity of senior officers with local problems.

This would mean that in the future, a nationalized bank could expand its branches in three or four states other than the one in which it had its head office or had a large number of offices. Adarkar noted acidly in the margin:

> In far-off Delhi, Syndicate Bank is making good use of its branches to extend credit to road operators to help cooperative marketing of potatoes in J&K, to collect savings deposits from jawans, etc. United Bank of India, which complains of remote spread, has no such claim to make, even in its own territory.

The government also wanted that the claims of smaller banks not be overlooked merely because they were not nationalized. It was worried that if a lead bank was given the preference in the opening of branches, it could easily lead to a monopoly for the lead bank in the allotted district. It rejected the preference aspect totally. Finally, said Bakshi, subject to the performance of the bank in opening adequate rural offices, every bank should have an opportunity to open an office on commercial considerations in all cities with a population of 1 million and above.

Seshadri also observed that once the Nariman Committee finalized the list of places to be covered by nationalized banks, licences could be given automatically to every allottee bank in respect of the allotted centres. Therefore, the question of licensing in the ordinary course would be relevant only in regard to opening branches on purely commercial considerations outside the list finalized by the Nariman Committee. He then suggested a modification of the licensing policy at this stage. Adarkar felt it necessary to remark in the margin thus:

> The present policy is to continue till 31.12.1970. Frequent changes of a basic character are undesirable, though modifications to suit the Nariman Plan must be made; and will ED(S) please put up 10 letters received by RBI containing any such complaints that *RBI found it difficult to resolve, and compare such instances with the total number of offices opened during the period concerned?*

Seshadri further noted that a revision of the licensing policy might take some time, and pointed out the need to clear pending and future applications as quickly as possible, and to allow complete freedom to the Reserve Bank to dispose of applications in individual consultations with the government. In Adarkar's view, the grant of licenses to banks as shown in the Nariman plan took care of most of Seshadri's concerns. He countered the fear that a lead bank might have monopoly business by pointing out that district-wise credit plans would be worked out involving the nationalized banks, including the lead bank, RBI, SBI and its subsidiaries. Such plans formed the core of the credit planning presented by the Professor Gadgil Group report. He also disagreed with the argument that every bank which fulfilled its quota of rural branches should be permitted 'to open offices in cities having a population of 1 million or more' as a 'hasty one', since it was here that restrictions were needed 'to prevent and even to rectify glaring duplication'.

When Jha saw Adarkar's response, he knew he had to perform a difficult balancing act. His reaction was swift. In a note dated 27 October, Jha disclosed that he had discussed with Bakshi the question of the branch licensing policy, and that Bakshi's views were 'not quite the same' as summarized in Seshadri's note of 17 October 1969. Pointing out that Bakshi's thinking and his own 'were not dissimilar', he then set out the major points of agreement. First, the responsibility for branch licensing must continue to be that of the RBI. Second, the interests of SBI and private banks should be taken into account. Third, in the attempt to share the responsibility for opening branches in rural areas, there should not merely be an arithmetical allocation under which all banks carry a pro-rata responsibility in all backward areas but the pattern should enable banks to concentrate and feel specially responsible for certain areas. Finally, towards this end, certain precautions may need to be taken. A Bombay bank opening a dozen branches in Bihar should concentrate the branches in a certain area in Bihar on which they can focus, and for which they can have one or two senior officers for overall supervision, rather than scatter the branches all over the state. Factors such as language and district, while being relevant, need not be given too much weight. This settled the issue for the moment. The Nariman Committee's main recommendations, which were eventually formulated after four meetings, were in respect of assigning lead districts, allotting unbanked towns and entrusting the treasury work to nationalized banks.

With regard to the allocation of lead districts, 162 districts in seven underbanked states, and 92 in the other states and most other union territories, were allocated to different banks. The Committee also assigned to the commercial banks the task of identifying backward pockets in 81 developed districts in states other than underbanked ones.

The Committee allotted 366 unbanked towns that remained to be taken up by banks and recommended that before the end of March 1970, offices should be established in 99 of the unbanked towns allotted by the Committee, having populations of over 10,000. In the remaining unbanked towns (with populations of less than 10,000), offices were to be opened before the end of 1970. Besides SBI and its subsidiaries, the nationalized banks were to be entrusted with the treasury business. It was decided by the end of 1972 that governmental work at all the treasuries/sub-treasuries would be taken over by the public sector banks.

In November, the allocation of districts became the subject of a minor controversy. Several banks sought clarifications. T.A. Pai, custodian of Syndicate Bank, wrote to the Governor of RBI, complaining about inconsistencies in allocation to Syndicate Bank. He said that although the bank had done a lot of work or conducted initial surveys in the districts, these had been allotted to other banks and so on. Jha was in broad agreement and asked Hazari to meet Mr Nariman and his group.

Meanwhile, M.R. Kamath from the DBOD, who was associated with the Committee, prepared a detailed note on the various points raised in Pai's letter. He explained the rationale and the circumstances under which decisions had been taken by it. F.K.F. Nariman apparently did not appreciate the manner in which Pai had raised a host of issues about the Committee's suggestions directly with the Governor. In a letter to Jha on 8 December he discussed the issues raised by Pai and pointed out that Pai had sent

> a manager of one of their Bombay branches who, perhaps, was not aware of the thinking and approach of his Custodian; nor did Shri Pai deem it fit to write to the Committee about the divergent views he had when the minutes of the meetings of the main Committee as well as Operational Heads were circulated

> well in time.… It was essentially a Custodians' Committee and it was, therefore, in fitness of things that Shri Pai should have addressed his points to the Committee and that too before the final report was submitted to the Reserve Bank of India.

Hazari met Nariman and Varadachary along with Mangesh Nadkarni from the DBOD. In a note submitted thereafter to the Governor, he emphasized the need to clear up the confusion about the role of the lead bank. 'In the thinking of the Nariman Study Group, the lead bank was to wear only a crown of thorns. It was to carry out surveys, act as consortium leader, open branches in backward areas, etc.—while other banks were to do the actual follow-up.' In effect, he felt that the Study Group had assigned only promotional functions to the lead bank and left developmental activities as a more or less open field to all banks. He confessed that this crucial point had escaped his notice even after a careful reading of the report. Leaving aside the actual shuffling and reshuffling of allotted districts and branches, which could be negotiated among the banks, Hazari highlighted the major point of contention as follows: 'The basic question to consider is whether a lead bank is to be only some kind of a loss leader or is it also to have a major part of the responsibility for opening branches in the district allotted to it.'

Thereafter, a series of meetings were held and the matter was settled by revising the allocations. The Lead Bank Scheme was formally launched on 23 December. While the lead bank was expected to assume the major role in the development of banking and credit in the allocated districts, there was

> no intention that the lead bank should have a monopoly of banking business in the district. The bank assigned the lead role is thus expected to act as the consortium leader and after identifying through survey, areas requiring branch expansion and areas suffering from credit gaps, it should invoke the cooperation of other banks operating in the district for opening branches as well as for meeting credit needs.

Representations continued to flow in for a while from a variety of sources, including banks, state governments and bank employees' associations, for changing the allocation of lead districts. The RBI chose to ignore them. The matter also came in the press and Parliament. Both were fended off.

The most noteworthy aspect, however, is that branch allocation from now on became subject to political pressure. For example, in May 1970, V.P. Naik, who was Chief Minister of Maharashtra, wrote to Hazari to the effect that allotting his native district, Yeotmal, to Central Bank of India was not satisfactory as that bank did not have many branches in the district. He wanted the district allotted to Bank of Maharashtra or Bank of Baroda. Hazari wrote back saying that the allotment of districts took into account the resources of banks, the geographical concentration of their operations and the need to have some contiguity of lead districts, and that although Central Bank of India did not have many branches in Yeotmal district, it was fairly well represented in the Vidarbha region and had been allotted the contiguous districts such as Dhulia, Jalgaon, Buldana, Akola, Yeotmal and Amaraoti, as well as neighboring districts in Madhya Pradesh. He concluded that the Reserve Bank had to balance several considerations and any changes at this juncture might lead to other requests for similar changes and upset the entire basis of the allocation exercise, and hoped that Naik would appreciate the approach that was adopted in the matter.

Political pressure also came in the form of interventions by MPs. A. Bakshi, Additional Secretary, Ministry of Finance, conveyed to Hazari the strong feelings of some Parliament members that the branch expansion programme in some districts like Darbhanga and Palamau was inadequate. Many MPs complained but, by the middle of 1970, things had settled down. The RBI was able to resist the pressures essentially because of the forceful personalities of both the Governor and Hazari, and the highest political support they enjoyed in New Delhi.

From now on, banks were under pressure to ensure that actual branch expansion was in line with the specified programme for each year. In the review of the progress of the Lead Bank Scheme with bankers on 24 April, the Reserve Bank expressed its dissatisfaction with branch expansion, especially in the east, and countered the view expressed by bankers that the delays in opening branches were on account of non-completion of district-wise surveys. Pending these surveys, the banks were asked to proceed with the opening of branches. The Bank also devised a common basic proforma for district surveys and recommended it for adoption by banks although this was not mandatory.

At the end of May, Jha left the RBI to go to Washington as India's Ambassador. His successor was S. Jagannathan but until he actually took over in 15 June, Adarkar was made Governor. Jagannathan was expected, or so went the grapewine, to be 'accommodating'. This did turn out to be the case and Jha's departure signalled the beginning of a period of growing influence of the Finance Ministry. The Bank was seen as being too conservative and as not having understood the aspirations of the people, not to mention the 'compulsions' of the government. The erosion of authority that began then continued over the next decade and a half.

By the early summer of 1971, it had become clear that rapid branch expansion could have a negative impact on profitability. This led to an exchange between the Finance Minister and the chief executives of public sector banks at a meeting called to review progress. Adarkar, who had become chairman of Central Bank of India, said that some of the branches opened by his bank were without 'valid consideration' and could be closed down. The Finance Minister was quick to respond that since many of the branches had been opened only recently, they should be given sufficient time to become stable. But R.K. Talwar, chairman of SBI, raised the question of profitability of rural branches and the overall profitability of banks. These were influential views and the conclusion drawn was that branch expansion should also be based on profitability. Eventually, though, this objective was jettisoned. A newspaper editorial led Jagannathan to arrive at the idea of subsidizing new branches. This was examined by the DBOD, which found that while it took two to four years for a bank office to break even, the banks could take the losses of rural branches in their stride in the initial years of their operation. The idea of a direct budgetary subsidy was rejected as the DBOD said it could act as a disincentive to banks in making branches function profitably.

EARLY SKIRMISHES

This early period was also full of skirmishes between the Reserve Bank and the Finance Ministry. Recounting all of them can be tiresome at this distance but a few are worthy of mention.

Jagannathan's sympathies were with the commercial banks, which were faced with sharp criticism from the press as well as from political personalities. In a reply to the Finance Minister, Y.B. Chavan, who expressed concern over the unsatisfactory performance of some of the lead banks, Jagannathan wrote that while the 'overall direction and pace of branch expansion have been reasonably satisfactory', 'the individual performance of a few banks has not been up to expectations'.

A perspective plan calling for a branch expansion programme covering three years, 1972, 1973 and 1974, was to be prepared by each bank, giving priority to underdeveloped/underbanked districts. By early 1973, the perspective plan was to be treated as the first of the 'rolling' plans with the addition of one more year thus covering the three-year period 1973–75. Most banks sent their perspective (rolling) plans by June 1973, according to which the number of offices to be opened in 1973 alone was placed at 2,600. This was perceived by the RBI to be 'ambitious'.

The introduction of a three-year branch expansion plan ran into some unexpected problems with the Department of Banking, Ministry of Finance. K.P. Geethakrishnan, director in the Department, wrote to M.L. Gogtay, chief officer, DBOD, politely asking for copies of the plans 'received from the banks . . . to the Department of Banking before a final decision is taken on these (plans) *by* the Reserve Bank of India' (italics and parentheses added). On 21 May, Bhuchar forwarded to the government four statements prepared by the DBOD on the basis of the perspective plans received from banks, indicating the overall picture as well as the proposed expansion. Bhuchar suggested that the government representative could participate in the discussions to be held in Bombay at a mutually convenient date, advising at the same time that it was not intended to call meetings of banks for the purpose.

On 7 June, D.N. Saxena, Joint Secretary, Department of Banking, wrote that S.S. Hasurkar, Under Secretary in the Department, would go to Bombay for discussions. He also pointed out that the four statements sent by the RBI pertained to only the ongoing year (i.e. 1973), whereas the perspective plan covered the three-year period 1973 to 1975. Further, he felt that the branch expansion plan for 1973 gave only bank-wise and population group-wise details without correlating them to the needs of underbanked states. He considered it necessary to have state-wise bank group-wise and state-wise population group-wise classifications so that the branch expansion programmes could be 'studied carefully' before holding discussions. The discussions convinced Hasurkar that the actions envisaged by the Reserve Bank were broadly in line with the objectives of the government. With this agreement, the Bank (DBOD) proceeded to issue licences to banks after getting the centres approved by Hazari.

The differences in perceptions, however, continued to simmer. At a meeting of the Central Board held on 16 July 1973, N.C. Sen Gupta who, as Secretary, Department of Banking, Ministry of Finance, was representing the government, observed that according to his Department's analysis, the proportion of rural offices opened by banks had been showing a declining trend. He followed these remarks by forwarding a copy of the note prepared by the Department of Banking to Jagannathan, and suggested that the modified formula had a built-in tendency to reduce the ratio of rural and semi-urban branches to total offices. Hazari was not convinced either by the analysis or the conclusion of the note. A subsequent study conducted by the DBOD in consultation with the Executive Director, K.S. Krishnaswamy, concluded that the revision of the formula in November 1971 had not adversely affected the opening of bank offices in rural and semi-urban areas, and had no built-in tendency to reduce the proportion of such offices to the total. Conveying the study's findings, Hazari wrote on 30 October 1973 to Sen Gupta that the Reserve Bank considered each application for opening an office in the light of the overall policy of giving preference to rural/semi-urban areas and unbanked/underbanked centres and areas.

After a lull of about three months, the issue was again taken up by M.G. Balasubramanian, Additional Secretary, Department of Banking. In a letter of 6 February 1974, Balsubramanian stated that the pace of growth of branches in rural and semi-urban areas between June 1972 and June 1973 had slowed down as compared with the period between the time of nationalization and the introduction of the new formula, either because of the change in the formula itself or because of a waning of initial enthusiasm on the part of banks due to concerns about decline in profits. He felt that the opening of bank offices at unbanked centres need not have decelerated if there had been insistence on opening branches at such centres. He also cited the low credit–deposit (CD) ratios for rural/semi-urban areas as compared with the CD ratios for urban/metropolitan areas. This meant that with the opening of more branches in rural and semi-urban areas, funds would flow from such areas to urban/metropolitan areas and not the other way about. Balasubramanian also raised the government's anxiety that if the number of branches opened in rural areas declined sharply, the policy adopted thus far would not be defensible.

This, in fact, was reflected in the meeting that the Finance Minister Y.B. Chavan held with chief executives of public sector banks on 1 November 1973, in which the Governor and Deputy Governor (Hazari) were invited to participate. Hazari was specially invited by the Finance Minister to present his views on branch expansion, after the Secretary, Banking, made sceptical initial remarks about realizing the objectives of systematic reduction of regional imbalances in banking facilities and avoidance of bunching of new offices in the closing months of the year. Hazari felt that the bunching problem was inherent, while increasing the number of branches in the central, eastern and northeastern regions was not easy. He argued that while licences were issued to banks, banks brought to the notice of the Reserve Bank the adverse impact on their profitability on account of opening additional offices in backward areas.

The concern about fall in profitability was voiced by a number of chief executives of banks (e.g., Union Bank of India, Bank of India, Bank of Baroda, Punjab National Bank and Dena Bank) at the meeting. Proposals also came up for charging higher rates of interest for large borrowers and for grant of subsidy by the government to preserve profitability. M. Narasimham, Additional Secretary, Department of Economic Affairs, cautioned that excessive concern for profitability would defeat the social objectives that banks were required to subserve and contended that as possible solutions, expenditures could be cut down and the minimum lending rate could be increased beyond the then prevailing level (of 10 per cent). The Minister reiterated the government's thinking and urged the Reserve Bank to make determined efforts to ensure that the gaps in the branch network were bridged.

The Reserve Bank urged upon banks to open a larger number of offices than in the earlier years, including a sizeable number in unbanked or underbanked or rural and semi-urban areas, and underbanked districts/ states.

By the middle of 1975, the Prime Minister announced the Twenty-Point Economic Programme and, in a related development, Government of India issued letters to state governments to take legislative action to liquidate rural indebtedness and for a moratorium on recovery of debt from landless labourers, small farmers and rural artisans. On 1 July 1975, the government constituted a Working Group under the chairmanship of M. Narasimham, Additional Secretary in the Department of Economic Affairs, Ministry of Finance, to examine the feasibility of setting up new rural banks as subsidiaries of public sector banks to cater to the needs of the rural people. On 2 August 1975, the Union Finance Minister, C. Subramaniam, at a meeting of the Western Regional Consultative Committee, desired that the working of the Lead Bank Scheme in all its aspects in Maharashtra and Gujarat be reviewed. Accordingly, the Reserve Bank by constituted study groups under the convenorship of Meenakshi Tyagarajan to review the functioning of the Lead Bank Scheme in these two states.

Realizing that the problems of the two states were common, the Study Groups submitted a single (common) report in December 1975 to K.S. Krishnaswamy, Executive Director. The general conclusion of the report was that the first phase of the lead bank programme, namely, identification of centres with potential for banking operations and the opening of bank branches therein, had been successful, whereas the second phase, of formulation and implementation of area development programmes, had been slow and at times uncertain. The need for dovetailing credit with the schemes under district development plans was emphasized by the report. The monitoring of such credit plans would have to be done by the District Consultative Committees. The report also suggested the constitution of a standing committee in the Reserve Bank to keep the overall progress under review.

As a sequel to this, a High Power Committee (HPC) was constituted in

March 1976 under the chairmanship of K.S. Krishnaswamy, who by then had become Deputy Governor. The members of the HPC included the chairmen of four public sector banks, senior officials of the Reserve Bank and a representative of the Department of Banking, Ministry of Finance. The HPC was set up essentially to assess the performance under the Lead Bank Scheme, both in terms of branch opening and priority sector lending where the Twenty-Point Programme's impact was sharply experienced. As such, the HPC was expected to issue policy guidelines for effective functioning of the Lead Bank Scheme, to examine specific problems that arose in the implementation of the scheme in different districts as reported by banks, to examine problems referred to by the state governments and regional offices of the Bank, and to act as a reviewing authority where defaults occurred in the fulfilment of allocations made to the participating agencies.

ENTER DRB

Within a few days of the meeting of the HPC, a development took place that had a profound impact on the relationship between the government and the RBI. By Circular No.F.1(154)/Admn/74 dated 13th April 1976, a new Department of Revenue and Banking (DRB) was created outside the Finance Ministry, to deal directly with the public sector banks. On 21 July 1976, Joint Secretary Kusum Lata Mital wrote letters to the chairmen of public sector banks to expedite the process of opening branches against pending licences. A copy each of these letters was endorsed to the Governor of the Reserve Bank 'for information'. In September 1976, Under Secretary S.S. Hasurkar of DRB addressed a letter to the DBOD chief officer, asking for details of pending applications from banks for opening branches. Hasurkar's letter also indicated that from the information received by DRB, there were, as of end June 1976, '855 applications from the public sector banks which were pending Reserve Bank's decision. Of these 446 are reported to have been pending for more than 6 months.' Hasurkar added that his Department should be

> advised about the number of applications from each of the public sector banks for branch opening pending consideration by the Reserve Bank as at the end of 31 July 1976, according to the population group-wise status of the centres involved and also according to the period for which they have been pending decision, viz. less than three months, between three and six months and more than six months.

The enthusiasm of DRB officials to expand branches, particularly into rural and semi-urban areas and unbanked centres, was more emphatically reflected in Ms. Mital's letter to Governor K.R. Puri (18 November 1976). She suggested in that letter that the existing formula for branch licensing needed to be revised because there was no stipulation as to where the rural/semi-urban branches should be opened. She followed that, up with another letter to the Governor on 20 November 1976, stating that in view of the large number of representations about 'opening of branches at different unbanked centres, particularly in the underbanked regions', the Minister of Revenue and Banking 'desired that to transmit these impulses in their proper perspective to the Reserve Bank of India, there should be a very close association of the Department of Revenue and Banking (Banking Wing) with the process of branch licensing in the Reserve Bank.'

The Secretary, DRB (Banking Wing), M. Narasimham, held a meeting on 21 January 1977 of chief executives of public sector banks, and wrote a letter to them on 25 February 1977 reiterating the decisions that were taken at the meeting. These decisions related to a variety of issues, such as the opening of branches in unbanked blocks, performance budgets, the operation of the Lead Bank Scheme, priority sector advances and deployment of funds in rural areas. As the government was committed to providing at least one bank branch in each of the 900 community development blocks having no commercial bank branch, the state-level bankers' committees were asked, 'through the convenor banks'—*not* through the Reserve Bank—to draw up an agreed programme. The lead banks were expected to keep the programme and its implementation under constant review. The letter also stated that the government did not accept lack of infrastructure facilities as a valid reason for not opening branches in an unbanked block. It was also suggested that where genuine problems existed, the banks could raise them with the state governments on a priority basis so that the minimum required facilities would be rendered available for branch opening before June 1978, the date agreed to with the Estimates Committee of Parliament.

Shortly after this incident the political Emergency ended and a new government was installed, replacing, for the first time in the history of independent India, the Congress-led government at the centre. Puri was replaced by M. Narasimham as Governor of RBI on 2 May 1977, on the clear understanding that Narasimham would hold the position temporarily, till I.G. Patel took over. In June 1977 Governor Narasimham appointed a Committee headed by James Raj to assess, among other things, the impact of branch expansion since 1969 and to suggest the future course of action, keeping in view the need for rural development and removal of regional imbalances.

On becoming Governor on 1 December, I.G. Patel took up the issue of branch expansion with a measure of urgency. Patel was not in favour of continuing with the existing policy, with or without marginal changes. He desired 'a more positive and drastic approach', as he noted on a DBOD note of 16 December 1977 on the subject. His preferences were for opening offices in deficit districts, for completely forgoing expansion of offices in metropolitan centres, and for cancelling licences that were not utilized. He was willing to wait for the reports of the James Raj Committee, the Kamath Working Group relating to a multi-agency approach to agricultural financing and the Dantwala Committee on the performance of regional rural banks (RRBs), before evolving a long-term policy for expansion of branches. This clearly suggested that the expansion programme had to be drawn up only for 1978. Accordingly, and in line with Patel's thinking, the DBOD issued a circular on January 1978 to all the commercial banks, wherein it was suggested that 'the stage has now been reached when banks have to give adequate and due consideration to the need for reducing the inter-state and inter-district disparities in branch development and also pay attention to the process of consolidation'.

This policy favoured a multi-agency approach to rural credit, in the form of coordination between financial agencies, commercial banks, cooperatives and RRBs, in order to avoid wasteful competition and duplication of effort. It aimed at expansion of banking facilities in deficit areas and for reduction of inter-state and inter-district disparities. It was also proposed to have at least one bank office in every unbanked community development block before the end of June 1979.

But this did not mean that there were no concerns about the evolving structure of public sector banks. M.R. Shroff, Additional Secretary in the Banking Division of the Department of Economic Affairs, Ministry of Finance, in a letter dated 8 February 1980 to Governor Patel, proposed that the bank branch structure should be rationalized keeping in view the regional specialization of banks. The Reserve Bank carefully studied Shroff's suggestion but concluded that instead of pursuing regional specialization, it would be necessary to persevere with the objectives of reducing inter-state and inter-district disparities, of encouraging RRBs to open branches in rural areas, commercial banks opening branches in unbanked block headquarters, and of restrictions upon opening branches in already overbanked metropolitan centres.

A letter signed by Executive Director W.S. Tambe, dated 1 April 1980, was sent to the government, stating the Bank's preferences. The ideas contained in this letter were largely reiterated in the Bank's memorandum to the Central Board in October 1981, wherein the thrust was on expansion of bank branches to cover all unbanked centres in deficit districts. It was proposed to have 9,000 additional offices in rural and semi-urban areas in this process. RRBs were to be given a greater role. It was proposed to continue with the restrictive policy in respect of branch expansion in metropolitan/port town centres. These proposals, as approved by the Central Board of Directors, were sent to the government for concurrence.

The government, while agreeing to the proposals, indicated that since a large number of licences had been issued by the middle of 1981, it would take time to clear the backlog of pending licences. Also, as it would take time to consult the state governments and to draw up lists of centres for opening branches, the government suggested that the proposals could be brought into effect from April 1982. The Bank accepted the suggestion.

REGIONAL RURAL BANKS

One of the new institutions to emerge in the 1970s that had an impact on the geographical coverage of the banking system and, to some extent, on the extension of credit to a section of the population in the rural areas, was the regional rural bank (RRB). It was created in 1975 at the initiative of the Government of India. There is no evidence of the government having consulted the Reserve Bank before creating the RRBs. The context in which it was created, according to the official letter, related to the Prime Minister's (Mrs Indira Gandhi) desire that the credit needs of the rural people be catered to, and that the setting up of 'new rural' banks as subsidiaries of public sector banks for the purpose be examined in depth. The official letter also observed that the new institutions would have to be imbued with an 'attitudinal and operational ethos' that would be entirely different from the one then obtaining in public sector banks. It was indicated that the new institutions should provide employment to the rural educated youth and bring down costs by recruiting staff on scales of pay and allowances equivalent to those of state government/local bodies. The Working Group appointed to examine the possibility of setting up these new rural banks was headed by M. Narasimham, then Additional Secretary, Department of Economic Affairs. P.N. Khanna, chief officer of DBOD, Reserve Bank of India, was one of the members of the Group. The Group was appointed on 1 July 1975. While forwarding its report on 31 July 1975, the chairman noted it as a unanimous report of the Committee on Rural Banks. The Working Group did not refer as such to 'regional rural banks' at any place in the report but proposed that the rural banks be 'regional banks'. It was only in the Ordinance of 1975 (later converted into an Act) that the words 'regional rural banks' occurred together.

The recommendations of the report were accepted as they were along expected lines. It was clear from the beginning that RRBs would be set up, given the growing industrial relations problems in commercial banking largely for improving the salary structure and other perquisites of the employees of commercial banks, and the reluctance of commercial bank staff to move into rural areas even where there was evidence of good potential for banking business in some of these areas. It was, therefore, not surprising that the report itself was required to be prepared keeping those two aspects in view. The report was to be completed within a month, one of the shortest periods given for submission of reports. The time period was taken as strictly binding, given the fact that the internal Emergency was promulgated on 25 June 1975. The government, by appointing the Working Group, succeeded in giving the impression that its own judgement on the issue on hand was not important and would be influenced by the views of persons acquainted with the banking business.

The basic idea behind the establishment of RRBs was not new. In fact, it was very much present in the work done by B. Venkata Rao, then deputy officer, Agriculture Credit Department (ACD) of the Reserve Bank of India, while working in the cell attached to the Banking Commission. Venkata Rao's technical papers, entitled 'Restructuring of Cooperatives at the Primary Level: Rural Banks' (published in *Studies Prepared for the Banking Commission*, Vol. II, Reserve Bank of India, Bombay, 1972, pp. 35–76 and pp. 77–90), laid out the proposal for 'rural banks' thus:

> It should be left to an appropriate institution, e.g., 'lead bank' to assess, on the basis of studies, the deposit and business potential of the centres and identify in which of them it would be worthwhile to open branches of banks, commercial or cooperative. Thus, would be left out in each district, particularly in the agriculturally developing areas to which it may be necessary to give priority in the matter of reorganization, those areas which are likely to need locally-based primary institutions. It is surely in these areas that the existing primary credit societies would have to be reconstructed. (paragraph 127)

The paper went on to state that the restructuring programme will mean creation of rural banks that can undertake multiple and diversified credit services to promote economic activities in the areas concerned. But where cooperative coverage was generally poor, 'the rural bank may have to be organized in a different way, say, e.g., a subsidiary of a commercial and cooperative bank or of a commercial bank alone with suitable local participation, according to local conditions' (paragraph 133). The Banking Commission, in fact, recommended that rural banks be established on the lines given in the technical papers.

The proposal of the Working Group, however, was slightly different in that RRBs would be set up as subsidiaries of commercial banks and would not have anything to do with the cooperative credit movement. The Working Group's preference for RRBs as subsidiaries of commercial banks was based on the premise that 'the weaknesses of the cooperative system appear inherent in their organization in several areas of the country and would require radical reorganization in their working if they are to be become effective over a countrywide area' (paragraph 1.15). The Group, however, recognized the difficulties of commercial banks covering 'a wide area of the country intensively'. 'What we need therefore', it observed, 'is an institution which would combine the better features of both systems while avoiding the disabilities inherent to them' (paragraph 1.15). RRBs, as proposed by the Working Group, were supposed to provide a degree of adaptation and improvisation. Although the Group proposed that 15 per cent of the shareholding should be left open to 'cooperative banks/societies, other local institutions and individuals so as to foster a spirit of local participation in the bank' (paragraph 2.5), the very fact that it did *not* provide for shareholding *exclusively* by cooperatives left room for the government to disallow any shareholding by cooperative banks/societies when the Ordinance was promulgated and the Act passed.

The government's stand in this regard was not surprising. First, there was no guarantee that linking up RRBs with cooperatives in any form would work effectively. On the other hand, it was known that between the end of June 1969 and end-June 1975, the number of commercial bank offices had gone up from 8,262 to 18,730. Such an expansion may not be achieved by linking RRBs with cooperatives. Second, linkage with cooperatives could bring about unavoidable political interference from diverse groups, given the presence of a large number of political personalities in the cooperative movement. The government was anxious to foster the impression that RRBs would be run on commercial lines for the benefit of the rural community. Finally, the government wished to distance itself from the proposal of the

Banking Commission for setting up 'rural banks', which, as mentioned earlier, was set up by Morarji Desai who had parted company with Prime Minister Indira Gandhi.

An Ordinance was promulgated on 26 September 1975 to enable Government of India to ensure that some RRBs were set up on 2 October 1975, to coincide with the birthday celebrations of Mahatma Gandhi. Five RRBs came into being on that day. On 30 October 1975, the Department of Banking, Government of India, invited comments and suggestions on the proposed RRB Bill substituting the Ordinance. The Reserve Bank sent its comments relating to (i) the salary and other allowances payable to the chairmen of RRBs and (ii) the disputes about remuneration and other emoluments payable to employees of RRBs. The Bank was not in favour of the terms and conditions of the service of the chairman being prescribed by rules since this could be cumbersome. These should be, in the Bank's view, determined by executive actions rather than by rules, since that would be consistent with the position that was taken in regard to the managing director or whole-time director of nationalized banks. Further, the Bank was not in favour of any reference to disputes on salary or other emoluments of an employee of an RRB being raised before any authority constituted under the Industrial Disputes Act, 1947, as the RRBs would be appointing staff for the first time and there would, therefore, be no question of the staff being governed by any earlier awards or judgements.

The Bank forwarded two more suggestions on 8 December 1975. The first was about amendments to the Banking Regulation Act, 1949, relating to maintenance of percentage of liquid assets by RRBs, and the other related to amending the Payment of Bonus Act. Since RRBs would be included in the definition of a banking company, these amendments were favoured by the Bank. The first amendment was, however, not regarded as necessary by the Finance Ministry after a discussion between officials of the Banking Department and the Legislative Department of the Ministry of Law. The second amendment later was taken up by the Ministry of Labour.

The RRB Bill

The RRB Bill was introduced in the Lok Sabha on 16 January 1976 and passed on 21 January 1976. The Bill was passed by the Rajya Sabha on 29 January 1976. It received the assent of the President on 9 February 1976. The discussions in the Parliament centred on a few issues—the criteria for opening rural banks, the local representation in the board of directors of RRBs, the pay scales of the staff, the security orientation in lending by RRBs, and the interest rates to be charged by RRBs. The government's views, as expressed by the Minister of State in charge of the Department of Revenue and Banking (Pranab Kumar Mukherjee), were as follows. Each nationalized bank would be entrusted with the opening of at least one RRB. At least one RRB would be opened in each state. RRBs would act as supplementary institutions to cooperatives, especially where cooperatives are strong. Fifty RRBs were to be initially set up, but there was no hard and fast rule that this number should be strictly adhered to. As RRBs will have to run efficiently, the boards were to be professionalized with experts drawn from agriculture and other fields relevant for furthering the interests of rural banks. The pay scales were to be at par with those of state government employees partly because state governments would have a share in the capital of RRBs, and also because the recruitment would be from the local areas of operation of RRBs where the presence of state government officials would be felt very strongly. On a security orientation in lending, the government felt that this matter should be determined by local officers to meet the local requirements. With regard to the interest rates on loans, it was of the view that they cannot be lower than those charged by cooperative institutions.

The Bill as passed indicated that while the central government could give policy directions to RRBs, this would be done after consultations with the RBI and the directions were to go through the Reserve Bank. RRBs were accorded the status of scheduled commercial banks. The shares of RRBs were deemed to be trustee securities under the Indian Trusts Act, 1882, and approved securities under the provisions of the Banking Regulation Act, 1949. The loaning business of RRBs was to be largely concentrated in agriculture and cooperative societies, and would be with persons including those engaged in trade/commerce or rural industry or other activities within the notified area of operation of the RRB. RRBs could offer higher rates of interest on deposits—at one half of 1 per cent—than what the commercial banks offered. The authorized capital of each RRB was to be Rs 5 crore of fully paid-up shares of Rs 100 each. The issued capital of each RRB may be fixed by the central government but would in no case be less than Rs 25 lakh. Fifty per cent of this would be subscribed by the central government, 15 per cent by the concerned state government and 35 per cent by the sponsor bank. The chairman would be from the sponsor bank and, besides the chairman, there would be eight directors on the board. The Reserve Bank exempted RRBs from maintaining cash reserves ratio in excess of 3 per cent for a period of two years from 2 October 1975. (This ratio was maintained throughout the period under view of this volume.)

The Bank fixed the statutory liquidity ratio (SLR) at 25 per cent. RRBs were also permitted to maintain cash balances in current accounts either with the State Bank of India or any other nationalized bank. The RBI extended short-term finance to RRBs, with sponsor banks as co-signatories, at rates of interest that were not to be more favourable than those charged for co-operative banks. RRBs were registered as insured banks with the DICGC.

The five banks that were first set up on 2 October 1975 were Prathma Bank at Moradabad (Uttar Pradesh), sponsored by Syndicate Bank; Haryana Kshetriya Gramin Bank at Bhiwani (Haryana), sponsored by Punjab National Bank; Gorakhpur Kshetriya Bank at Gorakhpur (Uttar Pradesh), sponsored by State Bank of India; Jaipur Nagaur Anchalik Gramin Bank at Jaipur (Rajasthan), sponsored by United Commercial Bank; and Gaur Gramin Bank at Malda (West Bengal), sponsored by United Bank of India. A Steering Committee was appointed to work out the details of the RRB programme and to monitor their progress under the aegis of the Ministry of Finance. The Reserve Bank was represented on the Steering Committee. The Committee held discussions at close intervals in the first year. At its fourth meeting, held on 19 November 1975, the Committee noted that in some areas the existing branches of commercial banks were doing little work and that these areas therefore needed to be more closely attended to by RRBs. The main issues discussed, however, were whether RRBs should open branches in areas served by branches of commercial banks, and whether RRBs could be given preference over commercial banks in opening branches in such areas. Narasimham held the view that as RRBs had just made an entry into the field, the time had not yet come for them to replace commercial banks. R.K. Talwar of State Bank of India observed that RRBs should be considered as complementary to commercial banks performing a number of functions including setting up remittance and bill collection facilities. C.D. Datey of the Reserve Bank felt that the branches of commercial banks could attract clientele not serviced by RRBs. Demarcation of functions between RRBs and other commercial banks was not seriously considered, since RRBs, at that time, were in their infancy.

On the question of RRBs opening branches at banked/urban centres, there was, in the initial months, no single view either in the Reserve Bank or in the Steering Committee. At a meeting between the Minister for Revenue and Banking and the chairmen of RRBs held at New Delhi on 15 July 1976, by which time there were 112 RRB offices, the Minister agreed with the suggestion that in districts where rural banks were operating, new branches could be opened by them rather than by other commercial banks. In view of this decision, the Reserve Bank gave preference to RRBs rather than debarring other commercial banks from opening branches in rural areas falling within the districts of RRBs.

At a meeting of chief executives of public sector banks with the Minister of Revenue Banking on 21 January 1977 at Delhi, the allegation was made that commercial banks were opening branches in areas of operation of RRBs. The Reserve Bank explained at the meeting that before allowing any commercial bank to establish an office in such areas, the view of the concerned RRB was sought as to whether it would be in a position to open a branch at the particular centre and if not, whether a commercial bank could be allowed to open a branch. The Bank added that only after obtaining clearance from RRBs were commercial banks allowed to open branches. The Minister broadly supported the Bank's stand on the matter. However, he observed that it was not open to RRBs to decline to open branches in their areas of operation, and suggested that any licence pending with commercial banks in areas of operation of RRBs be cancelled. The Bank acted upon this decision.

Policy Changes

However, within a space of three months, the government reversed this decision. This had to do with the change of government itself. Joint Secretary Kusum Lata Mital, in her letter of 9 May 1977 to P.N. Khanna, chief officer of DBOD, advised that by June 1978 all community development blocks that were devoid of banking facilities should be served by at least one commercial bank branch. As the full range of banking facilities would not be available to the community development blocks that were served by branches of RRBs alone, the government took the view that applications for licence from other commercial banks could be 'sympathetically' considered by the Reserve Bank. This made eminent sense and the Bank, therefore, decided upon a modification of its policy in certain respects. For example, where an unbanked block headquarters offered scope for more than one office, an RRB as well as another commercial bank could be allowed to open offices. Again, where an office of an RRB was already functioning at the block headquarters and there was scope for an additional bank office, a commercial bank could be permitted to open an office in a nearby outlying centre, on merits. Moreover, where an RRB had *not* established its office in block headquarters, a commercial bank would be allowed to open an office, and the remaining centres in the block would be reserved for the concerned RRB. This meant that, given the limited resources, both of finance and trained human power, RRBs would consolidate their position rather than expand their branch network. The Bank, on its part, sent a guarded reply to Ms. Mital's letter stating that the concerns of the government would be 'kept in view'.

The question as to why there was a shift in the new Janata government's viewpoint is not to found in any official document or study. One can only make a conjecture. The creation of the RRB, though bearing some resemblance to the 'rural bank' proposal of the Banking Commission, was associated with the 'Emergency' and Indira Gandhi, and, ironical as it might seem, required to be de-emphasized. The new Finance Minister, H.M. Patel, a civil servant, felt that the rural credit structure would be best served only if the original intent in the creation of RRBs was fully addressed. It is not clear whether the votaries of the cooperative credit movement who felt peeved at the creation of RRBs, influenced him in the matter. The fact is that H.M. Patel himself was involved intimately with a milk producers' cooperative in Gujarat and was a close friend of B. Venkatappaiah, a strong advocate of the cooperative movement, a civil servant, a one-time Deputy Governor of the Reserve Bank of India and chairman of the State Bank of India, to whom, it is said, Patel turned for advice on matters of finance.

Hardly three months into power, the new government decided that it was time to review the working of RRBs. It was aware that the Working Group on Rural Banks had suggested that in the first instance about five banks may be set up as 'pilot institutions' and, depending upon 'their performance and the experience that is gained on the basis of their working, an expansion in the number of banks and their extension to other areas could be considered' (paragraph 3.7). The government, after ensuring the establishment of five RRBs in October 1975, had, however, helped to set up 50 more RRBs by May 1977. Reviewing all the RRBs would have been difficult. The government, also, was not perhaps willing to do the review on its own because such an action would have been viewed as vengeful of the action of the previous government in the matter. It was therefore left for the monetary authority to take this task upon itself. One of the first acts of M. Narasimham as Governor of the Reserve Bank was to set up a Review Committee (in June 1977) for the purpose, with Professor M.L. Dantwala, an agricultural economist, as chairman. H.B. Shivamaggi, Adviser, Economic Department of the Reserve Bank of India, was the secretary of the Committee. The Committee was to submit its report within three months but could do so only much later—on 16 February 1978. The choice of Professor Dantwala as chairman was dictated by considerations of his professional competence rather than by any association with the cooperative credit movement or with commercial banking.

The Committee's assessment of the overall performance of RRBs took into account the Steering Committee's recommendation that RRBs should be located in areas where gaps in credit to the weaker sections of the rural population were large, and where the potential for agricultural development was seen to be high. The Dantwala Committee found that, by and large, the choice of districts for setting up RRBs was appropriate. The RRBs surveyed by the Committee had mobilized sizeable deposits, of nearly Rs 7 crore, as at the end of June 1977. Two RRBs, i.e. of Gorakhpur and Khammam, had collected deposits of about Rs 150 lakh each—beyond the government's expectation of deposit mobilization of Rs 100 lakh by each RRB in the first year of working. Strikingly enough, over one-third of the deposits of RRBs was from their branches at unbanked centres. The Committee felt that, in the interest of agricultural development, RRBs should not be precluded from extending credit to farmers on the basis of the size of landholdings, but suggested that for preserving the distinctness of being a bank for the small person/economic entity, 60 per cent of the loans advanced by an RRB should be earmarked for the benefit of small farmers, rural artisans and other rural poor. Noting that state governments prefer to keep the deposits of their institutions with cooperatives, the Committee also urged the development agencies of state governments to assist in linking cooperative societies with RRBs, since the surveyed RRBs showed evidence of bias in favour of loans to agriculture and allied sectors. The Committee observed that the recruitment of clerical and technical staff locally imparted a personal touch to the day-to-day banking operations in that the borrowers were known to the staff of RRBs.

A recommendation of far-reaching importance made by the Committee was that rural branches of commercial banks should be replaced by RRBs and their branches. It followed from this that the policy on expansion of rural branches of commercial banks needed to be reviewed by the Reserve Bank. The Committee urged Government of India and the Bank to take steps to initiate the process of making RRBs an integral part of the rural credit structure. It suggested that an RRB could cover a population of 10 lakh to 15 lakh, and that the number of branches per district for each RRB could be 50–60. The Committee further recommended (i) the winding up of the Steering Committee, as the RRBs had already come to stay, and (ii) the installation of an appropriate organizational set-up in the Reserve Bank to look after the work of RRBs.

The RBI took up for consideration the recommendations of the Dantwala Committee along with the recommendations of the James Raj and Kamath Committees, which had studied, respectively, the functioning of public sector banks and the problems in adopting a multi-agency approach in agricultural financing at around the same time. The promotional functions performed by the government through the mechanism of the Steering Committee were transferred to the Reserve Bank in October 1978. The statutory responsibilities provided for in the Regional Rural Banks Act continued to be exercised by the government pending necessary amendments to the Act, which took place much later in 1988. Following the Dantwala Committee's recommendation, the RBI did not rigidly apply the rule of 'one district, one RRB'. As a result, 83 RRBs set up till September 1980 covered 141 districts or a little more than one-third of the total number of districts in the country. Again, RRBs were permitted to make advances to persons against fixed deposits subject to stipulations of the Reserve Bank every now and then. They were also permitted to finance farmers other than small and marginal farmers who cultivated land within the project areas approved for refinance by the Agricultural Refinance and Development Corporation (ARDC).

The James Raj Committee, on its part, envisaged RRBs opening branches at a rate that would enable them, ultimately, to take over the existing branches of commercial banks. The Reserve Bank decided to accord priority to RRBs in branch expansion in rural areas, in areas where they were operating or proposed to operate later. Where there were special schemes for financing agriculture and where RRBs were not in a position to expand immediately, the concerned lead bank of the district was to be allowed to open branches.

All the three Committees, namely, those of Dantwala, James Raj and Kamath, favoured the process of transfer of rural branches of commercial banks to RRBs in the latter's command areas. However, while the Dantwala Committee envisaged a total replacement of rural branches of banks by RRBs over time, and the James Raj Committee suggested, in addition, widening the powers of lending by RRBs to all small borrowers, the Kamath Committee took a more specific stand and proposed that sponsor banks/other commercial banks might consider transferring their rural branches to RRBs by mutual consultation in a phased manner, spread over three to five years. The Reserve Bank too took this view, as is evident from the Memorandum to the Central Board No. B-19, 9 August 1978.

This decision was severely criticized at the meeting of the Agricultural Credit Board that was held on 29 August 1978. B. Venkatappaiah, former Deputy Governor of the RBI and a strong votary of the rural cooperative credit structure, voiced a strong protest against the proposal for transfer of rural branches of commercial banks to RRBs even if it were to take place with mutual consultations. Venkatappaiah went to the extent of stating that he would not be a party to a decision that entailed a wholesale transfer either of rural branches or of the rural business of commercial banks operating in the command areas of RRBs, as he felt that rural business was yet to be 'defined'. Deputy Governor M. Ramakrishnayya, who was the chairman of the Board, tried to clarify that the transfer was neither compulsory nor automatic. Venkatappaiah however maintained that it was yet to be established that RRBs were better agencies than the branches of commercial banks or cooperative banks, and that the proposed approach would negate the multi-agency approach to rural lending. He desired that the decisions emerging from the day's discussions be clearly recorded so as to avoid ambiguity on future occasions. He took the extraordinary step of demanding that the decisions arrived at in so far as they related to RRBs—(i) in addition to state cooperative banks, banks might also, on their own, sponsor RRBs, (ii) state cooperative banks might, wherever possible, sponsor RRBs jointly with commercial banks, (iii) there would be no freeze on the opening of rural branches by commercial banks and the State Bank of India would be permitted to go ahead with (the opening of) agricultural development branches—be recorded. Ramakrishnayya agreed that these decisions were 'clearly understood' and that, in regard to branch licensing policy, the point made by Venkatappaiah and other members had been noted for action. He assured that the ambiguities in the note would be removed.

Taking note of the broad decisions taken at the meeting, in its circular dated 8 September 1978 setting out the guidelines on the new branch licensing policy, the RBI refrained from making any reference to possible transfer of rural branches of commercial banks to RRBs, but indicated clearly that while priority would be accorded to RRBs in opening branches in rural areas falling in their command districts, commercial banks were not precluded from opening new branches in such areas wherever considered essential, or from continuing their existing branches in the command areas of RRBs. On another occasion, during a meeting with bankers at Lucknow to discuss branch expansion plans for Uttar Pradesh, the Bank clarified that it would not compel any bank to transfer its rural branches to RRBs unless the commercial bank in question wanted to do this on a mutually acceptable basis with the RRB.

This issue surfaced at a meeting of the Steering Committee on RRBs held in May 1979 and subsequent meetings held in July/August 1979, when the chairmen of three banks, namely, the State Bank of India, Central Bank of India and Canara Bank, were reported to have shown their willingness to transfer the business of their rural branches falling in the areas of RRBs sponsored by them, from the point of view of cost and convenience. Deputy Governor Ramakrishnayya asked them to submit concrete proposals. From the correspondence files it would appear that only Canara Bank showed its willingness to transfer its rural branches to two RRBs sponsored by it, and, in case there were any particular advances that fell beyond the purview of RRBs, to have them shifted to the bank's nearest branch. In this situation, notwithstanding its avowed stand (of leaving it to the sponsor bank and the concerned RRB to arrange the transfer on a mutually agreed basis), the Reserve Bank surprisingly indicated that it would have to be satisfied about the managerial and administrative capacity of the RRB to effectively take over the branches and run them on proper lines, the status of its existing branches and the number of licences pending with it. The Bank, also, could not wish away certain knotty problems, namely, rehabilitation of the staff of the sponsor bank at these branches, and the take-over of bad and doubtful debts of the branches either by transferring the necessary provision in respect of such advances to RRBs or by handing them over to RRBs on a collection basis. Only Canara Bank seemed to have evinced further interest in the matter by giving details of the proposed transfer of one branch each in Karnataka and Kerala. Again, the Reserve Bank opted to tread a cautious path and asked the bank to first tackle the problem of absorbing the surplus staff to the mutual satisfaction of the unions. The Bank decided to further examine the implications of this proposal on receipt of a reply from the bank.

While processing the proposal, Executive Director W.S. Tambe wanted to list the important points that the Bank would like to take into account and be satisfied about, when considering such proposals. Accordingly, the DBOD identified certain related points, as under:

(i) Whether the whole business of the rural branch or only rural business done at the branch was to be transferred. The term 'rural business' meant business which an RRB was permitted to transact under the guidelines issued by the government in 1976, i.e. loans to small and marginal farmers, rural artisans, landless labourers, etc., and advances against their own fixed deposits and financing land development schemes covered by ARDC. If the government took an early decision on a pending proposal that an RRB could do any business that the rural branch of a commercial bank did, there might not be any difficulty in transferring the entire business of the rural branch to the RRB.

(ii) Business that could not be transferred to an RRB, like industrial advance, could be transferred to the nearest branch of the commercial branch.

(iii) While the deposits and other liabilities of these branches could be transferred to the RRB almost in full after observing the legal formalities, the assets to be transferred might not be sufficient to offset the liabilities. In that event, the sponsor bank would have to provide funds/assets to make up the deficit, after carrying out an evaluation of assets.

(iv) In case bad and doubtful debts of the branch were also to be transferred to the RRB, either the provision held by the sponsor bank should be passed on to the latter or arrangements made for the RRB to take over these advances on a collection basis on behalf of the sponsor bank.

(v) The question of absorbing the staff of rural branches of the sponsor banks to be closed (at its other nearby branches) would have to be solved amicably, in consultation with the staff associations.

(vi) Till the RRBs were in a position to engage their own staff, the sponsor bank's staff would have to be loaned, and the difference in their salaries borne by the sponsor bank.

With the approval of Deputy Governor K.S. Krishnaswamy, it was decided that it might not be desirable for the Reserve Bank to either encourage or discourage the process of take-over. If any bank, particularly a sponsor bank, decided to transfer its specific branches to RRBs and evolve suitable modalities to take care of the above-mentioned points, the Bank should not stand in the way. Krishnaswamy commented on 2 April 1980: 'There will, doubtless, be problems in regard to transfer of assets/liabilities as well as personnel. But if a sponsor bank and its RRB have agreed on these, we need not raise any objections on grounds of general policy or philosophy.'

This issue, however, continued to engage the attention of the DBOD and RPCC in the Reserve Bank, albeit on a low key. Without making it an all-India issue, the Bank decided to encourage such transfers in case the sponsor bank took the initiative. In districts already identified for new RRBs, licences would be issued to RRBs and the licences held by commercial banks transferred to the new RRBs. Even as late as the middle of 1981, the Bank maintained that if RRBs could ensure adequate business and attain operational viability, the transfer of rural business of commercial banks could be more actively pursued.

The change of guard at the centre again in 1980 coincided with a more detailed review of the working of RRBs. (Routine reviews generally take place on the basis of off-site statistical returns, in any case.) A memorandum was submitted to the Central Board in December 1980 giving the results of the review. By September 1980, 83 RRBs were functioning with 2,700 branches in 141 districts. The bulk of them were in Uttar Pradesh, Bihar, Madhya Pradesh and Orissa. Punjab was an exceptional state with no RRB. The State Bank of India led other banks in sponsoring RRBs; it was followed by the Central Bank of India, Bank of Baroda, Punjab National Bank and United Bank of India. By March 1980, 60 RRBs reported total deposits of Rs 140 crore (Rs 500 per deposit account) and total advances of Rs 156 crore (Rs 950 per borrowal account). There was very little of consumption loans. Most loans were small and had met the composite requirements of production and investment of the weaker sections of the rural population.

The review study, however, showed that, because of slow growth and the low level of the loan business, the viability of RRBs would take about six years' time. It also concluded that an RRB would have to have 70 branches and a loan business level of Rs 8 crore, with 500 basis points forming the difference between the average borrowing and average lending rates, for gaining viability.

Professor Dantwala, who was the Director of the Central Board, clearly did not like the viability criteria that were set out in the memorandum. He wrote down his comments and got them circulated among the Board members. He argued that neither the government nor the Reserve Bank had paid enough attention to the critical issue of formulating and implementing a rural credit policy. Expressing his anguish at no action taken upon the recommendation of his Committee for total replacement of rural branches of commercial banks by RRBs, he stated in unequivocal terms:

> My submission is that the policy-makers should take a firm decision on the type of rural banking structure it wishes to establish; or more specifically, decide as to which of the patterns—the RRB with its low cost, low profit or the rural branch network of commercial banks—is better suited to the rural ethos and the requirements of the rural borrowers. The two patterns can be suitably linked or, to use the more familiar jargon, 'coordinated', but the two cannot coexist or, to put it more clearly, expand simultaneously on parallel lines. If the policy-makers are serious about a viable expansion of RRBs, they must take a firm decision to curb expansion of rural branches if not put a moratorium on it. In the absence of such a decision, I do not think the RRBs will be able to accomplish viable growth.

> Perhaps it is already too late, the pitch has been queered for the RRB by the addition of more than 4,000 rural branches of the commercial banks since 1977. If the stoppage of expansion of commercial banks' rural branch network is considered not feasible nor desirable, it would be advisable to wind up the RRBs.

There are no detailed records of the meeting of the Central Board on this issue. However, there is evidence of the Reserve Bank not taking a firm stand on the issue as posed by Professor Dantwala. It allowed the multi-agency approach to take root. A defence of this position was available in oral discussions with the former Deputy Governor, M. Ramakrishnayya. Ramakrishnayya stated that, while he shared the disillusionment of Professor Dantwala over the way in which rural credit had been disbursed by cooperative credit societies, he preferred to take a pragmatic view on the matter. This implied that the Reserve Bank felt that the role of RRBs should be viewed in a holistic manner, with the intention of ensuring that rural credit needs are met by different agencies. Accordingly, the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD) was set up by the Reserve Bank in 1980, with B. Sivaraman as the chairman.

The report of this Committee was submitted in January 1981. It led to the creation of the National Bank for Agriculture and Rural Development (NABARD), replacing the Agricultural Refinance and Development Corporation (ARDC) not only to provide project finance, but also working capital and long-term finance to state cooperative, central cooperative and urban cooperative banks by way of refinance. NABARD, according to the Committee, was to take over from the Reserve Bank the overseeing of the entire rural credit system including the operation of RRBs. We shall deal with NABARD in more detail elsewhere in this study. At this point of time, it is enough to note that the idea of setting up NABARD to focus on the credit needs of agriculture and other activities connected with rural development was not new, and was generally akin to the recommendations of the interim report in 1971 of the National Commission on Agriculture to set up an Agricultural Development Bank of India (ADBI) on the lines of the IDBI. This recommendation was forcefully placed in the National Commission's final report of 1976. M. Narasimham, in his book, From *Reserve Bank to Finance Ministry and Beyond* (2002), wrote in this context:

> While I was the Banking Secretary I thought I should moot the idea of a National Agricultural Development Bank, somewhat as a counterpart to the Industrial Development Bank for the

> agricultural sector and as an apex institution for agricultural credit, and wrote to the then Governor of the Reserve Bank Puri to that effect and sought the Bank's view on it. (p. 88)

In his oral discussion, G.V.K. Rao, formerly Principal Secretary, Ministry of Food and Agriculture, confirmed that Narasimham supported this idea that was first mooted by the National Commission. A Cabinet Committee was set up in September 1976 to go into the recommendations of the National Commission; after due deliberations, the Committee favoured the setting up of the ADBI on 21 January 1977. Coincidental as it might appear now, one of the internal notes of the Banking Commission, prepared by B. Venkata Rao obviously in early 1971, suggested that there should be a 'National Bank'. The internal note did not give any clue as to whether it was aware of the thinking of the National Commission on Agriculture on the subject.

The story of the development of RRBs was a somewhat chequered one, with very little prospect of their becoming the main institutional mechanism for providing credit to the relatively poor sections of the rural sector. Although the number of RRB branch offices increased sharply, from 112 at the end of June 1976 to 5,118 as of end-June 1982, they faced problems in day-to-day operations partly because of the lack of enthusiasm on the part of state governments for fear of RRBs adversely impacting on cooperatives, and partly because other commercial banks did not find it useful to have one more institution of their own competing with them for business.

3

To Whom to Lend, How Much and How

BILLS REDISCOUNTING SCHEME

We have seen how, after India became independent and acquired a democratic government, pressures arose from the political parties to increase the availability of credit to the less well-off. The 1960s were dominated by the debate over the adequacy of 'social' control of banks, which would force banks to extend credit to the less well-off, and the need for outright nationalization, which would enable the government to make absolutely sure that credit went where it wanted it to go. The matter was resolved in July 1969 when, for purely political reasons, Prime Minister Indira Gandhi decided in favour of nationalization. With this started a new era in Indian banking.

But expanding credit delivery required two things: vehicles of delivery, namely, branch expansion, which was discussed in Chapter 2; and more loanable funds, which we will discuss now. As an immediate solution, the Reserve Bank turned, as it had done once before in 1952, to an old practice capable of delivering quick results: commercial bills and the Bill Market Scheme. It was for more-or-less similar reasons that the scheme had been restarted in 1952 after going into decline during the decade preceding independence. Its purpose was to provide banks with a mechanism to obtain advances from the RBI against specially created bills of a self-liquidating character. But by 1958 the scheme had fallen into disuse. (See Volume 2 of the history of the Reserve Bank of India for details.)

In 1964, when the issue of credit expansion was once again being discussed, Governor Bhattacharyya took the initiative and the general question of creating a bill market based on genuine bills was examined by the Department of Banking Operations and Development (DBOD). The Department took the stand that the arrangement of obtaining manufactured bills, at Governor Bhattacharyya's initiative, as security for advances under the Bill Market Scheme was working well, and that the objective of relieving monetary stringency during the busy season was being met. It also felt that the Bank could exercise qualitative control on expansion of credit by commercial banks.

Having said that, however, the Department allowed that as a beginning the banks could start the acceptance business. This, in turn, could form the basis for the creation of a supply of prime bank bills, which, in due course, could be made eligible for rediscount with the Reserve Bank. But there was a problem. The offer of rediscounting facilities by itself would not encourage an open market in bills. So the idea of establishing an institution to act as a dealer in bills and as an intermediary between banks was mooted. This proposal envisaged several advantages. One was better deployment of the day-to-day surplus of deposits in the call market in granting call loans to the discounting institution against the security of packets of bills. This would link the call market to bills representing specific trade transactions and ultimately help the Bank in exercising greater influence on the call money market through its rediscount policy.

M. Narasimham was Director of the Banking Division at the time and he felt that use of the trade bill as a credit instrument called for a change in banking procedure. But the initiative for this change would have to come from the banks themselves. This meant that the existing Bill Market Scheme would have to continue until the volume of genuine trade or institutional bills increased sufficiently. V.G. Pendharkar, Economic Adviser, agreed with this argument and observed that for control by the central Bank it was not 'absolutely essential' to have a genuine bill market. He also pointed out that control of short-term fluctuations in the supply of credit could be effected in several ways. One of these was through the use of bills. However, under the prevailing conditions he did not think trade bills would become significant as a method of financing borrowers. B.D. Joshi, who was the Executive Director, felt that unless acceptance and discount houses were established, the scope for development of bills could not be exploited. He therefore suggested a discussion with representatives of the Indian Banks' Association and some prominent bankers. B.K. Madan was the other Executive Director and he too foresaw 'real' difficulties in resuscitating the genuine bill market. As a result of these views no particular action was taken.

In 1969, left with few options and as a result of a letter written by T.A. Pai on 19 May to Deputy Governor B.N. Adarkar, the Reserve Bank sought to breathe fresh life into the Bill Market Scheme. Pai, who was the chairman and managing director of Syndicate Bank, asked for two things: a review of the existing Bill Market Scheme and redesigning it so that a genuine bill market could be created. He said that the Bank should allow banks to offer inland usance bills up to 90 days for rediscount instead of the present practice of making advances to banks against the security of 'manufactured' or 'specially created' bills. Pai also pointed out that the banks had been financing manufacturers' and wholesalers' accounts receivables, and the most convenient way of doing it was to draw a bill against acceptance to be discounted by the Reserve Bank. In his view, the creation of such bills would help monetary management and impart flexibility to the credit mechanism if the bills were made eligible for rediscount by the Bank. Finally, he said, such bills satisfied the conditions laid down in Section 17(2)(b) of the Reserve Bank of India Act, as one of the signatures on the bills had to be that of the licensed scheduled bank and the creditworthiness of the manufacturer or wholesaler (being the second signature) could be verified. Drawing attention to the Bills Rediscounting Scheme of the Industrial Development Bank of India (IDBI), which provided that banks should retire bills three days in advance of maturity, Pai suggested that a similar procedure could be adopted in respect of the proposed bills and that the scheme as suggested could be introduced on merits.

Adarkar was aware of the need to do something quickly. He saw no difficulty in the RBI rediscounting bills, provided the banks took over the bills for collection just before maturity. So he instructed the DBOD to examine the matter quickly. DBOD considered the proposal from two angles: one was the possibility of better control over bank credit, and the other was the rediscounting of bills as a better method of refinance than the existing Bill Market Scheme.

DBOD, in a note, wrote that it was not necessary for the Reserve Bank to rediscount trade bills because adequate control was already being exercised under the existing scheme. It reasoned that once the bills were rediscounted with the Bank, RBI would not have an opportunity to ascertain whether the bills had arisen out of genuine trade and commercial transactions, and further, that the banks might not find it attractive to offer trade bills to any appreciable extent when it was much easier to obtain refinance under the Bill Market Scheme. Concluding that there was no need to provide facilities for rediscounting of trade bills, it offered, by way of a concession, to discuss the question with a few bankers, 'if considered necessary'.

But Adarkar was adamant. He pointed out that the DBOD had not taken adequate note of the advantages of trade bills in helping small traders to avail of credit offered by local banks instead of depending on credit from big wholesalers in the towns. L.K. Jha, who was the Governor, asked if it was a matter suitable for study by the Banking Commission or some other ad-hoc body. On 11 August, Adarkar sought the advice of the Secretary,

M. Narasimham, expressing the view that if the Reserve Bank encouraged the growth of a bill market and, in due course, the establishment of discount houses, it would have made a significant contribution to the development of the money market in India, and that a proper bill market would help to bring about better distribution of credit not only between different stages of distribution but also between different banks and other suppliers of credit, e.g. discount houses.

On 12 August, Narasimham and Adarkar met and discussed the issue. It was decided to constitute a Study Group comprising R.K. Talwar (State Bank of India), T.A. Pai (Syndicate Bank), Nariman (Union Bank), Laxminarayan (Indian Bank) and R.B. Shah (Bank of Baroda), with M. Narasimham (RBI) as Member Secretary. The Governor approved the proposal in principle on 13 August, but also suggested postponement ('the question is one of timing') because of the many urgent problems pending before the banks' chairmen. That was done and a few months later, in December, the idea was revived, this time successfully. The Bill Market Study Group was constituted on 22 January 1970 with a change in the originally proposed membership. The final composition of the Group was somewhat of a climbdown as the level of members was far lower than that envisaged earlier.

On 20 February 1970, a letter informed the members that the Study Group proposed to study:

(i) the efforts necessary to enlarge the use of bills of exchange as an instrument of credit and for the creation of a genuine bill market in India;
(ii) the factors inhibiting the growth of a bill market in the country;
(iii) the method to get over the impediments;
(iv) the steps necessary to increase the supply of genuine trade bills; and
(v) the institutional set-up necessary for the purpose.

The Group held its first meeting on 3 March and met three times in all. The final report was signed in the first week of May 1970. A copy of the report was forwarded to scheduled commercial banks on 17 July 1970.

Based on its recommendations, the Reserve Bank issued a circular on 28 August advising that a Scheme of Rediscounting of Bills of Exchange under Section 17(2)(a) of the RBI Act would be introduced from 1 November. The rediscounting facilities were to be made available at the Bank's offices at Bombay, Calcutta, Madras and New Delhi. The salient features of the scheme were as follows.

(i) Only genuine trade bills, i.e. evidencing sale and/or despatch of goods, were eligible.
(ii) Bills of exchange arising out of sale of commodities covered by selective credit control directives of the Reserve Bank, as also bills pertain-

ing to supplies made to government departments, were not covered by the scheme.

(iii) Accommodation bills were outside the purview of the scheme.

(iv) To be eligible for rediscount by the Reserve Bank, a bill of exchange should be drawn on and accepted by the purchaser's bank, and, where the latter was not a licensed scheduled bank, it should, in addition, bear the signature of any licensed scheduled bank as acceptor.

(v) In view of the absence of discount houses or acceptance houses in the country, the purchaser's bank should satisfy itself as to the ability of the purchaser to meet the bill on the due date and ensure that the bills were accepted by banks on behalf of 'first-class parties' only.

Anticipating that the scheme would experience teething troubles, the Reserve Bank advised that

> there may be resistance on the part of buyers of goods to accept bills drawn on them by the sellers or to ask their bankers to accept such bills on their behalf, as this process would bind them to make payment for the purchases on the stipulated dates. In view of the merits of the scheme, we suggest that the banks might persuade their borrowers to avail themselves of finance necessary for sale of goods on credit by way of discount of bills of exchange. The banks may ensure that not only bills drawn by bigger concerns on the smaller ones were financed through bills but also those drawn by smaller concerns on the bigger ones. In order to promote the development of the Bill Market, the banks may discourage giving credit in respect of sale of goods against book debts.

Commercial banks were asked to forward their applications for the grant of total limits under the new scheme based on their estimates of requirements of rediscounts for the year 1 November 1970 to 31 October 1971, and the Bank agreed to fix the limits on a flexible basis as the banks might find it difficult to make a realistic assessment of their rediscount requirements under the new scheme at the initial stage. These estimates could be revised once more accurate data became available.

The RBI, however, decided to continue the existing Bill Market Scheme in which advances were granted under Section 17(4)(c) of the RBI Act to enable commercial banks to meet the credit requirements of the priority sector. These facilities were available in respect of the banks' short-term lending to agriculture, including credit granted to primary cooperative societies in selected states as well as short-term lending to small-scale industries covered by the Credit Guarantee Organization and advances to banks for food procurement and distribution of fertilizers. In March 1973, refinancing arrangements in respect of defence packing-cum-supply credit were withdrawn.

The scope of the Bills Rediscounting Scheme was expanded in February 1971 by including, in addition to bills drawn on and accepted by the purchaser's bank, the following:

(i) a bill drawn on the buyer and the buyer's bank jointly and accepted by them jointly,

(ii) a bill drawn on and accepted by the buyer under an irrevocable letter of credit and certified by the buyer's bank which opened the letter of credit,

(iii) a bill drawn on and accepted by the buyer and endorsed by the seller in favour of his bank and a declaration in the prescribed format by the bank endorsing the bill.

In early April 1971, the State Bank of India (SBI) suggested a scaling down of the minimum amount of a single bill offered for rediscount from Rs 10,000 to Rs 5,000. This was because it had received representations from its constituents that they were unable to avail of the discount facilities to the full because of the nature of their distribution network and the prevailing trade practices; both these made it difficult for them to avoid drawing of bills for amounts less than Rs 10,000. For example, in the textile industry, where despatches were usually in small lots, most of the bills covering sale of cloth were for values less than the minimum stipulated under the scheme. SBI suggested that while lowering the bill amount would lead to a sizeable increase in the number of bills discounted/rediscounted and consequently to higher administrative costs, it was necessary because a large segment of internal trade would otherwise not be covered by the new scheme. This, in turn, would necessitate the grant of credit by commercial banks either in the form of cash credit against receivables or usance bill limits outside the scope of the scheme. As the suggestion was obviously sensible, Hazari approved it as did the Governor. Yet, surprisingly, the minimum value of bills offered at any one time by a bank for rediscount by the Reserve Bank remained unchanged at Rs 10,000!

Even though bills pertaining to supplies made to government departments were not covered under the scheme, in July, the RBI, with a view to 'further enlarging the scope of the scheme', made eligible for rediscount with it the bills of exchange arising out of sale of goods to government departments and quasi-government bodies as well as statutory corporations and government companies, provided such bills conformed to the conditions of the scheme. But in spite of this and other initiatives to expand and reorient the scheme, it received very little response. As early as 28 November 1970, DBOD was noting that some of the nationalized banks, for unknown reasons, had not yet applied for limits under the scheme. The Reserve Bank then requested its officers and those of IDBI on the boards of nationalized banks to discuss the matter with the respective banks and ask them to refer any difficulties to the RBI.

A proposal to include export bills carrying long usance up to 180 days was examined by the Bank but was not found acceptable for various reasons. These bills were discounted by banks in India, after which they were forwarded to foreign correspondents for acceptance. On acceptance, the bills had to be retained abroad till maturity for payment. Further, Indian banks obtained refinance from the Reserve Bank against these bills on the basis of their declaration under the Export Bills Credit Scheme (Section 17(3A) of the RBI Act) at a concessional interest rate of 4.5 per cent per annum or at the rate linked to the respective bank's net liquidity ratio. In July 1971, Governor Jagannathan considered extending the scope of the Bills Rediscounting Scheme to all institutions—financial and otherwise. However, it was decided that transactions should be limited for the present only to financial institutions and that the question of widening it could be considered only when the Bill Market Scheme developed sufficiently well. In fact, in March 1973, when some banks were found permitting non-financial institutions to deploy their surplus funds in the new Bill Market Scheme, the RBI advised them that they should not rediscount bills of exchange or allow taking up of such bills by agencies other than Life Insurance Corporation (LIC), Unit Trust of India (UTI), the general insurance companies and other financial institutions approved by the Bank. Increasingly, it was becoming clear that the scheme was an idea whose time had gone. But efforts to keep it alive were not given up.

In December 1970, the Reserve Bank requested the Director General of Supplies & Disposals (DGS&D) to evolve a procedure for bringing bills drawn by suppliers to government within the purview of the Bills Rediscounting Scheme. But, as is often the case in such matters, the DGS&D was not very helpful. They took eight months to respond and then said that the existing payment mechanism did not give any scope for drawing bills of exchange facilitating payment on a future date unless it was drastically altered to a system of deferred payment. It also pointed out that the traders were likely to resist any change, and that the system of bills of exchange, even if it could be fitted into payment for government purchases through DGS&D, was unlikely to be an improvement over the present system.

The Effort Intensifies

The Bank, being keen that the Bills Rediscounting Scheme should succeed in giving a fillip to the growth of the bill market, wished to leave no avenue unexplored. The Thakkar Committee had pointed out how delays in payment of bills by the government imposed a considerable strain on small-scale entrepreneurs. So, in March 1971, the RBI wrote to the Department of Banking in the Finance Ministry proposing that public sector undertakings should take the lead by arranging acceptance of bills drawn on their banks in regard to the supplies of goods made to them or, alternatively, agree to opening of irrevocable letters of credit in favour of their suppliers whenever required.

Meanwhile, it turned out that Tata Engineering and Locomotive Company Ltd (TELCO) and Air India were reluctant to have bills drawn on them or to accept bills in respect of purchases made from their suppliers. So, in June, Hazari asked the Credit Planning and Banking Development Cell of the Secretary's Department to make informal enquiries about these two firms. It transpired that TELCO was not in the practice of accepting liability on purchases not paid for until the goods were inspected and accepted by it. Furthermore, the company normally availed of buyers' credit of about 30 to 45 days or more against purchases. However, its bankers, Central Bank of India and Bank of India, were in the process of negotiating with the company for introducing a system of usance bills of short duration being drawn on it by its suppliers. Air India's purchases mainly related to fuel from the Indian Oil Corporation and some other oil companies in the private sector and it usually enjoyed credit for about 30 to 60 days from the suppliers. The airline had not given any serious thought to settlement of claims on the basis of bills drawn on it.

Hazari wrote semi-official letters during April and May 1971 to the chairmen of leading public sector enterprises seeking their cooperation in the development of a genuine bill market in India, where bills could be purchased and sold according to the requirements of the institutions concerned. The chairmen were advised that although it was not the intention of the Reserve Bank to replace the entire system of lending by way of cash credit with the proposed system of bills of exchange, the Bank felt it necessary for some short-term finance that was provided by banks for sale of stocks through cash credit against the collateral of book debts to be disbursed in the form of discounting of bills of exchange.

The RBI was hopeful that the public sector undertakings would provide a substantial source of eligible bills for the market and thus give an impetus to popularizing the bill as an instrument of finance. But, once again, the responses were unenthusiastic. Basically, the public sector enterprises said that they were not convinced about what the Bank was asking them to do because of their diverse operational structures and varied perceptions about the practical utility of the revised bill scheme.

In a meeting with Jagannathan in late June, R.K. Talwar, SBI chairman, had asked whether the restriction that was applicable to the purchase of participation certificates by financial institutions would be equally applicable to bills. Hazari, who was present at the meeting, had responded that there would be no such restriction. Talwar, in a strongly worded letter written on 9 July, argued that the bill market by itself was not going to add to the volume of funds in the banking system. He opposed any arrangement whereby parties with surplus funds in the 'specified centres' could divert deposits from banks to purchase bills from banks and thereby earn a higher rate of return than permitted by the deposit rates directive of the Reserve Bank. 'In our social set-up,' Talwar observed, 'I would submit that it is the large body of small depositors that need the opportunity for a better return and not the large business houses or other wealthy parties with substantial idle funds.'

He also cited instances where parties were able to buy bills with maturities of between 90 to 180 days from other banks, namely, some of the foreign banks, at rates up to 7.5 per cent or even higher. This, he wrote, did not in any way augment the resources of the banking system but instead impacted on the system's liquidity requirement under the law or in terms of the RBI's directives. He concluded by saying that he had returned (from the meeting) with the impression that the Governor was going to have this aspect thoroughly examined and he 'requested' that this might be done early. The next day, Jagannathan noted that the matter would be discussed after he and Hazari returned from Calcutta. But it is not clear whether this was done or whether Talwar received a reply.

For some reason that will probably never be known, C. Chittibabu, MP, tabled a question in the Lok Sabha, on 18 June 1971, on the inter-bank call money market. He wanted to know if the LIC and UTI were diverting their deposits with banks to the inter-bank call money market, and whether this withdrawal affected the liquidity ratio to be maintained by the banks and also deposit mobilization by the banks. Y.B. Chavan, who was Finance Minister at the time, replied that from 3 June 1970 onwards, the Reserve Bank of India had permitted the LIC and UTI to receive interest on call and short notice deposits made by them with banks at rates ruling in the inter-bank call money market. He added that their withdrawal of deposits would not affect the liquidity ratio to be maintained by banks.

To another query, the Minister replied that as scheduled commercial banks could secure call and short notice deposits from LIC and UTI in the inter-bank call money market, the quantum of deposits with banks was not adversely affected. Banks, however, had to pay interest to LIC and UTI at inter-bank call money market rates, which were generally higher than the rates admissible on savings and short-maturity deposits. He also clarified that the entire issue was one of adjustment in income and expenditure between two wings of financial bodies, viz. scheduled commercial banks on one side and long-term financial institutions on the other.

A. Bakshi, Secretary in the Department of Banking, wrote to the RBI Governor on 19 June that some of the banks had strong feelings on the subject and that Parliament was also becoming 'curious' as well.

At a meeting with Talwar on 26 June 1971, Jagannathan opined that funds placed in the call money market did not amount to diversion of funds from bank deposits but were an addition to the resources of the market. RBI took the view that LIC and UTI need not be debarred from operating in the call money market, provided they agreed to a reasonable maximum rate of interest at which such funds could be placed. Talwar's reaction was that this amounted to the two institutions being treated as preferred entities and earning a higher rate of interest on surplus funds than was permissible to the general public under the RBI's interest rate regime, but 'if the authorities had made up their mind, we had nothing more to say'. He suggested that the matter might be discussed again after the maximum rate of interest had been determined.

A question also arose over the rates of discount charged by banks. B.N. Adarkar, who had been a Deputy Governor of the Reserve Bank and who had later become custodian of the Central Bank of India, sought clarification from Hazari. He said that the rates charged by commercial banks for discount of bills accepted by the Bank as well as for issuing the acceptances differed widely. He requested that the Bank should ascertain the facts from different banks and guide them as to the rates of discount and acceptance commission to be charged on this type of business. The Bank looked into the request but, eventually, Hazari decided not to respond to Adarkar's letter. The reasons were as follows.

No ceiling had been imposed on discount rates or acceptance commission, and, irrespective of what the banks charged by way of discount or acceptance commission, the RBI discounted the bills at the Bank rate. Moreover, none of the bills tendered to the Bank for rediscount had been accepted by a bank other than the discounting bank and mostly the same bank that had discounted the bill had also accepted it. A quick study of the bills rediscounted with the Bank at its Bombay office revealed that the banks did not charge uniform rates of rediscount on such bills, and that the discount rates varied widely from bank to bank and even from customer to customer in the same bank. The scheme having been introduced in November 1970, it was considered too early for banks to decide upon a firm policy in regard to the discount rates or acceptance commission that should be charged by them. It was also observed that when a bill was accepted by a bank it became a bank bill and the rate of discount to be charged by the discounting bank on such bills should not ordinarily exceed a reasonable limit, say, 2 to 3 percentage points above the Bank rate. But none of the banks had so far discounted a bank bill in the strict sense of the term. Therefore, the Bank was not inclined to intervene in the matter and decided to review the position at a later date, when the scheme achieved a fair degree of success. So Adarkar's query went unanswered.

Another question that arose was about what would happen to cash credit. Ever since the Bill Market Scheme had been revived, the RBI had been trying to persuade banks to change from cash credit to loans and advances. This led to the Executive Committee of the Maratha Chambers of Commerce and Industries, Pune, writing to ask what would happen to cash credit. The Bank explained that the intention was to curb, as far as possible, certain unhealthy practices that had crept into the cash credit system. But it reassured the Chamber that the system would not be done away with altogether, that the change would be brought about gradually, and that, where practical considerations warranted, cash credit facilities would continue.

Early in 1971, Andhra Bank had suggested that bills of exchange accepted by state financial corporations (SFCs) and the Industrial Credit and Investment Corporation of India (ICICI) should also be made eligible for rediscount by the Reserve Bank. But, under the State Financial Corporations Act, 1951, SFCs were not authorized to accept the bills. So the question of rediscounting bills accepted by them was ruled out. ICICI, when asked, said that its Articles of Association permitted it to engage in all activities connected to financing of bills and envisaged two situations where it could help: first, by accepting bills on behalf of its constituents who were the purchasers of goods; second, by endorsing or discounting bills drawn by sellers where they had to carry a heavy load of working capital financing as part of normal business requirement. It wanted to know if the Bank would be willing to provide rediscounting facilities for bills accepted and discounted by it.

In July, DBOD wrote back that ICICI was not a banking company and so bills accepted or discounted by it could not be directly rediscounted by the Reserve Bank and such bills would have to come to it through eligible banks. The alternative was to amend the Act. Even so, argued DBOD, the Bank would have to take a decision on rediscounting of bills discounted by ICICI, which was a term lending institution and not intended for short-term-lending by way of discounting short-term bills. While there was no objection to the Bank rediscounting bills accepted by ICICI, the issue for consideration was whether it would be in order for the banks to directly rediscount the bills that had been discounted by ICICI.

It was decided to ask the Economic Department, which did not see any objection to ICICI accepting bills on behalf of its customers, which could be discounted at finer rater and later on. ICICI could sponsor a specialized acceptance house for conducting this business. In any case, even if ICICI were permitted to discount bills of medium maturity, IDBI, rather than the Reserve Bank, could rediscount bills of that type because it was already rediscounting bills/promissory notes covering sale of machinery on a deferred payment basis. This arrangement could be extended to cover medium-term bills discounted by term-lending institutions.

The director of the Banking Division of the Economic Department agreed that ICICI might not take up discounting of bills of medium-term maturity but pointed out that the possibility of its seeking refinance from the Reserve Bank was not strong since it had surplus investible funds. It was also stressed that one of the objectives of the scheme was to replace cash credit as far as possible, rather than to serve as a substitute for long-term lending. Eventually, DBOD concluded that ICICI could offer eligible bills for rediscount by the Reserve Bank only after suitable statutory amendments had been carried out. DBOD also suggested that, as a matter of policy, the Bank should not, for the present, rediscount bills for any institution other than eligible banks so long as there was excess liquidity in the banking system and the Bank did not possess any powers of supervision and control over the functioning of ICICI. Jagannathan and Hazari agreed with this assessment and ICICI was suitably advised.

After an initial phase of decline during July and August 1971, the outstanding level of bills rediscounted with the Reserve Bank stood at Rs 25 crore at the end of September 1971. With the progress of the busy season, banks began to avail of rediscounting facilities and, by the end of March 1972, the level of outstanding was Rs 42 crore. As mentioned earlier, refinance facilities under the old Bill Market Scheme were continued to enable banks to meet the credit needs of the priority sectors, especially in respect of short-term lending to agriculture, credit to primary cooperative societies in selected states, and short-term lending to small-scale industries covered by the schemes of the Credit Guarantee Organization. Refinance in respect of bank advances for food procurement and distribution of fertilizers also were made available after June 1970. The requirement of having to lodge eligible bills with the Reserve Bank for availing of rediscount facilities and then taking them back three working days prior to their maturity was found to be irksome, as banks were prevented from rediscounting the bills for the full period of their usance. Further, the bills that were discounted by banks in their mofussil branches could not be offered for rediscount. So, with a view to avoiding delays and to reducing the work involved in delivering the bills to the Bank and taking them back, from November 1971, the Bank waived the requirement of actual lodgment of bills of individual face value of Rs 2 lakh and below, and authorized banks to hold such bills as its agent. The discounting bank would have to retire such bills three days before the date of maturity. In view of this relaxation, the minimum face value of a single bill was abolished.

Rediscounting facilities were extended to five more offices of the RBI (at Hyderabad, Patna, Nagpur, Kanpur and Bangalore) in November 1971. A bill of exchange drawn on and accepted by ICICI on behalf of its purchaser constituents singly or jointly was made eligible for rediscount under the scheme from April 1972, provided it was offered to the Bank by an eligible scheduled commercial bank. The resource position of banks during 1972–73 was comfortable and this was reflected in the low of level of bills rediscounted with the Bank. In its *Report on Trend and Progress of Banking in India* for that year, the RBI hoped that as banks were prepared to lend against bills rather than book debts or inventories, this scheme should become an important means of rediscounting. In 1973–74, the scheme gained 'remarkable' momentum, largely due to the tight resources position of banks.

Efforts to promote the bill of exchange as an instrument of credit were continued in the subsequent years but within the framework of a restrictive credit policy. Consequent to the exceptional credit stringency that prevailed during 1973–74, bills rediscounted under the scheme shot up and by the end of June 1974, total limits of Rs 365 crore had been sanctioned to banks. However, the Reserve Bank imposed some restraint on the rapid increase in utilization of the rediscounting facility, in the context of the tight credit policy in vogue. It allowed the enhancement of limits sought for by banks only on a selective basis and, that too, generally up to the end of June 1974. Further, the minimum rate of discount fixed for bills eligible for rediscount was raised from 8 per cent to 9.5 per cent in November 1973. From 17 June 1974, the minimum rate for bills rediscounted at the instance of drawees was raised to the same level as the prevailing minimum lending rate, viz. 11 per cent. The minimum rate of discount in respect of bills discounted for drawers remained at 9.5 per cent.

When the slack season of 1974 began, the Reserve Bank directed banks to reduce bills rediscounted so as to bring the limits to about 40 per cent of the existing level for the banking system as a whole. This resulted in a return flow of funds to RBI. The banks were advised that rediscount limits would henceforth be sanctioned on a six-monthly, not annual, basis. Even though the Bank continued to announce its preferred position of promoting a genuine trade bill market and the use of bill financing in preference to the cash credit system as an objective of long-term policy, it was concerned at the instances of misuse of bills for circumventing the rigours of credit control. The Bank made a distinction between drawees' bills and drawers' bills, with a higher minimum rate for the former. It also stipulated, in June 1974, that the rate of interest on drawees' bills should be on par with the rate of interest on cash credit accommodation extended to the same borrower, thereby preventing bill finance for inventory purchase being cheaper than that under the cash credit system.

Banks were granted basic bill rediscount limits equal to 10 per cent of their inland bills purchased and discounted as at the end of September 1976. The Reserve Bank announced in May 1977 that limits aggregating Rs 133 crore would not be valid beyond the end of June 1977 and additional rediscount accommodation would be sanctioned at its discretion after detailed discussion with the banks concerned. The rates of rediscount in respect of these limits ranged between 10 and 12 per cent, depending on the size of the limits. Additional limits sanctioned during the year ended March 1977 were lower, at Rs 96 crore, as compared to the previous year (Rs 137 crore). The bill rediscounting facility to banks was placed on a discretionary basis from June 1977. In spite of restoration of normal conditions in the banking sector, the bill rediscounting limits at Rs 118 crore in June 1979 were lower as compared to Rs 187 crore in June 1978. Gradually, the Bank reduced the availment of funds under the scheme; during the year 1981–82 (July–June), no fresh limits were sanctioned to banks and there were no outstandings after October 1981.

The RBI had been trying to persuade banks to change from cash credit to loans and advances. However, due to practical considerations, cash credit facilities continued. It was perceived advantageous both to the seller and the purchaser if a bill of exchange was used more for settlement of trade transactions as also as an instrument of credit in that connection, thereby helping the creation of a genuine bill market in the country.

CREDIT AUTHORIZATION SCHEME AND INVENTORY NORMS

It is one of the features of the management of anything—from a small factory to monetary policy—that crises, small or big, lead to special measures involving discretionary permissions as a way of dealing with immediate problems. This is not a matter for concern. But what is a matter for concern is what happens to such special measures once the crisis is over; how quickly does the system revert to automaticity from discretion? The Credit Authorization Scheme (CAS) of 1965 provides an illuminating example. It marked the beginning of credit regulation and it held sway for over two decades. This section traces its course.

During the 1965–66 peak season, there was severe stress on the economy that culminated in worrying inflationary pressures. The Reserve Bank thought it would be prudent to restrain credit and that there was an imperative need to preserve a 'reasonable balance between aggregate monetary flows and the availability of real goods and services'. So a set of regulatory measures were adopted in the credit policy announcement for the busy season of 1965. It advised all scheduled commercial banks that, 'in order that the growth of bank credit may be more closely aligned to the requirements of the Plan and as an additional measure of credit regulation', they would be required to obtain the Bank's authorization before sanctioning any fresh working capital credit limit (including commercial bill discounts) of Rs 1 crore or more to any single party, or any limit that would take the total limit enjoyed by such a party from the entire banking system to Rs 1 crore or more on secured and/or unsecured basis.

Between 1965 and 1981, in keeping with the changing profile and needs of the economy, the scheme was significantly modified. The 1982 review committee categorized the changes into four distinct phases.

The first phase lasted till 1970. The Bank's role, in this phase, was confined to satisfying itself, through a brief scrutiny of the banks' applications, about the purpose of the advances and, in the process, monitoring the facilities allowed. The idea was to exercise a measure of restraint on bank lending to large borrowers so that they did not pre-empt the available resources. The emphasis was on preventing excessive lending to large units or business groups taking advantage of their close links with particular banks. There was, however, no method either of precisely assessing the credit needs of borrowers or ensuring the end-use of the funds by them.

During the second phase, from June 1970 to mid-1975, the RBI sought to introduce a more organized approach towards assessment of the credit needs of large borrowers. It also sought to streamline banks' decision-making on the proposals. It prescribed, for the first time, a set of forms in which certain essential data were to be obtained by the banks from borrowers seeking credit facilities covered by CAS. This modified mechanism enabled the banks to critically appraise the borrowers' credit requirements, and worked towards prevention of stockpiling and diversion or siphoning of funds for intercorporate investments or for lending to sister concerns.

The third phase commenced with the acceptance by the Reserve Bank of the recommendations of the Study Group to Frame Guidelines for Follow-up of Bank Credit (Tandon Committee) in mid-1975. There had been a steep rise in the demand for bank credit that was clearly unrelated to increases in production. Meanwhile, inflation reached unprecedented levels during 1973–75. So it became necessary to correlate the credit demand to business/production plans, as also the borrowers' own resources. The latter included long-term funds at their disposal. As a result there was a perceptible shift from a 'security-based' approach to a 'need-based' approach towards bank credit. The Tandon Committee recommendations proposed assessment of the credit needs of borrowers on the basis of certain norms linked to holdings of inventory and receivables, and working out the maximum permissible quantum of bank credit on the basis of prescribed methods besides supply of follow-up information by borrowers to banks. This phase lasted till about the end of 1980. Concepts like net working capital and acceptable minimum current ratio were adopted, and the role of a bank in financing working capital needs was defined in clearer terms.

Phase four commenced in December 1980 with the adoption by the Reserve Bank of most of the recommendations of the Working Group to Review the System of Cash Credit (Chore Committee). This sought not only the continuation but also a strengthening of the discipline introduced during the third phase. A brief note recorded by Governor L.K. Jha, on 29 June 1968, set the tone.

> It has been represented to me that the requirement that advances exceeding Rs 1 crore should receive the prior approval of the Reserve Bank should be waived in the case of packing credits for export. The point made was that these are short-term advances for an unquestionably good purpose and even the few days that may be necessitated in getting RBI clearance may well be vital for the execution of an overseas contract.

The larger point was clear, namely, that the rules would be changed if they were getting in the way.

The DBOD (Credit Authorization Scheme) objected. It wrote that banks usually applied for authorization of packing credit limits along with other credit limits such as cash credit/overdrafts/loans, term loans, bills purchase/discounting facilities, etc., and that banks sanctioned packing credit either against the security of stocks or on a clean basis. Further, although advances under packing credit limits were granted for periods not exceeding 180 days, such limits were usually sanctioned for a specific period, say, six months or one year, on a regular basis. The requirements for finance were estimated on the basis of past export performance and expected business in the ensuing year well in advance, and credit limits were sanctioned accordingly. These facilities were not generally availed of immediately after sanction but were utilized according to the borrowers' requirements over the period covered by the sanction. DBOD, therefore, insisted that the few days involved in obtaining the Bank's authorization were of no material significance and that, in cases where the banks approached for sanction of additional/fresh limits for financing urgent export commitments, authorizations were accorded expeditiously and at times even on the very day of the receipt of the application. The DBOD's note concluded that the existing procedure might continue. This was clearly a case of a regulator not wishing to give up power. But Adarkar was not convinced. He wrote back that 'despite what has been stated in the note above, I think we should exempt packing credit advances from the procedure for prior authorization of limits of Rs 1 crore or more. I would also recommend similar exemption for post-shipment advances for exports.' This was approved by the Governor in July and instructions were issued. Later, with effect from July 1974, pre-shipment advances above Rs 5 lakh were brought under CAS, in the wider perspective of addressing inflationary pressures.

THE ISSUE OF COMMON DIRECTORS

There was another ticklish issue that had been festering for long, which had to be resolved. This was the issue of common directors between banks and borrowers. In 1968, when the Banking Laws (Amendment) Bill, 1967, was being considered by Parliament and the Select Committee, the question of approving credit facilities during the interim period to big business houses—many of which had common directors with the financing banks—came to the fore. Under clause 5 of the Bill, which sought to amend Section 20 of the Banking Regulation Act, 1949, banks could not, after the amendment came into force, grant any loans or advances to, or give or renew any guarantee on behalf of any company of which any of the directors of the banking company was a director, managing agent, etc. Meanwhile, the DBOD, while dealing with applications received from banks under the CAS where the banking company and the borrowing institution had common directors, started stipulating that the increased facility allowed should be liquidated before the amended Act came into force or within a short period of, say, two months thereafter. Some of the cases that came under this category were Punjab National Bank's advances to the Delhi Cloth and General Mills Co. Ltd and to Mukand Iron and Steel Works Ltd; and SBI's advances to Rallis India Ltd, Andhra Pradesh Paper Mills Ltd, Gobind Sugar Mills Ltd, etc.

This measure gave rise to differing interpretations from the banks. SBI sought clarification on two points. It wanted to know whether the Reserve Bank stipulation regarding recovery of the increased facility granted before the amending Act came into force or within a short period thereafter, without availing of the grace period that might be provided in the Act, would still be applicable if the director in question vacated that post either in the bank or in the borrowing company. It further pointed out that the amending Bill as introduced in the Parliament—to which certain further amendments were being considered but had not yet been finalized—stipulated that where any loan granted before the commencement of the said Act was such that the loan could not have been granted if it were in force on the date of granting the loan, then steps should be taken to recover the loan within the period stipulated for repayment or within a period of three years from such commencement, where no period had been stipulated for repayment of the loan. The amending Bill further provided that if the loan was not repaid within the specified period/grace period, the concerned director of the bank would cease to hold that post.

SBI argued that the provision implied that if the concerned director ceased to be a director of either the borrowing company or the bank before commencement of the amending Act, the advance in question need not be repaid. In response, DBOD said that the specific stipulation made by the RBI in its authorization letters was not based on strict legal grounds but intended to ensure compliance with the spirit of the proposed provisions.

The second query presumed that the above stipulation contemplated only the recovery of such amount drawn as would be in excess of the limit in force prior to the sanction of the additional limit, with which the DBOD was also in agreement.

The points raised by SBI were referred to the Legal Department for comments. Concluding a detailed interpretation of the specific provisions of the proposed Bill in respect of the first point, the Legal Department wrote:

> The State Bank and the borrowing company had a common director. In these circumstances Reserve Bank, while granting permission for increase of the limit beyond Rs 1 crore, stipulated that the banking company should undertake 'to liquidate the increased facility' not later than two months after the date when the amendment Act comes into force, instead of seeking to avail of the three years otherwise permissible under Section 20(2) as proposed to be amended. As the stipulation was made in the light of Section 20(2), it is clear that it has reference only to the facts as they stood on the date on which the further facility was granted by the State Bank of India to each of the borrowing companies; and, changes in those facts subsequent to that date are irrelevant. Consequently, if, on the date when the increased facility was granted, there was a common director between the State Bank and the borrowing company, the stipulation applies; and it continues to apply to such facility, unaffected by the fact that, subsequent to the date when such facility was granted, the common director may cease to be such. The position holds good even if the common director ceases to be such before the date of commencement of the amendment Act (so long as such cessar is after the grant of the facility in question.).

As regards the extent of the credit facility to be recovered, the Legal Department ruled:

> By the stipulation made by the Reserve Bank and accepted by the borrowing bank, this period of three years was, by agreement, reduced to two months. It will thus be seen that the stipulation for recovery within the specified period relates to the recovery of the loan which could not have been made, if the amended section had been in force. Consequently, 'the increased facility' referred to in paragraph 2 in the letters to the State Bank mentioned above, applies to the entire amount of the increased facility granted by the State Bank to each of these companies, in pursuance of the increase of limit permitted by the Reserve Bank. There is no warrant for construing it as limited to the amount of the facility in excess of such limit, as could have been granted by the banking company at the time when it applied to the Reserve Bank for increasing the limit.

The State Bank of India was accordingly advised on the matter.

Various other references were made by banks in relation to the Banking Laws (Amendment) Bill that was being examined by the Select Committee. Most of these cases had to be referred to the Legal Department. In an interesting interpretation of the legal implications of the amending provisions under Section 20 of the Act, in February 1968 the Legal Department held that in light of the definition then proposed of the expression 'director' as including a member of any board or committee constituted by a banking company for the purpose of advising it in regard to the management of its affairs, and as the powers of members of the local board of the State Bank were not limited to advising the State Bank in regard to the management of the affairs of the bank but extended to managing a certain part of the affairs of the bank, they were not considered to fall within the definition then proposed of the term 'director'.

However, the definition of 'director' finally proposed by the Reserve Bank included members of advisory committees as also members of bodies entrusted with the management of the whole or any part of the affairs of banks. But the Select Committee had stopped with the words 'in regard to the management of its affairs'. The result was that the later part of the definition, dealing with a member of a committee constituted for dealing with the whole or part of the affairs of the banking company, was left out. Further, according to the Legal Department, the wording 'director means' (and not 'includes') had resulted in the anomalous connotation. The Legal Department, in its note dated June 24 on the subject, concluded:

> No doubt it may be argued that as the revised definition defeats the object with which the section was in the Act, and for which it is now being amended, the term 'means' shall be read as connoting 'includes'. Where the language of a statute, in its ordinary meaning and grammatical construction, leads to a manifest contradiction of the apparent purpose of the enactment or to some inconvenience or absurdity, hardship or injustice, presumably not intended, a construction may be put upon it which modifies the meaning of the words, and even the structure of the sentence. (Maxwell—11th Edition—page 221). Hence the definition may have to be construed, so as to avoid leading to an absurd result, as saying that in addition to members of boards or committees exercising executive functions, members of boards or committees set up for tendering advice are also to be regarded as directors. On such interpretation, a member of a

> Local Board of the State Bank would also be 'director' under the revised definition. In the circumstances aforesaid, a member of the Local Advisory Committee of a bank as also a member of a Local Board of the State Bank would be regarded as a 'director' within the meaning of Explanation(b) to Section 20(4) (as proposed by the Select Committee).

The Reserve Bank later issued a circular based on the above interpretation. As a result, when banks forwarded applications for CAS approval they had to, in addition to providing information as to whether any director of the bank was interested in the borrowing concern, also indicate whether any member of the bank's local board/advisory board/local advisory committee was interested. In a consequential development in January 1969, SBI forwarded a list of several of their directors/local board members who had tendered their resignations from the respective forums. These were accepted. SBI requested that as these directors/members were interested in the companies to which advances were granted under Reserve Bank authorization, the cessation of their association with the bank in these capacities should pave the way for withdrawal of the Bank stipulation regarding premature repayment of the loans and advances. This was in the context of the proviso to Section 20(2) of the Banking Regulation Act, 1949, as proposed to be introduced by the Banking Laws (Amendment) Act: that the subsection did not apply if and when the director concerned vacated the office of the director of the banking company, whether by death, retirement, resignation or otherwise. The Bank responded positively and after obtaining legal opinion on the matter, took decisions in individual cases.

Another reference made to the Legal Department related to the nature of bills purchased and discounted transactions vis-à-vis the term 'loans and advances'. The question whether purchase/discount of bills by a banking company would be prohibited, in terms of the proposed amendment to Section 20 which, *inter alia*, precluded a banking company from granting loans or advances to a company in which any of the directors of the banking company was director, managing agent, manager, employee or guarantor, or in which he held substantial interest, was examined by the Legal Department in February 1968. It held that the purchase or discount of bills simplicitor might not amount to making of a loan or advance because the transaction in each type of case would give rise to different types of obligations and rights, and that if the transactions were really discounts or purchases, they could not at the same time be loans or advances. Accordingly, DBOD treated purchase/discount of bills as not covered by the term 'loans and advances' used in Section 20(1)(b) of the Banking Regulation Act under amendment.

THE ISSUE OF DEFINITIONS

Definitions could also become a problem sometimes. There was, for example, a proposal to define the term 'credit facilities', which was intended to be used in place of 'loans and advances'. The idea was to cover purchase, negotiation and discount of bills of exchange. But it was subsequently decided to leave out bills for the time being and to make the definition more flexible by providing that the term would include such other credit facility as the Reserve Bank might, from time to time, specify. So the Select Committee did not replace the term 'loans and advances' with the term 'credit facilities'. It also did not make any specific reference to bills purchase/discounting facilities in Section 20 of the Act but added a clause providing that if any question arose whether any transaction was a loan or an advance for the purpose of Section 20, it should be referred to the Reserve Bank, whose decision shall be final.

Here it is worthwhile recalling the interpretation contained in the Legal Department's note on the nature of bills purchased/discounted facilities. It had held that when a bill of exchange was purchased or discounted in the real sense of the term, there was no relationship of debtor and creditor between the party and the bank (the obligation of the party arising only in the event of dishonour of the bill by the drawee). No doubt, in the event of the bank being unable to realize the amount from the drawee, it would have recourse against the customer, but this still did not involve the making of a loan or advance by the bank to the customer, which was prohibited by Section 20 of the Banking Regulation Act.

In 1969, a series of exemptions were afforded under the CAS on various grounds. A note recorded by Adarkar on 24 January 1969 pointed out: 'In view of the importance of fertilizer distribution and in fact that delay in authorization may result in fertilizer not reaching the cultivator in time, we should urgently examine the desirability of exempting limits for fertilizer distribution from prior authorization procedure.' The decision was conveyed to banks through a DBOD circular dated 27 January 1969. Later, in April 1969, instructions exempting 'credit limits against fixed deposits' were also issued to the banks.

A couple of piquant issues came to the fore when some banks sought the Reserve Bank's clearance for advance proposals even before they were placed before their own boards of directors. The Bank's stand was made clear on two major issues: first, while it was for the Bank to approve of or disagree with the board's decision, it was not for it to assume any primary responsibility for processing the proposal: second, the Bank would not to assume responsibility for the safety of the advance. The matter was discussed at the conference of regional heads of DBOD in November 1968, where Adarkar indicated that the Bank's clearance should be sought by banks only after the advance proposals had been approved by their own boards of directors. However, this stand had to be diluted in the case of the SBI and its subsidiaries in view of their internal regulations and well-set procedures for sanctioning of advances, and on the assumption that the proposals were initially approved by the SBI at the level of managing directors. In the case of these banks, while conveying the Bank's authorization, it was specified that the same was subject to the proposal being sanctioned by the competent authorities of the banks.

In the monthly list of cases put up to the Governor in March 1969, Adarkar pointed out that the question of exempting certain categories of credit facilities should be examined so as to minimize the workload under the CAS. After a detailed examination of various credit facilities/practices, a circular was issued to banks in May 1969 exempting the following from the purview of CAS.

(i) Transfer of limits from one bank to another not involving any increase.
(ii) Extension of time for limits sanctioned for a temporary period and authorized by the Reserve Bank earlier (provided the proposed extension of time was only up to an aggregate period of one year from the date of original sanction of the limit and such extensions did not conflict with the provisions of the Banking Regulation Act, 1949, especially Section 20).
(iii) Advances to state governments, the Food Corporation of India and state cooperative banks for financing of food procurement operations.
(iv) Advances granted to state electricity boards and public sector undertakings, and those granted against guarantees of the central and state governments.
(v) Advances against government and other trustee securities.
(vi) Limits against government supply bills.
(vii) Bill limits sanctioned under the rediscounting scheme of the IDBI and term loans sanctioned on a *pari passu* basis with the IDBI or the ARC, or under their refinancing schemes.

While these exemptions were afforded mainly on the basis of felt needs, the primary intention was to minimize the workload of the Section dealing with CAS matters. An interim assessment of the scheme from November 1965 to January 1968, in fact, showed that of the 2,436 applications received from banks for authorization of credit limits sanctioned/enhanced by them and falling under the purview of the scheme, 2,353 were authorized and the remaining rejected/withdrawn by the banks concerned. The increase in the number of applications seems to have prompted Jha to comment, in the case of a rejected application referred to him according to the old practice: ‘I feel that the practice of putting up all rejection cases to the Governor should be discontinued and the DG should pass final orders. However, when my successor joins, he may consult him on this matter again.’

As the turn of events would have it, the Deputy Governor became the next Governor. In May 1970, Jha’s observations were submitted to him for his comments, to which he responded: ‘I would not like the old practice of referring all rejection cases to the Governor to be revived. I would rather like the DG to consult the Governor, in particular in cases where he thinks such consultation to be advisable for any special reason.’

In August 1969, some more relaxations were allowed in the scheme according to which prior authorization from the Reserve Bank was not to be obtained by banks for sanction of the purchase/discount of inland documentary bills and limits against supply bills drawn on semi-government bodies. 1970 marked the end of the initial phase of the scheme and heralded the ushering in of a more organized and practical method of assessing the credit needs of large borrowers. In June that year, the Bank prescribed a set of proforma statements to be submitted while applying for prior authorization. The statements were designed to provide both to the lending bank and the Bank ‘as complete and comprehensive a set of data as possible to permit a proper evaluation and financial appraisal of credit proposals’. They included particulars of the existing limits from the banking system, a statement of assessment of the working capital requirements and bank finance permissible, and a comparative statement of financial position (which included financial summary, analysis of balance sheet, income statement, balance sheet reconciliation, and analytical and comparative ratios). In the case of proposals for grant of term loans, banks were asked to submit additional information in the form of a cash flow statement and a statement showing the total cost of the project and sources of finance. It was also emphasized that banks should endeavour to obtain the data indicated in the proforma statements not only for furnishing the Reserve Bank with complete information with regard to proposals for limits relating to parties enjoying credit facilities from the banking system as a whole to the tune of Rs 1 crore and above (which were covered by the scheme), but also for their own purposes in respect of appraisals for large individual credit proposals of, say, Rs 25 lakh and above. It was pointed out that although the discipline sought to be imposed might not be appreciated by the borrowers, and possibly even resented by them, it would be in the best interest of the banking system that steps were taken in this direction so that credit appraisal might be placed on a more organized footing. In cases where authorization was related to credit facilities to be granted by several banks on a participation basis, it was suggested that the banks concerned might designate one of the participating banks as a 'lead bank' for dealing with the Reserve Bank. The banks were, *inter alia*, cautioned that they should consider the collection of data in these statements not as an end in itself but as a tool for taking judicious decisions on proposals for credit facilities. The forms were thus not to be considered as substitutes for analysis and judgement based on the financial acumen and expertise acquired in the operational field. The data called for by the Reserve Bank for an 'account by account' scrutiny in the case of large borrowers did not fail to attract special media attention. *The Economic Times* dated 15 July 1970 reported: 'The information sought is so comprehensive that one banker commented: "It would now be easier for a camel to pass through the eye of a needle than for a big borrower to hoodwink the authorities."'

In an important case, the legal enforceability of the requirement of obtaining prior approval from the Reserve Bank was put to test. The First National City Bank had granted a medium-term advance to M/s Indian Express Newspapers (Bombay) Ltd without obtaining the necessary Bank approval under CAS. The question whether the RBI could direct the bank to recall such an advance was examined by the Legal Department in July 1970. After commenting on the scope of the relevant provisions under Sections 21, 35A and 36 of the Banking Regulation Act, 1949, the Legal Department finally concluded:

> Failure, on the part of the lending bank, to take the approval does not detract from the validity of the contract (of lending and borrowing) between the bank and its customer. There is, therefore, no means of requiring the bank or the customer to treat the said contract as non-existing and calling on them to recall (or repay) the loan before it becomes due.

Reviews of the exemptions/relaxations granted under the scheme were undertaken as and when the circumstances warranted. While studying why there had been large rise in credit expansion to public sector enterprises by the SBI, Hazari raised an important point in August 1970: 'The merits of these particular cases apart, I feel that government companies should also be brought within CAS for prior authorization.' As a result, the exemptions granted in May 1969 in respect of advances to state electricity boards and public sector enterprises, and those granted against guarantees of central and state governments came to be reviewed. A note dated 24 August 1970 said that the block requirements of projects which had been approved by the Planning Commission should primarily be met by the central/state governments out of their resources, and other suitable projects could, if the need arose, be financed by the IDBI and other term-lending institutions. Typically, the note said that there was no justifiable reason for commercial banks to lend to these projects. Alluding to external interference, it also noted that in respect of projects which did not have the Planning Commission's approval, the possibility of the concerned state governments pressuring the banks, particularly those with a pronounced regional presence, could not be ruled out. Hazari agreed and a draft circular was prepared. But when it was discussed with Jagannathan a different message came though and the matter was shelved for the time being. It took almost three years for it to be resurrected. It is worth noting in passing that the general election was held in March 1971 and assembly elections a year later.

But things could move in the other direction also. In May 1971, the purview of the scheme was extended to cover the segment of term-lending for the first time. The circular issued on 20 May 1971 advised banks that they should obtain the Reserve Bank's prior authorization under CAS for sanctioning, singly or jointly with other institutions, individual medium or long-term loans exceeding Rs 25 lakh, repayable over a period of more than three years, to any single party irrespective of the total credit limits available to it from the banking system as a whole.

The Indian Banks' Association, in a letter dated 7 July 1971, raised the issue of CAS approval for sanction of limits for acceptance on behalf of customers and sanction of limits for discount of bills that fulfilled the requirements under the Bills Rediscounting Scheme. Although the existing instructions and the clarifications were clear, it was decided to issue a formal circular on these issues clarifying that the limits for discounting accepted bills that were not accompanied by the documents of title to goods, as also the limits for negotiation of local usance bills accompanied by only invoices or challans, sanctioned to parties covered by CAS, required Reserve Bank's prior authorization. However, the limits for acceptance of such bills were kept out of the purview of the scheme, with the proviso that for the purpose of computing the total credit limits available to a party, limits for acceptance facilities sanctioned to it should also be taken into account. This was followed by a series of exemptions from prior authorization afforded under the scheme and put into effect in September 1971, viz.:

(i) Bills discounting limits in lieu of cash credit/overdrafts specifically authorized by RBI, not resulting in any increase in the overall limits.
(ii) Reallocation of limits within the overall working capital limits provided it did not result in waiver of any specific condition stipulated by RBI. However, reallocation of limits from exempted category to non-exempted category continued to be subject to prior authorization, unless it was of a purely temporary nature.
(iii) Occasional negotiation of bills, bank drafts or third party (outstation) cheques.

Three months later India was at war with Pakistan, and the Reserve Bank made certain special relaxations.

> In the context of the war situation, it is necessary that the banks meet, on a priority basis, any increase in the financial requirements of industry to manufacture and supply goods for the defence effort as well as to augment production in general and ensure smooth distribution of goods particularly in the border areas.

Another circular issued on 11 December 1971 exempted 'defence packing-cum-supply' credit limits granted by banks, on merits, against confirmed defence orders or acceptance of tenders, from the purview of CAS prior authorization. Further, for the purpose of sustaining and increasing production in all spheres, banks were allowed at their own discretion and on merits to permit enhancement of credit limits in the case of CAS parties, up to a maximum of 15 per cent, without prior approval from the Reserve Bank. Subsequently, in January 1972, an office note was put up explaining that the Bank had been exempting certain credit facilities from CAS prior authorization mainly because these facilities were for unquestionably good purposes, or because the grant thereof would not result in additional accommodation, or because the proposals concerned had already been examined by IDBI/ARC, or to popularize the Bills Rediscounting Scheme, etc. The note further suggested certain additional exemptions which were approved by the Governor on 1 January 1972. A circular was issued on 7 January 1972 indicating that the following credit facilities were exempted from CAS:

(i) sanction of credit limits up to Rs 10 lakh for periods not exceeding three months;

(ii) where application for enhancement in limits in excess of Rs 10 lakh was pending with RBI, banks might release an interim limit up to Rs 10 lakh;

(iii) purchase of third party (outstation) cheques/bank drafts;

(iv) advances against the security of inland documentary bills (demand documentary bills or usance bills drawn on D/P basis) received for collection;

(v) restoration to the original level of a limit authorized by RBI but reduced by the bank itself;

(vi) credit limits sanctioned to a party in replacement of its limits with another bank as a result of which during the intervening period, i.e. till the accounts with the existing bank were adjusted, the total limits of the party aggregate/exceed Rs 1 crore;

(vii) temporary excess drawings not exceeding 5 per cent or Rs 10 lakh, whichever is lower, over the sanctioned limit and advances against uncleared effects;

(viii) credit facilities for purchase/discount of bills/third party (outstation) cheques/bank drafts on an 'ad hoc' basis.

Some of these exempted facilities were reviewed and enhanced subsequently in December 1972: viz., the sanction of temporary limits up to Rs 25 lakh for a period of three months; interim accommodation up to Rs 25 lakh (where application for enhancement is made to the Reserve Bank of India and is pending authorization for a higher limit); and temporary excess drawings over the sanctioned limit up to 10 per cent or Rs 25 lakh, whichever was lower.

DIVIDENDS AND FOREIGN COMPANIES

An interesting issue that came up was the distribution of dividends by the foreign companies. Many of them drew on their reserves for this. The matter was initially discussed under correspondence between the Exchange Control Department (ECD) of the Bank and the government, but then it was referred to DBOD in December 1971. The question of excessive dividends declared by certain foreign-controlled companies out of their reserves was taken up by the Finance Ministry, which suggested that so long as the foreign-controlled companies distributed reserves as dividends they should not be permitted to raise finance from banks or other financial institutions. The ECD examined the issue and concluded that no change should be made in the criterion for clearing applications from banks for sanctioning credit limits to these companies, viz. that the debt–equity ratio should not exceed 2:1. The government apparently did not have an objection to these companies drawing upon their reserves for payment of dividends and advised that the ECD might continue to follow the procedure then in existence. However, it felt that at least the facility of having new borrowing limits sanctioned to such concerns, or an increase in their existing limits, should be denied until they had rebuilt the reserves that had been brought down for declaring heavy dividends. The government agreed to the ECD's suggestion that this could be done under the CAS.

DBOD, too, had its views on the matter. It wrote that if these companies desisted from declaring excessive dividends to be paid out of their reserves, their reliance on bank borrowings in India, as also the remittance of dividend amounts abroad, would, to that extent, be less. On the other hand, if they preferred to declare excessive dividends and draw upon their reserves, knowing fully well that their working capital requirements were also increasing, the government would be justified in concluding that their only intention was to take funds out of India. Also, these firms were perhaps emboldened to declare excessive dividends and take funds out of the country because of the easy availability of bank credit to them, mainly from foreign banks. The note, therefore, suggested that an effective check should be introduced to curb this tendency and that, as a matter of policy, the Reserve Bank should decide that where it was found that a foreign-controlled company seeking additional bank credit had declared unduly high dividends and had drawn upon reserves for the purpose, the additional bank credit sought should be denied to it till the reserves were rebuilt from its future earnings. This decision was later put into operation as part of the Credit Authorization Scheme.

BANKS AND SEBs

In mid-1972, there was a strong proposal to raise the cut-off point from Rs 1 crore to Rs 2.5 crore, on the argument that after the introduction in June 1970 of a comprehensive set of forms, the credit appraisal system in banks had been put on a strong and uniform footing. It was further pointed out that the economy had been developing well in many sectors. So the resources of banks were reasonably comfortable and the total bank credit was twice the size of that in 1965, when CAS was introduced. Out of the 1,000 and odd borrowers covered by the scheme at that time, those enjoying credit limits of up to Rs 2.5 crore were roughly about 500. The proposal was submitted to Jagannathan by Hazari and the former suggested that the cut-off point be fixed at Rs 2 crore instead of Rs 2.5 crore. He also said that the government should be consulted in the matter. So, in May 1972, separate letters were sent to I.G. Patel, Secretary, Department of Economic Affairs, and V.M. Bhide, Additional Secretary, Department of Banking. DBOD had also prepared, in the meanwhile, a draft circular for issue to the scheduled banks. The proposal was shelved.

But it would not go away. The related circular dated 17 March 1973 stated:

> In recent times, there has been a sizeable increase in the borrowings by various public sector and quasi-government undertakings. Advances to such units have hitherto been exempted from prior authorization of the bank under the Credit Authorization Scheme. All advances to public sector undertakings, including state electricity boards, as also advances against the guarantee of central or state governments will now come under the scheme. Prior authorization in respect of such advances will be needed for working capital loans totalling Rs 3 crore and above, and for term loans of Rs 1 crore and above.

How did this about-turn come about? In the end it was because of the excesses of the state electricity boards (SEBs). The Department of Banking studied the persistent demands of the SEBs for funds from nationalized banks and on 11 December 1972 its note to them on bank credit was forwarded to Hazari by V.M. Bhide, Additional Secretary, Department of Banking. The note dwelt at length on various aspects of the Plan outlays for operations of the SEBs, as also the avenues for bank finance to supplement these efforts, such as medium/long-term loans for financing specific programmes rather than as subscriptions to the open market debentures floated by the SEBs, bridge finance to meet advance payments, working capital requirements and finance for rural electrification programmes. As regards medium/long-term credit, the note made a simple but effective point: the circumstances under which and extend to which banks should extend credit for meeting a part of the outlay on power programmes were matters for the Planning Commission to decide in consultation with the Department of Banking. The note said that bank credit, excluding the proposed term-lending, ought to be brought under CAS.

These issues raised were examined by the Credit Planning Cell of the Bank and a copy of the note prepared by the cell was sent to Bhide by Hazari on 29 January 1973.

> The point is not adequately appreciated that the country now faces a power famine of serious dimensions and that further

> development hinges on the build-up of this vital infrastructure. This situation happens to coincide with one of adequate liquidity in the banking system. Even if this were not so, there would seem to be a case for involving banks to a greater extent in the financing of electricity projects. In the present circumstances, it would be little short of gross negligence to allow power schemes to languish for want of finance while banks are unable to find outlets for their resources. The alternative left for putting through the schemes would be through provision of governmental finance—which could mean, ultimately, recourse to the Reserve Bank. It would obviously make more economic sense to allow the turn-over of existing liquidity than permit further deficit financing.

As regards bringing the bank credit to state electricity boards under the purview of CAS, it was pointed out that

> the distinction drawn in the note between term loans to State Electricity Boards (which would require clearance from the Banking Department and the Planning Commission) and working capital and bridging loans (which would require Reserve Bank clearance) is somewhat ambivalent. A good portion of the so-called working capital now being provided is in actuality utilized to meet medium and long-term requirements. If it be conceded that lending to State Electricity Boards is desirable in the present context, then what is necessary is an evaluation of each proposal taking into account not only the financial prospects but the overall portfolio of the lending bank and the position of the concerned Board and the power requirements of the state as well. This could be done in an integrated manner in the bank, not just under the Credit Authorization Scheme but from the angle of overall credit planning.

Bhide, Jagannathan and Hazari met in Bombay to discuss these issues. Later, the Finance Minister, the Finance Secretary and senior officers of the Department of Banking were also consulted. Eventually, the Finance Ministry suggested a specific course of action, which was conveyed to the Governor by Bhide in a letter dated 1 March 1973.

(i) Bank finance for implementation of power programmes should take the form of increased subscription to open market loans floated by the boards and not be direct loans to individual boards in financing specific projects; banks may, however, extend credit directly for rural electrification programmes related to energizing tube wells or pump sets.

(ii) Banks could extend short-term accommodation to meet working capital requirements, bridging requirements and ways and means requirements.

(iii) The credit requirements of electricity boards, as well as of other public sector undertakings should be brought within the purview of the Credit Authorization Scheme.

The next credit policy announcement, in March 1973, therefore included the stipulation that CAS was applicable to advances to all public sector undertakings including SEBs, with cut-off points as indicated above. The attempts by some states to take recourse to these borrowings in an effort to circumvent the restraint placed by the Planning Commission on their access to market funds for budgetary and other requirements were under scrutiny. An article titled 'States' bid to by-pass RBI curb', which appeared in the *Economic Times* dated 28 August 1973, provided some valuable insights.

> At least three of the 20 State Governments which completed their market borrowing programme for 1973–74 today, with substantial support from the scheduled commercial banks, are pressing the banks for term loans.... Maharashtra, Rajasthan and Uttar Pradesh are among the states which want bank funds for financing electricity generation and rural electrification programmes....Willingness to lend notwithstanding, banks have qualms about assisting states on two general counts. First, the issue raised by certain bankers is whether the states are not seeking an alternative to ways and means borrowings from the Reserve Bank, the lid on which was tightened in early 1972–73. Second, these bankers wonder if the states are not seeking to tap voluntary public savings in excess of what the Planning Commission visualized.... What banks are worried about is the propensity of the states to ask for funds so much so that one state interpreted the Reserve Bank's permission to banks to extend 'bridging finance' as finance for construction of bridges.... As in the case of bridging finance where the states appear to be asking for credit in excess of the resources raised or to be raised by them through bond issues, in the case of rural electrification programmes involving energization of pump sets

etc. there are doubts if demand for agricultural power was being induced in excess of available and likely power supply.

The Reserve Bank's circular dated 27 March 1973 on some related subjects clarified that finance for implementation of 'power programmes' would cover all types of capital investment by SEBs, and that bank finance for these programmes should take the form mainly of increased subscription to open market loans or special debentures floated by them. The Bank also stressed the need for a proper scrutiny while extending credit for rural electrification programmes relating to energization of tubewells or pump sets. It cautioned that the proportion of expenditure on other items, such as street lighting, etc., should be kept to the minimum. As regards short-term accommodation to SEBs for meeting their working capital, bridging, and ways and means requirements, emphasis was laid on the need to extend such finance only for short periods not exceeding one year, and that too on a clear indication of the amount as well as the source of funds from which the bridging finance was to be cleared.

Perhaps as a part of its efforts to quell the criticism regarding the states' tendency to overestimate their requirements, the Bank followed this up with another circular on 24 September. It advised banks that they should, before submitting proposals for credit authorization for extending term credit for rural electrification programmes relating to energization of tube wells, pump sets, etc., satisfy themselves that the proposed programmes were technically feasible, economically viable and financially sound by getting the relative project reports vetted by the bank's own technical cell or the Rural Electrification Corporation or the Agricultural Finance Corporation.

There were some funny moments as well. It turned out that some state governments had interpreted the Bank's permission to extend 'bridge finance' as finance for construction of bridges. This came up when the Uttar Pradesh State Bridge Corporation, through Bank of India and Punjab National Bank, sought sanction for term loans of Rs 40 lakh and Rs 22.09 lakh respectively, for construction of bridges over Kali Nadi in Farukkabad and over Banaily in Bijnore district. The Bank had taken the view that bridge construction, being an infrastructure activity, should be financed by the state government through budgetary allocations and that bank credit for this purpose, if at all given, could only be marginal, say, not exceeding 25 to 30 per cent of the cost of the project. Accordingly, in 1976, approvals were afforded for term loans of Rs 12 lakh and Rs 6.60 lakh to Bank of India and Punjab National Bank, respectively. Subsequent demands from the Corporation were dealt with similarly.

In another singularly unique proposal in 1973, the Reserve Bank considered an application by Punjab National Bank for sanction of a bill discounting limit of Rs 5 crore to Haryana Roadways. The case was disposed of with Hazari commenting, 'We may inform PNB that we are not in favour of financing state governments. If the Roadways were a corporate enterprise, we would have considered the proposition on merits.' He also sought the opinion of the Executive Director, K.S. Krishnaswamy, on the subject, who replied that

> lending to departmental concerns, even though in the form of discounting usance promissory notes, contravenes the objective of ensuring that 'trading' activities of government are separated from 'general administrative budgets'. In other words, this will constitute technically, a loan to Government and hence does not come within the purview of the CAS.

In December the Bank set up a Study Group on Extension of Credit Limits on Consortium/Participation Basis, under the chairmanship of G. Lakshminarayanan, chairman and managing director of Indian Bank, to make recommendations for sharing of advances to units in public and private sectors, participation amongst banks for revival of sick units, and better cooperation amongst banks in respect of multiple banking. The recommendations of the Group were accepted by the Bank and communicated to all scheduled commercial banks on 8 August 1974. They were:

(i) Large credit limits by a bank to any single borrower in the private or public sector (including electricity boards) in excess of 1.5 per cent of its deposits should normally be extended on participation basis. This norm was in the nature of a guideline, to be operated flexibly.

(ii) In cases where the working capital requirements of a borrower were financed by a number of banks without a consortium arrangement, a proper procedure for coordination amongst the financing banks should be evolved on the following lines:
   (a) periodical exchange of essential information between the financing banks;
   (b) review of borrower's performance through periodical inter-institutional meetings; and
   (c) joint review of credit requirements of the borrower when the limits become due for renewal, etc.

In 1974, was a significant change made in the applicability of the scheme, relating to export packing credit and post-shipment credit, which were in the exempted category. From July 1974, while post-shipment credit continued to be exempted from CAS, export packing credit, including advances made against duty drawbacks, cash assistance, etc., were brought within the purview of the scheme. However, packing credit limit of up to Rs 5 lakh to a single bank borrower was exempted from prior authorization.

By 1975 the scheme had been in operation for a decade. A great deal had changed in the meanwhile. The economy had become more diversified. The financial sector had grown but banking was now practically a government monopoly. The banking system was asked to adopt a new approach as a credit agency, based on economic development potential rather than on security alone, to assist the weaker sectors of society and to lend to the public sector. Significant sectors of the economy, which were once outside the scope of bank lending, were brought within its ambit. However, the bulk of the credit was still availed of by the organized industry, though in terms of proportion to the total, its share had drifted downward. A worldwide flare-up of oil prices and stagnation in Indian industrial and agricultural production fuelled an unprecedented rise in prices; this, in turn, led to a rise in the demand for credit, part of which could be 'speculative' in nature. In late 1973, when the demand for credit rose steeply at a time when production was not keeping pace with the former, the Reserve Bank imposed certain credit restraints on the banking system. Later, in 1974, when inflation touched the unprecedented level of 31 per cent, a package of measures was introduced aimed at bridling the runaway inflation.

Clearly, the time had come to stop tinkering with the CAS and undertake thorough reform. It had become necessary to correlate the demand for bank credit of borrowers to their business/production plans, as also their own resources including long-term funds at their disposal. This implied the need for a shift from a 'security-based' to production-related ('need-based', as it was referred to) approach to lending.

A year earlier, the RBI had set up the Study Group to Frame Guidelines for Follow-up of Bank Credit (popularly known as the Tandon Committee). In 1975 the Group submitted its recommendations, and the Bank accepted them. With this the scheme entered its third and perhaps the most important phase.

The terms of reference of the Study Group were:

(i) To suggest guidelines for commercial banks to follow up and supervise credit from the point of view of ensuring proper end-use of funds and keeping a watch on the safety of the advances, and to suggest the type of operational data and other information that may be obtained by banks periodically from such borrowers and by the Reserve Bank of India from the lending banks;

(ii) To make recommendations for obtaining periodical forecasts from borrowers of (a) business/production plans, and (b) credit needs;
(iii) To make suggestions for prescribing inventory norms for different industries both in the private and public sectors and indicate the broad criteria for deviating from these norms;
(iv) To suggest criteria regarding satisfactory capital structure and sound financial basis in relation to borrowings;
(v) To make recommendations regarding the sources for financing minimum working capital requirements;
(vi) To make recommendations as to whether the existing pattern of financing working capital requirements by the cash credit/overdraft system, etc., requires to be modified, and if so, to suggest suitable modifications; and
(vii) To make recommendations on any other related matter as the Group may consider germane to the subject of enquiry or any allied matter which may be specifically referred to it by the Reserve Bank of India.

The Group met for the first time on 6 August 1974. Hazari initiated the deliberations. He said that various omnibus issues relating to credit had been referred to the Group because it had become necessary to take an integrated view of all these problems. But there was to be a departure from the supervision and follow-up of bank credit. The Study Group then formed three sub-groups.

INVENTORY NORMS

The Bank asked the Group to submit an interim report on inventory norms for the 1974–75 'busy season'. This was done in October and immediately accepted by the Bank. It communicated the decision to banks on 8 November for implementation but warned that the norms were 'tentative' and in the 'nature of an experiment'. Banks were advised to apply the inventory norms to both existing and new borrowers. While certain punitive measures, such as charging higher rates of interest, were suggested for non-compliance with the prescribed norms, the banks were also cautioned to exercise 'due flexibility and understanding of the circumstances' that might warrant deviation from the norms for temporary periods. The RBI asked the banks submit a report to it with industry-wise comments in regard to their experiences in applying the norms and with suggestions for improvement.

A second interim report was submitted by the Group in December, as it felt that an experimental set of statements for obtaining information from the customers of banks should be prepared and launched at a seminar. On 13 January senior credit executives of thirty-four banks with deposits of Rs 50 crore and above met at the Bankers' Training College in Bombay. Each participating bank was asked to introduce the forms devised by the Group in the case of a minimum of five to ten customers, on an experimental basis.

A suggestion was made at the seminar to constitute a Committee of Direction in the Reserve Bank, as also in those banks that participated in the seminar. The Committee was set up in the RBI in April. Its main function was to consider the problems that might arise in the implementation of the recommendations of the Study Group. Only a few banks were represented but it was clarified that other banks would be invited by turn to attend the meetings. At a follow-up seminar on 22 April, Hazari said that the new information system was intended to assist in improving the quality of supervision and to ascertain whether the borrower was responsive to the required discipline. Banks complained that the response from borrowers was slow and that they had not understood the need for the new system. They asked for the forms to be simplified and obtained at half-yearly intervals. The borrowers complained that the information sought was confidential and would affect the value of their shares in the market. Nevertheless, everyone accepted the need for a uniform approach in adopting the new system. After discussions, the participating banks were furnished with a simplified version of the statements under the new information system.

As regards the norms of inventory and receivables suggested in the first interim report, the bankers had the following things to say:

(i) The exemptions from the norms should be clearly understood and identified to leave no room for borrowers to circumvent the spirit behind the norms.

(ii) The bunching of imported and domestic raw materials caused difficulties in implementing the norms.

(iii) Classification of items like stock-in-process and finished goods varied even among units in the same industry.

(iv) The norms could be more liberal for new units.

These and similar observations made by the banks, based on the trial run of the information system and inventory norms, helped the Group in crystallizing its views and drafting its final report. It submitted the final report in August 1975. Its main focus was on working out uniform inventory norms and facilitating better bank supervision. The suggested inventory norms were to be applied to all industrial borrowers, including small-scale industries with aggregate limits from the banking system in excess of

Rs 10 lakh, and later extended to smaller borrowers progressively. All borrowers were to be brought under this discipline. However, in cases where inventory levels in excess of the norms prescribed were continued without justification, banks might, while not attempting to abruptly stop operations in such accounts, after a reasonable period of, say two months, consider whether they should charge a higher rate of interest on the portion of the borrowings considered as excessive.

The Group had worked out three alternatives for determining the maximum permissible level of bank finance on the premise that borrowers should be expected to hold only a reasonable level of current assets in relation to their production requirements. The total current assets would be carried partly by a certain level of credit for purchases and other current liabilities. The funds required to carry the remaining current assets represented the working capital gap and this gap, the Group contended, should be bridged only partly by short-term bank advances. The balance would be required to be provided by the borrower out of owned funds and long-term borrowings including those from banks. The three alternative methods worked out by the Group for this purpose were intended to progressively increase the involvement of long-term funds comprising the borrower's owned funds and term borrowings to support current assets. The first method arrived at the maximum permissible bank finance (MPBF) by deducting the amount of current liabilities (other than bank borrowings) from the total current assets to arrive at the working capital gap, and then allocating 25 per cent of this to be met out of long-term resources. In the second method, the total amount of current liabilities (other than bank borrowings) was deducted from 75 per cent of the current assets for arriving at the MPBF. The third method introduced the concept of 'core' current assets, which was excluded from the total amount of current assets to arrive at the 'real' current assets; thereafter, the MPBF was worked out as in the case of the second method. The Group had arrived at the current ratio of 1.17:1, 1.33:1 and 1.79:1 for the first, second and third methods of lending, respectively.

Banks were asked to initiate immediate action to place all borrowers with limits in excess of Rs 10 lakh on the first method of lending. Beginning with the weaker borrowers, the process was expected to be completed by the end of September 1976. In the case of borrowers who were already in a position to maintain the second method of lending, it was cautioned that they should not be allowed to slip back into the first method. As regards the third method of lending, the Bank did not take any decision at that time. As recommended by the Group, instead of making available the entire credit limit by way of cash credit, banks were advised to split the accommodation into two parts: a loan comprising the minimum level of borrowing that the borrower expected to use throughout the year, and a demand cash credit to take care of fluctuating requirements. Both would be reviewed annually. Within the overall eligibility, bill limits could also be allowed. Implementation of the various recommendations of the Group was to begin with bigger borrowers with limits aggregating Rs 1 crore and above, but eventually would cover all borrowers with limits of Rs 10 lakh and above from the banking system.

A QUESTION OF DISCRETION

While these far-reaching refinements were being introduced into general credit regulation, the Reserve Bank suddenly raised the cut-off point for prior credit authorization for working capital limits from Rs 1 to Rs 2 crore for borrowers in the private sector. The credit policy announcement on 1 November 1975 asked banks to ensure that this relaxation did not result in any dilution of the standards of credit discipline, both for appraisal and for supervision. But there is no official record of why this decision was taken. One of the Deputy Governors has said that it was entirely Governor Puri's decision, essentially to help Maruti. He says he told the Governor that the existing CAS limit of Rs 1 crore could not be raised without making a general policy review. Puri did just that.

Maruti had made an application for grant of credit facilities of about Rs 25 lakh in addition to the Rs 95 lakh it already had. The lead bank, Central Bank of India, had approached the RBI for approval of this arrangement under the Credit Authorization Scheme, which laid down that all credit facilities beyond Rs 1 crore needed the approval of the Bank. The Credit Planning Cell was of the view that the proposal should be rejected. The Deputy Governor concurred. The papers were then put up to Governor Puri—who simply raised the prevailing limit to Rs 2 crore.

The DBOD was upset but, under the prevailing circumstances, could do nothing about it. On 5 November 1975, the DBOD recorded a note making the following main points:

> The banking system is on the threshold of a big change in the manner of lending etc. arising from the implementation of the recommendations of the Study Group (Tandon Committee); the facility for overseeing the switchover to the new system which was available to us through the media of CAS would not cover a number of parties enjoying facilities up to Rs 2 crore.
>
> The raising of the limit would not also enable us to tender

> advice and guidance to banks in regard to improving their appraisal system and enforcing financial discipline in the above cases.
>
> Even from the statistical angle the absence of data in respect of units whose limits are now exempt from authorization might affect our 'study of trends' in different industries.
>
> Above all, the smaller/medium banks are likely to be practically out of authorization scheme.

It was also estimated that 848 borrowers would escape the CAS net on account of this quantum jump in the cut-off limit. In November 1975, banks were advised that interim/bridge finance exceeding Rs 25 lakh for private sector borrowers, and Rs 100 lakh and over for public sector borrowers for capital expenditure, would be subject to prior authorization, unless such finance was against the bank's share of term loan sanctioned on a *pari passu* basis with all-India term-lending institutions or against the latter's committed financial assistance.

The CAS database was revised in December 1975 in light of the discussion that took place in the meetings of the Committee of Direction set up to implement the recommendations of the Tandon Study Group recommendations. The impact of the new credit discipline was, however, debated within the banking system as well as in the press. The ramifications of the various recommendations were covered by the *Financial Express* of 4 and 5 May 1976 as follows:

> It is argued that the situation in which the Group was conceived has completely altered and its recommendations are no longer valid in the present economic situation. But this is not correct. The main thrust of the report is growth with discipline in the availment and use of scarce funds.… The timely action by banks could lighten the draft on the scarce national funds and lessen the burden on Government which could direct its attention to other areas of importance and urgency.… The type of attempt made by the Group is unique in the sense that no such attempt to traverse such a wide ground in the area of bank lending has been made in the past as has been done by this Group. There will be a fairly common approach towards the lending system by different banks once the new system gets going, and this will also facilitate orderly growth of bank credit. It needs to be appreciated that what the Group has attempted to do is to marry credit

flows with genuine production needs and avoid wasteful use of the scarce working capital funds

In 1976, comprehensive guidelines were issued to banks for scrutiny of annual/quarterly information/data received from borrowers. Further, in respect of borrowers having aggregate credit limits of Rs 1 crore and above, separate data on a monthly as well as quarterly basis was called for.

Following a decision taken by Puri and the chief executives of major commercial banks on 12 March 1976, the RBI constituted a Committee on transfer of borrowal accounts under the chairmanship of R.K. Talwar, chairman of SBI. A streamlined procedure for transfer of borrowal accounts with credit limits of Rs 25 lakh and above was communicated to all scheduled commercial banks in June 1977. From now on each bank would have to constitute a high-powered internal committee to give a hearing to the grievances of customers intending to transfer accounts to another bank, and while the internal committee was not to stand in the way of the customer selecting the bank of his choice, it would examine whether the customer was transferring the account to avoid financial discipline. Further, the two banks involved were asked consult each other and if a difference of opinion remained unresolved for a month, either bank was encouraged to approach the Reserve Bank.

The change in government in March 1977 did not lead to a change in the overall CAS limit. The only issue of note that took place before I.G. Patel took over as Governor of RBI was bringing advances against fixed deposits under the purview of prior authorization. Governor Patel invited comments on CAS with a view to streamlining the scheme, delegating more authority to the banks themselves and facilitating quick decisions. In an attempt to revitalize CAS and redefine its objectives, the Bank, in May 1978, issued detailed instructions to scheduled commercial banks, setting out broad objectives as under:

(a) to ensure that additional bank credit was in conformity with the approved purposes and priorities and that the bigger borrowers did not pre-empt scarce resources;
(b) to enforce financial discipline on the larger borrowers, where necessary, on uniform principles;
(c) where a borrower was financed by more than one bank, to ensure that the customer's proposal was assessed in the light of the information available with all the banks; and
(d) to bring about improvement in the techniques of credit appraisal by banks and their system of follow-up.

In August 1978, certain categories of non-fund-based facilities were brought under the purview of CAS. The cut-off point for working capital limits (Rs 2 crore for private sector borrowers and Rs 3 crore for public sector borrowers) was allowed to be computed without taking into account term loan outstandings.

In the meantime, a new issue had come to the fore, namely, the overlap between commercial banks and term-lending in institutions. An inter-institutional group was set up on coordination of the lending operations of term-lending institutions and commercial banks. On 28 March 1978, a decision to this effect had been taken at the Governor's meeting with representatives of term-lending institutions and commercial banks. A.K. Bhuchar, who was then chief officer in the DBOD, was named as head of the group. The over-riding consideration was that as the term-lending institutions geared themselves for meeting the increased long-term lending requirements, commercial banks should avoid undue involvement in term lending and conserve their resources for meeting the demand for short-term credit. The Reserve Bank later constituted a Standing Coordination Committee for considering policy issues pertaining to the coordination between banks and term-lending institutions.

Its recommendations, with certain modifications/clarifications, were communicated to banks in November 1978. These laid down that the term loan requirements of small and medium industries with a project cost not exceeding Rs 1.50 crore could be financed by banks, preferably in participation with state-level institutions such as state financial corporations (SFCs) and state industrial development corporations (SIDCs) irrespective of the size of the paid-up capital and reserves of the borrowing company. As regards other projects, where the total project cost exceeded Rs 1.5 crore but did not exceed Rs 5 crore, banks were told that they need not ordinarily participate in the extension of term credit. In the case of larger projects, where the project cost exceeded Rs 5 crore, banks might participate to the extent of 25 to 30 per cent of the total term loan (including deferred payment guarantees) requirements of the project. The recommendations also dealt with various aspects of coordination among the participating agencies in the spheres of appraisal, conduct/operation of accounts, joint inspections, etc.

By 1980, it became clear that the Credit Authorization Scheme was in need of some more modification. The banks were facing a major problem in implementing the credit regulatory measures. There was extensive use of the cash credit system. While reviewing the monetary and credit trends in March 1979, the Governor stressed the need for exercising continued restraint on further expansion of credit. He also indicated the need for considering certain long-term issues relating to banking operations. Many changes had been suggested but nothing had been done. Reform was needed and it was in this context that Patel wrote to banks on 16 March 1979:

> I would like to initiate action on certain structural matters which need further examination. It is necessary to take a fresh look at another major problem faced by banks in implementing the credit regulatory measures, viz., the extensive use of the cash credit system. Its drawbacks have been pointed out by various Committees in the past including the Tandon Committee, which suggested the bifurcation of credit limits into a demand loan and a fluctuating cash credit component. Although the banks were advised to implement this recommendation, I am afraid, the progress achieved has been very slow. Clearly this problem needs to be looked into further and for this purpose I propose to set up immediately a small Working Group, to report to me … on the reforms to be introduced.

With this, CAS entered its fourth phase. The terms of reference of the Working Group to Review the System of Cash Credit, known as the Chore Committee, after K.B. Chore, additional chief officer (later chief officer) of DBOD, were as follows:

(i) To review the operation of the cash credit system in recent years, particularly with reference to the gap between sanctioned credit limits and the extent of their utilization;

(ii) In the light of the review, to suggest:

  (a) modifications in the system with a view to making the system more amenable to rational management of funds by commercial banks; and/or

  (b) alternative types of credit facilities, which would ensure greater credit discipline and also enable banks to relate credit limits to increase in output or other productive activities; and

  (c) to make recommendations on any other related matter as the Group may consider germane to the subject.

The Group's suggestions were discussed and eventually the Bank accepted the recommendations, subject to certain modifications. The salient features of the main recommendations and the decisions taken by the Reserve Bank were advised in the circular dated 8 December 1980.

(i) It was not feasible to replace the cash credit system totally by another system. The banks should strictly ensure that review of all the borrowal accounts enjoying working capital credit limits of Rs 10 lakh and over from the banking system was made at least once in a year. The information system was also to be strictly enforced in respect of all borrowers having working capital limits of Rs 50 lakh and over from the banking system. It was also decided that the quarterly statements that were so far required to be submitted by borrowers enjoying credit limits of Rs 1 crore and over, should henceforth be obtained from all borrowers having working capital credit limits of Rs 50 lakh and over from the banking system. Non-compliance, if any, with the above requirements was to be reported to the Reserve Bank, specifying the reasons therefor, on a half-yearly basis.

(ii) As regards bifurcation of cash credit into demand loan for core portion and fluctuating cash credit component, as advised by the Tandon Committee, it was decided to withdraw the instructions issued earlier. In cases where the cash credit accounts had already been bifurcated, steps were to be taken to abolish the differential in interest rates with immediate effect.

(iii) While assessing the credit requirements of borrowers, the banks should fix separate limits, wherever feasible, for the normal non-peak-level as also for the peak-level credit requirements. One of the important criteria for deciding the normal non-peak-level and peak-level requirements should be the borrower's utilization of credit limits during such periods in the past. In the case of CAS accounts, the relevant forms had necessary provision for assessment of the peak-level requirements separately.

(iv) Within the limits sanctioned for peak-level/non-peak-level periods, the borrower should indicate, before the commencement of each quarter, the requirements of funds during the quarter (i.e. the operative limits). (While this part of the Group's recommendation had been accepted, the further suggestion that drawings less than or in excess of the operative limit so fixed—with a tolerance of 10 per cent each way—but not exceeding sanctioned limit, should be charged additional interest of 2 per cent per annum over the normal rate, however, was not accepted by the Reserve Bank, in view of the practical difficulties involved.) If the borrower did not submit the returns within the prescribed time limit, banks might charge penal interest of 1 per cent per annum on the total outstandings for the period of default in submission. In the case of persistent defaults in submission of returns the operations in the account of such borrowers might be frozen after giving sufficient notice, if, in the opinion of the banks, such deterrent action was warranted.

(v) While borrowers should be discouraged from approaching banks frequently for ad hoc or temporary limits to meet unforeseen contingencies, such limits if sanctioned should be allowed only for predetermined short durations and should be charged additional interest of 1 per cent, except in special cases.

(vi) In order to avoid over-dependence on bank credit by medium/large borrowers as well as to enhance borrowers' contribution, it was decided that banks should adopt the second method of lending recommended by the Tandon Committee, according to which the borrower's contribution from owned funds and term finance, to meet the working capital requirements, should be equal to at least 25 per cent of the total current assets; giving a current ratio of 1.33:1. In cases where the borrower was not in a position to comply with this requirement, the excess borrowing was to be segregated and treated as a working capital term loan (WCTL), which could be made repayable in half-yearly instalments within a definite period which should not exceed five years in any case. The WCTL was to carry an interest rate not less than the rate stipulated for the relative cash credit limit and banks were given the discretion to charge higher rates of interest within the ceiling prescribed. While the measures enunciated were made compulsory in the case of all borrowers, without exception, having working capital limits of Rs 50 lakh and over from the banking system, they were to be enforced in stages on borrowers who were enjoying credit limits less than Rs 50 lakh. As far as sick units under nursing programmes were concerned, the banks were to prescribe separate packages of measures for their rehabilitation.

(vii) Banks should take steps to discontinue the system of allowing cash credit limits against book debts and change over to financing through bill limits. The Group also suggested that, to start with, the banks should, in the case of borrowers having credit limits of Rs 50 lakh and over, extend at least 50 per cent of the cash credit limit against raw materials to manufacturing units by way of drawee bills only.

The Reserve Bank followed up the implementation by conducting seminars, providing further clarifications and incorporating certain refinements. The period essentially witnessed a reiteration of the unimplemented recommendations of the Tandon Committee regarding control over unduly heavy dependence on banks for working capital requirements.

On the organizational front, the RBI had advised all banks to set up 'cells' in their central offices to keep a continuous watch on the operations in large accounts and on key branches that accounted for the bulk of their advances. This suggestion was again emphasized in December 1980. The various functions that could be assigned to the special 'cell' to enhance the quality of credit regulation, while facilitating the work in the credit authorization section, were also spelt out. In mid-1981, the work relating to the Credit Authorization Scheme was taken over by the Industrial Credit Department (ICD) from DBOD. In an internal note prepared by ICD that year, certain critical issues involved in the operation of the scheme were discussed:

> It has been suggested that the Reserve Bank has been merely ratifying the decisions of the Boards of banks in respect of credit proposals received under CAS. While this may be true of a large portion of the proposals authorized by us, there is a sizeable number in which the proposals had been either turned down or modified by us after a detailed study; this will be borne out by the data on proposals received since 1979 onwards as given in the table below. What is more important, however, is the qualitative aspect of the relevant proposals. As a result of our scrutiny and our attempts to analyse objectively the need-based requirements of borrowers within the framework of the norms and other parameters laid down by the Tandon Study Group, limits approved by the banks are often trimmed down or they are allowed subject to certain conditions. At times, mainly because of certain objectionable aspects observed in the proposals, the validity of our authorization is restricted to limited periods considered adequate for the facilities in question, and within which borrowers are expected to take corrective steps. Instances are not wanting wherein the proposals have been rejected altogether. This happens when, even after obtaining clarifications from banks (including across-the-table discussions with bankers who at times are accompanied by the concerned borrowers), it is found that the proposals have been recommended by the banks ostensibly for attracting or retaining larger business, disregardful of certain undesirable tendencies like dilution in current ratio following diversion of short-term funds for acquisition of fixed assets, imbalance in capital structure, unrealistic projections in regard to production and sales, main-

tenance/projection of inventory/receivables levels considerably higher than the norms suggested by the Tandon Study Group or those prevailing in other similar industries, etc.… Due care is taken to ensure that the relaxations asked for are given in deserving cases and the concerned borrowers are advised to take steps to satisfy the requirements of norms etc. over a stipulated period.… The scrutiny of credit proposals under CAS is to be looked at basically not from the angle of avoiding credit risks but as a measure to restrain banks from deploying larger than necessary credit in the case of bigger borrowers. As such, it has become essentially a credit control measure at the micro level in the context of inflationary trends in the economy and pressing demand on bank credit from various other sectors, particularly the food and priority sectors.

Applications Treated under CAS

	1979	1980	1981 (up to March)
(i) No. of applications received	1497	1558	472
(ii) No. of applications authorized in full	903	1441	338
(iii) No. of applications authorized for reduced amounts	86	71	36
(iv) No. of applications rejected	55	46	24

A review of the Credit Authorization Scheme undertaken around the end of the reference period of this volume indicated that the scheme covered 877 borrowers and the total limits sanctioned to them amounted to Rs 11,395 crore. The public sector borrowers were 185, i.e. 21 per cent of the total number of CAS borrowers, but they accounted for as much as 44.6 per cent of the amount of total limits sanctioned.

PARTICIPATION CERTIFICATES

One of the biggest problems that banks had traditionally faced was paucity of resources. They simply did not have enough deposits to lend. The Credit Authorization Scheme described above was a negative way of dealing with the problem, namely, by credit rationing. The other way was positive: one of the financial instruments that flourished during the 1970s was the participation certificate (PC). These certificates became an important means of raising resources for banks during the entire decade of the 1970s. The Reserve Bank's approach in the initial years after the introduction of the instrument was one of ambivalence. It was only when it realized that its operations impinged on the effectiveness of monetary policy that it took action in line with the prevailing policy of credit control. The process of reaching this realization was accompanied by a minor spat with the Finance Ministry.

The PC was an instrument representing a part or all of an advance made by a bank to a borrower and sold by it to a third party, the transferee. As such, it was a deed of transfer. By implication, the bank would have transferred to the holder of a PC a part of the advance it made to the borrower against hypothecation of goods or against book debts. The PC holder was thus a participant along with the bank—a joint participant so to say—in lending to the customer of the bank. The security transferred was invariably the hypothecation right of the transferor bank over the borrower's movable assets. PCs were of two kinds—one 'with recourse' and the other 'without recourse'. But in India only certificates of the former kind existed, that is the ones without risk for the purchaser.

The initiative to introduce the PC in India was taken by the First National City Bank, Bombay. It approached the Reserve Bank in March 1969 for securing 'no objection' to its entering into participation arrangements with other banks, and permission was granted. Not being able to introduce PCs immediately, it requested the RBI again, in March 1970, for reconfirmation to launch the scheme. This was accorded on a pilot project basis in April 1970. Subsequently, National & Grindlays Bank Ltd., United Commercial Bank, Bank of Baroda and Bank of India were allowed to operate the scheme on an 'experimental' basis, followed by other banks.

As part of the scheme, PCs could be issued to another bank or to other financial institutions specifically approved by the Reserve Bank. The major financial institutions which were allowed to participate in the PC scheme were Life Insurance Corporation of India (LIC), Unit Trust of India (UTI), and Industrial Credit and Investment Corporation of India (ICICI). Some private insurance companies and other financial companies were specifically approved for the purpose.

To the extent that the funds accepted by banks on account of selling PCs were excluded from the requirement of maintenance of cash reserves in terms of Section 42 (1) of the Reserve Bank of India Act and liquid assets in terms of Section 24 of the Banking Regulation Act, the liquidity of such banks was augmented and their profitability improved. This was because, if a bank was a purchaser of a PC and the funds provided by it were not reckoned as 'dues from other banks' but were included in bank credit, double counting could result. If, on the other hand, PCs were purchased by other financial institutions, they became the 'liabilities' of the banks even though banks' liquidity was augmented in the process.

In the initial years, the amount of PCs issued and outstanding under the scheme remained at a very modest level—the amount outstanding at the end of December 1974 was only Rs 59 crore. As PCs became popular with banks, the amount outstanding showed a steady rise, which became more pronounced from 1977.

The table on the next page gives data for PCs issued and outstanding during the years 1971–82.

PCs outstanding nearly doubled, from Rs 59 crore at the end of 1974 to Rs 114 crore by the end of the next year. Thereafter there was a steep growth and over the two-year period from 1977 to 1979, the increase in PCs was nearly two-fold, on a heightened base. Throughout the period, PCs to financial institutions (other than banks) constituted the bulk of the PCs issued and outstanding; the proportion of such PCs to the total varied between 68 per cent in December 1976 and 94 per cent in June 1979. Both banks and financial institutions found the scheme to very useful. Banks were able to expeditiously meet urgent unforeseen demands for funds from their clients; moreover, the cost of raising funds through PCs worked out cheaper than raising funds from the call money market as PCs were not subject to statutory liquidity ratios (SLR) and cash reserve ratios (CRR) till 1979. For financial institutions—LIC, GIC and UTI—PCs were convenient for immediate day-to-day deployment of funds realized from sales of life insurance/general policies/units, pending their eventual investment in long-term assets. Non-availability of an adequate number of viable investment proposals fetching an attractive return was a contributory factor for the preference shown by financial institutions for PCs.

When PCs were launched in 1970, the Reserve Bank did not place any restriction on the maximum or minimum period for which they could be issued. Nor did it restrict the amount up to which resources could be mobilized through issue of PCs. In the initial months, the maturity periods of PC issues ranged between thirty days and 365 days. But in February 1971, the period of maturity was stipulated to be not less than 80 days and not more than 180 days. Subsequently, the RBI restored the minimum maturity period to thirty days. In March–June 1972, the Bank advised the participating banks that the maximum interest payable on PCs should be 8 per cent per annum. But the ceiling rate was periodically raised. The ceiling rate, however, was not applicable to PCs issued to other commercial banks.

Table 1 PCs Issued and Outstanding

(Rs crore)

Last Friday (1)	PCs outstanding (2)	Last Friday (1)	PCs outstanding (2)
1971 (December)	16	1980 (January)	472 (471)
1972 (December)	14	1980 (March)	485 (468)
1973 (December)	45	1980 (June)	312 (311)
1974 (December)	59	1980 (September)	265 (265)
1975 (December)	114 (101)	1980 (December)	256 (256)
1976 (December)	156 (107)	1981 (July)	188 (188)
1977 (December)	294 (257)	1981 (September)	190 (190)
1978 (June)	416 (372)	1981 (December)	99 (99)
1978 (December)	455 (419)	1982 (July)	59 (59)
1979 (January)	511 (456)	1982 (September)	49 (49)
1979 (April)	626 (575)	1982 (December)	23 (23)
1979 (June)	606 (572)		
1979 (July)	541 (486)		
1979 (September)	516 (505)		
1979 (December)	447 (454)		

Note: Figures in brackets relate to amount of outstanding PCs issued to financial institutions other than banks.

Source: Data for the years 1971–74 are taken from office files; for the years 1975–79 from the article in the *RBI Bulletin*, November 1979; and for the remaining years from Table 3 in *RBI Bulletin*, various issues.

This exemption led to situations where the rates of interest shot up, at times to 17–20 per cent, thereby placing pressure on the call market. The Bank overcame the problem by imposing a uniform rate of interest of 12 per cent but this was done much later, in 1977; this, again, was raised periodically.

The episode also raised questions about the definition of an eligible financial institution. The Finance Ministry enquired through a letter dated 8 May 1973 whether:

(i) the term 'financial institution' was defined,
(ii) PCs issued to banks should figure as 'liabilities' or 'contingent liabilities' in banks' balance sheets; and
(iii) the possibility of circumventing the Bank's directive regarding interest rates on deposits through the medium of the issue of PCs existed.

The Reserve Bank, for some reason, chose not to reply for some time. But it could not be silent for long, since pressures began to build on it to respond. It finally chose to inform the Ministry on 7 February 1974 that it had allowed 'some of the banks' to participate in the PC Scheme on an 'experimental' basis up to the end of June 1974 and that it would make a detailed review of the scheme soon, after which the specific points raised by the government would be clarified.

A few days later, at the annual general meeting of shareholders on 29 March 1974 at Madras, R.K. Talwar, Chairman of SBI raised the issue of the propriety of banks issuing PCs. He argued that the funds acquired by a bank from financial institutions through the issue of PCs 'steer clear of the discipline imposed on regular bank deposits'. He elaborated that while a bank might not lend more than 60 out of every 100 rupees of its deposits, it remained unhampered in lending the entire amount of Rs 100 derived through the issue of PCs. Talwar also raised two related points pertaining to the practice of approved financial institutions rediscounting bills when they were not eligible for refinance by the Reserve Bank, and the adverse impact on the banking system on account of the participation of LIC and UTI in the call money market. D.N. Ghosh, Joint Secretary, Department of Banking, in a letter of 6 April 1974, brought Talwar's speech and viewpoints to the notice of R.K. Hazari and requested a brief from the Bank on the matter. It was apparent that the government was not satisfied with the Bank's earlier reply.

The Reserve Bank sent a reply to Ghosh's letter by telex on 30 April 1974. It said that the funds raised by issue of PCs were equivalent to deposits; the PC Scheme envisaged loan participation and, as such, the funds derived through PC issue were in the nature of refinance obtained by the issuing bank. The net result was that the Bank was spared of such refinance. The Bank also noted that the cumbersome legal formalities associated with the issue of PCs showed that the transactions were in the nature of loan participation and not another mode of acceptance of deposits.

The first exhaustive review of the working of the PC Scheme during 1973–74 by the DBOD was, in a sense, a trendsetter. In its note dated 29 May 1974, DBOD observed that thirty-two commercial banks were authorized to issue PCs. The amount of PCs issued and outstanding increased over time—from Rs 25 crore at end-September 1973 to Rs 45 crore at end-December 1973 and further to Rs 61 crore at end-January 1974. Most PCs were obtained by private general insurance companies. LIC did not participate because it was not satisfied with the maximum rate of interest of 10 per cent allowed under the scheme. With the exception of a couple of certificates for Rs 75 lakh issued by Mercantile Bank to British Bank of the Middle East, there was no participation arrangement among the banks *inter se*. Of the total amount of Rs 45 crore outstanding at end-December 1973, five banks—Bank of India, Bank of Baroda, Central Bank of India, Indian Bank and First National City Bank—accounted for Rs 40 crore. The largest amount of PCs was issued by Bank of India.

The review also suggested that while banks accepted deposits at any time of the year, they issued PCs only to the extent necessary when they were faced with a resource constraint. It also stated that 'a distinction has to be made between the funds made available by financial institutions and others'. Financial institutions like LIC, UTI, general insurance corporations/companies, were not ordinary depositors. They were institutions that mobilized funds with their own effort and at their own cost. Therefore, there would be justification in giving them a special facility as envisaged under the PC Scheme. The review went on to say that it would not be correct to assume that all their surplus funds would necessarily be kept with banks in the form of deposits. These institutions would, to the extent possible, try to secure maximum returns on such funds. The scheme, therefore, offered an incentive to them to invest their funds in the banking system at a reasonable rate of interest and even to bring more funds to the banking system. Besides, to the extent that banks were able to attract funds by the issue of PCs, their recourse to the Reserve Bank would be less.

The DBOD suggested that, in view of 'the scale of operations under the scheme and the advantages that accrue to banks', the PC Scheme should be extended on 'an experimental basis' for a period of one year, up to the end of June 1975. In making this recommendation, DBOD also took into account the fact that abrupt discontinuation of the scheme would force banks to repay an outstanding balance of over Rs 60 crore as of 1 July 1974, a sum that they might find difficult to arrange for.

The scheme was renewed on certain conditions that consisted mainly of defining who was eligible to participate and who was not. It was restricted to a few financial institutions—LIC, UTI, general insurance companies/corporations and ICICI. The Industrial Finance Corporation of India (IFCI), the state finance corporations (SFCs) and state industrial corporations, as well as two private investment companies (viz., Industrial Investment Trust Ltd and Pilani Investment Corporation Ltd), were excluded. The inclusion of ICICI in the scheme was conditional on 'further examination'. It had been included because ICICI was approved by the RBI for acceptance of bills of exchange and for rediscounting them with the Bank. The decision to exclude so many institutions and financial entities was based on the advice of the Bank's Legal Department, which took the view that the statutes of the SFCs and IFCI did not permit them to subscribe to PCs. Besides, the bulk of the resources of SFCs was raised through issue of bonds in favour of commercial banks. It was, therefore, not appropriate for banks to get back the same funds at higher rates of interest. The arguments against the inclusion of state-level industrial development corporations were that they solely depended on the state governments for their financial needs and, as their financing activities were normally confined to units promoted by state governments, they should not be encouraged to divert their funds to channels that promised higher yields.

As for the two private investment companies, the issue was different. From the information available, it was not clear whether they were investment companies/trusts. Their investments in PCs ranged from Rs 1 crore to Rs 2 crore and aggregated Rs 2 crore at the end of January 1974. The legal adviser's view was that if they were trusts, they could not hold PCs as the loans normally granted by them were required to be covered by the first mortgage of assets, which was not available under the existing scheme. Further, there was no good reason to extend the PC Scheme to such companies once the state-level industrial development corporations in the public sector had been excluded. The Reserve Bank also feared that it would become difficult if requests were received for granting approval from other similarly placed investment companies.

The scheme did not allow cooperative banks to participate either, because they were exempted from the RBI's directive on deposit rates. Hazari recorded on the DBOD office note that he had discussed with the

Governor the proposals outlined in the note, and instructed that while the Bank might tentatively allow the position in the case of ICICI to continue, it should examine the issue further.

It is worth noting here that SBI had been operating, since 1971, a 'scheme' akin to the PC Scheme, for banks within its own group. The purpose was to even out temporary liquidity problems and to minimize borrowing from the RBI. The certificates were issued 'on demand' and carried interest rates at the same level as those charged on loans transferred but subject to a service charge of one half of 1 per cent payable to the bank issuing the certificates. The Bank had allowed this arrangement to operate outside the PC Scheme. This meant that SBI and its subsidiaries could individually participate in the Bank's PC Scheme vis-à-vis other banks or approved financial institutions.

In retrospect, it is not clear why the Reserve Bank allowed the PC Scheme on an 'experimental' basis for only one year, even after acknowledging the benefits of the scheme. One possible reason could be that it found the scheme to be of help in containing its accommodation of commercial banks. It is worth recalling that 1973–74 was a very difficult year for the Bank in that the net RBI credit to the government and to the commercial sector rose by Rs 963 crore and Rs 294 crore, respectively. The RBI's balance sheet for 1974 showed an increase in loans and advances to scheduled commercial banks of 271 crore, from Rs 138 crore in 1973 to Rs 409 crore in 1974. Had there been no PC Scheme, the Bank's accommodation of banks' needs could have been still higher, given the sharp credit crunch that had been experienced following the announcement of the monetary and credit policy measures in 1973 on account of the first oil crisis and the flare-up in the general price level.

The DBOD review for 1974–75, on 5 May 1975, recommended extension of the scheme for one more year. It also took the view that as ICICI was an important all-India term-lending institution, next only to IDBI, it could, on certain occasions, have substantial surplus funds to spare. It therefore proposed that ICICI be treated on par with LIC and UTI. It also said that, apart from the popularity of the scheme, the Study Group on extension of credit limits on consortium/participation basis had suggested that the growth of PCs between institutions approved by the Reserve Bank should not be discouraged. But it was only with the review for 1975, on 10 May 1976, that the Bank finally decided not to treat the scheme as 'experimental', subject to annual reviews. At the end of December 1975, the volume of PCs stood at Rs 114 crore as against Rs 59 crore a year earlier.

The review for 1976–77, on 14 May 1977, went further. It recommended that the scheme be made permanent and to do away with annual reviews. It, however, suggested retention of monthly reports from banks. The note also referred to the Bank giving permission to banks in February 1977 to issue PCs to Industrial Reconstruction Corporation of India Ltd and rejecting the requests of state-level institutions—Industrial Promotion and Investment Corporation of Orissa Ltd and Tamil Nadu Industrial Investment Corporation Ltd—to participate in the scheme. The ceiling rate of 12 per cent was prescribed uniformly without any exception. It was also noted that the requests of small banks to participate in the scheme, which were hitherto not acceded to, could be approved, since these banks too face liquidity problems just as large-sized banks do. Deputy Governor K.S. Krishnaswamy thought the DBOD proposals were 'reasonable' and regarded the scheme as useful for meeting liquidity mismatches and limiting the draft on the Bank. The review was approved by Governor Narasimham on 20 June 1977.

PCs were found to be most attractive for banks especially from 1973, when the liquidity crunch loomed large for the first time, and partly because PCs were not subjected to strict monetary and credit discipline till the end of the 1970s. The PC Scheme was an example of the Reserve Bank attempting to keep to itself the maximum degree of discretion in determining the number and the institutional size-class of the participants, the maturity period of the certificates, and the maximum interest rate that could be charged, and to limit the size of refinance/accommodation. The case by case approach was especially used in respect of institutions that sought approval of the Bank for participating in the PC scheme. Some such instances are given below.

Industrial Reconstruction Corporation of India

While considering the application of the Industrial Reconstruction Corporation of India (IRCI) to participate in the scheme in January 1974, even though the Department was satisfied that it could be termed as a financial institution, Hazari turned down the proposal on the ground that it received interest-free funds from government, which it was supposed to keep in government securities till required for disbursement. After discussion with the Governor, he instructed that, for the present, IRCI should be kept out of the PC Scheme.

In March 1976, IRCI came up with a different request, which ultimately resulted in it being allowed to keep its funds in PCs. Unlike other financial institutions and organizations, IRCI dealt only with closed or sick industries, many of which were not in a position to pay interest as per the payments schedule, leave alone timely repayment of the principal. Its disbursements were erratic as it depended on the requirements of industrial units, which were more intent on improving operations than working to a long-term plan. Sometimes, it was compelled to prematurely encash its deposits with banks as the needs of units had to be met suddenly. In the process, there was considerable loss of interest income. So IRCI requested the Reserve Bank to exempt it from the directive prescribing a ceiling on interest rates on deposits or, alternatively, to allow it to operate in the call money market like LIC and UTI until it got a higher rate on the funds raised through issue of bonds. The Credit Planning Cell of RBI examined the representation and said no.

> Banks have not been happy about the operations of the LIC and the UTI as perpetual lenders in the market since it meant that a part of the funds, which would have come back to the banking system as deposits, is made available to the banks at a higher cost in the call market. And there is a material difference between the funds which the LIC or the UTI place in the call market and the funds which the IRCI put in the call market. While the funds of the LIC and the UTI are obtained from outside the banking system, the funds which the IRCI proposes to invest are from the ten-year bonds subscribed entirely by banks and these bonds carry a coupon rate of only 6 per cent. Thus what the IRCI wants to do is to lend to the banks at a higher rate, the funds obtained from them at a low rate. This would be unfair to the banks and may even affect their willingness to subscribe to future bond issues of IRCI. While the concern of IRCI regarding the idle funds is conceded, allowing it to place the funds in the call market does not appear to be the solution to the problem.

The IRCI was not to be put off. It wrote to the Reserve Bank again on 7 December 1976 with the plea that unless it was allowed to keep funds with banks at negotiated rates or operate in the call market, it would be difficult to manage its interest commitments except out of fresh borrowings. This time the Credit Planning Cell reviewed the request from a different angle. A proposal from the IDBI for placing funds in the call market outside the purview of the directive on deposit rate had been turned down once, as its resources were generated mainly from Government of India or bank funds. But a similar request from the Tamil Nadu Industrial Investment Corporation had been approved on the reasoning that a part of its resources was raised from the public by way of deposits. The Bank thought it preferable to allow IRCI to participate in the PC Scheme, enabling it to realize its surplus funds at any point of time since the surplus funds could be invested for fairly short maturities. Krishnaswamy approved of the proposal on 27 January 1977 and IRCI was suitably advised on 2 February 1977.

In another decision taken in March 1974, the Reserve Bank did not allow the Agricultural Finance Corporation Ltd to participate in the scheme because its memorandum and articles of association revealed that its main objects were to finance agriculture and allied activities, and it was therefore not competent to finance large industrial/trading units as envisaged under the scheme. Similarly, the proposal from SBI to issue PCs to the Uttar Pradesh Small Industries Corporation Ltd in January 1974 was rejected because it had been established primarily to assist small-scale industries and not for granting assistance to larger units, which the scheme indirectly sought to promote.

Indian Overseas Bank Ltd, whose licence to carry on banking business was cancelled after its nationalization, made an application to the Reserve Bank in February 1974 for functioning as a financial institution and to invest its surplus funds in discounting of trade bills or in participation certificates with banks. The Bank did not find any merit in the application as the company could hardly be deemed to be a financial institution within the meaning of Section 45I of the RBI Act, and was therefore not eligible to be treated as an approved financial institution for PCs or bill discounting.

The Unit Trust of India (UTI) proposed certain major amendments to the Unit Trust of India Act, 1963, as it was facing difficulties in investing its surplus funds. The statutory provisions of UTI restricted it from investing its monies except in shares, securities or keeping them in deposits with scheduled banks or with other approved institutions. Securities of first-class companies were then not available in sufficient quantities and, pending investment of the funds on a long-term basis, UTI had recourse to government securities and call and short notice deposits with banks. These generally did not yield sufficiently good rates of return and hence were not considered suitable for investment in the context of UTI's obligation to pay reasonable dividends to unit holders. Moreover, unlike the other term lending institutions, it was precluded from giving direct loans; consequently, UTI had to take recourse to the tortuous procedure of subscribing to privately placed debentures, which was time-consuming as well as expensive. James Raj, UTI chairman, in a letter on 23 January 1974 to Governor Jagannathan, stated that the Trust proposed to invest in participation certificates or rediscount bills and thus earn better yield on its funds in terms of the powers already available under the existing statute.

DBOD, in its office note of 28 February 1974, while examining certain other proposals of UTI, noted that the latter was already one of the institutions approved for entering into participation arrangement with banks, and that the suggestion of UTI was in order. But the chief officer, M.L. Gogtay was doubtful. He wondered if the provisions in the UTI Act were adequate to empower the institution to invest in PCs. The matter was referred to the Legal Adviser, R.M. Halasyam, who wrote that it would be advisable to incorporate a specific provision in the Act for the purpose, as investment in PCs could neither be construed as 'making of loans and advances' nor could the certificates be treated as 'mercantile instruments' eligible for purchase even after the relevant clause in the Act was amended. Thus the Reserve Bank felt that it would be advantageous to anticipate any contingency and incorporate a suitable provision at the stage when the Act was being amended. The Bank advised UTI accordingly in March 1974.

The Export Credit and Guarantee Corporation Ltd. (ECGC), on 1 February 1975, requested the RBI to approve its name for being eligible to accept participation certificates. A central government undertaking, it had been established for financing exports, and its objects clause permitted it to draw, make, accept, discount, execute and negotiate bills of exchange, and also to invest funds not immediately required in such a manner as determined by it (from time to time); it was thus generally authorized to invest in participation certificates issued by banks. ECGC, according to its memorandum of association, could extend financial assistance to exporters by way of loans against pledge of goods, title to property, give facilities for financing exports, provide financial assistance for purchase of Indian goods on extended payment terms, provide guarantees in respect of advances given by banks and other financial institutions in connection with export of goods, and give guarantees to exporters with a view to assisting them in conducting market surveys, etc. But in the early 1970s, it had restricted its business to insurance of export risks and promotion of foreign trade.

The purpose of ECGC's request was to secure higher returns on its investments because participation certificates with maturity of 30–180 days would fetch a return of up to 12 per cent, whereas term deposits with banks of similar maturity gave a rate of interest only of 3–6 per cent. The Reserve Bank considered it to be primarily an insurance organization but with a difference. ECGC was a government undertaking meant for promotion of exports and any augmentation in its income was welcome inasmuch as the additional resources would go to assist development of exports, which was of great importance to the country. The Bank realized that if it approved

ECGC's request there could be some diversion of its funds away from term deposits with scheduled banks, government securities and units. Nevertheless, its core function was to cover the risk of loss involved in exports made from the country, and this was akin to the function of a general insurance company which also covered varied risks within the country, and which had already been approved under the scheme.

On these considerations, the Bank decided to approve ECGC's request on the usual terms and conditions. However, as instructed by Governor Jagannathan, the Corporation was advised that this facility was extended only for enabling it to temporarily utilize its surplus funds profitably and that it should not be used as an avenue for long-term investment of funds, which would disturb its normal pattern of investments including those in government securities.

Lakshmi Vilas Bank Ltd, Karur (Tamil Nadu), a licensed scheduled bank, was not on the list of approved banks for the issue of PCs. Nevertheless, it issued PCs to United India Fire and General Insurance Company Ltd in April/May 1976, to the tune of Rs 20 lakh. This unauthorized act became known during the inspection of the bank and the RBI sought an explanation. The bank clarified that due to its tight resources position, it resorted to issuing PCs against working capital advances made to industrial concerns and, at the same time, offered an application for inclusion in the scheme. Even though DBOD was inclined to accede to the request, Executive Director J.C. Luther instructed that while the breach of the regulation could be condoned, the bank was not to be given the permission to participate in the scheme. This was approved by Krishnaswamy. The bank made a representation against the decision and received favourable responses from DBOD and the Credit Planning Cell as another small scheduled bank in Karur, namely, Karur Vysya Bank Ltd, had been approved for issue of PCs, thereby placing Lakshmi Vilas Bank at a comparative disadvantage. But the Deputy Governor once again turned down the application with the observation that 'the Participation Certificate Scheme has not always been used with sufficient care by the small banks, with the result that they are apt to get into resource jam. On balance, we may say no to Lakshmi Vilas Bank and also review if the Karur Vysya Bank should remain in the list.'

Foreign Banks

In the early years of the Participation Certificate Scheme, only four foreign banks had been permitted to issue PCs, namely, First National City Bank, National and Grindlays Bank, Mercantile Bank and Banque Nationale de

Paris. The Reserve Bank had declined to approve applications from other foreign banks, the only exception being Algemene Bank Nederland N.V., which was allowed mainly on the ground that the bulk of its advances helped exports.

In 1974, requests from the American Express International Banking Corporation, Bank of America, Mitsui Bank and the Chartered Bank were turned down owing to instructions from Governor Jagannathan. American Express had earlier issued PCs without the RBI's prior approval. When this was pointed out to the bank, it had regretted the lapse. The Bank did not take any penal action and accepted the explanation. In the review of the working of the scheme conducted in May 1974, no specific decision was taken in so far as foreign banks were concerned. The Bank, after examining individual cases afresh, rejected their proposals citing the stance of a tight credit policy. On DBOD's office note of 5 December 1974, in which the joint chief officer, K.B. Chore, had proposed rejection of the request, Executive Director Krishnaswamy had commented:

> On the basis of Governor's decision for the last busy season, we may so 'no' to American Express Banking Corporation. However, I think Governor's general position regarding not giving this discretionary facility to foreign banks could perhaps be reconsidered. I am not sure it would be right to deny them this facility for the reason that they are 'foreign'. We might, in fact, say no to most of them for other reasons—such as, slender deposit base, limited clientele, etc.

This was forwarded to the Deputy Governor, Hazari, who was in agreement with the above views; he, therefore, requested Governor Jagannathan to consider the general point made by Krishnaswamy. Governor Puri recorded that (1) we may say 'no' to American Express; (2) on the general issue it would be alright to take a decision on bank-to-bank basis rather than on the ground of banks being foreign; (3) we would be justified in denying the facility to American Express.

Towards the end of 1975, the issue came up for re-examination by DBOD. Joint chief officer Chore, following the instructions of the Governor, proposed that the cases of foreign banks could be reconsidered if they applied afresh, on merits, i.e. on the basis of their export performance, deposit mobilization, etc. He also expressed the view that since they got refinance facilities from the Reserve Bank and could also rediscount bills with other banks, denying them the PC facility might not be 'reasonable'. Hazari, to whom the case was marked, agreed but instructed the banks to be advised informally—particularly American Express, which had raised this issue in the credit budget discussion. He also indicated that Mitsui Bank's performance so far was in overall terms rather poor and hence its proposal would have to be examined separately. During the course of the next one year or so, four foreign banks, viz., American Express, Bank of America, Chartered Bank and Mitsui Bank, got approvals.

Till the end of 1976, the Reserve Bank had not prescribed any uniform accounting procedure that banks had to follow for PCs. This was perhaps because the scheme had initially been evolved by the banks themselves and had been operated on an experimental basis subject to annual reviews. As and when the banks sought any clarification regarding reporting of PC transactions, the RBI had advised them to devise their own accounting procedure in consultation with their auditors. In early May 1973, the government had wanted to know from the Bank the manner in which such transactions should be reflected in the balance sheets of banks. The Bank had preferred not to clarify at that time. In the case of a reference made by SBI in January 1976, DBOD, in its reply in March 1976, had indicated that it was not appropriate to lay down any specific accounting procedure to be adopted by banks except for outlining certain essential terms and conditions governing the scheme.

But SBI was not satisfied and persisted with its query. It contended that the instructions sought earlier had been for classification of the amounts of PCs in the weekly returns submitted to the Reserve Bank under Section 42(2) of the RBI Act as well as in the balance sheet, and not exactly for the accounting procedure to be followed by the bank internally. DBOD, after examining the issue, 'suggested' in a letter of 4 June that the PCs issued by SBI might be treated as 'contingent liabilities' on the liabilities side of statutory and other returns, and the amount deducted from the figures of total advances. The amount of PCs purchased by it was to be included in the returns in the total advances on the assets side. As contingent liabilities were not reported in some of the returns, for statistical purposes, the quantum of PCs issued/purchased was to be explained in the footnotes to the returns. Soon thereafter, the Bank was compelled to abandon this approach. The Credit Planning Cell, on its own, instructed the banks, in September 1976, to adjust PCs in calculating gross bank credit for credit budget formulation and, at the same time, suggested to DBOD to lay down a uniform accounting practice in view of the varying practices followed by different banks. Consequent upon the scheme being placed on a permanent basis from June 1977, DBOD worked out the reporting details—which were the same as those advised to the State Bank of India—and formalized them in a circular dated 21 June 1977, which, *inter alia*, announced the continuation of the scheme beyond June 1977. Thus, the total advances figure of all banks taken together was inclusive of PCs issued by banks to other banks but exclusive of PCs issued by them to other financial institutions.

Around the middle of 1978, the Reserve Bank became concerned about the dominance of insurance companies. They accounted for nearly 80 per cent of outstandings and their proclivity to park their surplus almost on a continuing basis in PCs was aided by banks, who willingly renewed PCs on the due dates. Transactions in PCs were outside the scope of reserve requirements of banks and this became important in the context of the increase in SLR by 1 per cent, to 34 per cent—from 1 December 1978. In a note prepared by DBOD, the propriety of financial institutions' dependence on PCs was called into question:

> The disposable funds of the financial institutions are meant for investment in long-term projects and by investing in PCs the idea of employing their funds in long-term projects gets defeated. In fact, the funds are utilized for working capital finance. The surplus funds available with them should normally represent the liquid resources meant for day-to-day operations of the financial institutions. These resources should not be kept with banks on an on-going basis in the form of PCs, thus becoming a source of revenue for them. What started as an outlet for temporary investment of surplus funds has now become a source of almost continuous income at a high rate of interest (10 per cent) for the financial institutions.

The RBI was worried that commercial banks might get around the higher SLR requirement and restrict their non-food credit to 40 per cent of incremental deposits by selling PCs and obtaining finance from long-term financial institutions. It wondered if the credit window available to commercial banks through the PC Scheme needed to be closed, at least temporarily, so that the above objective could be achieved. This would have meant restricting PCs to commercial banks only.

It should be noted that while, in June 1977, the Reserve Bank prescribed broad guidelines for reporting the sale and purchase of PCs by banks, the credit extended by them through the issue of PCs did not get fully reflected in the advances figures, thus presenting an opportunity for them to circumvent the Bank's instructions issued in November 1978 that the incremental non-food gross credit–deposit ratio from 1 December 1978 should not exceed 40 per cent. In such a situation, the Governor pointed out on 15

March 1979, while marginal recourse to the PC facility was understandable, and might even be essential, any large use of such non-banking sector's resources was clearly inconsistent with credit planning or credit control. Simultaneously, the Governor announced the decision of the Bank to set up a Working Group to examine the entire question of PCs because the manner in which the scheme had evolved in practice had brought about several distortions in the banking system.

Accordingly, in early April 1979, the Bank set up a Working Group under the chairmanship of W.S. Tambe, Executive Director. The Group was asked to review banks' recourse to PCs and borrowings in the call money market. Its main terms of reference were to examine:

(1) the size and pattern of operation in the call money market in respect of PCs and clarify their implications for monetary and credit policies;
(2) the basis on which the broad magnitude of resources available to banks from sources other than commercial banks and refinancing agencies (such as IDBI and ARDC) might be assessed; and
(3) the implications of any limitations on supplies of such funds from the non-banking institutions participating in the all money markets and participation certificate arrangements, and suggest alternative avenues for productive use of such funds.

The Group submitted its report in May. It was decided, to begin with, to initiate measures to discourage banks from excessive recourse to PCs. So the RBI began to operate a tight monetary policy which blocked any source of funds of the banking system that was not amenable to its control. Gradually, PCs became an unattractive form of investment and this effectively ended their growth.

In view of the sizeable expansion in money supply in two successive years (1976–77 and 1977–78) and the prospects of only a moderate growth of national income in 1978–79, the Reserve Bank adopted a slew of restrictive measures to restrain credit expansion and relate it to increases in output, economic activity and employment creation. Governor Patel, in a circular letter dated March 16, commented that banks had not increased their investment in government securities as advised by the Reserve Bank but continued to expand credit by increased recourse to the call money market and sale of PCs to other financial institutions. Therefore, besides raising the SLR, stipulating an incremental non-food gross credit–deposit ratio, and imposing a penalty for default in maintaining SLR and CRR at the prescribed levels, banks were exhorted in mid-March 1979 to keep to a minimum their reliance on external resources, such as borrowings from RBI, the call money market and recourse to PCs.

A meeting with the chief executives of major scheduled commercial banks was held on 25 May 1979. Governor Patel outlined the credit policy measures proposed to be adopted that year and expressed concern at the trend of banks resorting to funds raised through the issue of PCs. The trend had become particularly noticeable from the previous November, when the Reserve Bank had sought to further tighten credit expansion. Since the arrangements were not considered satisfactory, the Bank decided to tell the banks about the decision taken on the interim recommendations of the Working Group that had been headed by Tambe—these included bringing under the purview of SLR and CRR, the funds raised through PCs after they were approved by the Governor. For the present, the banks were asked to keep their involvement in PCs to the minimum.

The RBI decided, in June, to bring the funds raised through PCs within the purview of SLR and CRR and to discourage banks from having excessive recourse to PCs. At the same time, it wanted to ensure that this did not result in large-scale dislocation in the operations of banks and financial institutions. The latter would have to shift to other monetary instruments for short-term investment. It decided that:

(i) Outstanding PCs should be treated as deposits.
(ii) The amount of PCs issued by banks should be included in the figure of total advances (replacing the earlier instruction of deducting the amount of PCs issued from total advances).
(iii) The funds raised through PCs should be subjected to control under SLR and CRR, with the process to be implemented in a phased manner.

Accordingly, the banks were told on 21 June that from the last Friday of July 1979, they should cease to classify outstanding PCs as contingent liabilities and instead treat them as deposits, and that such outstanding PCs would attract 34 per cent SLR and 6 per cent CRR in stages—50 per cent of the outstanding PCs from the last Friday of July, 75 per cent of the outstanding PCs from the last Friday of August and 100 per cent of the outstanding PCs from the last Friday of September. They were also asked to maintain with the RBI an additional average daily balance, equivalent to not less than 10 per cent of the increase in PCs over the outstanding level as on the last Friday of July 1979. Now that the RBI adjudged PCs as akin to deposits and hence not to be deducted from the banks' advances, the banks were asked to report the funds flowing from issue of PCs in weekly returns under Section 42(2) of the RBI Act—under 'Demand and Time Deposits from Banks' and under 'Other Demand and Time Liabilities', depending on whether the instruments were issued to banks or other financial institutions.

Further, banks which purchased PCs were instructed not to include the amount of such certificates in total advances (as they had been required to do earlier in accordance with the terms of the Reserve Bank's letter issued in June 1979) but to show it under 'Advances to Banks', i.e. due from banks. The letter to banks dated 21 June 1979, under the signature of Krishnaswamy, also forwarded the relevant directive and notifications, and reiterated the RBI's earlier advice to reduce their reliance on PCs and keep their involvement in PCs to the minimum.

Despite the Reserve Bank bringing PCs under the SLR/CRR regime, banks continued their recourse to this type of borrowing on a sizeable scale. The Governor, therefore, in a letter dated 24 August, urged them to limit their issue of PCs to the level on 27 July. Where the level of outstanding PCs was above the corresponding level on that date, banks were required to bring it down to the July 1979 level by the last Friday of September, and where the level was already below the July level, they were not to be raised.

On 24 November, the Governor once again advised banks to reduce their reliance on PCs during the 1979–80 busy season, and to avoid accepting special deposits at preferential rates from financial institutions and others, as these amounted to circumvention of the directive to reduce their reliance on PCs. But this had no effect. Between end-November 1979 and end-March 1980, some banks increased their dependence on PCs, while most others brought about only a small reduction. The Reserve Bank, therefore, once again directed banks, in March 1980, to bring about a significant and lasting reduction in their recourse to PCs within the next few months. The Governor, in a letter dated 28 March 1980, came down heavily on the banks.

> It is unfortunate that some banks have increased their dependence on Participation Certificates while most other banks have only brought about a small reduction. It is, therefore, necessary that banks should bring about a significant and lasting reduction in their recourse to Participation Certificates in the next few months.

At the time of their introduction, PCs had been envisaged mainly as a means of evening out liquidity imbalances within the financial system. The Reserve Bank felt that in the limited sense of providing a temporary avenue of investment for 'floating funds'—funds awaiting eventual investment—the PCs Scheme was justified.[1] But, subsequently, the financial institutions

[1] See article in *RBI Bulletin*, November 1979, titled 'Data Relating to Bank Credit Inclusive/Exclusive of Participation Certificates—An Explanatory Note'.

found PCs convenient for parking sizeable amounts on a continuing basis through renewal of maturing PCs. At the same time, since the cost of raising funds through PCs was relatively low, banks also resorted to PCs on a sizeable basis. 'It is this sizeable recourse by banks to PCs on a continuing basis which posed serious problems for credit planning and control' (ibid.).

The Bank perceived the modifications in the scheme as forming part of the kit of credit control instruments used to effectively decelerate credit expansion in 1979–80. The modifications introduced in July 1979 in respect of banks' recourse to PCs, among other steps, impacted on the resources position of commercial banks. The RBI tried to impress on the banks that while marginal recourse to the facility of PCs was understandable, any large-scale resort to such non-banking sector resources on a continuing basis was clearly inconsistent with credit planning and control. The other instruments deployed to keep liquidity under check in the banking system included quantitative ceilings, restriction on utilization of limits sanctioned under the cash credit system, application of SLR and CRR to resources raised through PCs, an upward adjustment in interest rates, reduction in the total assistance form the Reserve Bank as well as raising the cost of such assistance, and, finally, moral persuasion.

The regime of strict credit discipline was continued in the 1979–80 busy season as the normal seasonal fall in commodity prices did not manifest itself, and industrial and agricultural output recorded a slowdown. While reinforcing the already existing credit control measures, the Reserve Bank advised banks to limit credit expansion within their own resources, and to resort to refinance facilities at the Reserve Bank in only very special cases of need. As a corollary, banks were urged to refrain from giving guarantees for private placement of deposits with companies by financial institutions and other non-banking entities and to reduce their reliance on PCs; to avoid accepting special deposits at preferential rates from financial institutions as this would be tantamount to circumvention of the policy of reduced reliance on PCs. The RBI reiterated the continued need for banks to reduce their reliance on PCs on 27 June 1980, as the persistent pressure on prices and the incipient difficult balance of payments situation left no alternative but to continue a cautious monetary and credit policy.

In a letter of 1 July, the RBI Governor gave a clear indication to banks that the supply of PCs would get reduced as a result of the exhortation by the Bank in March 1980 to bring about a significant and lasting reduction in their recourse to PCs, and also as a consequence of certain measures introduced in the central budget. The interim budget for the year 1980–81, presented by Finance Minister R. Venkataraman, envisaged that a part of the investible resources of LIC, GIC and UTI should be lodged with the government in special deposit accounts to augment the resources for financing the plan budget for 1980–81; it took credit worth Rs 100 crore on account of these deposits. Therefore, banks were advised to plan their lending, taking into account the reduced availability from this source.

The cumulative impact of these credit control measures was that the level of outstanding PCs was brought down from Rs 606 crore in June 1979 to Rs 313 crore by June 1980, and the expansion in total credit during 1979–80 was significantly lower both in absolute and in percentage terms than during the previous year—Rs 2,366 crore or 12 per cent in 1979–80, as against Rs 3,621 crore or 22.5 per cent in 1978–79.

THE PRIORITY SECTOR

If credit could be rationed via the Credit Authorization Scheme, it could also be directed to flow into areas where it would not ordinarily flow. By the end of the 1960s, it had become very clear that state intervention was needed to push credit into such areas. The debate on social control had generated interest in 'social banking', the nucleus of which was the concept of 'priority sector' lending. Bank nationalization in 1969 gave the government just the tool it needed to direct credit into this sector.

The concept and rationale of priority sector lending was formalized by an economist of impeccable credentials, D.R. Gadgil. As Deputy Chairman of the Planning Commission, he circulated a note to members of the National Credit Council (NCC) at its inaugural meeting on 16 March 1968, which pointed out the shortcomings of the credit structure and the need to effect a structural reorganization of the banking system.

> It is the hall-mark of an unequal society that not only is the ownership of the resources of production not broadly distributed within it but also that operational and other facilities are equally mal-distributed. In case of the banking and credit system as it operated twenty years ago, this inequality was glaringly evident. Those commanding the largest resources not only could get their credit requirements satisfied in the fullest measure but also obtained credit at specially favourable rates. At the other extreme, large masses of small business and households had no access to any institutional credit facilities. Developments during the past twenty years have in part changed the picture. The successful carrying out by the State Bank of India of its programme of branch expansion, the bringing together of

> the State Bank and older Indian State Banks into one structure covering the whole country, and a number of experiments undertaken by the State Bank of India in financing small industry and cooperative organizations have contributed to this. Developments in the cooperative credit structure have made fuller and more widespread institutional credit available to much greater numbers than before and special schemes in finance of small industry have slightly improved the position of categories of artisans and small industrialists. Even so, the basic inequality is still large and the main objective of social control of banking and credit would appear to be that of more evenly spreading available credit over different areas and categories and relatively lowering the cost of credit to small operators.

Gadgil followed this up with a letter dated 1/2 July to L.K. Jha, in which he elaborated on the need to meet the credit needs of small borrowers. The problem, he wrote, was very difficult in the urban areas inasmuch as salary-earner societies, wherever they existed, looked after the consumption needs of their members but their operation was confined to those in regular salaried employment, and the consumption needs of the bulk of the urban population and of most small artisans and businessmen were not looked after by any appropriate institution. In exceptional cases, there were primary cooperative banks or industrial cooperative finance societies or small commercial local banks, which partially performed the latter function. But, for most of the country, no such institution existed. Gadgil wanted the National Credit Council (NCC) to give serious thought to this problem of 'appropriate institutional development' and to initiate action in this regard. His note was circulated among members of the NCC.

Jha responded on 18 July. He said he was doing 'a certain amount of loud thinking' with a view to enable Gadgil to deal with this question comprehensively when it came before the NCC. He admitted: 'I confess that I myself see no satisfactory answer even though I fully understand the problem you have posed.' He, however, identified certain major constraints. First, while it was true that the small borrower was not easily able to borrow from a big bank, when it came to depositing his money he preferred a big bank to a small one. Second, without adequate deposit resources, small banks might be willing but unable to help small borrowers. Third, all too often managements of small banks were susceptible to local influences and pressures, so that, in course of time, they ceased to be sound and viable.

Finally, small banks suffered from all the weaknesses of cooperative banks in certain states.

Jha went on to suggest that one solution was to get the large banks involved in financing small business but this was beset with obvious difficulties. He wondered if greater decentralization of authority and delegation of powers from the central offices of banks to field officers could make things easier. Alternatively, large all-India banks should have small subsidiaries that would be largely localized and oriented towards meeting the needs of smaller borrowers. Such bodies would not have to observe the same standards regarding wages and employment as all-India banks, because they would be separate and distinctly small entities. This idea, novel as it was then, was developed more fully by the Banking Commission and subsequently, in 1975, when regional rural banks (RRBs) became a reality. His main thrust was clear, even though it was not a widely accepted view: greater emphasis should be laid on the adequacy of credit availability than on cheapening its cost.

Gadgil proceeded to develop the issues on the lines suggested by him through the Study Group on the Organizational Framework for the Implementation of Social Objectives set up by the National Credit Council, of which he was the chairman. In its report, in October 1969, the Group drew pointed attention—perhaps for the first time—to the prevalence of credit gaps in key sectors of the economy, such as agriculture. It highlighted the skewed nature of distribution of bank finance and traced the causes for this, namely:

> Modern banking owed its origin to the development of trade and commerce to organized industry. The doyens of commerce and industry were, until recently, in substantial control of the management and policies of banks and hence commercial banks had a pronounced urban orientation in their development and did not encompass the rural areas to any significant extent. Against this background banks evolved procedures and practices primarily suited to cater to the industrial and commercial clientele on conventional basis. Banking norms established under such procedures and practices were not suited to meeting the needs of the rural sector and other non-conventional borrowers. Nor did they feel any urge to modify these procedures because there was no motivation on their part to spread to the rural areas and undertake non-conventional business.

The report pointed out that, in addition to uneven distribution of credit as between states, there was uneven distribution of credit among different economic sectors, and credit was virtually not available to certain types of borrowers, particularly small borrowers and weaker sections of the community. The Group estimated that in 1967–68, about 39 per cent of the total credit requirements of agriculture was met by institutional credit agencies, and the gap between the credit needs of small-scale units and the credit made available to this sector by institutional agencies was at least 35 per cent. It also found that the sectoral distribution of credit by commercial banks was skewed in favour of large-scale industries, wholesale trade and commerce, rather than agriculture, small-scale industry, retail trade and small borrowers. Agriculture, excluding plantations, accounted for less than 1 per cent of total bank credit, and advances to retail trade for less than 2 per cent. The data compiled and case studies undertaken for the Group revealed that credit extended by commercial banks was not widely dispersed and there were credit gaps particularly in the case of small borrowers, and confirmed that there was a potential demand for credit from small borrowers but the lack of institutional facilities resulted in their approaching moneylenders, who charged exorbitant rates of interest.

It was not that the big banks were oblivious to the needs of social banking. But whatever little assistance they provided to the agricultural sector was by way of credit for marketing of agricultural products or indirectly for distribution of fertilizers and other inputs, and to state electricity boards for pump-set connections. The banks also provided finance to plantations, such as tea, coffee and rubber, but these were in the organized sector. All these limited avenues of lending to agriculture by banks did not add up to more than 2 per cent of the total credit. The major banks had taken the initiative of setting up the Agricultural Finance Corporation (AFC) to identify agricultural projects and offer guidance for extending financial assistance. But such initiatives hardly touched the fringe of marginal borrowers.

New Demands

The RBI, on its part, tried to induce banks to channel more credit to sectors starved of credit. Jha, at a meeting of the representatives of major banks held in October 1968, stressed this aspect. His letter to the bankers proposed that they allocate 15 per cent of the banks' deposits to agriculture and 31 per cent to small-scale industry, after providing for statutory liquidity requirements. The Reserve Bank asked commercial banks to enhance the flow of credit to the priority sectors of agriculture and small-scale industry, so as to achieve the quantum indicated by the National Credit Council.

After the March 1969 meeting of the NCC, the Reserve Bank also asked the banks to provide credit to specific sectors, namely, retail trade in rural areas, hire-purchase of trucks, taxis and scooters and the self-employed. At the same time, banks were cautioned against lending for speculative activity and to restrict credit to sectors that exhibited an unhealthy rising trend in prices. It announced the continuation, after 30 June, of refinance facilities available under the Bill Market Scheme in respect of food procurement, agriculture and small-scale industries. Refinance for exports and in respect of packing credit was also extended beyond June 1969.

At its second meeting, on 24 July 1968, the National Credit Council considered the need for increasing the participation of commercial banks in financing agriculture and small-scale industries as being urgent. It therefore recommended that credit to agriculture should increase to Rs 300–400 crore by the end of 1968–69, including finance for plantations and the marketing of produce other than foodgrains. It also suggested that for credit to the small-scale industrial sector, commercial banks should allocate an additional amount of Rs 60–70 crore in 1968–69, as against the estimated expansion of Rs 30–35 crore in 1967–68.

The NCC propounded an important guideline: that banks, while providing finance for the priority sector, must consider the viability of the schemes, which meant that the banks would have to satisfy themselves that the projects and programmes being financed by them were viable. But this did not mean that undue emphasis was to be placed on margins and guarantees.

The Ad-hoc Committee of Bankers, at its meeting on 16 August, considered these proposals and came out in favour of individual meetings between the Reserve Bank and each of the major commercial banks. Accordingly, allocations were made to individual banks for credit that was to be extended to the two priority sectors. D.N. Ghosh had called for information in order to reply to a parliamentary question, and Narasimham conveyed the above decisions of the NCC. He assured the government that the Reserve Bank would follow these recommendations in formulating its own credit policies, and take appropriate steps to ensure that credit extended by the banking system was in conformity with these guidelines.

The RBI lost no time in tuning its credit policy to the new demands. It had decided in November 1967 to liberalize its refinancing scheme. It made available at the Bank rate (irrespective of the net liquidity ratios of the respective banks), refinance against advances covering sale and distribution of chemical fertilizers and pesticides. In February 1968, it announced that the total increase in bank advances to the three priority sectors—agriculture (defined as sale and distribution of chemical fertilizers and pesticides), small-scale industry covered by the Credit Guarantee Organization (CGO) and exports—over the average of such advances during the base period (i.e. July–October 1966 for the slack season and November–April 1966–67 for the busy season) was eligible for refinance at a concessional rate of 4.5 per cent, irrespective of the net liquidity position of the respective banks.

The Reserve Bank also granted relief in the computation of net liquidity ratios by banks (which governed the rate of interest on their borrowings from it) by treating the increases in lending to the above sectors as part of their liquid assets. Unsecured advances to finance sales on hire purchase or on deferred payment terms of machinery and equipment for agriculture, dairy farming and fishing were exempted from the norm stipulated for banks' unsecured advances and guarantees in terms of the RBI's letter of 3 May 1967. Advances to small-scale industries covered by the CGO and performance guarantees executed on behalf of small-scale industries were also exempt from the above norm. Further, term loans granted for agricultural development, whether refinanced by the Agricultural Refinance Corporation or not, and to small-scale industries covered by the CGO were excluded from the total term loans that were generally not to exceed the prescribed norm of 5 per cent of total deposits. In October 1968, the RBI extended refinance facilities under its Bill Market Scheme to banks' advances to cooperative banks, to enable the latter to make advances to small-scale industries.

The Industrial Development Bank of India, which was a subsidiary of the Reserve Bank, provided refinance to banks in respect of medium-term loans to small-scale industries covered under the Credit Guarantee Scheme at a concessional rate of 4.5 per cent (as against the normal lending rate of 6 per cent), provided the effective interest rate of the lending institution was not more than 8 per cent. The minimum amount of loan refinanced and the extent of refinance were also liberalized in April 1968. Another affiliate of the Bank, namely, the Agricultural Refinance Corporation, relaxed the conditions governing refinance to banks, to enable them to extend credit to farmers, especially in areas where the cultivators came under the area of operation of a sugar factory and that factory was prepared to assist the bank in supervision, technical guidance, recovery of loans, etc. The Corporation also decided to entertain proposals from banks for financing the purchase of power tillers, tractors, pump sets, etc., and to provide refinance for the same, provided the schemes were drawn up keeping in view the aspect of 'area development'.

In a detailed memorandum to the Central Board of the Reserve Bank, dated 21 October 1968, Deputy Governor Adarkar narrated that twenty major banks had agreed to increase their lending to agriculture in 1968–69 by Rs 44 crore and to small-scale industries by Rs 93 crore. On this basis, the overall credit to these two sectors amounted to Rs 51 crore and Rs 108 crore, respectively. But, as some of the major banks were known to deploy on their own a larger share of credit to these sectors, it was expected that total lending by the banking system to the two priority sectors as a whole would be larger than the amounts specified above. This analysis implied that banks would deploy about 47 per cent of their available incremental deposits (after providing for statutory liquidity ratio) for financing agriculture and small-scale industries, as against the National Credit Council's norm of 33–38 per cent. The memorandum examined whether the above allocations would starve other sectors of bank finance. The Bank concluded that although the banks would aim at higher targets, it was somewhat doubtful whether the actual utilization of credit would turn out to be as high as anticipated. Success in this matter depended on the progress they made with organizational and other arrangements. 'The higher target aimed at banks should, therefore, be regarded as what the banks are aiming at to ensure that at least the targets set up by the Council will be fulfilled.' Further, with the improved prospects for deposit mobilization, availability of resources to meet the requirements of other areas was not expected to pose a serious problem. In any event, refinance facilities available from the RBI—both for general purposes and for special purposes such as food procurement, exports, etc.—could ease seasonal pressures on individual banks.

Jha wrote to Narasimham on 17 March 1969, asking about the yardstick to be adopted for fixation of targets for agriculture and small-scale industries. He wanted to know whether this would be in absolute amounts or in terms of percentage of increase in deposits. He said that his understanding from the NCC discussions was that there was no attempt to relate the targets to any estimate of increase in bank deposits. The anxiety was to ensure that the targets were not placed too high because banks take time to build up the momentum of lending in new areas. He added that a high target was set for small-scale industry not because its needs were greater than those of agriculture, but because banks were more familiar with this type of lending and would have fewer organizational problems. Moreover, to avoid rigidity, a 'range' rather than a precise figure was indicated. Jha was constrained to remark that in many of the comments offered by the Reserve Bank, attention was getting focused 'on percentages of deposit increase', which was never intended by the NCC.

Narasimham marked the Governor's query to Director A. Raman, who clarified on 26 March that in the press note issued by the Reserve Bank after the meeting of the NCC on 24 July the previous year, the targets of lending to agriculture and small industries were indicated in 'absolute sums' and did not refer to any estimate of deposit mobilization. However, during the discussions at the NCC meeting, C.H. Bhabha of Central Bank of India had felt that, instead of indicating specific figures in absolute terms, it would be more appropriate for the NCC to consider percentage-wise allocations between the various sectors of the additional deposit resources accruing to banks. When the Bank held discussions with individual banks to draw up guidelines and targets, attention was focused on 'percentages of deposit increase' so as to arrive at the minimum target for an individual bank. The targets in relation to deposit increase for all the major banks as a whole with whom the Bank held discussions were mentioned in the paper subsequently circulated to NCC members. Adarkar remarked on the note that for apportioning credit targets among banks, deposit accretion was found to be a convenient basis and yet absolute figures were being used. The Governor saw the paper on 28 March 1969, but did not offer his views. It was against this background that, on 29 April, Jha highlighted the different considerations that had to be given due importance in framing the overall credit policy for the slack season of 1969, and urged both the Deputy Governors J.J. Anjaria and B.N. Adarkar, as well as Narasimham, to do 'some active thinking' and then take a final view.

Anjaria had been worrying about the general price trend and suggested that a measure of restraint be shown regarding expansion of bank credit. He sought parameters for the determination of priority sectors and targets for the period July 1969 to June 1970. Jha responded that merely to set up targets for agriculture and small-scale industries would not serve the purpose because the Reserve Bank had to evaluate whether, even after a sizeable increase in bank credit to small-scale industries, large-scale additional needs for working capital would still be left out. Agriculture was in a different position because it was much larger. The Bank had already brought in a variety of relaxations—some of them extremely easy, such as lending to government or government-sponsored bodies against stocks of food and fertilizers—as eligible to be included in priority sector lending. As such, he said that unless some kind of sub-quotas were introduced, the really difficult areas of lending may remain neglected. He also raised a rather moot point: whether these two areas really exhausted all the possibilities. In this connection, he cited the case of the export sector for which there was no target. 'Can anything else be done to ensure that banks are on the look-out for export business rather than merely deal with such requests as come to them? As the return to banks is not high when they finance exports the danger of their not being over-active is there.'

Jha also wanted the RBI to pay attention to regional imbalances. Not only were there many states that were underbanked, but there was also evidence that the banking system sometimes transferred resources from poorer areas to richer areas. He wanted something done about this. 'Can we have any objective non-political criterion on the strength of which we can ask banks to increase their lending in particular states and possibly set targets for it?' In attaining such targets, due credit would have to be given to the contribution of banks to state loans, etc. He wanted to weave into the scheme as 'area approach'. For example, he thought it might be better for particular banks to undertake to increase the supply of banking services in underbanked states. He concluded with instructions that in formulating the Reserve Bank's ideas on all these subjects, Anjaria's point about the need for monetary restraint should be borne in mind. The slack season policy of 1969, therefore, reflected the concerns expressed by the Governor. But the more important and pressing issues highlighted by Jha, namely, regional disparities in banking operations, more equitable distribution of credit through an area approach, etc., had to wait for bank nationalization.

In the course of discussions with individual banks, the Reserve Bank brought to their notice the areas where action could be taken by them with advantage. It advised them to set up a sub-committee of their board of directors consisting, among others, of the directors representing the interests of agriculture and small-scale industries, in order to adopt a focused approach to the problems involved in financing the priority sectors and to infuse a sense of urgency to such lending. Banks were also asked to devote special attention to expeditious processing of applications received from small-scale industries and to set up special cells or departments to deal exclusively with such applications. Qualified personnel were to be recruited to speed up completion of technical formalities involved in the processing of applications. To impart the desired orientation to their lending policies, banks agreed to bring all their new advances under the scope of the Credit Guarantee Scheme. This was expected to result in banks taking a larger interest in financing small-scale industries. The Reserve Bank, on its part, reduced the fee for guarantee cover under the scheme. Some of the procedures relating to obtaining guarantee cover, particularly relating to filling up forms, were considerably simplified.

This persuasion, however, had little effect on the banks and there was no perceptible increase in lending to agriculture. Then came nationalization and priority sector lending became a major policy objective of the government. The Statement of Objects and Reasons to the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1969, observed that the banking system had to be inspired by a larger social purpose and greater attention should be paid to sectors neglected till then.

> The banking system touches the lives of millions and has to be inspired by a larger social purpose and has to subserve national priorities and objectives, such as rapid growth in agriculture, small industries and exports, raising employment levels, encouragement of new entrepreneurs and the development of backward areas. For this purpose, it is necessary for Government to take direct responsibility for the extension and diversification of banking services and for the working of a substantial part of the banking system.

For the government to assume complete control and effective supervision over the functioning of the bulk of the banking system, extension of banking facilities to unbanked areas, larger mobilization of deposits (especially from rural areas) and distribution of credit in an equitable manner in tune with the priorities of socio-economic development became necessary. In this milieu, credit flow to the priority sectors was given top priority. That the banking policies were fashioned to serve as a powerful instrument of economic empowerment of the large mass of people was evident from the address of Prime Minister Indira Gandhi to the newly appointed custodians of nationalized banks in September 1969. She declared:

> Banks, being closely linked with the development of the economy, cannot remain entirely uninfluenced by the needs of the political situation. The political situation in our country demands that banking facilities should be extended in an increasing measure to backward areas, to agriculture, to small-scale industry and so on, and banking operations should be informed by a larger social purpose.

One of the immediate policy decisions taken as a follow-up to nationalization was a scheme of guarantees for lending by banks to channel more funds to the priority sectors and other sectors that had remained neglected. This resulted in the setting up of the Credit Guarantee Corporation of India under the aegis of the Reserve Bank. Chapter 6 narrates the developments in this regard.

The Reserve Bank had conceptualized the strategy of priority sector lending in association with the NCC, by integrating it with credit policy in a manner that commercial banks found easy to implement. The government, seeing in it a powerful opportunity, decided to prescribe targets for lending. The Bank had not, in the initial years, prescribed any specific targets to be achieved. Whatever quantum of lending it suggested was more in the nature of an indication, and that too at the instance of the NCC. After nationalization, too, the Bank sought to promote the same indicative approach. But the political and social demands were such that apportionment of credit to the priority sectors became unavoidable. This was reflected in recommendation no. 13 (paragraph 2.31) of the 62nd Report of the Estimates Committee. In 1974, the government accepted a target of 33.3 per cent for lending to priority sectors in a planned manner, such that the overall target could be achieved by public sector banks by the end of the Fifth Plan period, i.e. by the end of March 1979.

Further, as assured to the Committee, the plans for lending to the priority sector were made an integral part of the performance budget prepared by public sector banks every year. These decisions were conveyed directly to the chiefs of public sector banks on 11 November. Consequently, the priority sector advances of banks doubled from 15 per cent of total advances in 1969 to 33.3 per cent in 1979. The sectoral distribution of advances under the priority sectors at end-June 1979 stood as follows:

Sector	Amount (Rs crore)	Percentage to total of priority sector advances
Agriculture	2221	42.6
Small-scale industry	2061	39.6
Others	927	17.8
	5209	100

Soon after Indira Gandhi was voted back to power in January 1980, on 6 March, the Finance Minister and the CEOs of public sector banks met to discuss enhancement of the target for priority sector lending. It was decided at the meeting that public sector banks would aim at raising the proportion of their advances to priority sectors to 40 per cent by 1985, and that within the overall target, a significant proportion would be allocated to the beneficiaries of the Twenty-point Programme.

This target was endorsed by the Krishnaswamy Working Group, which noted that the ratio of agricultural lending to total advances was going up every year by 1 per cent and expected the same trend to continue on the assumption that banks would be actively participating in the Integrated Rural Development Programme (IRDP) introduced in 1976–77. It envisaged that banks should be able to step up their credit to agriculture to 16 per cent by March 1983 and exceed this ratio after March 1985. Moreover, in view of the dominant position occupied by agriculture in the national economy, the Working Group recommended that at least 40 per cent of priority sector credit should be extended to the agricultural sector (which roughly worked out to 16 per cent of the total credit), and that this limit was to be only a minimum; it did not place 'an embargo' on a bank to step up the limit if its operational strategies and the potential of the area of its activities warranted such an increase. For ensuring fair allocation of credit among the weaker sections within the priority sector, the Working Group recommended that advances to small/marginal farmers and agricultural labourers—collectively termed as weaker sections—should have a share of 50 per cent in indirect agricultural credit.

Important Findings

The Credit Planning Cell of the Reserve Bank carried out a study of commercial banks' advances to the priority sector during the years 1972, 1973 and 1974. A. Raman prepared a note on the basis of this study, which revealed that the share of priority sector advances in the total bank credit of public sector banks was 24.7 per cent in March 1974 as compared to 23.7 per cent in March 1973, and concluded, on that basis, that the share of the priority sector had not suffered as a result of the policy of credit restraint. Figures of advances to agriculture (direct and indirect) in respect of SBI and the fourteen nationalized banks indicated that, between March 1973 and March 1974, the share of advances to agriculture in total bank credit showed only a fractional decline, from 8.3 to 8.2 per cent.

The figures in respect of all scheduled commercial banks' advances to agriculture (direct finance) showed that the share of increase of such advances to increase in the total bank credit was 6.5 per cent between March 1972 and March 1973, and 9.1 per cent between September 1972 and September 1973. Of the direct finance given, term loans accounted for about 58 per cent. The Reserve Bank had provided refinance at the Bank rate between February 1970 and July 1973 (irrespective of net liquidity ratio but impairing net liquidity ratio for other borrowings), for incremental short-term direct finance to agriculture. Notwithstanding this statistical exercise, the real picture was much grimmer, according to the government.

In a d.o. letter dated 16 May 1974 to Governor Jagannathan, N.C. Sen Gupta, Secretary, Department of Banking, commented that even though the Reserve Bank had impressed upon banks the need to maintain the tempo in priority sector lending during the busy season of 1973–74, over the last busy season the incremental ratio in respect of priority sector lending was lower than the average at the commencement of the season (Document 4. D31). Alarmingly, quite a few banks were reported to have completely stopped further lending to priority sectors. 'This has laid them open to justifiable criticism that banks are using their branches in rural and semi-urban areas as mere deposit-collection points and the deposits were siphoned off to urban areas and organized centres', Sen Gupta averred. The letter also informed that the Finance Minister (Y.B. Chavan) had observed that small borrowers and priority schemes (like the Differential Interest Rate Scheme) were being denied bank credit, while the requirements of the organized sector were being met adequately. In view of this position and as the policy of credit restraint would have to be pursued through the slack season as well, the government considered it necessary to urgently formulate some scheme of assistance to encourage banks to maintain the tempo of flow of funds to the priority sector. Sen Gupta proposed the introduction of a scheme of refinance with two possible alternatives, namely, a differential rate of refinance covering priority sector advances over the specified base level, or cent per cent refinance in respect of the increase in advances over the base date in respect of all priority sector advances covered by the Credit Guarantee Scheme/Credit Guarantee Organization. Advances to small-scale industrial units drawing more than Rs 2 lakh from a bank were to be excluded from the proposed refinance facility. He clarified that 'priority sector' in this context was not to include 'exports', for which refinance facility was already available on a discretionary basis. Sen Gupta wanted this matter to be urgently examined and to be apprised of the policy measures the Reserve Bank proposed to initiate, to meet the situation. Jagannathan seems to have spoken on the matter with the Finance Minister during the course of a meeting held in June at Lucknow, but it was not pursued. Jagannathan, however, expected the matter to crop up again.

Finance Minister Y.B. Chavan, at an informal meeting convened by him on 5 June 1974 at Lucknow, discussed with bankers the setback to growth in priority sector advances after the imposition of credit controls in the busy season credit policy towards the end of November 1973 (Document 4.17). He pointed out that, for the banking system as a whole, priority sector advances had increased by Rs 58 crore over the three-month period from January to March 1974, as against a rise of Rs 58 crore during the month of October 1973 and the average of Rs 47.5 crore per month during the two subsequent months. Moreover, out of the figure of Rs 58 crore, Rs 57 crore was accounted for by small-scale industries. Thus, other areas of the priority sector had stagnated. A large number of representations had been received by the Department of Banking (Ministry of Finance), that new proposals from applicants in the priority sector were not being entertained by the public sector banks. While the Reserve Bank was examining the introduction of some sort of refinance facility to maintain the tempo of priority sector lending, the government was of the view that the 'need for the banks to ensure that restraint on credit did not mean a neglect of the priority sector lending'. The Finance Minister was also not happy that the performance in lending to agriculture was even poorer than that for the priority sector as a whole.

In defence of the Reserve Bank, Jagannathan pointed out that in order to comply with the credit restraints, certain banks had withdrawn all sanctioning powers from their field staff in the beginning but this anomaly was later removed. Jagannathan, however, felt that priority sector lending would not suffer much on account of this action. He was not in favour of instituting some sort of refinance facility for the priority sector as it was a 'complicated issue'. Banks had already been obtaining accommodation from the Reserve Bank in magnitudes that had been causing anxiety to all concerned. While he was against extending the refinance facility indiscriminately, he was prepared to further examine helping sectors like agriculture and small-scale industries selectively.

Prime Minister Indira Gandhi, at a meeting held on 16 September 1974 in her room in New Delhi (at which Governor Jagannathan was present), raised the issue whether within the sectors that received preferential credit there should be a redefinition of priority, particularly to prevent undue appropriation of the available credit by big farmers or big borrowers in the small industries sector. Finance Minister Chavan observed that in achieving this objective, there should be no downgrading of the preferential treatment accorded to deserving categories of the priority sector. Jagannathan was judicious enough not to join issue. That his judgment was correct was confirmed by the discussions, where there was a general recognition that the question of according relative preference within the priority sector (within small industry, for example) was a complex and difficult one. A mere redefinition on the basis of size-wise classification of advances might not be adequate unless it was related to the purpose of the loan, which again was subject to serious operational limitations. Therefore, it was not considered desirable to set up an elaborate system of centralized control for allocation of credit to individual borrowers. But in reality, credit authorization existed.

At a meeting of the Finance Minister with the chief executive officers of public sector banks held on 6 March 1980, it was agreed that the banks should aim at raising the proportion of their advances to the priority sector to 40 per cent by 1985, and that, within the overall target, a significant proportion would be allocated to the beneficiaries of the Twenty-Point Programme, which came into being in July 1975 in the initial stage of the 'Emergency'. It was also decided that the Reserve Bank should constitute a Working Group to consider the modalities of the above programme. Accordingly, the Bank set up a Working Group on 13 March 1980, under the chairmanship of K.S. Krishnaswamy, Deputy Governor, which included representatives of the government, public sector banks, the Reserve Bank, and the Agricultural Refinance and Development Corporation. The Group submitted its report on 22 April 1980, and its recommendations pertaining to the priority sector were as below.

Of the seven terms of reference of the Group, two related directly to the priority sector, namely: (i) the fixing of sub-targets (within the enhanced overall target of 40 per cent for assistance to the priority sector) for the beneficiaries identified under the Twenty-Point Programme; (ii) the modalities of evaluation of the performance in lending to the priority sector, particularly under the Twenty-Point Programme. On the first item, dealt with in Chapter IV of the report, the Group highlighted certain anomalies that had crept into priority sector lending, the need for uniformity in definitions, carving out a share for the weaker sections in the priority sector and the need for special concessions for the weaker sections. Firstly, there was found to be a lack of uniformity in the classification of priority sector advances by banks, which vitiated comparison of the data furnished by different banks for compliance with the prescribed targets. Secondly, as the guidelines issued by the Reserve Bank did not specify any ceiling on limits, the finance extended by banks to the more affluent sections within the priority sector came to be included under this category. The Group felt that the time had come when 'a new direction is to be given to banks' advances to these sectors'. To ensure that banks granted advances increasingly to the comparatively weak and underprivileged sections, the Group recommended certain modifications to the existing definition of priority sector advances. Further, the Group suggested introduction of the concept of a sub-sector within the two main priority sectors (i.e. agriculture and small-scale industries), to focus the attention of banks on the need to give more finance to relatively underprivileged sections. It advocated that the use of the term 'priority sector' should be restricted to the aggregate priority sector, and sub-sectors comprising the more underprivileged within this main group would be known as the 'weaker sections'. The weakness alluded to here might be due to either economic or social causes. The weaker sections were identified as small and marginal farmers, landless labourers, and borrowers from allied activities with credit limits up to Rs 10,000. Similarly, in the small-scale industry sector, units/borrowers with credit limits up to Rs 25,000 were to be treated as weaker sections. Thirdly, the socially weaker sections of the society (also known as underprivileged) were, as a class, financially weak, and suffered from a lack of bargaining power and articulation in getting their grievances redressed. The beneficiaries under the Twenty-point Programme who had been identified by the Group belonged primarily, such weaker sections. By introducing a separate sub-sector for three weaker sections within the priority sector, the Group felt that the objectives of the Twenty-point Programme would be met effectively. Fourthly, according to the Group, if the concept of 'weaker sections' in the priority sector was accepted, the concessions being presently offered to the priority sector as a class could be oriented to meet the needs of the weaker sections. While the banks should continue to give preferential treatment to the other groups in the priority sector, compared to the advances to the traditional sectors, the maximum benefit of all types of concessions should be invariably available to the weaker sections.

The government and the Reserve Bank generally accepted the recommendations. The need for a schematic and integrated approach for assisting the beneficiaries, in consultation with the state development agencies, was emphasized. At the district level, district credit plans (DCPs) prepared by banks were to explicitly provide for allocation of credit to the beneficiaries under the Twenty-point Programme. On its part, the Reserve Bank issued detailed guidelines to all the commercial banks for their implementation, in October 1980. They focused on overall assistance to the priority sector to constitute 40 per cent of total advances by March 1985; at least 40 per cent of the advances to the priority sector to be extended to agriculture and allied activities; direct advances to 'weaker sections' in agriculture and allied activities to constitute at least 50 per cent of the total direct lending to agriculture (including allied activities) by March 1983; 'weaker sections' in this sector to comprise small and marginal farmers and landless labourers; persons engaged in allied activities whose borrowing limits did not exceed Rs 10,000 also to be included in the 'weaker sections', and advances to the 'weaker sections' in small-scale industries, i.e. those with credit limits up to and inclusive of Rs 25,000, to constitute 12.5 per cent of the total advances to small-scale industries by 1985.

Policy on Refinance to Banks against Priority Sector Advances

The incentive to extend priority sector loans was provided by the Reserve Bank through the mechanism of refinancing. As stated earlier, till July 1973, advances by commercial banks to the priority sector were eligible for refinance from the Bank at the Bank rate, irrespective of the individual bank's liquidity ratio. Short-term direct lending to agriculture, to small-scale industries and to primary cooperative credit societies, besides exports, were all treated as eligible for refinancing. The lending banks could recoup their lendable resources because of the refinancing facility. However, while exhorting the banks to increase their advances to agriculture and small-scale industry, the Reserve Bank invariably impressed on them to ensure that there was an adequate turnround of the funds lent to these sectors (see circular DBOD. Sch.1696/C.96–70 dated 10 November 1970, reproduced here as Document 4. D32). The refinance entitlement for the priority sector, however, underwent modifications (in terms of quantum of availability and interest rates) from time to time, depending on the macroeconomic indications that influenced the formulation of monetary policy. For instance, the preferential treatment of priority sector lending came to an end in July 1973 as the serious price situation and the rigours of credit restraint warranted curtailment of overall borrowing from the Reserve Bank except in exceptional circumstances and for short periods. Governor Jagannathan, vide his letter dated 12 July 1973, withdrew, among others, the then existing concessionary refinance entitlements at the Bank rate or below, with the only exception of a limited amount of refinancing of export credit and refinancing of amounts lent by commercial banks to primary credit societies and farmers' service societies. At the same time, banks were advised:

> The withdrawal of some of the concessionary facilities in the reference system does not in any way alter the stress of policy to assist the priority sectors, namely, agriculture, small industry,

> other small borrowers and exports. Banks should continue to increase their involvement in financing these sectors.

In the subsequent credit policy pronouncements, exhortations not to neglect the export sector in particular and the priority sector in general, continued. This perhaps had to do with the growing perception of the government that preoccupation with credit restraint could lead to neglect of priority sector lending, a point made by N.C. Sen Gupta in his letter of 16 May 1974 to Governor Jagannathan, referred to earlier. In a letter dated 11 January 1974, banks were reminded that they should give primary consideration to the priority sector, including exports, and to meeting the essential needs of production and seasonal movement of commodities. The RBI always kept in view the special requirements of exports and the policy of refinancing a portion of export credit at the Bank rate was maintained. Again, in a letter dated 18 April 1974, the Bank expressed the view:

> It is likely that during the slack season there will be some additional demand for credit for financing food procurement, exports, priority sectors, and other essential production. Banks would be striving for better deposit accretions and return flow of funds than has been evident in the recent past. With the realization of these expectations, banks should by and large be able to meet these increases in credit requirements.

In its circular dated 22 July 1974 (paragraph 6), the RBI informed banks that in respect of direct short-term finance to agriculture, incremental performance over a determined base period would be one of the important factors that would be taken into account for providing discretionary refinance. The concern of the Bank for the growth of these sectors was again restated in its circular dated 29 October 1974 as follows:

(i) Agricultural credit requirements, including those for distribution of agricultural inputs, should continue to be given the maximum possible attention. In recent years, besides agriculture, certain designated priority sectors, such as, small-scale industry and other small borrowers, have received an increased share of bank credit. It is necessary to introduce in these sectors a greater degree of selectivity in the deployment of further credit. The benefit of access to the scarce resource of bank funds should be extended in accordance with the needs of the borrowing unit, determined not only by its size but also by the type of production in which it is engaged. Small-scale industrial units producing inputs for core sector and wage goods industries should be preferred to the small-sized units in less essential lines. The policy of giving priority to small industry as such may be refined in its application so as to accord such treatment more particularly to units having credit limits of Rs 10 lakh and below.

(ii) There should be no slackening of our export efforts. The special requirements of export credit should, therefore, continue to be accorded high priority. The policy will continue of applying the concessionary rate of interest on export credit to periods not exceeding 90 days, except in regard to post-shipment credit arising out of exports to the Western Hemisphere. The intention of policy is that credit may be made available even beyond this period of 90 days or 120 days, as the case may be, to meet all legitimate needs of exports, in particular difficult situations such as unavoidable delays in obtaining essential inputs and shipping bottlenecks.

(iii) In such exceptional cases, banks are required to charge their normal lending rates for the extended period.

Borrowers falling under the category of the priority sector were eligible to a number of benefits. First, they got preference over others in the allocation of bank credit. Second, banks normally allowed certain relaxations in the terms and conditions governing the loan, including the rate of interest and percentage of margin to be maintained. For some priority sector advances, the maximum lending rates were below the normal lending rates on traditional advances.

THE BANK AND THE EMERGENCY

Unlike its close involvement in the policy on priority sector lending, the Reserve Bank's involvement with the Twenty-point Programme was rather peripheral, mainly because not all the items specified in the programme needed help from the banking system. Also, agencies other than banks were also involved in implementation of the programme.

The banking system could play its part in the implementation of the following ten of twenty points, directly and indirectly. These were:

(i) procurement and distribution of essential commodities;
(ii) assistance to landless labourers;
(iii) assistance to released bonded labourers;
(iv) bridging the credit gap following a moratorium on rural indebtedness and its progressive liquidation;
(v) implementation of minor irrigation programmes and better utilization of underground water resources;

(vi) assistance to the handloom sector;
(vii) assistance to holders of national permits for road transport;
(viii) schemes for supply of essential commodities and books and stationery to students at controlled prices;
(ix) workers' participation in industry; and
(x) apprenticeship scheme for enlarging the employment opportunities particularly of the weaker sections of the people.

From the very beginning, the Finance Ministry liaised directly with the commercial banks in the implementation of the programme. Very rarely did it recognize the need to send signals through the Reserve Bank. The banks were

> expected to play an important role, among other things, in bridging the gap created in the rural credit structure following imposition of moratorium on debt recovery, in assisting the farmers who have been newly allotted lands for cultivation, in providing assistance to those released from bonded labour for taking subsidiary activities allied to agriculture, in financing minor irrigation programmes, in promoting development of handloom sector and in enlarging employment opportunities, especially for the weaker sections.

In April 1976, the government instructed banks to involve themselves more actively. K.P.A. Menon, Joint Secretary, Department of Revenue and Banking (Banking), in a letter dated 15/19 April 1976 to R.K. Talwar, chairman, SBI, specifically asked SBI to assist in the rehabilitation of freed bonded labour and distribution of surplus land among them. While the state governments were to take the initiative to facilitate the beneficiaries taking up productive activities, banks had a role to play wherever land had been distributed by the state governments. They were to make arrangements for extending production loans to the allottees, besides identifying the possibilities of rehabilitation and lending financial support to schemes prepared for emancipated bonded labour. Commercial banks, in districts where they carried the lead responsibility, were asked to shoulder the primary task of preparing a complete programme of financing new allottees of surplus lands and freed bonded labour either through their own branches or through the branches of other banks operating in that area.

SBI was also asked to ensure that the necessary credit was made available to implement the schemes prepared by the departments of the state governments. To monitor the progress made by public sector banks in this sphere, they were asked to submit periodical reports from the quarter ended

31 March 1976, *directly* to the Department of Revenue and Banking. The disquieting feature for the RBI was that, as the central banking authority, it was not kept in the picture at all.

In May, the government enquired of the public sector banks whether, in pursuance of the programme, they had evolved schemes for assisting landless labourers to undertake activities allied to agriculture and for assisting allottees of surplus lands by providing short-term and long-term credit. The banks were told that mere formulation of schemes was meaningless unless the benefits reached the weaker sections of the society. They were also instructed to advise their branches to keep in constant touch with the local administrative authorities so that allottees of house-sites and freed bonded labour were identified and assisted. They were advised to set up special implementation cells within the planning and development divisions of their head offices. Lead banks could play a useful role in promoting better liaison with the district authorities and in ensuring expeditious, collective action. District Consultative Committees were to be utilized for formulating schemes and for promoting the participation of all banks in the programme. As Members of Parliament had evinced a keen interest in the schemes, banks were asked to give greater attention to the publicity aspect. Among other things, each bank was advised to bring out every quarter brochures highlighting the various schemes under which the beneficiaries of the programme were assisted by them, the number of persons assisted and the quantum of assistance given in different states. A proforma was also prescribed by the government for providing quantitative quarterly information on the subject.

The Reserve Bank was not pleased at this turn of events. It was being continuously sidelined in the administration of the programme. It eventually decided to protest. Deputy Governor Krishnaswamy wrote to N.C. Sen Gupta, who was the Banking Secretary, on 13 July, that the RBI was not even informed of the government having issued instructions to public sector banks in five specific instances during the first half of 1976, and stressed the need for involving the Bank at least in an indirect manner.

> We feel that normally, instructions to banks should issue from the Reserve Bank. This will not only avoid confusion at the banks, but would also lead to better coordination. In case of any urgency, while Government may write to banks direct, copies of these letters should invariably be endorsed to us. In case Government asks the banks to submit any information/statements to them directly, the banks should also be advised to

> forward copies of such statements etc. to us to avoid our writing to them again on the same subject. It is also necessary that copies of all important communications addressed by Government to any bank are endorsed to Reserve Bank.

Krishnaswamy requested that suitable instructions be issued to all concerned.

In October, things came to a head. It was from a report in *The Economic Times* on 29 October that the Reserve Bank came to know that the Department of Revenue and Banking had allocated the task of coordinating the efforts for implementation of the schemes prepared under the Twenty-point Economic Programme in the various states, to nine public sector banks. The designated banks were to form a Bankers' Committee for each state, to consider problems requiring inter-bank coordination, for allocation of schemes to be implemented at the district level, and for bringing uniformity in the terms and conditions of credit under specific schemes. The members of the committee included the banks, chairmen of RRBs, government agencies, and representatives of state cooperative banks and lead development banks. The Reserve Bank was not included. The DBOD recorded in an office note of 4 November that the Bank had been consulted neither nor had a copy of the government's instructions been sent to it. Krishnaswamy asked the chief officer to write to the ministry asking for definite information as to what instructions had actually been sent to the banks. Later, he decided to write the letter himself. On 17 November, he conveyed the disappointment of the RBI at being completely sidelined in the matter. He drew his attention to his letter of 13 July and pointed out that 'the basis on which the allotments of states have been made to banks is also not known to us'. He reiterated the Reserve Bank's request that the government issue instructions to public sector banks only through the Bank and not directly. The only result was that the government, *post facto*, endorsed to the Bank a copy of the circular instruction sent earlier to the SBI and other nationalized banks; it did not care to assure the Bank of the better treatment in future.

In despair, Krishnaswamy asked the DBOD to prepare a note chronicling the events. The note was sent to Governor Puri on 25 November, with the remark: 'This is yet another instance of bypassing of the RBI by the Department.' But, again, nothing happened. The Governor merely initialled the note on 9 December without any comments, despite Krishnaswamy's prompting.

Meanwhile, another issue was coming to boil: the treatment of senior

Bank functionaries by the government. Puri was not inclined to join issue with the Ministry and preferred to softpedal the issue. But in November Krishnaswamy again submitted a draft letter for Puri's approval. The letter was addressed to K.P.A. Menon and drew attention to two specific instances of instructions issued to banks on important matters that had implications for credit planning, without the knowledge of the RBI. One of them was the government's letter of 4 September issued to the chairmen of SBI and other nationalized banks enhancing the banks' lending target to the priority sector to 33.3 per cent of their total advances by the end of the Fifth Five Year Plan. Krishnaswamy pleaded: 'We would once again request Government to ensure that there is no communication gap between the Reserve Bank and the Department of Revenue and Banking on such vital matters of policy and also in other matters and to instruct all the officials concerned suitably in the matter.' This attempt, too, was stillborn. The draft letter was returned to the DBOD in May 1977, with the remark: 'returned by Shri Raman, Adviser, with whom it was left by Governor Puri'. It was clear that the Governor was not willing to confront the government.

With the lifting of the Emergency in January 1977 and after the general election of March, a new government took office. With that the Reserve Bank's relations with the government returned to normalcy.

DIFFERENTIAL RATE OF INTEREST SCHEME

The Differential Rate of Interest (DRI) Scheme was based on the budget speech for 1970–71. Prime Minister Indira Gandhi had kept the Finance portfolio with herself after the split in the Congress party in July the previous year. She had emphasized in the speech:

> The weaker sections of the society are the greatest source of the potential strength and with our limited resources, a balance has to be struck between outlays which may be immediately productive and those which are essential to create and sustain a social and political framework which is conducive to growth in the long run.

The DRI scheme was probably the brainchild of Ashok Mitra, Chief Economic Adviser in the Finance Ministry. In 1977, he became the finance minister of West Bengal in the first communist government of the state.

By May 1970, Mrs Gandhi had handed over the Finance portfolio to Y.B. Chavan. He urged the chief executives of public sector banks and senior officials of the Reserve Bank, on 22 July, to charge lower interest rates on loans given to 'carefully selected low income groups, who deserve financial assistance for productive endeavours' but could not easily negotiate with banks. Affluent borrowers could be charged higher rates, he said. The Bank appointed a Committee in September to examine the question. It was headed by Hazari and had six other members; Ashok Mitra was also a member. The Committee's terms of reference were to:

(i) Review the scope and extent to which differential interest rates were already being charged by banks to borrowers in each sector;
(ii) Determine the criteria for identifying borrowers who could be granted the benefit of a lower interest rate within each sector;
(iii) Indicate the range of the differential that could be allowed in each sector; and
(iv) Examine if any other concessions could be granted either in lieu of or in addition to lower interest rates.

The Committee submitted its report in May. It was not unanimous, as Ashok Mitra recorded a minute of dissent (see below). The report said that the interest rate mechanism by itself provided rather limited scope for adopting redistributive policies, and that any wide-ranging selective subsidization for the DRI Scheme could have far-reaching implications for bank earnings and financial policies and practices in general. In the majority view, an element of differential had already been built into the interest rate structure, applicable to certain priority sectors such as exports and the financing of primary cooperative societies by commercial banks in selected areas. In certain cases, banks had been obtaining refinance from the Reserve Bank, IDBI and the government. The Committee observed that since the cost of servicing or administering loans to small borrowers was more than that of loans to large industry and trade, the effective additional cost to banks on account of lending to priority sectors was higher than the interest rates charged for borrowers in these sectors.

The Committee also pointed out that there was no attempt to assist weaker borrowers within any sector through reduced interest charges. In working out a scheme of intra-sectoral differential rates, it implicitly assumed that a reduction in interest rate to some borrowers should not adversely affect the earnings of banks, and, for this purpose, the cost of credit extended to other borrowers should be enhanced suitably to cover both the fall in income caused by disbursal of selective cheaper credit and the rise in costs following from the administration of a number of small loan accounts.

As regards the criteria for identifying borrowers who could be granted the benefit of lower interest rates within each sector, the Committee favoured confining the scope of preferential interest rates to those sectors in which the economically handicapped were preponderant, i.e. borrowers from agriculture, small-scale industry, small business, transport operators and professionals.

For identifying eligible borrowers in agriculture, the size of the loan was considered 'clear, objective and administratively practicable'. As a measure of automaticity for the selection of small borrowers, the majority of the Committee suggested that the DRI Scheme should be linked with the new Credit Guarantee Scheme for covering small loans to borrowers in the priority and neglected sectors.

The report contended that in order to be beneficial, acceptable and practicable, too wide a range of differential would be inadvisable. It was feared that very low interest rates on loans to some borrowers would lead to a sharp increase in the demand for bank funds, generate pressures that the banks might not be able to withstand, and involve charging an unusually high rate at least from some sections of borrowers. Besides, banks were not in a position to charge interest at rates that were 2–3 percentage points higher than the current maximum lending rates of 12 per cent per annum due to the provisions in the prevailing legislation aimed at regulation of moneylending. The report reasoned that even if there was a possibility of charging higher interest rates from the bigger borrowers, the higher costs could get transmitted through marking up of prices.

In view of these considerations, the majority report suggested that the lowest interest rate to be charged to any borrower (exclusive of any direct subsidies) should be approximately equal to the ratio of the cost of raising and using funds (i.e. deposits, borrowings and owned funds). With the current structure of interest rates, this rate was estimated at about 8.5 per cent on an average. The Committee favoured the system of a single cut-off point, setting apart preferred borrowers from the others, rather than credit slabs for different interest rates. Accordingly, it suggested charging rates varying between 8.5 and 10 per cent to preferred borrowers. To all other borrowers, banks were allowed to charge higher rates as they considered appropriate and permissible by law and/or as indicated by the Reserve Bank. It was also recommended that the guarantee fees in the case of all borrowers who were granted preferential interest rates should be borne by the lending bank.

On the last of the terms of reference, a relaxation in favour of weaker borrowers, of the standards adopted by banks in regard to margins and securities, was considered essential. Concessions in the form of lower margins were envisaged for such borrowers as farmers, small retail traders, small business concerns, transport operators, doctors setting up practice and small-scale industrial concerns. Experimenting with unsecured loans was also advocated. Going a step further, it was suggested that margin requirements could be dispensed with in deserving cases and loans sanctioned to the extent of the full value of the security offered. This could be of special assistance during the gestation period of projects started by small entrepreneurs. Concessions by way of relaxation in security and repayment holidays were also viewed as options. In the case of self-employed persons, particularly, softer terms could prove even more meaningful than cheaper credit. Finally, the majority report acknowledged that while its suggestions had immediate relevance to commercial banks, the possibility of extending similar concessions to weaker borrowers from cooperative banks should be examined.

In his dissenting note, Ashok Mitra did not concur with many of the recommendations of the majority of the members. He did not agree that the size of the loan should be the principal determinant of eligibility for the benefit of an interest differential. He argued:

> If the smallness of the size of the loan asked for would automatically qualify the applicant for being offered a favoured rate of interest, the genuinely needy parties would often be crowded out by those who have the organization, acumen and ingenuity to set themselves up as small farmers, or small traders. It should be possible to evolve more objective criteria for judging the economic condition of the parties seeking loans.

He also thought that the proposed linking of the selection of small borrowers with the new Credit Guarantee Scheme was neither justifiable nor necessary. Differential lending rates, including, in some instances, loans at even zero interest rate, were an established feature of international lending and it should be possible for banks to charge varying rates of interest to different income groups, beginning with a very low nominal rate of interest for the most needy and going up to 20 per cent for prosperous traders. He then argued that the current practice of offering loans at preferred rates for exports or to cooperative societies or to small industries, borrowers who scarcely belonged to the category of the underprivileged, had perpetuated and had even aggravated inequalities in the distribution of incomes and assets. The majority report's recommendation for keeping the rates of interest within the range of 8.5 to 10 per cent for weaker borrowers when the overwhelming proportion of advances already attracted interest rates in the range of 8 to 12 per cent amounted to maintenance of the existing structure of lending rates with minor modifications.

Mitra was of the view that, along with the commercial banks, the cooperative sector should be brought under the proposed scheme, as roughly two-thirds of the total institutional loans flowing to agriculture still emanated from the cooperative sector. He wrote:

> To leave out this sector from the purview of the differential rates structure would, therefore, mean the exclusion of institutional financing of the bulk of the most important economic activity in the country. It would also lead to the absurdity of two parallel rate structures obtaining in agriculture, with attendant practical difficulties. There is hardly any economic justification for according a kid-glove treatment to the cooperative sector.

On the feasible structure of interest rates, Mitra agreed that a reduction in the interest charged to some borrowers would not adversely affect the overall earnings of banks (i.e. the average return from total advances should yield at least 10 per cent), but he was against equating the lowest rate of lending to the ratio that the cost of raising and using funds bore to total banking resources, as suggested by the majority report. He contested the logic that the incidence of higher interest would be shifted to the consumers as, in most cases, manufacturers, traders and speculators were generally aware of the limit as to what the traffic could bear at any given moment.

He favoured cross-subsidization, i.e. raising the lending rate to 20 per cent for the bigger borrowers in selected sectors, making it possible to reduce substantially the rate for the less affluent groups without affecting the overall return from lending operations. More importantly, he wanted one-fifth of the total credit to be earmarked for the economically deserving groups, who could be asked to pay only a commitment charge of, say, 1 per cent. According to his scheme, a return of 10 per cent on total advances could be arranged thus:

Advances	Rate of interest
1st quintile	20 per cent
2nd quintile	14 per cent
3rd quintile	10 per cent
4th quintile	5 per cent
5th quintile	1 per cent

Y.B. Chavan, while admitting in a policy statement made in the Parliament on 25 March 1972, that it was difficult to reconcile the two points of view, expressed no doubts about the basic soundness of the idea that led to the formation of the Committee. The government then formulated guidelines for identifying persons eligible to get loans at concessional rates and other rules of operation, and advised the public sector banks directly in the matter. The records do not show whether the Reserve Bank was consulted in framing the guidelines. As regards cooperative banks, since their ability to recoup consequential losses by charging higher interest rates from larger farmers was in doubt, the government decided to consider in detail, in consultation with the Bank, the extent of differential rates and the manner in which cooperative banks should be compensated for the loss incurred.

Things went on in this mode for a few years. Then, on 24 September 1975, N.C. Sen Gupta wrote to Hazari advising that the government proposed to make certain changes in the scheme so as to extend its geographical coverage and to provide for special treatment to government-sponsored corporations concerned with the welfare and development of scheduled castes and scheduled tribes.

The major issues identified for reconsideration were as under:

1. Extension of the geographical coverage of the DRI Scheme to all the districts in the country, except the metropolitan areas.
2. Restricting the scope of the scheme to lending to scheduled castes (SCs) and scheduled tribes (STs) only. This would mean that persons belonging to the 'rest of the community' would cease to be eligible and the scheme would operate virtually for the benefit of SCs/STs.
3. Government-sponsored corporations concerned with the welfare of SCs/STs (besides the institutions then eligible to borrow under the scheme) should also be declared eligible to borrow, provided they satisfied certain criteria, such as: services exclusively for the welfare of SCs/STs, formulation of specific schemes to be operated on commercial basis and bank lending to be utilized only for these operations and not for meeting normal administrative and other costs, and the borrowing institution undertaking repayment of the bank loan and interest thereon.

As an alternative, it was suggested that no change was required to be made in the 275 districts where the scheme was in operation but in the remaining 108 districts (where the scheme was not in operation), only members of SCs/STs were to be declared eligible. The rationale for this suggestion was that the districts in the latter category were neither backward nor SFDA/MFAL districts and, thus, somewhat better-off; as such, there was some justification for confining the scheme to SCs/STs.

Sen Gupta finally requested the Reserve Bank to keep in mind the fact that regional rural banks were being set up to serve the rural population and that this opened another avenue for making finance available. He suggested convening a meeting of commercial banks to expedite decision on the above issues, to which he offered to send a representative from his Department.

Raman, who was then Director of the Credit Planning Cell of RBI, discussed the matter with the Finance Ministry and suggested that the scheme had to be extremely selective in application, that its scope be confined to lending only to scheduled castes and tribes, and that the income criterion be retained to ensure that even among these categories the really poor got the benefit. At the same time, Raman recognized that some special institutions, such as those for physically handicapped persons, orphanages and women's homes, were already within the purview of the scheme. After further discussions, on 2 December, between Raman, Hazari and K.S. Krishnaswamy, the Reserve Bank finalized its views. Hazari wrote to Sen Gupta on 3 December 1975 suggesting some modifications.

1. The scheme should be made applicable in respect of persons belonging to SCs/STs throughout the country, irrespective of the size of their landholdings (as hitherto). The ceiling on annual income (i.e. Rs 3,000 in urban/semi-urban areas and Rs 2,000 in rural areas) and other conditions, such as ceiling of Rs 1,500 for working capital loans and Rs 5,000 for term loans, could continue unchanged.
2. Government-sponsored corporations should be set up exclusively for the promotion of welfare of SCs/STs to be made eligible to borrow under the scheme, subject to their satisfying the prescribed criteria. However, the limits up to which advances might be granted to such corporations was to be specified and authority conferred on the lending banks to inspect the accounts of the corporations covered under the scheme.
3. In respect of persons other than those belonging to SCs/STs who had already availed of loans in the districts to which the scheme extended, the amounts were to be recovered as and when they fell due for repayment but the facilities would not be renewed.

In 1977, the guidelines of the scheme were revised. The more important changes were:

1. The scheme was extended to the whole country. (As it stood, since August 1976, the scheme had been extended to all SFDA districts/areas declared by the central government, including those set up in

the Fifth Five Year Plan period, and was operated in the districts declared as industrially backward by the Planning Commission and notified as such by the Reserve Bank.)

2. With a view to ensuring the flow of adequate benefits of the scheme to rural areas and to persons belonging to scheduled castes/tribes, banks should ensure that at least two-thirds of their total advances under the scheme are made through their rural/semi-urban branches.
3. At least one-third of the total DRI advances should be given to members of scheduled castes/tribes. It was expected that any regional imbalances in the existing pattern of disbursal of a bank's lending under the scheme would be corrected by individual banks in accordance with these norms at the latest by March 1979, and that the flow of credit would be biased in favour of underdeveloped states.

In October 1978, after the Prime Minister met the chief executives of public sector banks, a Working Group was set up to further revise the DIR Scheme. The Group suggested the following changes, which were accepted. Its emphasis was on the need to gear up the administrative machinery in banks to improve recoveries and ensure the rapid recycling of the limited funds available under DRI. At the same time:

(i) The prescribed limit of DRI advances was raised from 0.5 per cent to 1 per cent of the aggregate advances of the bank as at the end of the previous year.

(ii) A minimum of 33.33 per cent of loans under the scheme was to be given to eligible borrowers from among the scheduled castes and scheduled tribes, which was enhanced to 40 per cent to ensure that persons belonging to these categories got their due share of benefits under the scheme.

(iii) Banks were permitted to route their advances through the medium of cooperative societies/large multipurpose societies (LAMPS) organized specifically for the benefit of the tribal population in areas identified by the government; this was in addition to banks routing their DRI loans through state-level corporations for scheduled castes and scheduled tribes.

At a meeting convened by the Governor on 28 November, the major private banks agreed in principle to lend 1 per of their aggregate outstanding advances under the scheme. But they also suggested that, to begin with, this proportion could be 0.5 per cent in the case of smaller banks, say, those with deposits of less than Rs 25 crore. The government agreed. The Reserve Bank then asked all private sector Indian commercial banks (excluding three banks that had lead status and which were already implementing the scheme) to initiate immediate action to implement the scheme. To correct the regional imbalances in flow of credit under the DRI Scheme, the banks were asked to step up their lending under the scheme in backward areas.

Several knotty issues came up during the implementation of the scheme. First, there was the question of the levy of a penal rate of interest in case of default. One of the public sector banks had enquired of the Reserve Bank in May 1973, whether it could levy a penal rate of interest on default in respect of overdue loans granted under the scheme. The Bank sought instructions from the Finance Ministry. Its own view was that although the persons eligible for assistance under the scheme belonged to the poorer sections of the society, enforcement of a certain amount of discipline was necessary. So charging a penal rate of interest of 2 per cent in case of default should not be considered unreasonable. It took the Department of Banking ten months to reply. Eventually it said no, because this could kill the momentum that was in evidence, and because there had been criticism both in the Parliament and outside it that the performance was still not up to expectations. Moreover, the government felt that levying such a penal rate at that stage could be misconstrued as withdrawal of the concessional interest rates that formed an essential element of the scheme. But the Ministry offered to review its position later if defaults under the scheme turned out to be substantial.

In 1980, this issue came up once again. During the course of the debate over the Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1980, the Minister took up with the Reserve Bank the question of not charging a penal rate of interest on defaults against DRI loans. On a reference received from the government, the Bank replied, on 26 September, that, based on the recommendations of the Committee on Penal Rates and Service Charges, it had advised scheduled commercial banks on 26 June 1976 that all small loans up to a credit limit Rs 5,000 and all advances made by public sector banks under the DRI Scheme to selected low income groups should be exempt from the levy of a penal rate of interest. Similar instructions were given to private sector banks in October 1980.

The Question of Rates

Then there was the interest rate question: should it be continued at 4 per cent? In 1972, when the scheme was introduced, it was thought proper to charge 2 per cent below the then prevailing RBI rate of 6 per cent. Although the Bank rate was raised subsequently to 7 per cent in May 1973, 9 per cent in July 1974 and 10 per cent in August 1981, the rate of 4 per cent stipulated initially was allowed to remain unchanged. As a result, the differential widened from 2 per cent to 6 per cent. Banks wanted to know why the DRI rate could not vary with the general level of interest rates. The Working Group appointed in 1980 to examine the role of banks in implementation of the new Twenty-point Programme had given the verdict on the matter. It pointed out that a substantial portion of the prio-rity sector advances of banks carried a lower rate of interest. Further, export credit and food credit carried lower rates. Considering the effect of this on the profitability of the banks, it was not considered possible for the banking system to lend at a low rate of 4 per cent to any significant extent. Taking these aspects into account, the Group was of the view that there was no scope for raising the target. Within the target, however, there was need to ensure that the benefits of DRI lending went to the weakest among the eligible borrowers. But nothing happened and the rate was left as it was, at 4 per cent.

There was also the question of how much the scheme was costing the banks. A Working Group set up by the government in October 1978 conducted a review of the scheme. It estimated the cost of its administration by the banking system to be 13 per cent and, as a result, banks suffered a loss in terms of 900 basis points. Subsequently, from 2 March 1981, the interest rate on deposits was raised. The Group also recommended that, considering the risk involved in lending under the DRI Scheme, the guarantee cover of 75 per cent then available under the Small Loans Guarantee Scheme, 1971, for such advances should be increased to 90 per cent in order to induce banks to step up their advances to weaker sections of the community. Accordingly, in January 1979, the guarantee cover in respect of such loans and advances was increased to 90 per cent.

The recoveries of DRI advances also became an issue, as they were far from satisfactory. So the Reserve Bank asked the DICGC to review the extent of the guarantee cover and to take steps to increase the lending bank's share in such lending. The government referred this issue to the National Institute of Bank Management (NIBM), which was then doing a study of the DRI Scheme. But nothing concrete emerged from this referral.

Extension of the Scheme to Private Sector Banks

In early 1978, Governor of RBI wanted to know the manner in which the Differential Rate of Interest Scheme was working, particularly after May 1977 when it was extended all over the country, and how the parties were selected. The DBOD explained the operational details to him and highlighted two crucial features. One was the problem faced by banks in identifying borrowers even though, by and large, they were guided by the list of borrowers previously identified by SFDA, MFAL or state government agencies. The other was the slowdown in the flow of information on the bank-wise position of outstanding advances, due to the introduction of a comprehensive format by the government in 1977.

The DBOD highlighted the comparative performance of banks in complying with the target of one half of 1 per cent of the total loans and advances under the DRI Scheme. The overall achievement of SBI and its subsidiaries, bar two, and the fourteen nationalized banks was considered satisfactory, as they had already crossed the target. The advances, in end-September 1977, stood at 0.54 per cent of the aggregate advances, compared to the goal of 0.50 per cent. Patel enquired whether the Reserve Bank could issue some sort of 'exhortation' to Indian private banks as well, and whether foreign banks could be involved in the DRI Scheme. He met bankers on 28 March where a view was expressed that Indian private sector banks should be called upon to fall in line with the public sector banks in the implementation of the scheme. The RBI then issued a circular to thirty-six private sector Indian banks, on 6 July 1977, inviting them to voluntarily adopt the scheme. Five said yes, one said no and the rest did not reply.

The banks that did not respond had a network of 4,259 branches, of which 2,775 were located at rural/semi-urban centres, at small places which allowed little scope for other banks to open offices there for a long time to come. The disinclination of these banks meant that several eligible persons would not be able to borrow under the scheme. The Reserve Bank took the view that since the aggregate amount to be advanced under the scheme would not be very high, the profitability of the banks would not be materially affected. It also believed that the private banks should discharge certain social obligations. Accordingly, in April, the RBI issued a circular which said that it was only fair that they participate in the DRI Schemes, to benefit the poorest among the poor. It pointed out that the modest target set for individual banks was unlikely to affect their profitability. Basically, it said, 'fall in line' by sending a quarterly report.

Foreign banks, as before, were excluded.

The private sector banks responded slowly. On 27 October, the Finance Ministry asked the Reserve Bank to urge them to improve their lending under the DRI Scheme and also to expedite submission of the outstanding quarterly reports. The Bank replied that while it had already issued instructions to private sector banks to fall in line with the public sector banks, the position about submission of quarterly reports continued to be unsatisfactory despite reminders. The Ministry then wrote directly to the private banks.

A copy of the letter was marked to Krishnaswamy, who was peeved enough to ask if it was the normal practice of the Banking Division to instruct private sector banks. He spoke to M.R. Shroff, who was then an Additional Secretary in the Finance Ministry, who promised to 'look into this'. There the matter was allowed rest.

There were several allegations of misuse as well. On 20 November 1981, *The Indian Express* reported that Rs 2 crore were being distributed by a nationalized bank in Kanpur under the DRI Scheme, and that application forms had been sold at Rs 10 each. The Finance Ministry requested the Reserve Bank to get the full details. A question was also raised on this issue in the Lok Sabha. The Kanpur and New Delhi offices of the Bank made detailed enquiries and it transpired that Punjab and Sind Bank had organized, on 21 November 1981, a mass loaning programme under the DRI Scheme and the Twenty-point Economic Programme at their Transport Nagar branch, Kanpur. Rajiv Gandhi was supposed to attend the function but did not. Loans aggregating Rs 18,300 were disbursed by Chief Minister V.P. Singh to ten borrowers. The branch manager of the bank denied the alleged sale of application forms or their distribution through any agency.

The Business Standard, in its edition of 25 November 1981, carried a more tendentious report on the same event. It alleged that certain Congress(I) leaders of the city had spearheaded this scheme to help the needy with bank loans ranging from Rs 500 to Rs 5,000 at differential rates of interest through the medium of Punjab and Sind Bank, which agreed to disburse Rs 2 crore. The newspaper also said that as criticism mounted, the bank slowly backed out and decided that only persons who filed applications in the prescribed form would be eligible for the loan.

The officer of the Reserve Bank deputed to inspect the branches of Punjab and Sind Bank reported that the quality of the appraisal left scope for improvement inasmuch as the income of the borrowers was not assessed properly, and the information supplied by the borrowers was taken for granted without verifying from independent sources, especially where the income related to the whole family and not to the individual. However, no relaxation of normal terms and conditions was made and the branches had paid the amounts directly to the suppliers, and obtained invoices/cash memos that were retained for record.

In another case, the Finance Ministry wrote to the Reserve Bank that South Indian Bank Ltd had rejected the loan application of one N.M. Sriramulu, a cobbler, on the basis that his yearly income was Rs 4,200, i.e. higher than the eligibility limit. This was contested by no less a personage than the Deputy Speaker of the Lok Sabha, who annexed a certificate according to which the income of the cobbler worked out to only Rs 2,880. The government wanted to know the circumstances under which the application was turned down. After repeated reminders, the head office of the South Indian Bank Ltd at Trichur clarified, in January 1982, that the party himself had stated in his application that his annual family income was Rs 4,800 and that his family consumption need was only Rs 4,200. (According to the eligibility criteria under the DRI Scheme, the total income of the applicant family from all sources was not to exceed Rs 2,000 in rural areas and Rs 3,000 in urban areas.) The Reserve Bank added that the party had neither submitted an income certificate along with the original application nor made any fresh application. Since the Madras branch of South Indian Bank Ltd had forwarded all the files to its head office at Trichur, the Trivandrum office of the DBOD was asked to depute an officer to the bank to verify the papers. The inspecting officer of the RBI confirmed that the applicant did not satisfy the eligibility requirements.

Cooperatives were not allowed to operate under the scheme because they largely depended on the Reserve Bank for their resources, with refinancing provided at 2 to 3 per cent below the Bank rate of 9 per cent. They could not lend directly under the scheme at 4 per cent unless their overdue position improved and the loss was made good by a subsidy from the state or central government. The issue was raised when Pratibha Patil, the minister for prohibition, rehabilitation and cultural affairs in the Maharashtra government, wrote to Puri in July 1976, that cooperative banks run by women should be allowed to give finance at differential rates of interest to needy women and women's organizations. The Agricultural Credit Department (ACD), to whom the case was referred, said that cooperative banks could not afford to lend at differential rates, notwithstanding the availability of refinance facilities from the Reserve Bank at concessional rates of interest. The question was also discussed at the seventh meeting of the Agricultural Credit Board, where the consensus was that the feasibility of introducing a differential interest rate depended on the number of farmers to be covered under the scheme. If the size of holdings of the beneficiaries was kept sufficiently low, it would not be difficult to implement the scheme by slightly increasing the rate of interest on loans to other farmers. But in states where the majority of farmers had small-sized holdings, it would be difficult to implement the scheme without external aid. So the Board left it to the discretion and judgment of the banks.

As regards cottage and small-scale industries, the ACD felt that they should be treated separately as business enterprises. While sanctioning limits to cooperative banks, the Reserve Bank made a stipulation that the rate of interest to be charged from industrial units should not be unreasonably high. It was noted that the bulk of the resources of urban cooperative banks was raised by way of deposits. Their borrowings from higher financing agencies being very small, urban banks offered higher rates of interest on deposits than other banks and hence the cost of funds to them for lending was higher. The Bank, therefore, had not prescribed any minimum rate at which they should lend to any class of borrowers; it was left to the discretion of the banks. The ACD had no objection to banks implementing the scheme in respect of any particular type of advances or advances to any class of borrowers.

Krishnaswamy eventually replied to Pratibha Patil that the RBI had no objection to urban cooperative banks, on their own, extending the benefits of the DRI Scheme to any type of loans and advances made to any class of borrowers, including women. However, advances made by these banks in respect of commodities covered under the selective credit control measures should carry a minimum rate of 15 per cent per annum.

The issue of extending the DRI Scheme to cooperative banks was raised by the Home Ministry also. The Finance Ministry referred it to the Reserve Bank in January 1981. The Banking Division expressed the view that no useful purpose would be served if the meagre funds allocated for the scheme were spread thinly to cover all lending institutions, including cooperative banks, and that any meaningful extension of the scheme would call for allocation of more funds under the scheme. A suggestion was made that either the state governments could provide interest subsidies to cooperative institutions or, alternatively, the Agricultural Refinance and Development Corporation (ARDC) could provide funds at a lower interest rate for advances under the scheme, the cost of subsidy being shared by the ARDC and state governments on a matching basis. The RBI agreed.

Regional rural banks were required to make available credit to borrowers at the same rate as cooperatives and were thus precluded from granting loans at concessional rates of interest. In order that customers served by RRBs were not deprived of the benefits of the scheme, the sponsoring banks were permitted to lend under the DRI Scheme through RRBs on an agency basis; consequently, the eligible borrowers were able to obtain loans at the concessional rate of 4 per cent in areas served by RRBs. On receipt of a query from certain banks, the Reserve Bank clarified that they may lend directly to beneficiaries under the scheme so long as they were within reasonable distance from the branches of RRBs. Also, the banks were allowed to lend through the agency of RRBs to beneficiaries in remote areas not easily accessible through their own branch network. While RRBs might serve as a conduit for disbursement of credit to the ultimate beneficiary and for recovery of dues, the overall responsibility for proper appraisal, disbursement, supervision, follow-up and recovery of the dues would continue to rest with the sponsor banks.

In March 1978, the board of directors of Syndicate Bank took a policy decision not to implement the DRI Scheme through RRBs. This was because their bank had already achieved the target and had a good network of branches in the districts where the RRBs sponsored by them were operating. The decision was conveyed to the Finance Ministry by the Reserve Bank. The government did not take kindly to this decision and wrote to the chairman of Syndicate Bank that it was not correct to totally exclude RRBs from lending under the DRI Scheme since there was no limit for maximum lending, and since RRBs were meant for offering cheaper credit to the weaker sections and most of their clientele would otherwise be ineligible to get loans under the scheme. The government 'requested' Syndicate Bank to continue to implement the DRI Scheme through RRBs on an agency basis.

In January 1981, the government allowed sponsor banks to lend through RRBs on a refinance basis as well. Eligible borrowers under the DRI Scheme were granted advances by RRBs at 4 per cent, preference being given to small borrowers. The RRBs would make advances on their own account and the sponsoring bank provided refinance to RRB on the basis of outstanding amounts at 2 per cent rate of interest. The sponsor banks were entitled to take into account, for the purpose of the target of 1 per cent of the total lending under the scheme, the amount of refinance made to RRBs.

The Department of Revenue and Banking (Banking Wing) advised (by a letter dated 22 July 1976) that the benefits of the DRI Scheme had been made available to all SFDA districts/areas and industrially backward districts declared by the Planning Commission, and requested the Reserve Bank to issue suitable instructions immediately to the public sector banks to extend this benefit to these categories. The Reserve Bank issued a circular on 18 August 1976 to public sector banks extending the scheme to all SFDA districts/areas covered by the central government—but not to SFAL and other similar agencies created by state governments—and in the districts declared as industrially backward.

Social Service Agencies

Governor M. Narasimham, acting on the suggestion made to him by the Finance Minister, instructed the DBOD in May 1977 to examine whether banks might be asked to lower the rate of interest charged on advances to purely social service institutions like tribal welfare associations.

The Department studied the activities of these voluntary agencies and found that, in a majority of the cases, administrative grants released by the government were utilized for organizational purposes, for maintenance of the office or for providing training facilities. Apart from purely social service activities involving administrative expenditure, such as those on training, research, provision of scholarships and child development programmes, the Department of Social Welfare had started socio-economic programmes aimed at providing opportunities for work and earning wages to needy women, such as widows, destitutes and physically handicapped persons. The Social Welfare Boards provided financial assistance for setting up small production units in sectors like small-scale industry, ancillary units, handicrafts training-cum-production units and dairy schemes. The Department took the view, on 29 June 1977, that it would not be appropriate to provide bank funds to finance purely administrative activity or any other activity that did not generate income for repayment of the loan. In other words, only the production and sale activities of the units should be provided bank credit facilities at low rates of interest. Since the total credit disbursed under the scheme amounted to Rs 17 crore at the end of September 1976—far short of the target of 0.5 per cent of aggregate advances—the Department suggested widening of the list of eligible categories under the DRI Scheme to all social service institutions under the Department of Social Welfare which were engaged in economic activities (besides orphanages and women's homes, institutions for the physically handicapped, and state corporations for scheduled castes and tribes). Where the credit requirements exceeded the ceilings, interest should be charged on the entire advance at 5 per cent per annum. Governor Narasimham, while appreciating the suggestion, cautioned that there would be no dearth of special cases in our economy.

However, he used the logic of the DBOD note in his correspondence with the government on the issue. In a letter to Manmohan Singh, Secretary, Department of Economic Affairs, dated 21 July 1977, Narasimham argued that with the scheme already covering a few institutions—namely, orphanages and women's homes, institutions for the physically handicapped and state corporations for scheduled castes and scheduled tribes—there was no reason why social service agencies should be excluded from its purview, provided other terms and conditions stipulated in the scheme were satisfied. The government preferred not to make any change in the scheme (vide telex dated 16 August 1977).

State-Sponsored Corporations

One of the recommendations of the K.S. Krishnaswamy Working Group on Priority Sector Lending and the Twenty-point Economic Programme was that banks, while continuing to provide direct assistance, might also route credit to individual beneficiaries through state-sponsored corporations/agencies, besides functional cooperatives. Till then, DRI advances were routed only through state corporations set up for the welfare of SCs/STs and cooperatives/LAMPs in identified tribal areas. RRBs were permitted to utilize the scheme either as an agency or on refinance basis. Some state governments and state-sponsored corporations made requests to the Finance Ministry to be recognized as approved intermediaries for channelling credit under the DRI Scheme, to scheduled castes, scheduled tribes and other weak sections of the society. The government's Banking Division was not inclined to agree to such requests but wanted the RBI to consider the issue *de novo* in light of the recommendation of the Working Group.

The Bank explained, in its reply dated 9 May 1981, that one of the main reasons that prompted the Working Group to suggest routing assistance through intermediaries was because it might not be possible for commercial banks to directly cater to the credit requirements of a large number of beneficiaries in the future. Moreover, banks were under compulsion to ensure that the proportion of advances to the priority sector went up to 40 per cent by 1985, as against 30 per cent of total advances at the end of December 1979, and it was expected that by 1985, the volume of priority sector advances would be more than double the present level while the number of beneficiaries would be about three times the present number. In contrast, under the DRI Scheme, banks had to lend a minimum of 1 per cent of their aggregate advances; at the end of March 1980, advances under the scheme amounted to Rs 150 crore, constituting 0.9 per cent of total bank advances. Banks had almost reached the target and the additional funds that would be available for lending under the scheme were limited. Besides, the RRBs that operated mainly in rural areas had also been recently permitted to lend under the scheme on refinance basis. In the circumstances, the Reserve Bank felt that no useful purpose would be served by allowing state-sponsored corporations as intermediaries to lend directly with their own resources under the scheme. Further, it feared that permission to lend under the DRI Scheme through them might also bring about an anomaly in the interest rates charged to the borrowers, as these corporations were expected to finance other schemes at normal rates of interest.

Scheduled Castes/Scheduled Tribes

The Ministry of Finance forwarded to the Reserve Bank in August 1973, a letter from the Commissioner for Scheduled Castes and Scheduled Tribes, New Delhi, asking that instructions might be issued to nationalized banks to provide for gathering information about SC/ST borrowers. The Department of Banking Operations and Development, in its reply to the Ministry of Finance (Department of Banking), expressed the view that getting such statistical data through earmarking of a column in loan applications would be neither practicable nor desirable. Besides, there was no system in the banks for earmarking of funds or fixing targets for lending to any sector or class of borrower. The Delhi Scheduled Castes Welfare Association, as well as a member of the Minorities Commission, Government of India (Ven. Kushok G. Bakula), took up the matter raised by the Commissioner for Scheduled Castes and Scheduled Tribes, New Delhi. The Reserve Bank, however, did not change its views. It was only when the government accepted the recommendation of the Working Group set up in 1978 to review the DRI Scheme, to ensure that banks routed credit under the scheme through large-sized multiple purpose societies (LAMPS) in the cooperative sector (organized specifically for the benefit of the tribal population in areas identified by the government on the same terms and conditions applicable to state-owned corporations for the welfare of scheduled castes/scheduled tribes), that the DBOD issued necessary instructions to commercial banks on 22 December 1978. However, as the progress in the implementation of the DRI Scheme in tribal areas was found to be slow, the Bank suggested in January 1980 that the credit guarantee cover of the DICGC might be extended to LAMPS by the state government providing the guarantee. Also, the Bank asked banks to grant such advances and suggested that this approach could be adopted in the case of LAMPS as well. As regards the flow of information from banks relating to direct and indirect finance, the Bank suggested that it could be given in their quarterly returns prescribed by the government.

Irregularities in Implementation

In the course of a scrutiny conducted by the New Delhi regional office of DBOD, of Bank of India, Chandni Chowk branch of Delhi, it was found that the branch was sanctioning advances under the DRI Scheme to various parties in a highly irregular manner, viz.:

1. More than 80 per cent of the accounts under the scheme were introduced by staff members, with the whereabouts of some of the bor-

rowers not known to the branch. In most of the cases, the borrowers were close relatives or friends of the concerned staff members.

2. Application forms were, in most cases, filled by staff members; these were found to be incomplete/incorrect as to the occupation of the borrower and his income, purpose of the advance, etc. As the borrowers were otherwise gainfully employed or belonged to affluent families, they were not eligible for any advance under the DRI Scheme.
3. The branch had not ascertained the end-use of the funds in all the accounts, as the pre-sanction and post-disbursement inspections were waived altogether.
4. The photographs affixed on the application forms were not those of the borrowers but of their relatives, and the signatures on the account opening forms and security documents were found to be fictitious/forged.

The DBOD did not rule out the possibility of negligence/malafides on the part of staff members in introducing DRI advances and misutilization of the proceeds although the advances were sanctioned in different names. K.R. Subrahmanyan, additional chief officer, DBOD, brought this to the notice of N. Vaghul, chairman and managing director of Bank of India, and advised him to take corrective action.

The Bank and a State Government

At meeting of the District Consultative Committee for Mandya held on 2 July 1976, S.M. Krishna, Minister for Industries, Karnataka state (also in charge of implementation of the Twenty-point Economic Programme), was reported to have made certain unflattering comments about the branch managers of banks, to have threatened to withdraw government deposits from banks that failed to toe the line of the state government, and also instructed the deputy commissioner of the district to 'create problems' for banks. The Reserve Bank—perturbed by the news about the state government officials' attempts to exert pressure on bank officers to lend liberally under the DRI Scheme without observing the prescribed norms—considered it appropriate to take up the issue with the state government and also to bring it to the notice of the Department of Banking. The decision was taken at a high management level, having been approved by the Executive Director, J.C. Luther, and Deputy Governor, K.S. Krishnaswamy.

Accordingly, P.N. Khanna, chief officer of DBOD, in a letter to G.V.K. Rao, Chief Secretary to the government of Karnataka, reported that the assistant commissioner of Puttur, at a meeting of banks convened on 29 May

1976 had told bank officials that the block development officer would obtain loan applications from villagers and forward them to banks with endorsements of two functionaries, namely, the village accountant and himself, and that banks on that basis should disburse the loans straightaway to such people without observing the usual formalities like enquiry, spot inspection, etc. Moreover, the assistant commissioner threatened the branch officials that if they did not carry out his instructions, he would 'take action' against them. The Reserve Bank pointed out that, while officials of the government 'can and should help' bank officials in identifying genuine borrowers, the branch manager was duty-bound to satisfy himself that the applicants fulfilled the conditions laid down in the scheme in all respects, and that the final decision to sanction or reject a loan application rested solely with the branch manager concerned. 'Both the Government of India and the Reserve Bank of India are vitally interested in ensuring that banks increase their lending under the scheme, but if the standards of lending are diluted, banks will only be faced with the difficult problem of recoveries later.' The Bank requested the Chief Secretary to explain the position to the district officials and other officials of the state government and instruct them to refrain from interfering with the normal functioning of bank branch managers in the districts; if the district officials had any problems, difficulties or grievances against the banks, they were to take up the matter with the Reserve Bank either through him or the Finance Department of the state government. A copy of the letter was endorsed to Government of India.

On account of the serious implications of the attitude of the Karnataka Industries Minister, the Reserve Bank reported the incident to the Ministry of Finance, Government of India. P.N. Khanna, in a letter dated 20 October 1976 to Kum. K.L. Mital, Joint Secretary, Department of Revenue and Banking (Banking Wing), informed her of the Minister's threat and added, whatever may be the justification for the Minister's dissatisfaction with the performance of banks in lending under the scheme in the district, his observations at the meeting were bound to have a demoralizing effect on the branch managers functioning there. The letter did not seem to have much impact on the state government, as the events that unfolded subsequently revealed.

The Karnataka government decided, in January 1976, to extend the benefits of the Differential Rate of Interest Scheme to those districts in the state that were not covered under the scheme by agreeing to provide subsidy to public sector banks on advances granted to eligible borrowers for the difference between their normal lending rate and 4 per cent.

Going a step further, in October 1976, the Karnataka government, by an order, directed all Indian private sector banks to lend at 4 per cent to eligible borrowers in the eleven districts covered by the central government's DIR Scheme and offered to provide interest subsidy in the remaining eight districts not covered by the scheme.

The Reserve Bank reported to the Government of India the action taken by the Karnataka government in directing Indian private sector banks to implement the DIR Scheme. As a follow-up, B.C. Patnaik, Deputy Secretary, Department of Revenue and Banking, wrote on 24 February 1977 to the Secretary, Planning Department, Karnataka government, that in the absence of any decision by the central government it might not be advisable for the state government to ask the Indian private sector banks (other than those having lead responsibility authorized to operate the scheme) to implement the scheme, and suggested that the instructions already issued by the state government needed to be reconsidered. Alternatively, the state government could subsidize the difference between the normal rate and the fixed rate of 4 per cent to the Indian private sector banks in the eleven districts covered by the DRI Scheme, as has been done in the case of eight other districts. The state government seemed to have agreed with the views of Government of India.

The implementation of and progress achieved under the scheme were reported by the Reserve Bank management to the Central Board of Directors at the latter's request. The ideas presented by the Central Board at its meeting held on 15 October 1980 and subsequently by the Committee of the Central Board, provide a glimpse of the concerns of the management as well as the enlightened membership of the Board that represents a broad spectrum of society. That is why it is reported here. The note to the Board observed that, while the banking system as a whole had almost achieved the target of 1 per cent of aggregate advances at the end of December 1979, the percentage of overdues to demand in most banks was very high. It ranged between a low of 62 per cent (Indian Overseas Bank) to 96 per cent (State Bank of Indore), as on 31 December 1979. Some of the causes of high overdues were cited as practical difficulties in verifying the income of the weakest sections of the society as well as in conducting viability studies, non-availability of alternate source of repayment in case of failure of ventures financed by them and diversion of credit to consumption purposes, and banks' complacency in regard to recovery as individual loan amounts were very small.

The discussions of the Board and its Committee on the working of the scheme underscored the need for improving its implementation. Not permitting RRBs and cooperative banks to extend advances under the scheme created anomalies, but it would be more anomalous if RRBs were allowed to lend directly under the scheme and obtain refinance from their sponsoring banks. The Board felt that the utility of the scheme would be enhanced if integrated assistance in the form of supply of inputs and marketing facilities were provided to the beneficiaries with the help of voluntary organizations, in addition to the provision of credit at concessional interest rates. The Board also suggested that the rate of interest should first be enhanced reasonably, in view of the higher cost of funds to banks. It considered that the low recovery of dues under the scheme was because of the guarantee cover from the DICGC up to 90 per cent and banks therefore made little effort to recover advances. The Board suggested that, as in the case of other borrowers, the DICGC should offer only 75 per cent coverage to advances under the DRI Scheme. More important, the Board viewed the need to examine whether the ceiling fixed was adequate for financing the productive activity of the borrowers, while evaluating the scheme. Also, it should be ensured that funds advanced were in fact utilized for the proposed economic activity.

At another Central Board meeting at Bombay, on 27 August 1981, the Board pointed out that while many were eligible to benefit under the scheme, the scheme itself could not be extended to a large number because the lending rate was fixed at a low level of 4 per cent. This meant that there was no incentive for banks to increase lending under the scheme. The government, according to the Board, could select certain schemes, such as housing, meant for the benefit of poor families, and link it with the DRI Scheme.

In retrospect, the Board's views seemed to be more of academic value, since the government's views on the scheme did not show any change after the 1978 revision of guidelines. Besides, the scheme was subsequently extended to RRBs on both agency and refinance basis, and to LAMPs.

The Scheme and Overdues

The Ministry of Finance monitored the progress of the scheme every now and then. In fact, in 1979, concerned over the slow progress, the Ministry enquired of the Reserve Bank whether more stringent measures could be adopted to compel the banks to increase their advances under the scheme. K.B. Chore, chief officer, in his letter dated 15 June 1979 to Kum. K.L. Mital, Joint Secretary, explained that the Bank was closely watching the progress by means of periodical returns and progress reports. According to the returns received from banks, only six banks lagged behind in achieving the erstwhile target of 0.5 per cent as on 31 December 1978. The banks had

TABLE 2 Advances under the DRI Scheme by Public Sector Banks

As at end-December	No. of borrowal accounts (in lakhs)	Amount of loans outstanding (in crores)	Percentage of DRI loans to total loans and advances at the end of previous year
1972	0.26	0.87	0.02
1973	2.30	10.06	0.22
1974	3.13	13.35	0.23
1975	4.65	20.99	0.31
1976	10.05	47.24	0.56
1977	13.92	67.99	0.61
1978	16.20	89.99	0.74
1979	20.72	139.49	0.98
1980	25.10	193.56	1.04
1981	29.25	257.00	1.17

TABLE 3 Position of Recovery of DRI Loans of Public Sector Banks

(Rs lakh)

End-December (1)	Demand (2)	Overdues (3)	3 as % to 2 (4)
1978	2931	2170	74
1979	4039	2815	70
1980	5967	4130	69

Source: RPCD office note dated 26 October 1982 in file C453 (U)

given various reasons for the shortfall (which were relevant to shortfalls in priority sector lending as well), such as their operation in backward areas, lack of infrastructure facilities, poor credit absorption capacity of the borrowers, etc. Since a sizeable proportion of their lendable resources were locked in sick units, any increase in credit to the priority sector and in loans and advances under the DRI Scheme would adversely affect the banks' profitability. The Reserve Bank, therefore, was not inclined to take any punitive-cum-inducement measures at that time but proposed to continue with persuasion, sustained monitoring and continuous review of progress in achieving the desired norms. Moreover, the Bank suggested that the nominees of the government and the RBI on the boards of banks that had not achieved the norms so far might be asked to discuss the matter in detail with the chairmen of the concerned banks whenever the opportunity opened up, and to provide feedback.

The facts, however, were somewhat different from the perception of the government, regarding the progress of the scheme in the first ten years of its existence. In terms of the percentage of DRI loans to total credit, there was continuous improvement year after year, although the absolute amounts remained relatively small. The following table shows that in terms of percentage of total loans and advances, DRI loans moved up from a negligible proportion to over 1 per cent by the end of 1981. (The Reserve Bank as a facilitator played its role admirably and acted in concert with the government enabling the banks to fulfil the social responsibilities cast on them.)

One of the objectives of the scheme was that, over a period of time the beneficiaries would graduate into borrowers at normal rates of interest and contribute to the recycling of funds by making regular repayments; thereby, the benefits could be extended to an increasingly broad segment of eligible borrowers. However, owing to certain structural rigidities in the scheme, the quantum of overdues assumed disquieting proportions over time.

Besides the high level of overdues as compared to demand, overdues were high in the states that had granted a comparatively larger share of loans under the scheme, e.g., Uttar Pradesh (65 per cent), Gujarat (61 per cent), Maharashtra (66 per cent), Karnataka (70 per cent), Bihar (80 per cent) and Tamil Nadu (67 per cent). The high level of overdues adversely affected the ability of banks to recycle blocked funds and, as such, the benefits of the scheme could not reach correspondingly larger number of borrowers.

National Institute of Bank Management Study

The DRI Scheme was one of those on which the government bestowed considerable attention during the 1970s. To have a qualitative review of the scheme from an objective academic institution, the government entrusted a study to the National Institute of Bank Management (NIBM) in November 1980, an interim report of which was sought within three months from 19 February 1981, the date on which the main theme and focus of the study was determined.

The final NIBM study, submitted to Government of India in December 1982, was based on a field survey of DRI borrowers from 72 selected branches of eighteen banks in thirty-four districts of sixteen states which yielded data on 1,600 borrowers, and data on 4,300 borrowers received from forty-three branches of banks. Interestingly, about 10 per cent of the total borrowers were estimated to be ineligible to borrow under the scheme. Small businesses and dairying were the main activities in which the DRI borrowers were engaged. In a large number of borrowal accounts, the loan amounts, the amounts needed for particular purposes, the term and periodicity of repayment had been mismatched, thus sowing the seeds of borrower delinquency and non-fulfilment of the objectives of the scheme from the very beginning. Almost one-half of the borrowers felt that the loan amounts were inadequate and did not match the minimum viable level of activity. At the end of June 1981, 50 per cent of the loans disbursed during 1972–81 were outstanding from 70 per cent of total borrowers; and 30 per cent of total borrowal accounts had been closed on full repayment. Repayments by 'small business' borrowers were better than by other groups; loan amounts of Rs 201–2,000 resulted in better repayments than those in other loan-sizes; direct lending to borrowers without the involvement of government agencies resulted in better repayment; repayment behaviour of subsidy recipients was worse than that of those who did not receive subsidies; and lending for periods of thirteen to thirty-six months resulted in better repayment than lending for shorter or very much longer terms. The study also noted that the majority of borrowers had recorded positive changes in their financial position; the non-DRI debt of these people had 'possibly' declined to the extent that the DRI loan had replaced the moneylender.

A disturbing outcome of the NIBM study was that it showed that a large number of borrowers were incurring high costs over and above the interest cost for securing DRI loans; many of them did not know the exact interest rates on DRI loans and a large number of them were prepared to borrow at higher rates of interest. The study felt that most of the activities financed by DRI loans yielded a return high enough to be able to afford a rate higher than the 4 per cent rate of interest.

The outcome of the NIBM study corroborated the Reserve Bank's own assessment of the scheme. The Bank's role in the conduct of the DRI Scheme was subsidiary but critical, in that its views and comments played an important role in shaping the government's policies on the matter. But, by 1981, it was clear that the scheme would not progress further unless the banking system was willing to incur additional costs in meeting the target, and in implementing the scheme in the spirit in which it was conceived. Yet, it was one of the few instances where the viability/profitability of banks in lending was openly discussed. It was also one of the instances where the Reserve Bank and Government of India acted in concert to enable banks to fulfil the social obligations cast on them.

4

Venturing Overseas

This period also saw a significant expansion in the number of overseas branches of Indian banks. The Reserve Bank of India is empowered by the Banking Regulation Act to issue licences to commercial banks incorporated in India to open a branch or office either in India or abroad. No branch or office in India, in other words, can operate without the licence. Nor can a foreign bank open a branch or office in India without getting a licence. Indian banks are required to obtain the approval of the Bank before opening offices abroad. Licensing the entry of a bank through a branch or office requires policy-makers to take into account a variety of considerations, not all of which are purely commercial. The process of consideration requires the Bank to consult a number of departments within its own organization and other ministries through the nodal Finance Ministry. Given the multiple considerations, the Bank did not attempt to frame any definitive policy or guidelines in regard to the opening of branches or offices abroad by Indian banks till almost the onset of the 1980s. There was also no clear-cut procedure laid down for the processing of an application in this regard. Nor, in general, did Indian banks show much interest in venturing overseas.

Three major elements influenced the Reserve Bank's policy towards Indian banks opening offices abroad till the early 1970s. First, and overriding all else, there was the question of foreign exchange for meeting the capital requirements and other expenses connected with the setting up of an office. Given the scarcity of foreign exchange reserves, the Bank and the government were concerned about the foreign costs. Foreign exchange was allocated on the basis of potential benefits and costs. Second, there was the issue of business potential. This was related to the number of persons of Indian origin residing in the country in question. The perception was that the branch or office abroad would grow in size if it was supported by a large number of ethnic Indians. Third, there was the principle of 'reciprocity'.

For instance, during 1963–64, Punjab National Bank as well as Bank of India applied for opening offices in the United States but the Bank did not grant them permission on the ground that requests could in turn come from US banks to open offices in India. In 1964, Bank of India sought permission to open offices at Hamburg, Dusseldorf and Milan but these requests too were turned down on the ground of possible application of the reciprocity principle, which, at that time, was considered undesirable from the exchange control angle—i.e. having to permit remittance of profits by branches of foreign banks as well as from the point of view of its adverse effect on the expansion of business of Indian banks within India. The Bank was cautious about allowing foreign banks to expand in India. It expressed its concern about this several times.

Soon after the introduction of social control over banks, in November 1967, foreign bankers met Deputy Prime Minister Morarji Desai. RBI Governor Jha took the initiative of writing to S. Jagannathan, who was the Finance Secretary outlining the policy. Jha foresaw that foreign banks would raise a point about the policy on opening of new branches.

> While none of them is being uncooperative in respect of any of the suggestions which we make, by and large they are seeking to be accepted and recognized as Indian banks and to have wider opportunities for opening of branches so that they can mobilize more deposits. As you know, the policy in this respect has been to restrict them to the port towns, and even in respect of port towns for the last few months I have given no new approvals until future policy regarding banking was clearer. Now that there is no proposal to nationalize the banking system, I think it is but fair to tell the foreign banks that we would have a stable long-term policy regarding branch expansion.

Jha also enquired whether foreign banks should be allowed to go outside the strict confines of port towns. At least one of them was anxious for permission to open a branch in Poona on the ground that industrialists in Poona were exporting on a large scale and that, in effect, Poona was an extension of Bombay. Jha said that permission to open branches in other industrial cities like Ahmedabad and Kanpur might also be sought on similar considerations and pointed out that Delhi was already open to them. 'One idea that I have in my mind, which I confess I have not considered in full, is to link the total amount of sterling which they bring in as a permanent measure not to their volume of business but the number of their branches.'

Jha expressed these views within the Reserve Bank as well. He wondered whether the view that the deposits that a new foreign bank branch mobilized were mainly at the expense of deposits that would have otherwise gone to other Indian bank branches could be supported by data, in which case the continuing strictness with regard to licensing of foreign bank branches in the country would be justified. Although there is no evidence of any such study having been conducted within the Bank, this policy was followed throughout the period under review.

Much later, on 7 February 1979, Governor I.G. Patel wrote to Manmohan Singh, who was then the Finance Secretary, 'we continue to adopt a restrictive policy in allowing foreign banks to open branches in India', and

> within this restrictive policy, we aim at diversifying the presence of the international banking community in India and not enlarging that part of the international banking community which is already represented in the country. Accordingly, the UK and the US banks will not be encouraged to enlarge their presence in India and we would prefer opening of new branches in India by banks from countries not already represented in India but where Indian banks have branches. The principle of reciprocity will be a major consideration in dealing with these cases although it would not be desirable to try and quantify how exactly 'reciprocity' is to be defined. This will naturally vary from region to region.

This viewpoint was accepted by the government.

THE QUESTION OF RECIPROCITY

This view about reciprocity was probably appropriate. The fact is that, notwithstanding the legal position relating to the licensing of banking companies in India and of branches abroad, as given in Section 22 of the Banking Regulation Act of 1949, the principle was not spelt out in detail. But reciprocity, in practice was not viewed as a rigid position. It was applied flexibly in the early years of the period covered by this volume. For example, in June 1969, under the aegis of the Indo–Iran Commission for Economic, Trade and Technical Cooperation, the two countries explored the possibilities of closer cooperation between their banking systems. When the Reserve Bank examined the legal position in Iran, it found that no foreign bank could open a branch in Iran and that only joint ventures were permitted, provided at least 51 per cent of the capital was held by Iran or Iranians. Opening a branch also involved remittance in foreign exchange of about

Rs 15 lakh to comply with the minimum capital requirement under the laws of Iran, which amounted to one hundred million rials, with 50 per cent of it forming the paid-up capital. As regards an Iranian bank opening an office in a port town in India, the Bank saw no objection, even though it meant a relaxation of the practices followed till then. There was, however, one precedent to cite in favour of allowing an Iranian bank to open an office, namely, the grant of licence to Bank of America. This exception had been made in consideration of the role that Bank of America had played in financing Indian enterprises.

Another example was of Indian Overseas Bank, which had a branch in Thailand at the time of nationalization. As the Thai government did not, as a matter of policy, permit branches of nationalized banks of other countries to function in Thailand, the Indian Overseas Bank branch was converted into a branch of a private bank in September 1973. The newly created bank was named Bharat Overseas Bank Ltd, to make it distinct from Indian Overseas Bank. It took over the assets and liabilities of the Bangkok branch of the erstwhile Indian Overseas Bank Ltd and commenced business from 26 October 1973. No foreign exchange remittance from India was required for meeting the preliminary expenses of the Bangkok branch. The new branch had, however, to invest 10 million baths as additional capital. The Reserve Bank allowed Bharat Overseas Bank Ltd to open the branch at Bangkok under Section 23 of the Banking Regulation Act, 1949.

This flexibility did not mean that the RBI was not concerned about the possible demand for application of the reciprocity principle by other countries. In general, the offices of Indian banks abroad performed well in terms of earnings, notwithstanding the temporary setback to the process of increasing the presence of Indian banks in the United Kingdom on account of the fraud at the Central Bank of India's London branch in the Sami Patel case.

The working arrangement was that the Reserve Bank would consult the Finance Ministry on applications from banks to open branches or offices abroad. An important reason for this was the need to ascertain the views of the Ministry of External Affairs and the Commerce Ministry. This often created tensions.

Nationalization added a new dimension. The first problems arose when the Reserve Bank made a routine reference to the government, in June 1972, regarding the opening of a representative office by Bank of India in Jakarta. The Bank had earlier approved the State Bank of India's application to open a branch in London's West End. The government was critical of the Bank giving approval to SBI without consulting it. D.N. Ghosh, Joint Secretary in the Department of Banking, wrote to Hazari on 23 November that the opening of a branch or a representative office by an Indian bank in a foreign country has political overtones. The government will have to keep in view the mutual relations between India and the country concerned, and also the future prospects. Therefore, he suggested, whenever any application from any bank is received for opening a branch or a representative office in a foreign country, whether for the first time or not, a reference may be made to Department of Banking; it would in turn consult the Ministry of External Affairs and the Department of Economic Affairs, and communicate the views of the government to the Bank. He further wrote that it would be greatly appreciated if this was followed as a convention in the future, and that this had the approval of the Finance Minister.

Governor Jagannathan was irked by this. He asked the Department of Banking Operations Division (DBOD) to see if any recommendation had been received in recent years from the Ministry of External Affairs or Foreign Trade through the Finance Ministry. DBOD confirmed that the Reserve Bank had received a reference in August 1967 from the government calling for comments on a suggestion made by the Indian Ambassador in Indonesia to open an office of an Indian bank in Jakarta. As the proposal involved a remittance of US$ 1 million and SBI had expressed its inability to provide the requisite funds from its overseas branches, the government was informed that it might not be worthwhile to pursue the matter. However, at a meeting between Hazari and Baksi, the Secretary in the Banking Department, Hazari was given to understand that the government had no objection to Bank of India opening a branch in Djakarta. Hazari, in reference to Ghosh's letter, said it would be better to get a general approval from all the ministries concerned rather than accept a procedure of formally consulting the government on each proposal. The latter procedure, he said 'would be time-consuming, ad hoc and in terms of perspective, unsatisfactory'.

Jagannathan agreed with this and during his subsequent discussions with N.C. Sen Gupta, who was Additional Secretary in the Department of Banking, he set forth what he termed as the Reserve Bank's 'ideas'. He said it would be advantageous to have branches opened in Germany for 'trade reasons', and in France because a French bank was already functioning in India and it could be, therefore, expected to reciprocate. Referring to the branches to be opened in West Asia, the Governor added that it would be advantageous for one more bank, namely, SBI, to open a branch in Tokyo and Indonesia or reconstitute the existing branch in Thailand, and to consider especially the question of opening branches in Africa.

The Bank's 'ideas' went down poorly with the government. Sen Gupta wrote to Hazari on 13 July 1973 that the 'decision to open banking offices abroad' is a 'complex matter involving various aspects—political relations, trade prospects, foreign exchange release, etc.' The government felt it necessary to state that while overseas banking had so far been confined to the UK, East Africa and Southeast Asia, it would be desirable to have a chain of branches of Indian banks opened in Afghanistan, Iran and the Persian Gulf area right up to Lebanon, and another chain from Singapore to the Philippines, because of the expected growth of India's exports to these areas. The government also felt that profitability should be a vital consideration and, as such, it was necessary to weigh the volume of business that was likely to accrue against the overhead expenses of branches, which would be especially high in Western Europe, the US and South America, before deciding on the opening of branches. The government also recognized to keep in view the possible use of the reciprocity principle by foreign countries, and the need to give thought to issues of logistics relating to training of personnel and control of branches by the head offices.

It is not clear whether the government's caution influenced the Reserve Bank but it did give the impression, from then on, that it took the government view seriously. Hazari convened a meeting on 18 April 1974 with the chairmen of selected commercial banks. D.N. Ghosh was present at the meeting. The bankers wanted the restriction on Indian branches abroad for drawing an overdraft from their head offices to be removed because of the difficulties these branches faced in getting adequate lines of credit from foreign banks for financing their business. They also felt that where branches were not allowed to be opened by law, Indian banks might be allowed capital participation either with local banks or with other foreign banks already operating there. In this connection, they wanted guidelines to be issued regarding the quantum of capital participation and the remittance of funds that would be permitted towards capital requirements, initial expenses and working capital requirements, till the branch became viable.

The bankers also favoured suitable amendment of the law to protect Indian bank branches abroad from any legal action that customers or constituents abroad might take. They were of the view that, to enhance the incentives for non-residents to keep their funds with banks in India, it would be necessary to permit banks to maintain foreign currency accounts in India with some protection provided for against fluctuations in exchange rates. (This idea led to the Non-resident (External) Account Scheme.) Besides eliciting the bankers' views, the meeting took the decision that Punjab National Bank and Syndicate Bank could explore the possibility of opening a branch each in London.

Hazari forwarded the summary record of the discussions to N.C. Sen Gupta on 7 May. In Jagannathan's opinion, the Reserve Bank's view was reasonably liberal in facilitating the setting up of branches abroad of Indian banks. In reply, Sen Gupta, while appreciating the Bank's efforts, conveyed his intention to convene a meeting on 25 May at the government level, and raised a poser as to whether it would be worthwhile from the country's point of view to allow new banks like Punjab National Bank and the Syndicate Bank, which had no branches abroad, to open a branch each in the UK, instead of permitting existing banks to expand. Hazari countered on 17 May that unless the banks opened branches abroad, they would never acquire the necessary competence in international finance, and that getting a licence or its equivalent from a foreign monetary authority depended not so much upon a bank having or not having a foreign branch already but upon its credit standing, its size and management.

At the 25 May meeting, B.K. Sanyal, who was Secretary in the Ministry of External Affairs, pointed out that Bank of Baroda had delayed opening branches in Dubai and Abu Dhabi, and had not utilized the licence obtained to open a branch at Muscat. He wanted such situations to be avoided and the highest priority to be accorded to the opening of branches in the Gulf region, as well as in Panama, Afghanistan, Lebanon, Zaire, Moscow and South Korea. Narasimham, representing Economic Affairs, while favouring the generally restrictive policy in respect of remittance of foreign exchange to meet the expenditure and capital requirements of newly opened branches, observed that this policy would have to be applied on the merits of each case and that he was not in favour of framing specific guidelines. Deputy Governor Shiralkar agreed with Narasimham. On the opening of branches in the Gulf region, Sen Gupta felt that creating a base in London would help banks to open branches there both in terms of funds and expertise. Punjab National Bank and Syndicate Bank were to be asked to send concrete proposals about opening branches in the UK for consideration by the Reserve Bank and the Finance Ministry.

A MINOR SKIRMISH

What was perhaps most vexatious for the Reserve Bank was the government issuing a letter on 6 June to all leading banks, informing them about the 25 May meeting. This should have emanated from the Bank. The situation was exacerbated by the government conveying its intention to hold inter-departmental committee meetings to consider applications from the public sector banks to open branches abroad.

The Finance Minister got involved in this little scuffle, apparently at the instance of N.C. Sen Gupta, who had by that time become Secretary in Department of Banking. He conveyed to the RBI Governor the following message from the Finance Minister:

> In the matter of opening branches in foreign countries we would be generally guided by the RBI who should have the expertise with them to advise Government in this matter. Let me discuss this with the Governor of the Reserve Bank before we take a final decision. Governor may be requested to come prepared to speak to me when he comes to Delhi next.

But when the Governor met the Finance Minister, the latter indicated that as a normal rule it would be desirable for the government to accept and act on the recommendations of the Bank, and to pass on to the Bank any facts and suggestions that would enable it to consider and take a final decision on the matter. This, however, was not to be.

On 21 April 1975, the Governor wrote to Sen Gupta giving a gist of his discussions with the Finance Minister and added that the Minister's decision/approval could be sought wherever necessary after the Bank had finalized its views. Jagannathan thought that 'this arrangement will be quite satisfactory'. He reiterated the case for a branch each of Punjab National Bank and Syndicate Bank in the UK, as already recommended by the Bank and pending with the Finance Ministry. He thought that banks should be allowed to open branches in the UK, where entry was free, and felt that this would 'in no way interfere with or be allowed to affect our efforts to open banks/branches in the Middle East/West Asia, in countries such as Iran, Lebanon (where there were legal restrictions) or in other countries'. Finally, he requested Sen Gupta to confirm the facts he cited in favour of the opening of branches by Punjab National Bank and the Syndicate Bank. There was no reply.

On 12 May, Jagannathan again took up the issue with Sen Gupta, citing the healthy growth of deposits in the UK branches of India-based banks, and pointing out that branches opened in the middle of 1974 had begun to attract deposits even before the end of that year without cutting into the deposits of other Indian branches. But the government delayed taking a final decision in regard to Punjab National Bank and Syndicate Bank, presumably waiting to implement some changes in the procedure. Jagannathan pressed for a decision, even offering to work out some kind of an accepted procedure for arriving at one. The government seized the opportunity with both hands and decided to make the Finance Ministry the focal point for dealing with applications for opening branches abroad. Thus was the Reserve Bank's role diminished.

Jagannathan retired on 19 May and N.C. Sen Gupta succeeded him for a three-month period. But he left this issue well alone and returned to Delhi. On 22 August 1975, two days after K.R. Puri took over as Governor of RBI, M.G. Balasubramanian, Additional Secretary in the Department of Banking, conveyed to Puri the decision taken by the Finance Minister about the revised procedure, in order to expedite decisions. The procedure was that individual proposals to open branches or offices abroad by the public sector banks should be sent directly to the government, with a copy to the RBI, and these were to be considered by a committee consisting of officials of different ministries and the Bank. This, in effect, meant that the Department of Banking, through this committee, took over the powers vested in the Reserve Bank, under Section 23 of the Banking Regulation Act. The letter also stated that the proposals of Punjab National Bank and Syndicate Bank would be placed before the said committee for its consideration.

The letter so surprised K.S. Krishnaswamy, who was by then an Executive Director of the Bank, that he wrote on it: 'One more encroachment on the RBI's territory! Why?' Why, indeed? Chief officer of the DBOD, P.N. Khanna, in his note of 12 September 1975, traced the background of the impasse and remarked that the RBI's image in the eyes of the banks had been lowered in the process.

On 22 September, the first Inter-Departmental Committee meeting was held at Delhi, with N.C. Sen Gupta in the chair. Khanna represented the Reserve Bank at the meeting. Economic Affairs and the Banking Department opposed the granting of licences to Punjab National Bank and Syndicate Bank on the usual grounds. Khanna countered that without a base in London it would not be possible for these banks to operate elsewhere abroad, and that remittances were in the nature of working funds that could be sent back to India within three years. The External Affairs Ministry strongly supported Khanna. Ultimately, it was decided to allow the two banks to open branches in London subject to the approval of the Finance Minister and on a clear understanding that the banks would repatriate within three years the amounts remitted from India for their establishment in London. The Committee also discussed other proposals of banks for opening branches/offices and took decisions thereon. The Finance Minister eventually approved the recommendations of the Committee.

The second meeting of the Inter-Departmental Committee was held on 1 March 1976, to consider proposals to open four branches in the UK, one in Abu Dhabi and a representative office in Toronto. The Committee approved the proposals to open branches in the UK, two each by Bank of Baroda and Bank of India, as also a representative office at Toronto by SBI. It also considered two proposals for opening an agency: one at San Francisco by Bank of India and the other at Los Angeles by SBI. It turned down Bank of India because under California's banking laws, an agency working there was not immediately allowed to mobilize deposits from the local population and the applicant bank had asked for a remittance of $560,000. But the SBI proposal was approved as it did not require any foreign exchange remittance from India. Besides, the Los Angeles agency could mobilize deposits on behalf of the New York and Chicago branches of SBI.

Strangely, however, the Committee took exception to the Reserve Bank permitting a representative of a private sector bank, Bank of Madura, to visit Kuala Lumpur for more than a year to canvass deposits. It ruled that requests for such long stays should be put up to it for clearance! But when the minutes of the meeting arrived, the Bank was informed that the Minister for Revenue and Banking had approved the recommendations of the Committee, and the Department of banking was advising the banks to submit formal applications to the Bank for seeking the necessary permission. This was a welcome departure from the earlier position wherein the Reserve Bank was asked to initiate action on the basis of the Committee's recommendations by getting in touch with the banks.[1]

In November 1976, by which time Narasimham had become Secretary in the Department of Revenue and Banking, three policy guidelines were set before the Committee:

(i) Applications for opening of branches should be examined with reference to the constraints of foreign exchange and manpower.

(ii) Ordinarily, only one bank might be permitted to open a branch in a new area, although in international financial centres like London and

[1] There is an interesting little interlude here. N.C. Sen Gupta, Secretary, Department of Banking, had specifically invited Hazari to attend the two meetings. But on both the occasions, Hazari could not attend on account of his commitments elsewhere. Sen Gupta himself held the post of Governor in the three-month period between 19 May and 19 August 1975. When Jagannathan relinquished the Governorship, Hazari, who was then the seniormost Deputy Governor, was rumoured to succeed him. It is not clear why the Bank chose to send its senior officers but not Heads of Departments to the meetings. It is likely that this level of representation had placed it at a disadvantage vis-à-vis the government. This position, however, was sought to be corrected when M. Narasimham, on becoming Secretary, Department of Revenue and Banking, in November 1976, specifically requested Governor Puri to attend a meeting of the Inter-Departmental Committee he convened on 28 December 1976. Puri, however, deputed P.N. Khanna, by then the chief officer of DBOD, to the meeting.

New York, there could be more than one Indian bank in operation.
(iii) If a bank did not open a branch within a year of getting approval, the licence would not be renewed.

Against this background, the Committee considered applications for opening of branches abroad. Of these, two proposals are worth mentioning. Bank of India and Indian Overseas Bank applied for opening a branch each in Seoul and the Committee felt that, given the presence of IOB in Southeast Asia, it should be allowed to open a branch in Seoul.

At the fourth meeting, held on 15 March 1977, R. Vijayaraghavan, joint chief officer, DBOD, was present. The simmering differences between the government and the Reserve Bank surfaced at this meeting in four instances. First, the Bank was not inclined to support the application of Punjab National Bank to open branches in the UK at Wolverhampton and Gravesend, because of that bank's presence in London. But Narasimham had had a prior discussion with the chairman of the bank. He felt that the application could be considered because a large number of Punjabi businessmen and other Indians were residing in these places. The Committee approved the proposal subject to repatriation of the foreign exchange remittance from India within three years.

Second, the RBI felt that State Bank of India's request to open a representative office at Vancouver need not be considered in view of its new office in Toronto. Narasimham, again, justified the request on the ground that the chairman of that bank was satisfied with its critical significance. The Committee agreed with his view.

Third, RBI did not support the State Bank's presence in Tokyo on the ground that Bank of India already had branches in Tokyo and Osaka. The Bank also pointed out that there was already a proposal under consideration, of Bank of India opening a branch at Kobe. However, the chairman over-ruled that Tokyo and Hong Kong should be regarded as important financial centres in the same way as London and New York. The Committee again concurred with this view.

Finally, the RBI had reservations, on two counts, about the External Affairs Ministry's proposal to support State Bank of India's request to open a branch or subsidiary in Zurich. Firstly, it felt that the Swiss laws insisted on strict secrecy of accounts and the Bank would not be able to inspect them. Secondly, a large remittance (equivalent of Rs 4.12 crore), towards minimum capital and preliminary expenses, would have to be made for the purpose. The chairman intervened to say that secrecy laws should not deter India from considering the proposal since in any case foreign branches of Indian banks would have to comply with the rules and regulations of the respective countries of operation. He pointed out that relatively small banks, like Habib Bank of Pakistan, had an office in Switzerland and did good business. He hoped that SBI would remit the funds from its other overseas establishments if it were to set up branch/subsidiary in Switzerland. On the question whether it should open a branch or establish a subsidiary in Switzerland, the Committee felt that this was a general policy issue, and therefore could be referred to the Minister. Eventually, it was decided that the Department of Banking would take up the request in greater detail with the Reserve Bank and, subject to the latter's approval, the Committee would agree to the entry of SBI. This meeting once again proved that the real decisions would be taken by the government through the Inter-Ministerial Committee, although for the sake of form and compliance with the law, the Reserve Bank's approval would be sought.

DIFFERENCES PERSISIT

The sudden change in the government at the centre in March 1977 led to a marked shift in the perceptions on the subject. At the behest of Deputy Governor Krishnaswamy, the DBOD prepared a note on the perspective plan on the opening of branches abroad, and on the relative responsibilities of RBI and the government in the matter. The note was helpful when the next meeting of the Inter-Ministerial Committee was convened on 28 July by Manmohan Singh, Secretary, Economic Affairs. Krishnaswamy saw an opportunity to normalize relations between the government and the Bank. The meeting proceeded on the familiar lines of considering applications of banks for opening of foreign branches/offices. In four out of the six applications, the Committee's views were in line with those of the Bank.

In one case, however, the application was approved notwithstanding the Bank's recommendation for its rejection. In another case, involving SBI's application to open a joint venture bank at Jeddah, the Bank wanted deferment and the Committee felt that the proposal required to be examined in further detail and after consultation with the Indian embassy. As a policy departure, however, the Committee took the view that where joint ventures and finance companies were to be established in foreign countries, it would be preferable to set them up on a consortium basis by associating one or two Indian banks rather than on the basis of participation of only one Indian bank. SBI was asked to re-examine the proposal and come up with a concrete scheme spelling out the financial details before the Committee.

The thaw in the relationship was in evidence in the subsequent two meetings as well, held on 26 November and 21 July 1978. In general, the Committee's decisions on banks' applications were in line with the perceptions of the Reserve Bank. However, before the 21 July meeting, the Department of Banking, which by that time had been downgraded as the banking division, raised a discordant note by trying to empower the Committee to decide on applications of foreign banks wanting to open offices in India.

Baldev Singh, Joint Secretary, in his letter of 2 February 1978 to Governor I.G. Patel, argued:

> Under the Banking Regulation Act, 1949, grant or refusal of a licence for banking business to a bank, including a foreign bank, is a function exclusively assigned to the Reserve Bank of India. A convention has, however, developed over the years for the Reserve Bank to consult the Ministry of Finance and for the Ministry of Finance to consult the Ministry of External Affairs before any decision is taken either to give or to refuse a licence to a foreign bank for conduct of banking business, mainly due to the political angle involved in such a decision. Of late, both the Government and the Bank have received a number of requests from the foreign banks operating in India for expansion of their branch network in India and from other foreign banks for their entry into India. Some canvassing by the banks concerned in support of their applications has also been noticed.

He said that the applications received from foreign banks for establishing representative offices or branches in India would be placed for consideration before the existing Committee (which considered proposals by Indian banks wanting to open branches abroad). In his eagerness to formalize the arrangement, Baldev Singh proposed, if the RBI agreed, to place such applications received thus far before the next meeting of the Committee. But this time the Bank was alert and managed to stave off the attempt to erode its authority further and even made an effort, albeit only partially successful, to retrieve the powers that had been taken over by the government in the case of Indian banks opening branches abroad.

The Reserve Bank responded with a long note on 24 February, which examined the implications of the government's move. After narrating the determined manner in which the erstwhile Department of Banking had succeeded in usurping the statutory powers of the Bank, the note said that its suggestion would further erode its authority and dwelt on the political implications involved in dealing with such applications. Finally, it said that the present procedure, which had been unilaterally decided by the government, had *executively abrogated* (the Governor italicized the two words) the powers that were lawfully vested in the Bank. The note cautioned that the revised procedure might open itself to allegations of lack of transparency at a later date.

> Yet another aspect is the need for keeping the records straight of both government and the Reserve Bank of India so that at a future date, one will be able to correctly interpret the circumstances and factors taken into account while taking a particular decision. The absence of formal communications between the Bank and the government wherein the grounds on which a particular view is supported or otherwise are clearly spelt out in the notes or letters exchanged may lead to possible suspicion or view that the decisions were taken arbitrarily.

On a milder note, the note added that the Finance Ministry was at liberty to obtain the opinion of the Ministry of External Affairs or any other ministry before communicating its final view to the Bank. Besides, it could pass on to the Bank any facts or information that any government department might have and any of its own suggestions as well, which the Bank would take into consideration. The note asserted that the Bank was not in favour of the Committee considering such applications, so that 'the autonomy of the Reserve Bank of India is preserved'.

Krishnaswamy, in his noting, summed up the position vis-à-vis autonomy of the central Bank thus:

> In my view, this is a matter on which the present position is quite unsatisfactory. Every time we put up a memorandum to our Board regarding opening of foreign branches by Indian banks or of Indian branches of foreign banks, we are merely asking the central Board to endorse a government decision. This is not right for either the RBI or the government. Since, under the statute, RBI is the authority to grant the licences the process should in both form and substance, conform to the statutory provisions. Hence, we should take up the matter with government and set right the machinery. To do so does not, clearly, imply any reduction in RBI having to consult with, and generally respect the views of, government.

Governor Patel, while concurring with the contents of the note, instructed that a copy of the note be sent to the government. Krishnaswamy did so on 28 February. In his covering letter to M.R. Shroff, he conveyed the opposition of the Reserve Bank not only to the proposal made by Baldev Singh but also to the functioning of the Inter-Departmental Committee, and called for retracting the steps already taken.

> We are not in favour of the Committee considering applications received from foreign banks for establishing representative offices or branches in India. We are also not in favour of the Committee taking decisions on the applications received from Indian banks for opening branches abroad. We are of the view that both these categories of applications should be received by the Reserve Bank who will refer to the Ministry of Finance, which may consult other ministries or departments as expeditiously as possible and convey the views of the Government to the Reserve Bank.… If Government agrees, appropriate instructions will have to be issued to the public sector banks requiring them to submit the applications for opening branches abroad to the Reserve Bank direct. I have also discussed this with the Governor.

Manmohan Singh, while sending out invitations for convening the meeting of the Inter-Departmental Committee on 17 April 1978, informed Krishnaswamy that he was having the matter examined and that, in the meanwhile, 'I thought we should not hold up the various proposals we have received.' Significantly, the agenda for the meeting included applications received from five foreign banks to open branches in India. A few days later, the Bank's strong resistance paid off and the government climbed down by modifying that the agenda for the meeting would be confined only to the proposals of Indian banks for opening branches/representative offices abroad.

On 7 February 1979, I.G. Patel wrote a detailed letter to Manmohan Singh that the Committee's approach was far from desirable since it could not avoid placing the Reserve Bank in an embarrassing position. He referred to the discussions between himself, Manmohan Singh and the Finance Minister in the first week of February 1979, regarding the policy for foreign banks opening branches in India, and the practice followed for processing applications from Indian banks for opening branches abroad. Patel expressed the view that only the bigger banks with the expertise needed to open branches abroad and joint efforts for opening of branches/offices abroad of a few of the nationalized banks should be encouraged, wherever feasible, rather than make them compete with each other for the sake of so-called 'prestige'. He also said that, instead of taking decisions under pressure or persuasion from individual banks, a perspective plan for the next few years should be drawn up for Indian banks desiring to open branches abroad. He wanted Manmohan Singh to confirm whether the general approach set out by him was acceptable to the Ministry and mentioned that he intended to ask for a meeting with select banks to discuss the general approach. The letter concluded by highlighting the key issues in the whole controversy, which touched on the relations between the Bank and the Finance Ministry:

> I would be grateful if you could let me know whether the general approach in this letter is acceptable to the Ministry of Finance and also that we may not act at cross-purposes—and what is more important, do not encourage our own banks to play us one against the other. Between the Ministry and the RBI there should, in fact, be informal discussion and agreement on individual cases before we discuss them at a general meeting, as otherwise the danger I apprehend would be difficult to avoid. That is why we had earlier suggested a reconsideration of the present procedure which, to say the least, puts the RBI in an awkward position; and I hope that it would be still possible for us to evolve something better than the present procedure which puts us more in the role of, at best, a public prosecutor rather than at least a member of the judiciary.

Manmohan Singh replied on 15 February in a typically disarming manner. He clarified that the government was not wedded to any particular procedure and was willing to consider any alternative procedure that the Reserve Bank would suggest. Patel responded on 1 March apologizing for the 'insinuation' and conceded that he did not see any reason 'for making a change in the present practice', which, however, seemed like a climbdown from the high moral ground that his letter of 7 February 1979 had assumed. He requested that a representative from the banking division be present at the meeting arranged by Krishnaswamy with the banks. The meeting was for discussing the Bank's plans for the next two or three years, to 'avoid ad hoc decisions'.

In June, the government told the RBI that it would be necessary first to draw up a set of guidelines regarding the future approach towards permitting branches abroad by Indian banks and thereafter prepare a perspective plan for such expansion. The government said it wanted the guidelines to be discussed at the next meeting of the Inter-Departmental Committee.

Accordingly, on 6 September, the Bank forwarded the guidelines to the government.

The meeting of the Inter-Departmental Committee was held on 5 November. The agenda was heavy. It included twenty proposals from banks for expansion overseas, as also the draft guidelines prepared by the Bank. Krishnaswamy said that the Bank could only process five proposals and that it needed more time for making its recommendations. The Committee agreed and the discussion on the draft guidelines ended with the conclusion that the guidelines would have to be more specific so that banks became aware of the policy in precise terms.

In the meantime, another interesting development came to the notice of the government. Certain public sector banks had been submitting applications to the central banking authorities of foreign countries for permission to open branches/representative offices even before obtaining the prior approval of the authorities in India. The Finance Ministry asked the chairmen and managing directors of the public sector banks to stop this. Governor Patel, on the copy of the letter endorsed to the Reserve Bank, was quick to instruct that it should be made clear that the prior approval referred to 'approval of both and not of either'. Some of the banks were annoyed by all this and there was some heat generated.

The revised draft guidelines were presented and approved on 11 June. One of these was intended to ensure that the opening of a new branch in an area where an Indian bank was already established should be justified on the basis of creation of potential for 'additional' business. It was also decided that representative offices should not be allowed to be opened unless full justification was provided by the banks because these offices did not directly conduct banking business and as such did not earn profit. But the guidelines took a long time to be issued—almost a year and four months.

The basic objective in permitting banks to expand abroad was to enable them to enlarge their international business, act as catalysts in the development of India's foreign trade and to raise resources abroad. As there were implications for the Reserve Bank's approach to foreign banks opening offices in India, Indian banks were asked to be fairly certain that the host country was willing to permit them to operate there on terms equal to those of other foreign banks. Each bank was expected to formulate the proposal for establishing or enlarging its business abroad in the context of its overall development plan. Small banks were advised not to venture into international money and capital markets because of severe competition and market volatility.

However, the government, at whose instance the guidelines had been prepared and circulated to banks, did a sudden about-turn on realizing that it amounted to a dilution of its powers. While deciding on the countries/areas where Indian banks are to be permitted to establish/increase their presence, the following aspects had to be taken into account:

(i) India's political relations with the concerned country and the political conditions obtaining there.
(ii) The extent of existing/potential trade between India and the foreign country concerned.
(iii) The population of Indian origin in that country.
(iv) The financial importance of the centre from an international point of view.
(v) The projected business and profitability estimates of the proposed branch, particularly in the context of local laws relating to liquidity, credit control and taxation.
(vi) The Foreign exchange remittance required for establishing the branch and the source from which this will be met.

Every bank had to keep the Reserve Bank of India informed of its programme for surveys, before these were taken up, in order to establish better coordination in bank surveying.

On 12 August 1981, the Finance Ministry wrote a letter to Patel that practically ended any hope of the Bank's autonomy: in view of political, foreign exchange and other factors, it said, it would be desirable to obtain the government's approval 'in principle' for opening of branches/offices, etc., abroad, and for participation in the equity capital of foreign banks or institutions. The letter went on to say that the Inter-Departmental Committee would continue to carefully examine the proposals and make suitable recommendations to the government, and that the government's approval, with or without modifications, would be communicated to the Reserve Bank. The Indian banking companies should not, however, normally submit formal applications for licences to the central banking authorities of other countries without first obtaining the approval of the RBI/Government of India.

5

The Dictates of Prudence

New approaches bring new problems in their wake. The stated objective of bank nationalization in 1969 was to expand the spread and reach of banking. This objective was pursued with exemplary doggedness but, as the spread and reach of banking expanded, an important new problem came to the fore: the viability of banks. This was partly because of the deterioration in the quality of lending that was inherent in the large amount of loan operations, and partly because of inadequate appreciation of the need for instituting mechanisms for internal controls. It fell to the Reserve Bank of India to rectify these. One of the important approaches it adopted was closer inspection of accounts.

INSPECTION OF BANKS

The inspection machinery in the RBI had been set up following the Banking Companies Act, 1949.[1] Vide Section 22 of the Act, the Bank had to satisfy itself whether:

(i) the banking company is or will be in a position to pay its present or future depositors in full as their claims accrue; and

(ii) the affairs of the banking company are not being or not likely to be conducted in a manner detrimental to the interests of its present or future depositors.

By the beginning of the 1970s, the RBI's practice of pointing out areas that required urgent action was more or less stabilized. This was often done even before a formal report had been submitted and banks were asked to take remedial action. Weaker units that appeared incapable becoming viable were asked to consider merging with other suitable institutions. Sometimes the Bank even deputed an 'observer' to keep an eye on things.

[1] Renamed in 1966 as the Banking Regulation Act, 1949.

Usually, though, informal observation was the norm. The Bank could also demand full access to all the papers.

With the advent of 'social control' of banks in 1967, the instructions to inspecting officers underwent a change. The purport was clear: if the loans were for social purposes, go easy. Thus the Department of Banking Operations and Development (DBOD), in a circular in June 1968, emphasized that 'although the time-honoured considerations of safety of funds lent and protection of the depositors' interest are not meant to be ignored, particular attention should be devoted to the examination of the advances portfolio of banks from the point of view of a socially oriented deployment of their funds.' The inspecting officers were also asked to assess how sincere banks were in giving loans to the priority sector.

If this was unorthodox, more was to follow after the nationalization of fourteen major commercial banks in 1969. In his inaugural address to a conference of heads of the DBOD from various centres in March 1970, Governor Jha highlighted the changes in the role of the Reserve Bank. His message was clear: the Bank's main duty was to ensure the flow of adequate credit to the neglected sectors of the economy in the country, and not only to look to the safety aspect of funds but also to see that the funds were not lent to a borrower who was likely to misuse the credit by diverting it for speculative or other purposes. He also said that inspectors could play a vital role in ensuring that the declared policies of the government were implemented. The proceedings of the conference stated:

> The scope of these inspections will cover, apart from the standard drill, the following aspects: the efforts and the performance of each branch in respect of deposit mobilization and advances to priority/neglected sectors vis-à-vis the performance of the branches of other banks at that centre, and the delegation of adequate powers to branch agents and their judicious use and profitability position (the attainment of social objectives should be consistent with profitability).

Consequently, four types of inspections were decided upon:

(i) Inspection to assess the financial position
(ii) Centre-wise inspection of branches
(iii) Ad-hoc inspections to examine implementation of selective credit controls, frauds, complaints, etc.
(iv) Inspection to examine the systems and performance of banks.

A major consequence of the expansion of banking was that it became virtually impossible to carry out inspection as frequently as had been the case earlier. So the DBOD issued detailed guidelines to cover all branches of commercial banks once in three years, as opposed to at least once a year. But foreign and private banks were to be inspected once a year; this was later relaxed in the case of banks with deposits of over Rs 50 crore. The public sector was effectively let off the hook.

This was also a period that saw a spurt in fraud within public sector banks. On 25 June 1971, Finance Minister Y.B. Chavan wrote to Governor Jagannathan:

> I have been very much perturbed over the spate of frauds in recent weeks in some of the public sector banks. You will agree that what is at stake in these bank frauds is not merely the large sums of money involved, but also the reputation and the image of public sector banks in general and the trust and confidence reposed by the public in the banking system of the country.

Chavan went on to add that one common feature in these frauds was the direct involvement of bank employees, largely facilitated by the non-observance of the instructions laid down for safeguarding banks' funds. He concluded:

> As the matter is one of great public importance, I feel that the Reserve Bank alone can undertake a quick study in depth, of the extant practices and procedures in the public sector banks, to identify the deficiencies that give scope to frauds, with a view to eliminate such deficiencies.[2]

[2] In a secret note dated 6 May 1970 to Shri A. Baksi, Secretary, Department of Banking, Ministry of Finance, Government of India, Shri B.N. Adarkar, Governor of RBI wrote: 'The internal working of commercial banks in India has so many deficiencies that it is a matter of surprise that the number of frauds actually occurring is so small. Over the last few years, we have been trying to improve the working in many respects, but this is a task which will take some years to be fully accomplished. My four years of hard work in the DBOD were not enough. There are a number of areas where it is essential to improve our inspection procedures and also bring about radical changes in the internal working of banks. . . . I would ask you to appreciate that given the limitations of personnel and the importance and urgency of developing the social aspects of banking, the Reserve Bank could not possibly do all it wished by way of cleaning up the internal working of banks. In fact, it was the Reserve Bank's excessive preoccupation with mere policing that had led to the development work being somewhat neglected prior to the introduction of social control. I recognize, however, that both development and improvement of personnel and procedures must now be pursued simultaneously and with equal vigour.'

DBOD initiated prompt action and a team of four officers, including an officer from the Organization and Methods Division, was formed. The first study of systems and procedures was taken up in Central Bank of India towards the middle of August 1971. The second study was undertaken in Allahabad Bank towards the end of January 1972.

Centre-wise inspection of branches had a brisk take-off. The main purpose of these inspections, as stated earlier, was to assess the performance of the branches of different banks at the same centre in the context of achieving social objectives, and to relieve the financial assessment type of inspection from the burden of inspecting too many branches. The scope and coverage of the inspection were designed accordingly; these included, apart from an examination of the affairs of the bank branches, an assessment of the business potential at the centre, as also a study of local problems with the assistance of knowledgeable agencies at the centre and pragmatic suggestions for their solution. The inspection team for a particular centre functioned under a leader, who directed and supervised inspections of branches. The leader also contacted representative bodies (if any) of borrowers in the neglected sectors, concerned state government departments/agencies and officers in charge of a few offices of the banks operating at the centre, and held discussions with them so as to elicit, *inter alia*, information on aspects such as deposit potential, credit gaps, customer service and specific local problems.

During the early 1970s, officers of the DBOD were deputed for training, from time to time, to courses and seminars organized by the Indian Institutes of Management, Calcutta/Ahmedabad, National Institute of Bank Management, Bombay and other training institutions, including those of the commercial banks, to equip them for effective implementation of the new pattern of inspections. Besides, revision of the existing *Inspection Manual* was taken up and a proposal mooted for opening offices of the DBOD in states where they did not exist. Officers of the Reserve Bank who were functioning as additional directors, under Section 36AB of the Banking Regulation Act, 1949, in banks that were working under directions and under formal observation, were instructed to watch the performance of the developmental activities of the banks and not merely the progress of implementation of the directions issued to them. The first batch of centre-wise inspections was carried out in 1970 on an experimental basis. The inspecting officers prepared initial branch inspection reports in free style and the leader of the team prepared the consolidated report on the centre, based on the reports of the inspecting officers.

In November 1970, the Efficiency and Development Sub-Committee, while approving the proposal for opening more offices of the DBOD, directed that the O&M cell in the Reserve Bank should study the forms, inspection procedures and other items of work handled by the regional offices of the DBOD with a view to improving operational efficiency, and set up a model so that the new offices could be started on that basis. The preliminary study showed that about 80 per cent of the officers of the regional offices were deployed for inspections, and that the major part of the inspection work was on account of the centre-wise inspections introduced at that time. Hence the study initially concentrated on this type of inspections. The first phase of the study relating to centre-wise inspections was taken up in February 1971, and the O&M division submitted its detailed report in July 1971. For the purpose of the study, the O&M team associated itself with centre-wise inspections carried out at Vizianagaram and Cannanore, and also scrutinized about 100 centre-wise inspection reports from various regional offices. The report, *inter alia*, observed that the existing instructions on the scope of centre-wise inspections provided that it should cover certain specific aspects 'apart from the standard drill'.

According to the O&M study team, the insistence on a 'standard drill', which involved a scrutiny for assessing the financial position, had, in actual practice, tended to make the centre-wise inspection an extension of the inspection under Section 35 of the Banking Regulation Act, both in methodology and content. The study team stated that tighter scrutiny of the financial position uniformly applicable to all categories of banks was not necessary in the changed context obtaining then. It suggested that the scrutiny for assessing the financial position in the case of branches inspected under the centre-wise scheme should be limited to the minimum extent necessary, so as to have only a general feel of the state of affairs at the branches concerned. On this premise, the study team suggested certain modifications in the existing procedure, which, *inter alia*, involved:

(i) discontinuance of narrative reports and introduction of a standardized format for reporting
(ii) sample check for scrutiny of advances as against item-wise scrutiny of individual accounts
(iii) discontinuance/reduction of work involved in voucher auditing, balancing and reconciliation of books, and scrutiny of drafts payable, bills payable, payment orders, sundry deposits and suspense accounts
(iv) elimination of items of physical verification, like petty cash, parcels, documentary stamps, bills, and simplification of cash verification.

It was assessed that the suggested modifications would save inspection time to the extent of about 44 per cent. The study team also suggested that the leader of the centre-wise inspection team should not be tied down with a heavy inspection schedule, so that he had ample time to guide and supervise the work of the other members of the team, to contact government agencies and other representative bodies responsible for developmental activities, and to ascertain the potentialities, credit needs and special problems of the centre.

The various recommendations of the O&M study team, including the form suggested for branch inspection, were discussed with DBOD officials and revisions, as mutually agreed, were carried out. In a note submitted by the DBOD in this regard on 5 October 1971, it was emphasized: 'Some of the recommendations made in the O&M report emerged out of the suggestions made by the officers of central DBOD at the time of informal discussions with the O&M team.' Further, regarding the format of the branch inspection note, which, incidentally, was a major innovation in the newly suggested pattern of centre-wise inspection, it was unequivocally made clear:

> The statistical parts as well as the questionnaire of the format originally designed by the O&M Division were based on our existing instructions regarding centre-wise inspections. Besides suitably modifying the statistical outline, we have since revised the questionnaire extensively in the light of our experience and new thinking. The revised format has been shown to the O&M Division and they have cleared it with a few minor changes here and there.

The DBOD, apparently, was unwilling to give the entire credit for the innovation to the study team.

The draft circular laying down the instructions and guidelines for centre-wise inspections was shown to R.A. Gulmohamed, V.D. Thakkar and L.C. Mistry of Dena Bank, Bank of Baroda and Union Bank of India, respectively, and their suggestions were incorporated before it was submitted to the Deputy Governor of RBI, Hazari. The circular, addressed to the various offices of DBOD, was issued on 5 October 1971. Apart from forwarding the format of the branch inspection note, it also contained exhaustive guidelines for examination of various aspects of the working of the branches. The regional offices were advised to forward a copy of the consolidated report on each centre-wise inspection to the central DBOD. The listed irregularities/deficiencies, etc., of a major nature were to be pointed out to the concerned banks and their comments called for. If the banks' comments indicated that they were seized of the matter and were taking appropriate steps, such cases were not to be pursued at least till the time of the next inspection, which would take up the issue of compliance with the recommendations/comments pointed out by the inspection team that preceded it.

The guidelines for centre-wise inspections underwent periodic modifications, including certain revisions in the format of the branch inspection note, in the subsequent years, in light of the issues raised and the experience gained during the inspections. In the late 1970s, with the Lead Bank Scheme dominant in the exercises for preparation of district-wise credit plans, the regional offices of the DBOD were advised that, on completion of centre-wise inspections in a district, a district-wise note examining the role played by banks in the development of the district as a whole should be prepared and forwarded to the central DBOD. This note was to contain the district profile with details such as population, occupational pattern, developmental programmes, etc., as also the number of commercial bank offices, their distribution in rural, semi-urban and urban areas, their deposit potential, their credit dispensation (especially to priority and weaker sections), etc. These instructions were issued in March 1977. Given the arduous amount of work involved, it became apparent that the instructions could be carried out in full. A decision was therefore taken to discontinue the scheme of centre-wise inspections, following a conference of the regional in-charges of the DBOD, held in Bombay on 6 and 7 August 1979. It is thus unlikely that any extensive use of district-wise notes was made in the preparation of the district credit plans, systematic formulation of which commenced only in 1980. Besides discontinuance of the centre-wise inspections, the systems inspections were also wound up with the introduction of the new scheme of annual appraisal inspections of banks in 1978. The latter was introduced at the instance of Government of India, with a focus on the working of the public sector banks.

The scheme of centre-wise inspections, which was implemented from May 1970, till the time of its discontinuation in 1979, had covered 6,867 centres served by 13,875 offices of commercial banks, while the systems inspection, which was introduced in 1971, did not make much headway and had completed studies of only six banks in the public sector and three banks in the private sector by the time of its winding up in 1977.

The centre-wise and systems inspections were replaced by annual appraisal inspections that would complement the statutory financial inspections, which normally take place at relatively large intervals of time. Put together, these inspections would reveal the overarching concerns relating to the functioning of each bank. In the report on the activities of the DBOD submitted to the Central Board in 1978, the unveiling of the scheme of annual appraisal was referred to follows:

> Having regard to the fast developments taking place in the field of banking and the need for the Reserve Bank to assess how the banks are discharging their responsibilities and to enable the Bank to issue suitable instructions and guidelines, it was considered necessary to make an assessment of the affairs of the banks at short intervals, say, once in a year. Accordingly, it has been decided to institute a new type of inspection, viz., Annual Appraisal of banks, under Section 35 of the Banking Regulation Act, 1949. It is proposed to undertake, under this system, a quick and overall assessment of the working of banks. In a way, it can be construed as a sort of management audit and emphasis will be laid on examining the organizational set-up, manpower planning, machinery for supervision and control over branches, management of funds, credit etc. of banks. This type of inspection will thus embrace the study of systems and procedures followed by banks. Initially, it is proposed to restrict this type of inspection to all the twenty-two banks in the public sector and eight larger private sector banks.

During the quarter April–June 1978, inspection of one public sector bank in the Bombay area was taken up on a pilot basis under the scheme. Besides the bank's head office, sixteen regional managers' offices and seventeen major branches spread over the country were also inspected. It was decided to schedule more banks for inspection on a regular basis, and to issue suitable guidelines on the basis of the experience gained. Subsequently, after a conference of the heads of the regional offices of DBOD in August 1979, it was decided that annual appraisal of a bank would cover only a few important controlling offices and branches, besides the head office/central office. Apart from an appraisal of the standards of management, the inspection would cover a broad assessment of the financial position of the bank on the basis of the records available at its head office/central office. A decision was also taken to carry out financial inspection of public sector banks as and when they fell due, alongside the annual appraisal of the bank for that particular year. The same inspection team deputed to conduct the annual appraisal of a bank was required to carry out the financial inspection of the bank as well, in such cases, and both the inspections had to be carried out with reference to the same date.

As the annual appraisal inspections of public sector banks was taken up at the instance of the central government, the inspecting officers were initially advised to prepare a self-contained note for forwarding to the government. Later, in July 1980, it was decided to forward to the government a copy of the inspection report itself. At a conference of the heads of the regional offices of DBOD in February 1981, it was decided to introduce an innovative technique for monitoring the progress of annual appraisal and financial assessment inspections, namely, the PERT (Performance Evaluation and Review Technique) Chart. The PERT Chart was devised with the help of the Management Services Department, mainly with a view to reducing the time-lag between the commencement of inspection of a bank, and the forwarding of the inspection report to the government and the bank concerned. The technique broadly relied on breaking up the entire process of inspection into various identifiable components and estimating the time requirement for completion of each of them, on the basis of past experience and/or experts' guesstimates.

At one of the meetings of the Committee of the Central Board, towards the end of the reference period of this study, Governor I.G. Patel pointed to the desirability of an outside Working Group to examine the Reserve Bank's system of inspections. Accordingly, a Working Group under the chairmanship of V.G. Pendharkar, retired Executive Director of the Bank, was appointed in December 1981, to review the existing system of inspection of commercial banks, regional rural banks and urban cooperative banks, with particular reference to the objectives of the banking and credit policy of the Bank, and the scope, coverage, methodology and periodicity of inspections.

Foreign Banks

The inspection procedure—including taking up surprise inspections, the audit element, and the examination of various items of assets and liabilities—adopted in the case of foreign banks was similar to that of the financial inspection of Indian banks. However, apart from assessing the progress made by a foreign bank in regard to mobilization of deposits and in granting of advances to the priority sector, and its role in financing import/export trade in India, the inspecting officer was also expected to critically assess the functioning of the local board/committee (which the foreign banks were asked to constitute in 1968 on the lines of the reconstituted boards of Indian banks) and the progress made by the bank in Indianization of its staff. Other aspects examined by inspecting officers included the extent of 'own funds' deployed in Indian business, the credit–deposit ratio, the booking and transfer of profit, provisioning for bad debts, compliance with exchange control regulations, etc.

Foreign Branches of Indian Banks

After the failure, in 1950, of the Exchange Bank of India and Africa Ltd, which had a network of branches in foreign countries, it became necessary to regulate the opening of overseas branches of Indian banks with a view to ensuring the maintenance of a satisfactory financial position and the observance of sound banking traditions by foreign branches. These objectives reaffirmed the vital importance of safeguarding the prestige of Indian banks abroad and the larger interests of the country. Accordingly, Section 23 of the Banking Regulation Act, 1949, was amended in 1950, so as to require every banking company incorporated in India to obtain prior permission from the Reserve Bank for opening a branch in a foreign country. It was also considered necessary that foreign branches of Indian banks be subjected to inspections by the RBI in order to ensure that the deficiencies in their working were removed, and that they continued to work satisfactorily and be in a position to meet the demands of depositors as and when their claims accrued. As the Reserve Bank had no statutory powers in this regard, Section 35 of the Banking Regulation Act, 1949, was suitably amended in 1959, empowering it to inspect, at any time, the branches of Indian banks operating in foreign countries.

The first round of inspections of foreign branches of Indian banks, which commenced in 1961, was over by 1962. Although it was originally envisaged that foreign branches, once in three years, the second round of such inspections was postponed from time to time, mainly on account of the then prevailing tight foreign exchange position and because, from the data provided to the Reserve Bank, it was observed that they were working satisfactorily. In 1968, the branches of three Indian banks in Ceylon were inspected, followed by inspections in 1969, 1970 and 1971 of some more branches in other countries. Certain fraudulent transactions of large amounts and several grave irregularities at the London branch of Central Bank of India came to light in 1970, about which we shall provide more details later in this Chapter. In this backdrop, it was decided that inspection of overseas branches of Indian banks should be conducted with greater frequency than in the past; however, the decision did not get implemented to the extent contemplated.

The policy of inspection of foreign branches that was evolved in 1960 emphasized that inspecting officers of the Reserve Bank should not be unduly critical of locally prevalent practices that the branches of Indian banks in foreign countries might be forced to follow, in order to compete with other banks there. Strict adherence to norms obtaining in India were not, therefore, to be, insisted upon, and practices followed by other banks were to be the guiding factors in deciding policies and procedures. The inspection of foreign branches of Indian banks by the Reserve Bank essentially aimed at finding out whether these offices were functioning efficiently and on a profitable basis, and whether their working in general was on sound lines. The working losses of foreign branches, as also losses arising out of their bad debts, were adjustable against profits earned in the foreign country concerned over a period, and were eventually reimbursable from Indian resources, which meant loss of foreign exchange. The inspection aimed at finding out how the working of these offices could be improved so as to avoid such losses and secure higher foreign exchange earnings for India.

DEPOSIT INSURANCE

The origin and early years of the Deposit Insurance Corporation (DIC), a wholly owned subsidiary of the Reserve Bank of India, are detailed in the second volume of the *History of the RBI*. When the DIC commenced operations in 1962, 287 banks registered with it as insured banks. By the end of 1967, the number of insured banks was a mere 100, largely as a result of the Reserve Bank's policy of reconstruction and amalgamation of small and financially weak banks so as to make the banking sector more viable. Up to 1967, the liabilities of the Corporation were invoked in the case of eleven banks;[3] and the licenses of three of these banks, viz., Habib Bank, National Bank of Pakistan and Bank of China, were cancelled for reasons other than financial viability. As at the end of 1966, the amounts paid or provided for in respect of these eleven banks amounted to Rs 56.83 lakh of which Rs 39.85 lakh, had been recovered by the DIC and the overall risk experience of the Corporation was 'favourable'.

[3] The Bank of China, Calcutta (1963); Bank of Alagapuri Ltd, Alagapuri (1963); Unity Bank Ltd, Madras (1963); Metropolitan Bank Ltd, Calcutta (1964); Unnao Commercial Bank Ltd, Unnao (1964); Cochin Nayar Bank Ltd, Trichur (1964); Latin Christian Bank Ltd, Ernakulam (1964); Southern Bank Ltd, Calcutta (1964); Shree Jadeya Shankarling Bank Ltd, Bijapur (1965); National Bank of Pakistan, Calcutta (1966); Habib Bank Ltd, Bombay (1966).

Important events that took place during 1967–81 were: the amendment of the Deposit Insurance Corporation Act in 1968 to extend the insurance scheme to deposits with cooperative banks; the strong growth and consolidation of the deposit insurance fund consequent upon the expansion of bank deposits; the progressive increase in the coverage of insured deposits; and, finally, the merger of the Credit Guarantee Corporation of India Ltd with the DIC, leading to the formation of the Deposit Insurance and Credit Guarantee Corporation of India, with the 'twin and cognate' objectives of giving protection to small bank depositors and providing guarantee cover to credit facilities extended to certain categories of small borrowers belonging to the weaker sections of society. We shall discuss each of these in what follows.

Cooperative Banks

The need for insuring deposits with cooperative banks was considered during the course of the deliberations on the draft scheme and also after the enactment of the Deposit Insurance Act, 1961, but was not acted upon because, while the Reserve Bank did not possess the authority to regulate and inspect the affairs of cooperative banks, state governments were unwilling to cede the power to wind up or reconstitute such banks. A detailed account of this is given in the second volume of the *History of the RBI*.

In course of time, with some state governments showing an inclination to favourably consider the RBI's point of view, the Deposit Insurance Corporation (Amendment) Bill, 1967, was introduced in the Lok Sabha on 17 July 1967. The Bill proposed to extend the deposit insurance scheme to state, central and larger primary non-agricultural credit societies, i.e. urban cooperative banks with paid-up capital of Rs 1 lakh or more. The Bill was passed by both the Lok Sabha and Rajya Sabha, and it received the assent of the President of India on 27 December 1968. To extend deposit insurance to cooperative banks, the state governments, on their part, were required to amend their respective cooperative laws to the effect that, *inter alia*, the winding up, reconstruction or amalgamation of a bank could be undertaken only with the written approval of the Reserve Bank. The Bank could wind up a cooperative bank by not granting licence or if it considered that continuance of the cooperative bank was prejudicial to the interests of its depositors. Moreover, on winding up a bank, the liquidators of the insured bank or the transferee bank would be under obligation to repay the Deposit Insurance Corporation the sums due to it as its share of recoveries. Given the nature of the tasks involved in the state governments amending their cooperative laws, the Deposit Insurance Corporation (Amendment) Act provided that it could be brought into force in stages on different dates in the various states and union territories.

In 1968, the position of cooperative banks was somewhat ambivalent. The Banking Laws (Application to Cooperative Societies) Act, 1965, that came into force from 1 March 1966, required cooperative banks to obtain a licence from the Reserve Bank to undertake banking business. However, the cooperative banks that were in existence on the said date were permitted to carry on banking business till they were granted a licence or were informed that a licence could not be granted to them. It was in this context that the RBI took up the task of persuading salary earners' societies to restrict their deposit collection to members. As a result, several salary earners' societies, which were earlier classified as primary cooperative banks, were reclassified as non-banking societies and excluded from the purview of the Banking Regulation Act upon their agreeing not to receive deposits from non-members. The available statistics as on 30 June 1967 indicated that deposits in cooperative banks formed 14.7 per cent of those in commercial banks, and that deposits in these banks assessable for insurance premium formed 9.7 per cent of those in commercial banks.

It must be noted that under the federal structure delineated by the Indian Constitution, cooperation is a state subject, and the powers relating to cooperative banks are vested with state governments. The amended Section 2(gg) of the DIC Act, defining an 'eligible cooperative bank', required state Governments to transfer these powers to the Reserve Bank to avail of the advantages of deposit insurance.

The powers sought to be transferred to the Reserve Bank from state government were rather sweeping. While some states readily agreed to the Bank's proposals, there were some detractors. Maharashtra, where the cooperative movement was well established, had initial hesitation and sought assurances regarding prior consultations with the state government if reconstruction, amalgamation or winding up of a cooperative bank had to be undertaken. The state of Madras was not in favour of giving powers over cooperative banks to the Reserve Bank nor were the states of Kerala and West Bengal, which felt that deposit insurance would not be of any significant help. Nevertheless, over time, state governments realized the benefits of deposit insurance to cooperative banks, and amended their laws to extend the facility in their states.

The state of Maharashtra was predictably the first to amend its cooperative laws, followed by the states of Madhya Pradesh and Andhra Pradesh, and the union territory of Goa, Daman and Diu amending their

Cooperative Societies Act on the lines suggested by the RBI. Government of India issued the necessary notification bringing into force the provisions of the Deposit Insurance Corporation (Amendment) Act, 1968, in relation to the three states and one union territory, with effect from 1 July 1971. These states and union territory accounted for 382 out of the 1,318 co-operative banks in India. The state of Jammu and Kashmir and the union territory of Delhi soon followed in their wake.

The extension of deposit insurance to cooperative banks in various states was largely due to the determined efforts of the Agricultural Credit Department (ACD) of the Reserve Bank in pursuing the matter with the various state governments, and also in undertaking the groundwork necessary for the Deposit Insurance Corporation to enrol the cooperative banks as insured banks. Specifically, the role of the ACD covered: (i) verifying, in consultation with the Legal Department of the Bank, whether the amendments to the cooperative societies acts passed by the state governments were in order, vesting the necessary powers with the Reserve Bank to make co-operative banks eligible for deposit insurance; (ii) furnishing to the DIC a list of existing cooperative banks in the state/union territory which had applied for a licence and was not refused a licence so as to enable the DIC to register them as insured banks within a month of its coming into force; (iii) eliminating from the list such cooperative banks as had become defunct but could not be taken into liquidation by refusing a licence to them, if possible, before registering them as insured banks; and (iv) furnishing statements to the DIC showing the total insurable deposits of co-operative banks in the concerned state/union territory and the extent to which they are likely to be covered by the existing limits of insurance. Thus, the larger burden of the task of extending deposit insurance to states devolved on the ACD, with the DIC merely issuing the registration letters, calculating the premium payable and ensuring the adequacy of resources and reserves in bringing the cooperative sector into the scheme of insurance.

The Reserve Bank's perspective was that even if the state governments amended their cooperative societies acts, it was neither 'possible or desirable' for the RBI to recommend to the DIC to extend the facility of deposit insurance to all existing cooperative banks in the concerned states. The amended Act of 1968 defined the expression 'existing cooperative bank' as one that either held a licence or was not denied a licence, but did not include a defunct bank. Prior to extending insurance cover, the Bank felt that it would be necessary to 'eliminate the risks involved in including banks which are sub-standard'. Sub-standard banks were those that had suffered an erosion in their net worth and had an aggregate of paid-up capital and reserves less than Rs 1 lakh, and were not in a position to pay their present or future depositors in full as their claims accrued. Technically, they were defined as those banks that did not comply with the provisions of Section 11(1) and 22(3)(a) of the Banking Regulation Act, 1949, as applicable to cooperative societies. The policy pursued by the ACD was to weed out sub-standard banks before recommending to the DIC, extension of the deposit insurance scheme to the state. The instruments for 'weeding out' included refusal or cancellation of a licence, or a process to rehabilitate the banks as early as possible. The programme of rehabilitation would be aimed at strengthening their share capital by additional collection or by government contribution, as well as recovery of overdues. Such programmes were to be drawn in close consultation with the state governments, state cooperative banks and the managements of the banks concerned, to ensure that they complied with the provisions related to minimum net worth. For those beyond redemption, steps would be initiated, in consultation with the state government, to refuse a licence, cancel a licence or liquidate the bank. The other aspect considered by the ACD was the completion of formalities by primary cooperative banks or salary earners'/employees' credit societies for being declared/notified as non-banking institutions. The ACD would use its leverage with state governments to ensure that such societies completed the prescribed formalities and got themselves declared as non-banking institutions. The rationale to hold back the extension of deposit insurance till weak banks were weeded out and salary earners' societies were removed from the banking fold was to coopt the support of state government authorities for the incentives associated with the scheme.

This policy of weeding out sub-standard cooperative banks was not without its share of problems. When the three states of Maharashtra, Madhya Pradesh and Andhra Pradesh, and the union territory of Goa, Daman and Diu amended their respective cooperative acts in 1970, before the provisions of the DIC Act were brought into force with effect from 1 July 1971, four primary cooperative banks were taken into liquidation at the instance of the ACD.[4] There yet remained twenty-one sub-standard banks in these states. By early 1972, these had increased to twenty-four of which eight were central and sixteen were primary cooperative banks; in addition, there

[4] These were the Barsi Merchants' Cooperative Bank Ltd, the Manmad Merchants' Cooperative Bank Ltd, the Kalyan Peoples' Cooperative Bank Ltd in Maharashtra, and the Jhabua Nagrik Sahakari Bank Ltd in Madhya Pradesh.

were fourteen primary cooperative banks that were at the margin. The reason why some of the sub-standard banks were not 'weeded out' was partly because of an assurance given in the Parliament at the time of the enactment of the Banking Laws (Application to Cooperative Societies) Act, 1965, that, in administering the provisions of the Act, the special needs and requirements of cooperative banks would be borne in mind by the Reserve Bank. The sub-standard primary cooperative banks were deemed to be 'existing cooperative banks' under the DIC Act, 1961. In other words, they were not denied a licence to operate. Where central cooperative banks were concerned, it was felt that liquidation or winding up of any district central cooperative bank (DCCB) would create an institutional gap in the existing cooperative banking structure, impeding the flow of credit to the primary societies and thus adversely affecting agricultural production. The issue of rehabilitation of weak DCCBs was also discussed at the Planning Commission at its meeting of 25 October 1971, where it was felt that the Reserve Bank should go ahead with their rehabilitation. It suggested government contribution to the share capital of DCCBs, outright grants and/or long-term loans by state governments, to aid their rehabilitation.

Notwithstanding the efforts of the Bank in extending deposit insurance to cooperative banks in the states, the progress was rather slow. It was extended to Jammu and Kashmir in 1973, to Delhi and Pondicherry in 1974, to Kerala and Tripura in 1975, to West Bengal and Rajasthan in 1976, to Karnataka in 1977, to Orissa in 1978, to Uttar Pradesh and Gujarat in 1979, and to Tamil Nadu in 1980. Often the scheme was extended pending the completion of formalities, as in the case of Uttar Pradesh and Gujarat, and it was felt that the existence of a few banks involving limited liability for the Corporation need not stand in the way of extending the scheme to the states. By the end of 1981, deposit insurance was made applicable to cooperative banks in thirteen states and three union territories.[5] With this, all commercial banks (82 commercial banks and 106 regional rural banks) and 1,459 cooperative banks stood registered as insured banks under the scheme. This covered about 13.77 crore accounts with aggregate assessable deposits of about Rs 35,004.43 crore.

[5] These were the states of Andhra Pradesh, Gujarat, Jammu and Kashmir, Karnataka, Kerala, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Tamil Nadu, Tripura, Uttar Pradesh and West Bengal, and the union territories of Delhi, Goa, Daman and Diu and Pondicherry.

Increasing Capital

Bringing cooperative banks into the scheme of deposit insurance entailed insuring over 1,000 banks, as against 88 banks in 1968. Anticipating the higher establishment costs that the increased workload would involve, the Act amendment of 1968 empowered augmentation of the authorized capital of the Deposit Insurance Corporation from Rs 1 crore to Rs 5 crore. Increasing the authorized capital was necessary, as the establishment costs of the DIC were met from the general fund, and not the deposit insurance fund that was earmarked exclusively to meet claims in respect of insured deposits. The source of the general fund was from capital and reserves. On 1 January 1972, the share capital of the Corporation was raised from Rs 1 crore to Rs 1.5 crore. The structure of the board of directors, too, was changed to accommodate eight directors in lieu of five, as was the case earlier. The capital was further raised to Rs 2 crore in 1975, in view of the anticipated establishment expenses arising from the proposed extension of the scheme to the states of Kerala, Karnataka and West Bengal. The capital structure next underwent major changes, as we shall see later, when the DIC took over the assets and liabilities of the Credit Guarantee Corporation to form the Deposit Insurance and Credit Guarantee Corporation in 1978.

Coverage of Deposit Insurance

The question of raising the coverage of insured deposits came up for discussion at a cabinet meeting held on 12 December 1967. It was felt that 'the limits of Deposit Guarantees should be raised and a larger volume of deposits should be covered by the Guarantees'. The minutes of the meeting were conveyed by S.S. Shiralkar, Additional Secretary, Ministry of Finance, to RBI Governor L.K. Jha; it led to raising the deposit insurance cover from the then existing level of Rs 1,500 to Rs 5,000 from 1 January 1968. As a result, the percentage of insured deposits to total assessable deposits jumped up from 26 per cent at end-September 1967 to 50 per cent at end-September 1968, and the proportion of fully protected accounts to the total number of deposit accounts increased from 76 per cent to 91 per cent in 1968. The significant increase in the coverage of insured deposits instilled public confidence in the banking system, augmented deposits and fostered banking in unbanked areas. During the period of this study, the coverage of deposits was raised on four occasions and by twenty times, i.e. to Rs 5,000 per depositor per bank effective 1 January 1968, Rs 10,000 from 1 April 1970, Rs 20,000 from 1 July 1976 and, further, to Rs 30,000 from

1 July 1980. At the end of 1981, the number of secured accounts stood at 13.65 crores, representing 99 per cent of the total number of accounts, and the volume of insured deposits stood at Rs 25,859.20 crore, representing 74 per cent of aggregate deposits with commercial and cooperative banks. By 1981, deposits with 1,647 banks were insured with the Corporation, as against 96 in 1967. Of these, 82 were commercial banks, 106 were regional rural banks and 1,459 cooperative banks. The regional rural banks that were established under the Regional Rural Banks Ordinance, 1975, were registered as insured banks.

Claims against Insurance

During the period 1967–81, the DIC's deposit insurance cover was invoked in the case of three commercial banks and eleven cooperative banks. In 1969, Chawala Bank Ltd, a commercial bank with its head office at Dehra Dun (Uttar Pradesh) was amalgamated with the New Bank of India Ltd, under Section 45 of the Banking Regulation Act, 1949. The Corporation had to pay or provide for claims to the extent of the difference between the insured amount and the initial credit afforded by the transferee bank, out of the readily realizable assets taken over by it. In the case of Chawala Bank Ltd, this claim amounted to Rs 0.18 lakh, of which Rs 0.14 lakh was recovered in due course and the rest written off.

The amalgamation exercise of Bank of Bihar Ltd, a Patna-based commercial bank, and of National Bank of Lahore Ltd, a Delhi-based commercial bank with the State Bank of India was a protracted one. The Reserve Bank, the central government and the State Bank of India, in consultation with the DIC, made arrangements to pay the depositors in full, on the understanding that the Corporation would reimburse to SBI the difference between the *pro rata* payment of the balance due out of readily realizable assets under the scheme and the actual insured deposits. The Corporation provided for Rs 46.32 lakh in the case of Bank of Bihar and Rs 9.69 lakh in the case of National Bank of Lahore. Thus the total liability that was paid or provided for between 1967 and 1981 amounted to Rs 56.19 lakh in respect of the three commercial banks, of which Rs 37.73 lakh was recovered by the Corporation by the end of 1981.

The Corporation provided for about Rs 191 lakh for deposit insurance claims in the case of eleven cooperative banks, of which ten were in Maharashtra and one in Karnataka. These were: Bombay Commercial Cooperative Bank, Bombay (liquidation); Malvan Cooperative Urban Bank Ltd, Malvan (liquidation); Ghatkopar Janata Sahakari Bank, Bombay (liquidation); Bombay Peoples' Cooperative Bank Ltd, Bombay (liquidation); Aarey Milk Colony Cooperative Bank Ltd, (liquidation); Ratnagiri Urban Cooperative Bank Ltd, Ratnagiri (amalgamation); Vishwakarma Cooperative Bank Ltd, Bombay (amalgamation); Prabhadevi Janta Sahakari Bank Ltd, Bombay (amalgamation); Kalavihar Cooperative Bank Ltd, Bombay (amalgamation); Ramdurg Urban Cooperative Credit Bank Ltd, Ramdurg (liquidation); Vysya Cooperative Bank Ltd, Bangalore (amalgamation). Only Rs 11 lakh was recovered till 1981.

Nationalized Banks

When the fourteen major banks were nationalized, a question arose as to whether deposits with banks owned by the central government need to be insured, and the significance of the DIC in the changed context. Whether or not nationalized banks should be excluded from deposit insurance was not a new issue; it was considered at the time of the very inception of the scheme in 1961, in the context of the State Bank of India and its subsidiaries which had been taken into public ownership. The arguments then advanced were that the deposits of SBI and its subsidiaries were not legally guaranteed by the government and, if these banks were to function as commercial banks, there was no reason why they should be given any special status merely on the ground of ownership. In 1971, while these arguments were found to be still relevant, some additional arguments were made in favour of extension of deposit insurance to the nationalized banks. First, the possibility of any of these banks having to face financial difficulties and being merged with the stronger of the nationalized banks could not be ruled out in eventualities like large-scale default, industrial sickness, fraud, etc. Besides, the Companies (Acquisition and Transfer of Undertakings) Act, 1969, did not provide any guarantee to the depositors of the nationalized banks. Second, if the exclusion of nationalized banks was officially permitted, foreign banks operating in India would also like to opt out of the scheme and the Corporation would not have any justifiable reason to force them to continue in the scheme. Third, if the nationalized banks were exempted from the scheme, it would give the impression that deposits in such banks alone were safe, placing other banks at a disadvantage.

CREDIT GUARANTEES

One of the features of the 1967–81 period, in the context of institution-building, was the setting up of the Credit Guarantee Corporation of India Ltd, in 1971, to ensure that the credit needs of hitherto neglected socio-economic sections were met. While deposit insurance had been introduced in India for protecting depositors and instilling confidence in the banking system, the establishment of the Credit Guarantee Corporation represented an affirmative action to induce banks to make credit available to priority and hitherto neglected sectors.

Credit guarantees had already been instituted by Government of India in July 1960 but in the context of lending to small-scale industries, and was administered by the Reserve Bank on an agency basis. The issue of credit guarantees then shot into prominence during the debates on social control and nationalization of banks. When RBI Governor Bhattacharyya, towards the end of his tenure, made out a case against nationalization in his letter of 2 June 1967 to Deputy Prime Minister Morarji Desai, he was also not quite in favour of a rigid and statutory system of directed credits whereby banks would be required to grant loans to small industries and agriculture up to certain prescribed limits. Instead, he viewed credit guarantee as an instrument to channel the flow of credit in desired directions set by national priorities. In his letter, Bhattacharyya observed:

> In order to facilitate the grant of loans by the commercial banks to the smaller individuals and establishments, our credit guarantee scheme for small-scale industries will however have to be decentralized; and clean loans of relatively small amounts may have to be guaranteed on a much larger scale. We are also tentatively of the view that the benefit of protection, in the form of a guarantee cover, should be made available directly to the non-scheduled commercial banks, urban cooperative banks and the relatively well-managed non-banking financial companies, like loan offices and nidhis, so that these institutions can play a much larger role than at present in the field of financing small industries.

Bhattacharyya's ideas were exploratory and were probably expressed to tone down the demands for nationalization and directed credit. By the late 1960s, however, the idea of credit guarantee had not only gained acceptance but also come to be viewed as an instrument of productive deployment of bank credit. The Reserve Bank, on its part, took to the idea very positively and instructed that the incremental rise in advances of scheduled banks to small-scale industries covered by the Credit Guarantee Scheme be taken into account in the calculation of the net liquidity ratio of individual banks so that the banks could gain in terms of refinance accommodation from the RBI. In February 1968, a further facility of refinance from the

Reserve Bank at concessional rates, to the extent of the incremental rise in their advances to small-scale industries covered under the Credit Guarantee Scheme, was made available to scheduled commercial banks. In March 1968, the Industrial Development Bank of India also announced a scheme of refinance in respect of term loans to small-scale industries by the approved credit institutions covered by the Credit Guarantee Scheme, at concessional rates.

As at the end of June 1968, the aggregate of credit guarantees totalled Rs 125 crore while the total sum paid on account of claims since the inception of the scheme amounted to Rs 12 lakh, of which Rs 6 lakh were recovered after settlement of claims, leaving a balance of Rs 6 lakh pending recovery. The cumulative guarantee fee received during this period amounted to Rs 83 lakh. These operations were conducted on behalf of the central government and, accordingly, the guarantee fee collected and recoveries made were passed on to the government even as the claims paid were charged to the government. The Reserve Bank, however, met the administrative expenses for the management of the scheme.

There were complaints from many small-scale industrialists that the fee levied, at 0.25 per cent of the amount of guarantee issued, was high, especially as the utilization of working capital advances generally averaged 50 per cent of the limits (i.e. the guarantees issued). The matter was reviewed by the Reserve Bank and it observed that the cushion of Rs 76 lakhs of guarantee commission realized was already available with the government and that the proportion of losses incurred was extremely small. It felt that a sizeable reduction in the guarantee commission would be 'a good token of the Government's and Bank's warm interest in the development of small-scale industries and would induce private sector banks and state financial corporations to go more actively than before to the aid of that sector'. The reduction in guarantee fee that the Reserve Bank, as the 'guarantee organization', proposed, and which the government accepted, was, in point of fact, sizeable and was applicable to credit institutions that agreed to cover, under the scheme, *all new loans* as well as renewals of existing loans to small-scale industries. K.N.R. Ramanujam, the chief officer of the Industrial Finance Department (IFD) of the Reserve Bank, proposed a reduction in the commission, from one-fourth of 1 per cent to one-tenth of 1 per cent, to the Secretary, Ministry of Industrial Development and Company Affairs. Ramanujam, in his letter of 17 July 1968, did anticipate that there could be 'a larger rise than hitherto' in the amounts under default and that, in the years ahead, the claims could outstrip the guarantee commission receipts, although he felt that the claims may not be significantly in excess of the overall receipts. The reduction would, nonetheless, be justified, as the 'Central Government and the Reserve Bank will be able to state with greater cogency that they are going all out to encourage large and liberal institutional lending to small industries'. He indicated that the rate of guarantee commission would be kept under periodic review in light of the emerging trends of amounts under default.

Interestingly enough, a few banks resisted the move to cover *all* advances to small-scale industries under credit guarantees to take advantage of the reduction in the guarantee fee, and preferred, instead, a selective approach with the considerably higher fee of 0.25 per cent per annum. Indian Overseas Bank was particularly keen to leave out advances for cashew decortication from the purview of the guarantees on financial considerations. The Reserve Bank was 'unable to comprehend' IOB's stance when 'other banks ... have taken a policy decision to bring all their advances to the small-scale industries under the Credit Guarantee Scheme and are seeking guarantee cover in respect of their advances to cashew industry as well'. It came to light subsequently that other banks, while having agreed to do so, were not in fact covering cashew and tobacco curing advances under the scheme. IOB's resistance was not taken kindly to by the Bank. The IFD, which was administering the scheme, in a communication to the Department of Banking Operations and Development (DBOD), felt that the latter should take up

> the matter with the Custodian of the bank and impress upon him that for the purpose of extending credit to small-scale units on a more liberalized basis, it is necessary for the bank to fall in line with the decision taken by the other major banks and place all its advances to the small-scale sector under the guarantee scheme.

The Bank's rationale, as elaborated in a circular issued on 8 April 1970, was that 'the success of the scheme, which is run on the principles of insurance, depends on the diversification of risks covered and as such it is essential that all eligible advances should be covered under the scheme'. There is little evidence to suggest that the possible impact of such a measure on the incentive for risk-taking was deliberated upon at any length. Nor whether the effort to provide risk support to particular categories of advances led to complacency across the entire spectrum of lending to small-scale industries.

Credit Guarantee Scheme in Unlicenced Banks

When an exception was made for including unlicenced central cooperative banks in the scheme in 1966, similar demands were received from unlicenced scheduled banks. This was a time when the Reserve Bank was in the final phase of its reconstruction and amalgamation of financially weak commercial banks, and, logically, it was felt that the feasibility of extending facilities to such banks as were expected to qualify for a license within a period of five years could be examined. The Industrial Finance Department recommended that 'unlicenced scheduled commercial banks whose financial position and methods of operations are, in the opinion of the guarantee organization, satisfactory' could be included. On this criterion, the names of two unlicenced scheduled commercial banks, viz., Benares State Bank and Oriental Bank of Commerce, were recommended to the government for inclusion, as these banks were expected by the DBOD to qualify for licences within five years.

When scheduled unlicenced banks were deemed eligible, how could one stop unscheduled unlicened banks from demanding that the same criterion be applied to them? The matter came up for serious examination in the context of a meeting that Parmananda, chairman, Bank of Behar, an unscheduled unlicenced bank, had with Governor Jha in December 1968. The former pleaded that his bank was unable to take advantage of the Credit Guarantee Scheme for small-scale industries and was consequently unable to utilize its resources to its best advantage. Deputy Governor Adarkar's noting dated 23 December 1968 on the subject is worth quoting.

> I suggest we may examine the possibility of extending these facilities to the Bank of Behar as well as to other banks in similar position where their ability to grant loans to small-scale industries is restricted as a result of the facilities of the Credit Guarantee Scheme being denied to them on the ground that they are not yet licenced. We may have to wait considerably before the affairs of these banks improve sufficiently to enable us to licence them and in the meanwhile an important objective of policy, viz., aid to small-scale industries, for which the small banks are likely to be most useful, may suffer. In view of the higher priority now attached to this objective, the matter may need sympathetic consideration.

Adarkar instructed that a list be prepared of banks not eligible for the facilities of the scheme, but which could be recommended for availing them on the basis of certain criteria, such as the area of the bank's operations, its business prospects, the percentage of sticky advances, etc. In response, the IFD evolved certain eligibility criteria for covering unlicenced scheduled and unscheduled banks under the Credit Guarantee Scheme:

(i) the management of the bank was in competent hands;
(ii) the system and procedure followed by the banks were sound; and
(iii) the advances made in recent periods were conducted generally satisfactorily or, if there were sticky advances relating to a recent period, the undesirable features in such advances were the result of factors beyond the control of the bank and despite the safeguards observed by it.

In early 1969 there existed twelve unlicenced scheduled banks and fifteen unlicenced non-scheduled banks. The DBOD was requested to recommend banks for inclusion in the Credit Guarantee Scheme on the basis of the criteria drawn up by the IFD. After excluding banks that were under liquidation, amalgamation, with the Custodian of Enemy Property, etc., the DBOD arrived at a list of sixteen banks. Of these, the position of ten banks was satisfactory in that they could, in the DBOD's opinion, pay depositors in full as and when claims arose. Of the other six banks, most had their paid-up capital substantially eroded and, while most of their deposits were intact, they did not appear to be in a position to pay depositors as and when claims arose. The DBOD, however, added that the sixteen banks recommended did not satisfy the criteria of managerial competence and operational efficiency indicated by the IFD and, but for the weaknesses in their management and methods of operation most of these banks would have been licenced and automatically included in the list of approved credit institutions. The DBOD also felt that the banks'

> advances operations in the recent period, by and large, do not disclose major irregularities. The deposits of practically all these banks are on the increase and considering their resources and the areas of their operations they are capable of playing a useful role in financing small-scale industries. *In view of the fact that all the central cooperative banks numbering 346, whether licenced or not, have been included in the list of approved credit institutions, it is suggested that we may consider the cases of the above 16 commercial banks also for inclusion in the approved list (italics added).* Having regard to their overall position and resources and also because their affairs are under constant observation by the Reserve Bank, these banks are not likely to undertake any

> undue risk or make serious lapses in the matter of granting and conducting advances to small-scale industries.

On the specific case of Bank of Behar, the DBOD observed:

> The bank's management does not appear to have either been sincere or capable of improving its affairs. The quality of staff is generally poor. The defects in the bank's working have become chronic and their rectification would take considerable time. However, this bank is the only Bihari bank and the Government of Bihar is keenly interested in it. Its deposits, which show an increasing trend, amount to Rs 14.27 crore as on 29.11.1968. Recently an officer of the Department of Banking Operations and Development has been appointed as a special officer in the bank to assist its Chief Executive Officer in toning up the administrative machinery and bringing about the desired improvement in its affairs.

The opinion given by the DBOD to the IFD, which was operating the Credit Guarantee Scheme for small-scale industries on behalf of Government of India, did not lead to an immediate decision. IFD kept the matter pending for some time before accepting the DBOD view.

Credit Guarantee Corporation of India

After the nationalization of fourteen major Indian banks in July 1969, Prime Minister Indira Gandhi took the initiative of meeting with the custodians of the nationalized banks to discuss the lending pattern of the banks. The meeting, which took place on 30 September 1969 at New Delhi, indicated that 'a simple but wide-ranging scheme of guarantees or comparable facilities for lending by banks in fields which have remained relatively neglected so far, such as retail trade, small business, minor repair industries, small farming and the self employed sector' should be formulated. A Working Group with S.S. Shiralkar, Additional Secretary, Department of Banking of the Finance Ministry, as convenor was constituted to 'to examine and make detailed recommendations for the Government's consideration, regarding the scope and provisions of the proposed various schemes of insurance'.[6]

[6] Report of the Working Group on the Insurance of Loans and Advances granted by Commercial and Cooperative Banks to certain Priority Sectors. The other members of the Group were R.K. Seshadri, K.P.J. Prabhu, T.A. Pai, K.M. Nanjappa, H.E. Chatelier, Y.V. Sivaramakrishanayya and C.D. Datey.

The Group considered the issue of increasing the volume of lending to small borrowers, as distinguished from 'other more substantial and credit-worthy constituents of the banking system', and gave the rationale for the need to bring some of the neglected sectors into the organized banking sector. Essentially, the Group felt that small borrowers who were outside the purview of the banking system were charged interest rates that were 'unjustified by any standard', and bringing them into the banking fold would help reduce costs, foster investment, generate employment and, in general, catalyse development. For instance, a drastic reduction in the cost of credit to the retail sector was expected to bring down retail margins and, thus, reduce prices; credit to small servicing and repair units could go a long way in ensuring that equipment like pump sets, tractors and other machinery in the rural sector were not left unused for want of repair facilities; and credit to engineers for small-scale industries would help solve the unemployment problem and enhance production. In short, provision of credit would help increase production, facilitate cheaper flow of trade and distribution of goods, and help mitigate unemployment.

The Group noted that while, in the wake of social controls and nationalization of banks, lending to the priority sector had been marked by a considerable increase, the magnitude of the problem was enormous. Lending to the neglected sectors would, in the long term, lead to accretion of deposits with the banking system, but the risks of lending to these sectors in the transitional period could be appreciable. The Group expressed apprehensions as to whether the banks could, on their own, undertake the risks entailed in realizing the new social objectives. Moreover, considered that it would not be feasible for existing insurers to cover these risks on a voluntary basis, given the magnitude of the expected volume of lending. The Group felt that these risks, as affecting particular banks or lendings in particular areas, could be uneven, and came to the conclusion that the risks could be pooled and covered under a common and centralized guarantee scheme. As regards administration, the Group held the view that all eligible loans under the scheme should be guaranteed automatically and in bulk, and the statistical returns of the outstanding loans and defaults on the basis of which the guarantee cover was to be provided should be simplified to the extent possible. To obviate the 'moral hazard' problem, it was felt that the extent of guarantees could be limited to 75 per cent of the loss in all cases, to 'ensure that the eligible institutions granting loans continued to be interested in the appraisal of the loan applications on business principles and also in the subsequent supervision of the loan accounts'.

The scheme was intended to be self-supporting. A guarantee fee of 0.5

per cent on the outstanding amount of loans was suggested, which, however, was to be subjected to review from time to time. Interestingly enough, the guarantee fee of the small-scale industries scheme then was lower, at one-tenth of 1 per cent on sanctioned limits. The Working Group suggested an amendment to the Deposit Insurance Corporation Act, 1961, to enable the DIC to take over the responsibility of the guarantee scheme in addition to deposit insurance. This, however, was not accepted by the government. It opined that it was desirable to entrust the responsibility for credit guarantees, *for the time being,* to an entity that could be incorporated under the Companies Act, 1956. Furthermore, the Working Group suggested that the guarantee cover in the case of all sectors, including small-scale industries, should ultimately be provided by one independent organization. Thus, the existing credit guarantee scheme for small-scale industries, which was administered by the Industrial Finance Department of the Reserve Bank on behalf of Government of India under Section 17 (11A) of the Reserve Bank of India Act, should be taken over by the new organization. It was, however, felt that this issue be deferred and taken up 'at the appropriate stage', after the scheme for other sectors had been implemented. The 'appropriate stage' arrived after about ten years, when the small-scale industries scheme was finally integrated with the DIC in 1981.

The Group submitted its report in 1969. After some recommendations of the Group had been modified by the government, a new institution called the Credit Guarantee Corporation of India Ltd (CGCI) was constituted as a public limited company, promoted by the Reserve Bank, with 71 scheduled commercial banks contributing to its share capital. The objective of the CGCI was to afford a measure of protection to banks and other financial institutions against risks, if any, in meeting the credit needs of smaller borrowers in the priority and hitherto neglected sectors, such as farming, small-scale industries, small business ventures, road transport and self-employed professional or technical service or productive enterprises. The Corporation was registered under the Companies Act, 1956, on 14 January 1971, and it received the certificate of commencement of business on 29 January 1971. The CGCI was notified as a financial institution for the purpose of enabling State Bank of India and the Reserve Bank to become members of the company. The board of directors of the Corporation consisted of six members, of whom two (including the chairman) represented the Reserve Bank and the remaining four represented scheduled commercial banks. R.K. Hazari, Deputy Governor, was appointed the first chairman of the Corporation; R.K. Seshadri, Executive Director, Reserve Bank, T. Varadachary, managing director, State Bank of India, K.P.J. Prabhu, custodian, Canara Bank and P.F. Gutta, custodian, Union Bank of India, were appointed as directors; W.J.F. Vaz was appointed the first manager of the Corporation. The preliminary spadework for setting up the Credit Guarantee Corporation of India, as well as the administrative arrangements, were made by the Reserve Bank.

Schemes

The CGCI, in its first year of operations, introduced three separate guarantee schemes, each of which provided to the eligible credit institutions, guarantee cover automatically and in bulk, for all their loans, advances and other credit facilities. The first scheme formulated by the Corporation was termed the Credit Guarantee Corporation of India (Small Loans) Guarantee Scheme, 1971, and it was extended to scheduled commercial banks with effect from 1 April 1971. The scheme covered credit extended by scheduled commercial banks to transport operators, fertilizer dealers, traders, professional and self-employed persons, owners of business enterprises, and farmers engaged in cultivation and allied agricultural operations.

The second scheme, called the Credit Guarantee Corporation of India Small Loans (Financial Corporations) Guarantee Scheme, 1971, was introduced from 1 July 1971. This scheme was essentially an extension of the first scheme to state finance corporations. It focused on credit extended by these corporations to transport operators, hoteliers and enterprises generating or distributing electricity or any other form of power, as well as enterprises managing or developing industrial estates.

The third scheme, called the Credit Guarantee Corporation of India (Service Cooperative Societies) Guarantee Scheme, 1971, extended guarantees to scheduled commercial banks as well as certain select state and central cooperative banks. The scheme came into force from 1 October 1971 and guaranteed credit facilities to service cooperative societies assisting artisans and workers engaged in any form of industrial activity. The eligible state and central cooperative banks were those in the states to which the Deposit Insurance Corporation Act, 1961, had been extended. In the first year, 61 of the 72 scheduled commercial banks and 21 of the 99 eligible cooperative banks joined the scheme.

Variants of these three schemes formulated by the CGCI, together with the original scheme for small-scale industries which was being administered by the Reserve Bank on behalf of Government of India, constituted the core of credit guarantees in India. The report of the Working Group on the Integration of Credit Guarantee Schemes for Small-Scale Industries and Other Small Borrowers was submitted in 1981, and the scheme for small-scale industries was integrated with the schemes of the Deposit Insurance Corporation and Credit Guarantee Corporation.

The Twenty-point Economic Programme announced by the Prime Minister in July 1975 envisaged a more strategic role for the banking sector in economic development. Under the programme, the small loans guarantee scheme was required to be given a thrust. Accordingly, amendments were made to enlarge the scope and benefits of the guarantee, essentially to cover loans for consumption needs and housing. The provisions of the small loans guarantee scheme were liberalized with effect from 1 October 1976, to extend the guarantee support for certain credit facilities granted by banks to the weaker sections of the society. Advances for consumption needs and purchase or construction of houses or tenements, wholly or mainly for dwelling purposes granted directly to the various categories of borrowers already covered by the scheme, were brought within the purview of the guarantee.

Regarding the extension of guarantees to cooperative institutions, the Corporation had, at its very onset in 1972, constituted a Working Group to examine the feasibility of extending the guarantee schemes to credit facilities granted by cooperative credit institutions. The Group, which submitted its report in 1975, felt that it would not be practicable or necessary at that stage to cover the risk in respect of credit provided through cooperative credit institutions for agricultural purposes. It suggested that the situation could be reviewed after five years, after taking into account the progress made by cooperative banks in bringing down their level of overdues as well as the level of bad and doubtful debts. The Group, however, recommended that the guarantee schemes could be extended to state, central and primary urban cooperative banks, which were eligible for deposit insurance cover in respect of their advances to the non-agricultural sector, on terms and conditions similar to those applicable to commercial banks. In pursuance of these recommendations, the Corporation took steps to sound out the relevant cooperative banks and seek their response. As participation in the Corporation's guarantee schemes was voluntary, it requested the eligible cooperative banks to indicate their willingness to join a scheme that may be formulated on lines similar to the small loans guarantee scheme but excluding cover for advances to agriculture. The response was, however, poor, notwithstanding the follow-up by the CGCI and the Agricultural Credit Department of the Reserve Bank. Hardly one-tenth of the cooperative banks indicated their unqualified willingness to join such a scheme, perhaps deterred by the prospect of having to furnish information regarding the quantum of their advances in the specified categories that were required to be covered.

The issue of extending guarantees to cover advances granted by cooperative credit institutions at the primary level for agricultural and allied activities was reviewed by a Working Group constituted in 1979, with Dr M.V. Hate, Executive Director of the Reserve Bank, as chairman. At the instance of the Hate Working Group, certain pilot studies of the cooperative institutions in several states and union territories were conducted by the Reserve Bank of India. The Group submitted its report in November 1980 and recommended the extension of guarantee cover to agricultural credit societies and land development banks at the primary level in a 'phased manner', keeping in view the then existing administrative capacity of the DICGC and the very large number of institutions that needed to be covered. The Hate Working Group also recommended that guarantee cover be extended to urban cooperative banks for their advances to the non-agricultural sector. The recommendations of the Group were not implemented during the period under study. However, on the basis of its recommendations, the Small Loans (Cooperative Credit Societies) Guarantee Scheme, 1982, was formulated, to cover advances granted by cooperative credit institutions at the primary level for agricultural and allied activities.

The Problem of Claims

The expansion of credit guarantees brought with it the problem of claims. The annual report of the Credit Guarantee Corporation for the year 1977 claimed an 'impressive increase of 33.2 per cent in the advances covered by the CG schemes', but took note of the fact that the 'rising trend in the inflow of claims noticed in the earlier years became very much pronounced in 1977, the claims received during the year exceeding both in number and amount, the total claims lodged in all the previous years'. This marked a recognition of early warning signs of an impending crisis relating to the claims arising from the guarantee schemes. The CGCI responded to the incidence of mounting claims in two ways: on the one hand, by processing the claims expeditiously and, on the other hand, by responding to the adverse impact on the financial viability of the Corporation. In 1977, the administrative machinery was strengthened and the processing of claims further simplified. To address financial issues, emphasis was placed on the verification of claims of paid accounts and recovery of the amounts due from the borrowers. The Reserve Bank's inspecting officers were asked to look into this aspect in some detail. They were asked, in the course of their normal inspection of the concerned offices, to scrutinize the claims of paid accounts and, *inter alia,* verify the particulars furnished in the claim applications, ascertain the steps taken to recover the dues from the borrowers after settlement of the claims, and examine whether the recoveries due to the Corporation by virtue of its subrogation rights were remitted correctly and promptly. The correctness of the compilation of statements of guaranteed accounts and computation of guarantee fee thereon was also to be verified by them. In some instances, the Corporation deputed its own officers to scrutinize the books and other records of some claimant institutions. The energetic efforts on this count paid dividends and the Corporation realized a sum of nearly Rs 10 lakh as its share of recoveries during 1977, as against Rs 2 lakh recovered during the previous two years.

Deposit Insurance and Credit Guarantee Corporation

It was essentially the concern about the financial viability of the CGCI that hastened the decision on the merger of the CGCI with the DIC. This was foreseen by the Shiralkar Working Group, while recommending the scheme for credit guarantees. The Group had suggested that the guarantee fund should be in a position to draw upon the deposit insurance fund in case of need. The merger of the two institutions was imminent since the objectives of the two institutions were cognate in that both sought to protect banks and their depositors. It was considered advantageous as 'the resources of the Deposit Insurance Corporation were greater than those of the CGCI in relation to the risks carried by the respective organizations'. The Deposit Insurance Corporation (Amendment and Miscellaneous Provisions) Bill, 1978, seeking to provide for the acquisition of CGCI by DIC, was introduced on 21 February 1978, passed in the Lok Sabha on 29 April, received the assent of the President on 27 May and was enacted as the twenty-first Act of 1978. The provisions of the Act, except Section 9, came into effect from 15 July 1978.

With the merger of the two institutions, the name of the Corporation was changed to Deposit Insurance and Credit Guarantee Corporation (DICGC). The Act provided for an increase in the authorized capital of the Corporation from Rs 5 crore to Rs 15 crore. The paid-up capital of the Corporation was raised to Rs 10 crore after obtaining an additional contribution of Rs 8 crore from the Reserve Bank of India. With this, the entire capital of the DICGC stood allotted to the Reserve Bank. In the organizational context, the Act provided for the chairman of the Corporation to be either the Governor or a Deputy Governor of the RBI. K.S. Krishnaswamy, Deputy Governor, was appointed as chairman of the newly formed Corporation in place of I.G. Patel, the Governor. With the enlargement of the functions of the Corporation, and as provided for in the Act, the strength of the board was increased from five to nine.

Section 22 of the Deposit Insurance and Credit Guarantee Corporation Act, 1961, as amended, provided for the transfer of liabilities and assets of the Credit Guarantee Corporation and the constitution of the credit guarantee fund. The Credit Guarantee Fund was constituted on 15 July 1978, i.e. the date of the take-over of the undertaking of the Credit Guarantee Corporation of India. The DICGC, thus, had three funds: the existing deposit insurance fund, which was dedicated to deposit insurance and funded by premium income; the credit guarantee fund, dedicated to the credit guarantee function of the Corporation and funded by guarantee fees; and the general fund constituting the share capital and reserves out of which the establishment and other expenses were met. Under Section 25A, introduced by the Amendment Act of 1978, amounts in one fund could be transferred to the other fund or be utilized for other purposes. In 1979, for the first time, the Corporation voiced concern about the finances of the credit guarantee fund. The annual report for the year stated that

> the guarantee fee income is proving to be inadequate in relation to the claim liability devolving on the Corporation. Thus, the guarantee fee for 1979 at Rs 10.76 crore fell short of the total amount of claims received during that year at Rs 11.30 crore by Rs 0.54 crore. It is, therefore, necessary to take steps to improve the financial viability of the guarantee schemes.

This was in contrast to the officially stated position of 1978 that there was no need to raise the guarantee fees even though the claims were large and posed administrative problems in their expeditious disposal. The shift in the viewpoint a year later was prompted also by the fact that the guarantee cover was to be raised to 90 per cent (from 75 per cent) in respect of advances granted under the differential rate of interest scheme and on account of credit facilities for the consumption needs of small borrowers.

Integration of Schemes

In line with the recommendation of the Shiralkar Committee in 1969 that the credit guarantee scheme for small-scale industries, which was then administered by the Reserve Bank on behalf of Government of India, be integrated with the new schemes, which the Committee envisaged as being undertaken by the Deposit Insurance Corporation, the process of integration was initiated in 1979. A Working Group was set up by the government with representatives from the government, Reserve Bank and the Corporation, 'to examine the draft outline of the proposed integration, along with the modalities of integration, question of existing liabilities, expansion of the scope of the existing schemes and all other connected matters'. The Working Group submitted its report to the government in September 1979 and the integration was effected in 1981. Accordingly, the credit guarantee functions of the credit guarantee organization wing of the Industrial Finance Department of the Reserve Bank were terminated on 31 March 1981, and the functions were transferred to the DICGC, which introduced its own Small Loans (Small-Scale Industries) Guarantee Scheme with effect from 1 April 1981.

Till the integration, the DICGC had operated from one office at Bombay. With the integration, the regional offices of the IFD at Bombay, Calcutta, Madras and New Delhi became the branch offices of the Corporation. The head office of the Corporation was established at Bombay, consisting of the erstwhile credit guarantee organization wing of the central IFD and the sections of the Corporation that were connected with central office functions. The head office was to broadly confine itself to policy functions, board matters, investments, introduction/modification of insurance/guarantee schemes, settlement of claims beyond prescribed limits, liaison with the Reserve Bank and central government, and overall control and supervision of the regional set-up. The branch offices would administer the insurance/guarantee schemes. The complement of staff of the credit guarantee organization of the IFD stood transferred to the Corporation. As the Reserve Bank was not receiving any reimbursement from the government for the cost of administering the earlier scheme, the Corporation requested the Bank to bear the expenditure for staff and premises in the initial stages.

Under the new scheme, the guarantee fee was enhanced by 0.25 per cent so as to bring it in line with that being charged for the other schemes of the DICGC. With the increase in guarantee claims and expansion that took place, the administrative costs marked a considerable rise. As these were being met out of the general fund, the Corporation had raised its paid-up capital from Rs 2 crore to Rs 10 crore in July 1978, when the Deposit Insurance Corporation took over the erstwhile Credit Guarantee Corporation. Even this proved inadequate in view of the large increase in the volume of operations. It was felt that the income from the general fund would fall short of the anticipated expenditure and the capital of the Corporation was raised from Rs 10 crore to Rs 15 crore with effect from January 1981, which was the maximum permissible level of authorized capital under the DICGC Act, 1961. The central government was requested to amend the Act to raise the permissible level to Rs 50 crore. In the meanwhile, the Reserve Bank made available staff, premises, furniture and fixtures, and other office assistance necessary for carrying out the new credit guarantee functions free of cost to the Corporation for a period of two years, commencing 1 April 1981. Pending amendment of the Act, the Bank placed two interest-free deposits, of Rs 15 crore and Rs 10 crore, with the Corporation in 1982, which were to be adjusted against the Reserve Bank's contribution to the additional capital when the enactment was completed. The Act was eventually amended and the capital raised to Rs 50 crore in May 1984.

The issue of extension of guarantee cover to advances granted by cooperative credit institutions, which has been mentioned earlier, resulted in the formation of another scheme for cooperative credit societies. The Corporation constituted a Working Group under the chairmanship of M.V. Hate, Executive Director of the Reserve Bank and a Director of the DICGC, to consider this issue. The report of the Group, submitted in November 1980, *inter alia,* recommended extension of credit guarantee support to agricultural credit societies and land development banks at the primary level in a phased manner in the context of the very large number of institutions to be covered and the present administrative capacity of the Corporation. The Group also recommended that guarantees may be extended to cooperative urban banks for their advances to the non-agricultural sector. The recommendations were accepted and another credit guarantee scheme relating to the cooperative sector, viz., the Small Loans (Cooperative Credit Societies) Guarantee Scheme, 1982, providing guarantee cover to select primary agricultural credit societies (PACS), primary land development banks (PLDBs) and branches of state land development banks (SLDBs), in respect of their lendings for agricultural and allied activities, was formulated. Select institutions were invited to join the new scheme from 1 January 1983. The expansion of the schemes had financial implications that were not foreseen with clarity.

ANNEXURE

Fraudulent Transactions at the London Branch of Central Bank of India

A major instance that invited unsavoury comments regarding the supervision of foreign branches was the surfacing of certain fraudulent transactions involving a substantial amount of foreign exchange at the London branch of Central Bank of India in April 1970. The branch had been inspected by the Reserve Bank way back in 1960.

It transpired that the manager of the London branch of Central Bank of India, Sami J. Patel, issued certain fraudulent guarantees on behalf of some parties—viz. Wexler and his companies, Houry and his companies, and C.M. Shah and his companies—guaranteeing payment on due dates of bills in deutsche mark to a total value of DM 10.5 million. Subsequent investigations by the Reserve Bank as well as the Central Bank of India revealed that the fraud, which was being perpetrated for some time past, involved mobilizing of money against accommodation bills, initially in sterling and subsequently in deutsche mark, from 1967 to early 1970. The modus operandi in regard to sterling was to have certain accommodation bills drawn in sterling by some of the constituents of the bank, with the bank issuing the requisite guarantees and/or making endorsements to have them discounted in the London market (not with the Central Bank of India). These guarantees/endorsements were unauthorizedly issued/made by Sami J. Patel, and were signed by himself and another officer of the bank. The bills were being regularly drawn (i) by National Sales Corporation Ltd on City of London Garages Ltd (T.W. Wexler and his son, B.W. Wexler, were directors of both concerns), (ii) by Worldwide Shipping Co. Ltd on G.E. Houry & Son Ltd (these were concerns of G.E. Houry), and (iii) by Montex Ltd on C. Ramon & Co. Ltd (both these were concerns in which C.M. Shah was interested as director). The discount proceeds were generally being received and credited, and the bills on due date were being met by debit to the concerned constituents' accounts. None of these discount transactions figured in the books of the bank as they should have if the transactions had been handled by the bank in the usual course; nor was there any indication that the bank received any payment in the form of commission for such execution of guarantees/endorsements. It was, therefore, obvious that Sami J. Patel had obtained monetary benefit out of these fraudulent transactions. During the period 1967 to 1969, Patel had, through such unauthorized guarantees/endorsements, enabled negotiation in the London market of sterling bills to the tune of about £1,855,400.

Later, due to tight money market conditions in the London market and the credit squeeze, Patel and the constituents of the bank, who were raising money in London against the bank's guarantees/endorsements, could not continue these operations to their advantage. They, therefore, struck upon a plan for carrying out similar operations in the German market, where money conditions at the time were relatively comfortable. The modus operandi was to have accommodation bills (similar to those in the case of the sterling bill operations) drawn by the associate companies in the Wexler, Houry and Shah groups, except that in these cases the sets of bills were drawn in deutsche mark and made payable at a small private bank in Hamburg, Alexander Levy & Co., and its successor institution (after October 1969), L. Behrens & Sohne. The bills found their way, through a party called M. Di Racca and his companies, to a Swiss bank called Ingeba and some German banks, including B.F.G., Global & Wolbern. The fraud came to light in April 1970 with bills discounted and pending payment aggregating DM 10.50 million; the outstandings in respect of the Wexler, Houry and Montex groups were DM 6,500,000, 2,000,000 and 2,000,000, respectively. The foreign banks involved sued the Central Bank of India as guarantor for recovery of their dues; the drawers and drawees were also made defendants.

The magnitude of the fraud created ripples in the banking industry and became a subject of active debate in India, in the Lok Sabha, Rajya Sabha and the media. The role of the head office of the Central Bank of India as well as that of the Reserve Bank of India in supervising foreign branches of Indian banks came under scathing criticism. In a letter addressed to B.N. Adarkar, Governor of the Bank, on May 1970, A. Baksi, Secretary, Department of Banking, Ministry of Finance, commented:

> In particular, serious misgivings have arisen why branches abroad of Indian banks appear to be left on their own and not subjected to anything like adequate supervision and surveillance from India, particularly from the headquarters of the bank concerned and the Reserve Bank. It appears difficult to avoid altogether the impression that the internal audit of branches abroad by the headquarters of the bank is very weak, if it exists at all; … Furthermore, how much responsibility the Reserve Bank has assumed so far and is able to assume now in the matter of checking that the branches abroad of Indian banks function properly is not clearly known. To take the last point, for instance, we ourselves are not sure why the London branch could not be visited by Reserve Bank Inspectors for so many years.

He desired that the Reserve Bank examine all facets of the problem and send a report to the government. He followed this up with another letter addressed to the Governor two days later, indicating that the Reserve Bank might undertake a special scrutiny, without delay, of the affairs of the Central Bank of India. In response to these letters, Adarkar wrote two separate letters to Baksi, both on 26 May 1970: one explaining the aspect of Reserve Bank's supervision of foreign branches of Indian banks, and the other regarding the steps being taken to investigate the fraud in question.

On the subject of inspection of foreign branches, it was explained that the last round of such inspections were carried out in 1960–62. Referring to the delay in taking up the next inspection, Adarkar pointed out:

> During the discussions on the subject at the Central Board meeting in

> October 1961, a decision was taken at the instance of the then Governor, Shri H.V.R. Ienger, that such inspections need not be carried out more often than once in three years. The reasons given were (1) that they were expensive and (2) that by and large the foreign branches were found to be working on the right lines. In February 1965 this question was taken up again and the then Deputy Governor, Shri C.S. Divekar, and Executive Director Shri D.R. Joshi, decided that the matter be deferred for some time. In November 1967, the position was reconsidered and in February 1968 a decision was taken to resume the inspections of foreign branches.

However, priority in this regard was given to the branches in Asia and Africa, as it was presumed that the branches in London and the UK would be in charge of senior and responsible officials, and could, therefore, be taken up after the inspection of the Asian and African branches. Elaborating on the other important commitments that engaged the attention of the Reserve Bank on a priority basis during this period, Adarkar referred to the Bank's main preoccupation for a number of years, up to 1965–66, of bringing about the elimination or mergers of a number of small banks which were then tottering or in a semi-solvent state; the enhanced emphasis on the Bank's policy of reorganization and development from 1967 onwards; as also the need to generate a tempo of development work in order that social control might show results within a reasonable period of time, in terms of branch expansion and increased lending to agriculture and small-scale industries. All these required deployment of the services of the Bank's senior and experienced personnel, and the shift in emphasis resulted in lower priority being accorded for some time to mere policing work. He hastened to add that it should not be presumed that such work was neglected, but the more expensive type of inspections (like inspections of foreign branches), where experienced personnel had to be deployed for long periods, were undertaken on a modest scale. Moreover, no amount of policing by the Reserve Bank, which in any case had to be carried out on a selective, sample basis, could be an effective substitute for the bank's internal management, especially when the bank concerned was one like the Central Bank with a vast network of branches. Concluding the first letter, Adarkar stated:

> I would ask you to appreciate that given the limitations of personnel and the importance and urgency of developing the social aspects of banking, the Reserve Bank could not possibly do all it wished by way of cleaning up the internal working of banks. In fact, it was the Reserve Bank's excessive preoccupation with mere policing that had led to the development work being somewhat neglected prior to the introduction of social control.

The second letter to Baksi dealt with the various steps initiated by the Reserve Bank to look into the London branch fraud.

The first official from the Reserve Bank to visit London in connection with the fraud, in the second week of June 1970, was P. Krishna Iyer, a senior officer of DBOD, who was deputed as officer-on-special duty with the Central Bank of India. He was soon followed, by the end of that month, by M. Narasimham, Secretary to the Reserve Bank's Central Board and representative of the Bank in the internal management committee of the Central Bank of India. While these officials were engaged in assessing the situation and providing the necessary feedback to the Bank and the government, the financial inspection of the branch under Section 35 of the Banking Regulation Act, 1949, by a Reserve Bank inspection team led by K.K. Ray, was taken up on 20 June 1970. In his book, *Some Reminiscences*, M. Narasimham recalls the initial reaction of the Bank of England to this episode thus:

> When I went to London to meet the officials of the Bank of England, I met the then head of the Discount Office and over a cordial lunch he pontificated on the importance of credibility of institutions in the City of London and said that one bad apple could spoil the entire basket and the Bank of England was concerned that no City institution defaulted on its payments.

As the official was not convinced by the explanations offered by Narasimham, the latter had to meet the Deputy Governor of the Bank of England, who was in charge of the discount operations and related functions. The Deputy Governor maintained the threatening posture of taking 'severe action against errant institutions', despite Narasimham pointing out to him that the 'Central Bank was not sinning but sinned against'. During the discussions, the Bank of England executive went so far as to indicate that the option of ordering the closure of the Central Bank's branch was not ruled out. Narasimham then explained that the major banks in India, including Central Bank of India, had only recently been nationalized, and any such action by the Bank of England could have political repercussions at home and give a handle to those who were critics of bank nationalization. He requested the Bank of England to bear this in mind, emphasizing that the Central Bank branch was a victim of a fraud.

However, these arguments did not make much headway, as Narasimham noted.

> At that point, I told him that we in the Reserve Bank had reasons to believe that a couple of British banks were also transgressing our exchange control regulations. But we had held our hand in view of the cordial relationship between the British and Indian banks and between the Bank of England and the Reserve Bank and that we were expecting the Bank of England to bear the same sentiments. He tried to get me to name the banks, which I refused to do on the ground of confidentiality of relationships.

Narasimham added that while this approach worked, the head of the Discount

Department at the Bank of England did not conceal the feeling that what Narasimham said seemed to be close to a veiled threat.

The London branch of Central Bank of India, which was opened in the early 1950s, was under the charge of Sir Cecil R. Trevor, former Deputy Governor of the Reserve Bank and designated as London Adviser, until his retirement in 1967, when Sami. J. Patel was appointed manager of the branch. Patel enjoyed the confidence of Sir Trevor and earned excellent reports from him, which enabled him to maintain a high profile.

Apart from the dishonest behaviour of an overly trusted official, the Central Bank of India management was also found to have been lax in heeding the early warning signals. The head office supervision of the branch was woefully inadequate. During the years 1960 to 1965, no branch audit was carried out. While one senior executive each had visited the branch and examined certain aspects of the working of the branch in 1966 and 1968, a formal audit of the branch was carried out only in August 1969. Even this detailed audit did not bring out the fraudulent transactions in question. However, the officer who visited the branch in 1968 and the auditor who went a year later had pointed out serious irregularities in the manner of functioning of Sami J. Patel. The head office, inexplicably, chose to softpedal the issue. This aspect was succinctly brought out in one of the notes recorded by Krishna Iyer:

> However, for quite some time, even before the recent disclosure of the huge frauds, it was within the knowledge of the Head Office that affairs of the branch were conducted in a most unbusinesslike way and were far from satisfactory. The fact that notwithstanding the above and the findings of Mr Premani, who was specially deputed from India in 1968 to look into the affairs of the branch, which indicated an extremely irregular manner of handling of the affairs of the branch, Mr Patel continued to enjoy the confidence of the higher-ups in the Head Office and no serious action against him was taken for the various irregularities perpetrated by him, speaks eloquently of the patronage he must have enjoyed at certain powerful quarters in the bank's management.

Immediately prior to the surfacing of the fraud in April 1970, P.C. Mewawala, general manager from the head office of the bank, visited London in March, to enquire into the reported irregularities at the branch, as desired by V.C. Patel, custodian of Central Bank of India. During his visit, Mewawala asked Sami J. Patel to submit his resignation, citing various irregularities, *inter alia*, including several instances where he had exceeded the powers bestowed on him and instances of suppression of details by not recording his actions in the books of the bank. Patel submitted his resignation on 9 March 1970, which was accepted. The action by the head office of the bank, when it was finally taken, proved to be far too late.

During the court proceedings of the suit filed against Central Bank of India by the three foreign banks, a demand was raised by the solicitors of the German banks that the inspection reports of the London branch of Central Bank of India by the Reserve Bank be produced. On receiving the request through the Central Bank of India, the Reserve Bank advised the former in August 1972 that the inspection reports were sent to that bank on a strictly confidential basis and that the Reserve Bank had been taking the stand that the inspection reports of a functioning bank should not be disclosed to the public, as their disclosure, especially out of context, would be contrary to public policy and interest. It was also pointed out that it was considered objectionable to disclose the inspection reports in the proceedings pending against the Central Bank of India in London.

However, the London solicitors of Central Bank of India (M/s Herbert Smith & Co.) felt that such a letter would be insufficient to fend off the demand for production of the Reserve Bank inspection report in the court. Later, in consultation with the Legal Department, the Bank issued a direction to the custodian of the Central Bank of India under the provisions of Section 35A of the Banking Regulation Act, 1949, signed by Deputy Governor R.K. Hazari, advising the bank:

> Now therefore in exercise of the powers conferred under Section 35A of the Banking Regulation Act, 1949, the Reserve Bank of India, being satisfied that it is in the public interest so to do, hereby directs that the Central Bank of India shall not disclose or cause to be disclosed in any manner the reports on inspection of Central Bank of India or of the Central Bank of India Ltd carried out from time to time, as well as the correspondence between the Reserve Bank of India and the Central Bank of India or the Central Bank of India Ltd relating to such inspections.

After protracted litigation, over a period of almost three years, Central Bank of India, on 12 January 1973, entered into an out-of-court settlement with the three foreign banks—B.F.G. (Bank fur Gemeinwirtschaft Aktiengesellschaft), Ingeba (Internationale Genossenschaftsbank Aktiengesellschaft) and Global (Gerling Global Bank Aktiengessellschaft)—for an aggregate amount of £ 680,000 in respect of claims and £ 70,000 towards the cost of actions.

Thus, an instance of obvious indiscretion on the part of the head office of a bank in handling the affairs of a foreign branch and the crucial delay in taking appropriate action translated into a substantial loss of foreign exchange for the country.

6

The Bank and Farmers

From the very beginning, the Reserve Bank had played a role in developing agricultural and rural credit, mainly by fostering the growth of cooperative credit institutions (see Volumes 1 and 2 of the history of the Reserve Bank of India). Until 1966, the main instrument for promoting the flow of agricultural credit was cooperative credit. With social control, the paradigm shifted. The possibility of commercial banks providing agricultural credit in increasing measure became evident. It also became clear that the credit needs of agriculture engendered by the new technology would have to be met by multiple agencies, rather than by one, as hitherto. Thus, from the mid-1960s, the role of the RBI became more varied, inasmuch as it began to emphasize a multi-agency approach to rural credit, and integration of term lending and working capital finance. Term lending for agriculture to primary land development banks was mainly undertaken by central land development banks with the support of the Agricultural Refinance Corporation (ARC)/Agricultural Refinance and Development Corporation (ARDC). Institutions also received its attention. The multi-agency approach, and the integration of term lending and working capital finance, reflecting a slight shift in focus, were high points of the period under review in this volume. This chapter discusses these developments.[1]

[1] The discussion is based on published accounts with clarifications, amplifications and confirmations gained from interviews with persons who were associated with cooperative credit and banking developments during the 1970s. The Reserve Bank's records on the subject were transferred to the National Bank for Agriculture and Rural Development (NABARD), upon the creation of NABARD. Unfortunately, with the collapse of the building in which the records were said to have been preserved by NABARD, all the records were reported to have been destroyed. We, therefore, had no option left than to go by published accounts and perspectives from 'oral history'.

Section 54 of the RBI Act in its original form had required the Reserve Bank to set up a special Agricultural Credit Department (ACD) with an expert staff to study all questions of agricultural credit, to be available for consultation by the central government, state governments, state cooperative banks and other banking operations, and to coordinate the operations of the Bank in connection with agricultural credit and its relations with state cooperative banks and any other banks or organizations engaged in the business of rural credit. The Bank's core financing role was covered under Section 17.

Under the provisions of the Act, the Reserve Bank enabled provision of agricultural credit either through scheduled commercial banks or through state cooperative banks for agricultural operations and for marketing activities. The Bank provided for medium-term loans to state cooperative banks for agricultural and allied activities against specified securities and guarantees of state governments, as also for conversion of short-term loans into medium-term ones when there were problems of recovery due to crop failures or natural calamities. Besides, the Bank provided long-term loans to state governments for contributing to the share capital of cooperative credit societies. The Bank also held debentures of land development banks, against which long-term loans were provided to them.

When regional rural banks (RRBs) were set up as scheduled commercial banks in 1975, the Reserve Bank supported them in so far as provision of credit for agricultural and other rural production and marketing activities was concerned. The Bank was instrumental in setting up the Agricultural Refinance Corporation (ARC) in 1963, and provided credit to it. The ARC was renamed as the Agricultural Refinance and Development Corporation (ARDC) in 1975. The Bank's credit support, thus, was not merely in terms of refinancing, but also consisted of extending short-term and long-term loans to institutions that provided credit for agricultural development.

By 1979 the authorities felt that the Reserve Bank would have to shed its function of supporting rural credit. Instead, a separate, government-owned, apex development finance institution dedicated to rural credit was envisaged. Thus was born, on 12 July 1982, the National Bank for Agriculture and Rural Development (NABARD), based on the recommendations of a Committee headed by B. Sivaraman, former Secretary, Ministry of Agriculture, Government of India. The ACD was wound up but its Rural Planning and Credit Cell was left intact as a separate department.

The RBI's financial support was largely by way of helping to refinance state cooperative banks to provide short-term and medium-term loans for agricultural purposes. But it was not such as to fill the gaps in credit for

TABLE 1 RBI's Short-Term Loans to State Cooperative Banks for Agricultural Purposes

(Rs crore, rounded off)

Years	Agricultural operations		Marketing of crops including cotton and kapas		Purchase and distribution of chemical fertilizers		Total	
	Amount drawn	Outstand-ings	Amount drawn	Outstand-ings	Amount drawn	Outstand-ings	Amount drawn	Outstand-ings
1	2	3	4	5	6	7	8	9
1960–61	131.7	79.1	–	–	–	–	131.7	79.1
1965–66	249.4	144.7	–	–	–	–	252.2@	146.3@
1966–67	305.1	149.1	–	–	–	–	311.2*	151.3*
1967–68	356.8	159.1	–	–	32.2	10.0	389.0	169.1
1968–69	403.1	208.9	–	–	38.3	10.5	441.4	219.4
1969–70	416.7	234.8	7.1	4.9	37.5	9.6	461.3	249.3
1970–71	413.2	265.4	7.8	3.4	11.3	1.7	432.3	270.5
1971–72	482.7	251.1	12.8	7.3	23.0	2.4	518.5	260.8
1972–73	549.8	237.3	95.4	12.2	7.5	–	652.7	249.5
1973–74	603.3	207.8	45.3	11.2	–	–	648.6	219.0
1974–75	785.7	335.8	64.7	22.1	29.0	7.4	879.4	365.3
1975–76	914.6	321.2	28.7	12.2	59.9	2.7	1003.2	336.1
1976–77	810.2	346.1	2.7	0.01	18.9	0.01	831.8	346.1
1977–78	892.2	419.5	3.8	0.01	22.4	–	918.4	419.5
1978–79	1220.5	396.1	4.0	0.01	8.3	–	1232.8	396.1
1979–80	985.2	351.8	–	–	2.7	–	987.9	351.8
1980–81	993.9	447.6	–	–	3.8	–	997.7	447.6
1981–82	1242.6	660.6	30.1	0.01	6.7	0.15	1279.4	660.8

Note: @ Inclusive of loans given for financing Intensive Agricultural District Programme.
* Inclusive of loans given for financing high-yielding varieties programme.

Source: *Reports on Currency and Finance* (various issues).

agriculture, which can only be estimated. If major cash inputs (i.e. excluding cattle feed, seed, manure and marketing charges) alone were to be reckoned, the share of short-term credit was about 36 per cent in 1970–71, moving down to around 30 per cent by 1980–81. If one reckons short-term credit as a proportion of 'key inputs' (defined as chemical fertilizers, diesel oil, pesticides and insecticides), it was at a high of 97 per cent in 1970–71, mainly because of the limited application of these inputs then, and it came down to 54 per cent by 1980–81, as key inputs were more and more utilized.

TABLE 2 **Credit Requirements for Agriculture**

Committees	Year of reference	Estimate (Rs crore)
1. All-India Rural Credit Survey of 1951–52	1951–52	750
2. All-India Rural Debt and Investment Survey of 1961–62	1961–62	1,034
3. Working Group of the Agricultural Production Board, Government of India, 1965	1970–71	
Short-term demand for credit		1,106
4. Panel of Economists that reviewed the Working Group estimate for 1970–71	1970–71	
(a) Method 1 as per cent of total borrowings		
(With 100 per cent for households)		1,228
(With 75 per cent for households)		1,011
(b) Method 2 as per total borrowings		
(With 100 per cent for households)		1,341
(With 75 per cent for households)		1,174
5. Fertilizer Credit Committee on	1970–71	
Fertilizer Credit Requirement		520
6. All-India Rural Credit Review Committee	1973–74	
(a) Short-term credit		2,000
(b) Long-term need		1,500
(c) Medium-term need		500
7. Sub-Group on Agricultural Credit of the Working Group on Cooperation for the Fifth Plan	1978–79	
Short-term need		3,000
1. National Commission on Agriculture (1976) * Total of short and term credit requirements	For 1985	9,400

Note: * The Commission's total credit requirements actually came to Rs 16,549 crore for meeting the full requirements of crop production but the realistic financial programme that could be met by cooperative and commercial banks—the graduation, as it was called—was placed at Rs 9,400 crore.

The increase in credit was obviously not matched by credit supply. Kahlon and Karam Singh estimated the share of term credit to gross private capital formation in agriculture at about one-third. Whether one agrees with the estimates or not, they show that credit gaps during the period of their study, which coincides with our own, were financed by non-institutional sectors including own savings and private credit agents such as moneylenders, friends and relatives.

Other estimates of credit gaps were given by some official Committees, Working Groups and Surveys. These estimates provide an idea of the magnitude of credit requirements in different reference years. None of the Committees, however, gave a widely accepted reasoning for the 'stability' of their estimates. Overall, the short-term credit requirement from institutional sources was anywhere between Rs 1,100–1,300 crore in the early 1970s, going up to around Rs 3,000 crore by the end of the decade. Then there was credit needed for investment and this was almost as much. But this was not conclusively stated by any of the official Committees and Surveys. This, despite the fact that the All-India Rural Credit Review Committee, which submitted its report in 1969, had worked out short, medium and long-term credit needs, albeit with a large number of caveats. The plausible conclusion from this Committee's findings was that medium and long-term credit needs would not be very different from short-term credit needs because agriculture required the infusion of a considerable amount of investment.

Institutional finance for agriculture grew sharply during the late 1960s and 1970s. The main institutions to provide credit were the state cooperative banks, central cooperative banks, primary agricultural credit societies, land development banks and scheduled commercial banks including RRBs. The outstanding loans and advances of the entire cooperative credit sector went up eight times, from Rs 603 crore in 1965–66 to Rs 1,435 crore in 1970–71 and further to Rs 4,939 crore in 1981–82.[2]

During this period, the proportion of RBI's outstanding loans to the cooperative sector to loans outstanding of the sector declined from 35.3 per cent in 1965–66 to 32.4 per cent in 1966–67 and further to 20.7 per cent in 1981–82. The average share for the period stood at 24.2 per cent. The shares declined in the years of severe credit tightening, in 1973–74 at the time of the first oil shock and again in 1979–80 at the time of the second oil shock. The falling share was accompanied by an increasing share of commercial banks' finance for agriculture.

State governments also gave loans to agriculture, mostly for short-term

[2] We have not considered the loans issued by the cooperative institutions because of absence of data of such loan issues between the tiers of the cooperative credit structure. It is only in respect of the data on outstandings that one could work out the correct amounts of loans outstanding against individuals and others that do not form part of any credit society. Avoidance of double counting of loans and advances was achieved by deducting the loans outstanding against cooperative credit societies from the total outstanding loans and advances of each of the tiers of the credit structure.

purposes. The *Report on Currency and Finance* for various years indicate that from Rs 70.20 crore in 1969–70, such loans increased to Rs 176.80 crore by 1972–73. In 1982–83, the amount was placed at Rs 202.6 crore.

Apart from its financing role, the Reserve Bank also provided advice and helped develop agricultural credit institutions. It became an important adviser to cooperative credit institutions and scheduled commercial banks on matters relating to agricultural credit disbursement and mobilization of resources from rural/semi-urban areas. It also collected enormous information on the liabilities and assets and cash flows of cooperative credit institutions and commercial banks. The ACD acted as an important centre for sanctioning short-term assistance and for regulation and inspections. Inspections of cooperative banks were placed on a statutory footing from 1966 onwards. The Bank also periodically inspected primary cooperative banks from then.

The Agricultural Credit Board was created on the recommendation of the All-India Rural Credit Review Committee, which submitted its report in July 1969. Its recommendations were quickly implemented. For example, one of the Committee's recommendations related to the need to adopt what came to be known as a 'multi-agency approach' towards agricultural and rural credit. This led to the establishment of the Rural Electrification Corporation and the Small Farmers Development Agency (SFDA), for identifying the problems of small but potentially viable farmers, and for ensuring that agricultural inputs, services and credit were made available to them. The Committee also recommended the linking of the rate of refinance from the Reserve Bank with the cooperative banks' own efforts to mobilize deposits.

As the volume of loan disbursements by cooperative credit institutions increased, their overdues also went up. In December 1972, the Reserve Bank appointed a study team to examine the growing problem of overdues of cooperative credit institutions and to suggest corrective actions. The team submitted its report in 1974; suggested automatic disqualification of managing committees/boards and relief from stabilization funds to those who were adversely affected by natural calamities.

To make sure that the cooperative credit structure in different states was strengthened, the Bank set up study teams for West Bengal, Assam, Kerala, Maharashtra, Bihar, Rajasthan, Madhya Pradesh, Uttar Pradesh, Himachal Pradesh, Jammu and Kashmir, Orissa, and Karnataka. Cooperative credit societies in these states were known to be weak or facing severe financial problems. The teams gave comprehensive reports on how to strengthen the cooperative credit structure, besides identifying credit gaps in the agricultural sector in the respective states.[3]

In spite of its efforts, by the end of the 1970s the impression gained ground that the Reserve Bank's actions in strengthening cooperative credit institutions and in integrating the different agencies' functioning for improving credit for agriculture had pretty much failed. This led to the demand for a separate apex bank for agricultural and rural credit, on the lines of the Industrial Development Bank of India (IDBI). The Working Group on Cooperation, appointed by the Administrative Reforms Commission, which had submitted its report in June 1968, was the first to recommend the establishment of a national bank for agriculture and cooperatives through a statute of Parliament. The interim report of the National Commission on Agriculture echoed this in 1971. By the end of the 1970s it was clear that this demand could no longer be kept in abeyance, especially since, notwithstanding the efforts of the Reserve Bank of India to bring about orderliness and discipline, the overdues of cooperative credit institutions had been rising year after year.

The logic behind the need for such a bank was impeccable and the RBI was unable to counter it. It came under pressure from the government to agree to examine the issue through an expert committee. Accordingly, it appointed a Committee in 1979 under the chairmanship of B. Sivaraman, former Secretary of the Ministry of Agriculture.[4]

Thereafter the Agricultural Credit Board lost its relevance and, with that, the role of the Bank in agricultural credit greatly diminished.

[3] Among the Committees/Groups constituted by the Reserve Bank, the major ones were the following: the Expert Group on State Enactments, having a bearing on commercial banks lending to agriculture (1970); the Committee on Cooperative Land Development Banks (1973); the Committee on Integration of Short-term and Long-term Credit Structures (1976); the Working Group on Multi-Agency Approach in Agricultural Financing (1976); the Committee on Regional Rural Banks (1977); the Expert Group on Agricultural Credit Schemes by Commercial Banks (1978); the Study Group to make an in-depth study of State and Central Cooperative Banks having Surplus Resources (1981); the Standing Committee on Term Lending through Cooperatives/Land Development Banks (1981); the Study Group to Review the Working of the Scheme of Financing Primary Agricultural Societies by Commercial Banks (1978); the Committee on Urban Cooperative Banks (1977); and the Committee to Review Arrangements for Institutional Credit for Agricultural and Rural Development (1979). These initiatives were in response to the evolving developments in agriculture and allied sectors.

[4] This was the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development, popularly known as CRAFICARD. The inclusion of G.V.K. Rao as a member of the Committee was the first signal that the Reserve Bank would not be

TABLE 3 **Overdues of Cooperative Credit Institutions: Short-term Credit** (Rs crore)

Year	Total overdues				4 as % total
	PACS	DCCB	SCB	Total	loans outstanding
	(1)	(2)	(3)	(4)	(5)
1965–66	125	87	9	221	18.86
1966–67	160	124	17	301	23.14
1967–68	171	136	18	325	22.54
1968–69	214	173	23	410	23.85
1969–70	268	215	28	511	26.06
1970–71	322	274	36	632	29.66
1971–72	377	319	38	734	31.91
1972–73	368	310	42	720	27.25
1973–74	443	376	63	882	30.16
1974–75	503	434	44	981	28.48
1975–76	561	460	44	1065	29.38
1976–77	683	596	58	1337	29.82
1977–78	810	754	96	1660	31.59
1978–79	927	835	127	1889	32.59
1979–80	1089	969	175	2233	34.33
1980–81	1086	940	162	2188	29.39
1981–82	1248	1110	164	2522	12.78

Note: PACS: Primary Agriculture Cooperative Societies.
DCCB: District Central Cooperative Banks.
SCB: State Cooperative Banks.

Source: RBI/NABARD, *Statistical Statements Relating to Cooperative Movement in India* (various issues).

able to withstand the pressure for the creation of a separate agricultural development bank. Rao strongly believed that agricultural development required a combination of credit, policy and institutional support, which the Reserve Bank could not provide. The Committee gave an interim report in November 1979 in which it recommended the setting up of the National Bank for Agriculture and Rural Development (NABARD). The final report was submitted in January 1981 and NABARD came into existence in July 1982.

THE MULTI-AGENCY APPROACH

The All-India Rural Credit Review Committee submitted its report in July 1969, just before the nationalization of fourteen major commercial banks. It recommended the adoption of a multi-agency approach as the most feasible and appropriate response to the credit requirements of agriculture and allied activities. Commercial banks had begun to provide direct and indirect finance to farmers/agriculture even earlier. There were two driving forces behind this. One was 'social control', which forced banks to extend agricultural and rural credit on a significant scale. The other was the introduction of the high-yielding varieties programme from the *kharif* season of 1966. The programme involved large outlays on irrigation and inputs and, consequently, the credit disbursed by cooperatives was expected to expand enormously. But this did not happen. Cooperative credit institutions, especially the central cooperative banks and the primary agricultural credit societies in several states, continued to be in poor health. The Reserve Bank did not envisage any significant role for the commercial banks in ensuring timely and adequate credit for agriculture. But soon its view changed because of the comprehensive work done by the All-India Rural Credit Review Committee. The Committee estimated the credit requirements to be Rs 2,000 crore for short-term credit and another Rs 2,000 crore for capital investments. Given the state of the cooperative banks, this credit could only come from the commercial banks. Meanwhile, the Fourth Five Year Plan was to commence in 1969–70. It accepted the estimate of short-term credit needs as given by the Committee (Rs 2,000 crores by 1973–74) but said that the medium-term credit need could be placed at Rs 500 crore while the long-term investment need would be Rs 1,500 crore during 1969–74.

It was against this background of large agricultural credit requirements that the Plan document advocated a multi-agency approach. This required the Reserve Bank to encourage commercial banks to lend to agriculture, even as it took measures to strengthen cooperative credit institutions and to adopt a multi-pronged strategy that went beyond making additions to the capital base of land development banks through investments in their debentures, or providing refinance to state cooperative banks, or giving directions to cooperative credit institutions in regard to their deposits, lending and investment activities. These exhortative tasks were handled admirably by the Bank, as shown by the various circulars and exhaustive notes that the RBI staff prepared for consideration of the Agricultural Credit Board and its Standing Committees.

It was seen that the multi-pronged strategy worked in at least four areas.

First, the initiatives taken in respect of the Lead Bank Scheme helped commercial banks to usefully 'intermediate' between rural savings and rural investments in specific geographical areas. Second, the Bank attempted to reduce the legal constraints on banks for lending to agriculture and sought to promote special legislation for facilitating the flow of credit to agriculture. A sound legislative framework was considered necessary to provide greater confidence to commercial banks to lend to agriculture without facing unknown hazards. A Working Group led by R.K. Talwar, chairman, State Bank of India (SBI), made several important recommendations that involved amending a large number of enactments then in force in the states.[5]

[5] The main recommendations were:

LEGISLATIVE PROVISIONS

Land Alienation Rights of Agriculturists

(i) Cultivators who have no rights or have only restricted rights of alienation in their lands or interests therein—such as landholders belonging to scheduled tribes/castes, backward classes/castes, tenant-cultivators, fragment holders, allottees of *Bhoodan* land and of Government land—should be vested with rights to alienate land/interest in land held by them in favour of banks for obtaining loans for agricultural purposes.

(ii) In the case of sharecroppers, banks would be able to grant loans only if their status is properly recorded in the record of land rights. Further, they should be enabled to create a charge on the crops raised by them, notwithstanding the fact that they are not the owners of the land over which the crop is raised by them.

Priority of Charges

(iii) The general principle of priority, as between institutional credit agencies in regard to loans based on common security, should be such that the concept of first charge in favour of cooperatives does not adversely affect commercial banks. However, all institutional credit agencies should have priority of charge vis-à-vis private credit agencies.

(iv) The restriction on alienation of land subject to a charge in favour of a cooperative should be relaxed so as to permit subsequent alienation thereof for security supplementary credit from another institutional credit agency.

(v) On the same basis, where crop loan for current production purposes is granted by one institutional credit agency and term loan for development purposes is granted by another institutional credit agency against common security, priority of security should accrue to the agency providing the term loan, provided the encumbrance in its favour was made with the knowledge and concurrence of the institution holding the encumbrance for crop loan for current production purposes. The existing priorities under the cooperative legislation, as between the cooperative credit societies and land mortgage banks, will remain unaffected.

(vi) As between two institutional credit agencies providing term loans for development purposes against common security, priority of claim should arise according to the point of time of creation of encumbrances.

(vii) To facilitate expeditious disposal of loan applications, provision should be made to enable agriculturists to create a charge on land/interest therein by declaration in favour of

The Group also prepared a model Bill for state legislatures to bring under one statute all the rights and privileges that could be conferred on commercial banks.

The second meeting of the Agricultural Credit Board, held on 15 July 1971, endorsed the Group's recommendations. As the matter related to state governments, the Governor addressed letters in August to the Chief

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commercial banks. Appropriate arrangements should also be made to have such charge noted in the record of rights and in the office of the Sub-Registrar.

(viii) To overcome the prolonged delays involved in securing registration of mortgages created in favour of commercial banks, it is necessary to provide that it would be sufficient if a copy of the mortgage deed is sent for registration to the Sub-Registrar. The mortgage so created should also be noted in the record of rights.

Recovery and Other Operational Difficulties

(ix) Enactments relating to moneylending regulation and debt relief should exclude commercial banks from their purview.

(x) To facilitate prompt recovery of dues of commercial banks without having to resort to protracted and time-consuming litigation in civil courts, the State Government should empower an official with authority to issue an order, having the force of a decree of a civil court, for payment of any sum due to a bank by sale of the property charged/mortgaged in favour of the bank.

(xi) As banks may have need to foreclose mortgages of land executed in their favour, bring the property to sale and purchase the property if there are no bidders at auctions conducted for the purpose, they should be permitted to purchase the land and, if necessary, acquire land in excess of the ceiling limit fixed. However, State Governments may fix a time limit within which land acquired by banks is to be sold. Ultimate disposal of land by banks will, of course, have to be subject to State enactments as regards the persons to whom land can be sold etc.

(xii) In order to facilitate commercial banks financing agriculturists through primary agricultural credit societies, the societies should be made eligible to borrow from commercial banks. Further, the commercial banks concerned should be eligible for such facilities as are ordinarily available to a central cooperative bank.

ADMINISTRATIVE MEASURES

(xiii) To enable banks to get adequate and reliable information about the operational holding of an intending borrower land records should be made up-to-date.

(xiv) Meanwhile, it is necessary to prepare and maintain interim registers indicating the existence of sharecroppers and other informal tenants and the particulars of land cultivated by them.

(xv) As and when land records are brought up-to-date, pass books may be issued by State Governments to owners and tenants so that such a pass book can serve as prima facie evidence to the rights in land of an agriculturist and as a starting point to banks to verify such rights and details pertaining to encumbrances thereon.

(xvi) Cultivators borrowing from commercial banks should be exempted from payment of stamp duty, registration fee and charge for issue of non-encumbrance certificate to the extent to which they are eligible for these concessions if they borrow from cooperatives.

Ministers and Chief Secretaries emphasizing the need for urgent action. Some states, like Himachal Pradesh, Madhya Pradesh, Mysore and Uttar Pradesh, quickly initiated action but in general the progress was not uniform and satisfactory across the states. The Board reviewed the actions taken for implementation periodically. Till the end of 1976, only twelve states (Haryana, Himachal Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Orissa, Rajasthan, Uttar Pradesh, West Bengal, Manipur, Bihar, Tripura) had enacted legislation and promulgated them, although in some of them the enactments were 'materially different' from the suggested model. The Reserve Bank pointed out the deficiencies and, by the end of 1979, Assam, Gujarat, Meghalaya, and Punjab had also enacted legislation. Of the sixteen states, however, the Acts passed by only nine (Assam, Haryana, Himachal Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Manipur, Tripura, Uttar Pradesh) broadly conformed to the model Bill.

This slow progress ensured that banks were not placed at a disadvantage compared with cooperative credit institutions, in lending to agriculture. In several states, as Manmohan Singh, who was then Secretary, Department of Economic Affairs, pointed out in a tone of exasperation on 26 March 1979, while legislations had been passed, they were rendered inoperative because the rules thereunder were not framed. Even where legislation and rules were in place, there were complaints from commercial banks that loan recoveries were not forthcoming. The Agricultural Finance Corporation, a body set up by the commercial banks to evaluate projects, had set up a Committee to review the implementation of the recommendations of the Talwar Group but its efforts did not yield positive results till the end of 1980. The Reserve Bank was clearly aware of its limitation in persuading state governments to frame the rules, and had to be content with the knowledge that the states were aware that commercial banks faced constraints on their agricultural and rural lending. The states, on their part, were reluctant to place cooperatives on a different footing for quasi-political considerations.

The Reserve Bank also attempted to provide incentives to cooperatives for mobilizing deposits and to set in place disincentives to borrowing from the Bank. This was recommended by the All-India Rural Credit Review Committee. But since credit or refinance from the Bank was generally at a concessional rate, usually a few basis points below the Bank rate, the cooperative banks did not have enough incentive to mobilize deposits.

P.N. Damry, Deputy Governor of RBI, on 3 August 1970, at the first meeting of the Agricultural Credit Board, remarked that there was a tendency on the part of cooperative banks to exaggerate the requirements of credit for agricultural production programmes in their areas, and to ask for credit limits from the Bank to meet these requirements more or less fully. The Agricultural Credit Department had to, therefore, form its own view when sanctioning the credit limits. As the drive for deposit mobilization had not been successful, Damry suggested that the Bank should initially charge interest at 4.5 per cent and grant no rebate where less than 50 per cent of the deposit target was reached, and allow a rebate of 0.5 per cent where 50 per cent or more but not the whole of the target was reached and of 1.5 per cent where the target was reached or exceeded.

No agreement could be reached because of hesitation about the appropriateness of high credit requirements for agriculture, but the members agreed in principle to linking concessionality with deposit collection. The proposal, therefore, was referred to a Study Group under the chairmanship of Maganbhai R. Patel, appointed by the Governor in September 1970. After studying everything, the Group recommended an alternative formula:

(i) The Bank's lending rate could be fixed at 0.5 per cent below the Bank rate, and the central cooperative banks may be allowed a rebate of 1.5 per cent on (a) the borrowings up to the 'base' level, and (b) the additional borrowings up to twice the increase in the central cooperative bank's involvement out of its own resources in agricultural loans.

(ii) The highest level of borrowings from the Bank for seasonal agricultural operations reached during the preceding three years could be fixed as the 'base level'. Where the banks did not avail themselves of the maximum loans from the Bank and consequently the 'base level' had been unduly low, the entitlement for rebate on the additional borrowings could be higher than twice the increase in the central bank's own involvement and be even three or four times depending on the merits of each case.

This formula had the merit of protecting the banks by facilitating continuity in the availability of funds at the existing concessional rate and at the existing level of borrowings from the Bank. It also linked the additional rebate to the deposits mobilized and utilized in terms of agricultural loans.

But the problems in the delivery of credit to agriculture remained. Throughout the 1970s, the government and the Reserve Bank tried to improve matters but not to much avail. All sorts of problems, some anticipated and others unanticipated, arose.

The first meeting of the Standing Committee on Linking Borrowings with Deposit Mobilization was convened on 9 January 1974, and it discussed each of these problems threadbare. But nothing practical emerged. The Committee eventually took the position that only banks that had not attained a loan business of Rs 1 crore would be exempted from the scheme. Questions were also raised as to whether cooperative lending to small farmers should centre around production or consumption, and whether the linkage between borrowings from the Bank and deposit mobilization should not reckon such lending in the context of the possible drying up of credit for such farmers consequent upon the measures taken by state governments for moratorium and discharge and scaling down of debts from non-institutional sources.

The debate went on and the scheme kept getting modified. In March 1976, when the Emergency was its height, an Expert Committee on Consumption Credit was appointed by the government under the chairmanship of B. Sivaraman, Member, Planning Commission. It was asked to suggest measures for meeting the consumption needs of the weaker sections of the community. The Committee held that only those reorganized societies, including farmers' service societies (FSS) and large-sized multipurpose societies (LAMPS), with full-time, paid secretaries or managers should be allowed to grant consumption loans to their members. The weaker sections eligible for such loans were defined as borrowers cultivating up to 0.50 acre of land, landless labourers and rural artisans.

The Committee believed that central cooperative banks should be permitted to reimburse the loans issued by primary societies for consumption purposes from their own resources or from out of the borrowings from state cooperative banks. The Committee also held the view that the Reserve Bank should 'treat the finance so provided as a legitimate charge on the central bank's resources and sanction a higher credit limit for short-term agricultural purposes', and suggested that cooperative institutions should augment resources for facilitating consumption loans through deposit mobilization.

The Reserve Bank supported these recommendations but very soon it was confronted with representations to the effect that there would be diversion of resources by state/central cooperative banks from short-term agricultural loans to consumption loans, leading to a reduction in their own involvement in short-term agricultural loans. As a consequence, the banks' eligibility for refinance from the RBI at the fully concessional rate of 2 per cent below the Bank rate would be considerably reduced.

This issue was examined in detail by the Standing Committee of the Agricultural Credit Board at a meeting on 27 July 1977. It was decided that the own resources utilized by state/central cooperative banks for consumption loans to the weaker sections should be taken into account for determining the 'base level' and 'aggregate level' of borrowings from the

Reserve Bank. The 'aggregate level' was to represent borrowings over and above the base level, either up to twice the increase in a bank's involvement out of its own resources in short-term agricultural loans during the calendar year over and above the base calendar year, *plus* its involvement in medium-term conversion loans in excess of the stipulated level of 15 per cent, *plus* its involvement in consumption credit to the weaker sections in a financial year or the full extent of increase in loans granted by it to societies for small/marginal farmers during a financial year, whichever was higher.

But the issue of linkage did not figure in the discussions of the Agricultural Credit Board after its eighth meeting, held on 7 August 1975 under the chairmanship of N.C. Sen Gupta who was the Governor at that time. By then the decision had been taken to set up regional rural banks (RRBs) as entities sponsored by commercial banks to extend loans to small/marginal farmers and other relatively weak members of society pursuing allied activities.

The multi-pronged strategy had been devised within the framework of differing modes of operation of cooperative credit institutions, commercial banks and RRBs, with coordination rather than competition as the essential element in the financing of agricultural borrowers. The idea of coordination between cooperatives and commercial banks had been recognized in the days of social control of banks itself. This was reflected in a meeting convened by the Agricultural Finance Corporation (AFC) in June 1968, between representatives of the two types of institutions. A National-Level Consultative Committee was constituted, as a result, under the aegis of the AFC, which recommended the constitution of coordination committees at the state level and district level. But, as desired by the Agricultural Credit Board at its meetings on 3 August 1970 and 15 July 1971, the secretariat of the National Level Consultative Committee was shifted out of the AFC.

Coordination was then entrusted to a Standing Committee of the Board presided over by the Governor of the Reserve Bank. The first meeting of the Standing Committee was held on 30 July 1974. It reviewed the scheme of financing primary agricultural credit societies by commercial banks, besides the terms and conditions of financing agriculture by cooperative and commercial banks and of financing farmers' service societies. Integration of the lending operations of the different agencies turned out to be an issue that required to be tackled, to prevent duplication of banking facilities and unhealthy competition.

It was against this background that the Governor appointed a Working Group, in August 1976, to study the problems arising out of the adoption of a multi-agency approach to agricultural financing, with C.E. Kamath, chairman and managing director of Canara Bank, as its chairman.

The Group considered that there were many other important aspects requiring attention, such as a balanced dispersal of bank branches, rationalization of the rates of interest charged on agricultural advances by different lending agencies, effecting uniformity or developing satisfactory norms for obtaining security for agricultural advances, rationalization of inspection or supervisory charges for agricultural advances, and whether the premium payable to the Credit Guarantee Corporation (CGC) for covering agricultural advances should be absorbed by the lending agencies or passed on to borrowers. The Working Group's report was submitted to the Governor on 18 April 1978. After identifying the basic problems in the multiple-agency approach, the Group made recommendations in eight specific areas.

Area Demarcation

The most important issue emerging from the functioning of a multi-agency system was of defining the respective roles of cooperatives, commercial banks and regional rural banks in any given area of operation, and of evolving an appropriate mechanism for bringing about effective coordination between them in their operations. The Working Group considered several options: area demarcation, functional demarcation and consortium arrangements between several participating lending agencies.

There was a convergence of views regarding the demarcation of the area of operation for each of the credit agencies operating in a given area. The Working Group recommended a geographical demarcation of the operational area for each agency rather than a functional jurisdiction, because the former was considered to be more appropriate and practical.

In providing credit for agricultural and allied activities, the primary role, the Working Group felt, had to be assigned to the cooperatives, in view of the fact that only cooperatives possessed the organizational potential to reach out to the millions of small and marginal farmers, and to develop grassroot contacts. All rural areas needed to be covered by a network of viable cooperative credit institutions.

As regards areas served by more than one commercial bank/regional rural bank, the Working Group suggested that the bankers should mutually allocate villages in the district amongst themselves so as to avoid competition.

Commercial banks and regional rural banks, the Working Group felt, should play a supplementary role till cooperatives could be placed on a viable footing at the field level. To facilitate area demarcation amongst the different institutional lending agencies, the Group underscored the need for compiling an objective report for each district on the efficiency/efficacy of the cooperative institutions. The Reserve Bank could consider how this task could be efficiently and smoothly accomplished.

Focusing on the role of regional rural banks vis-à-vis that of commercial banks, the Working Group preferred the former because they were better suited to direct financing of farmers on account of their low-cost structure and rural ethos. The commercial banks needed to continue to extend refinancing facility to the regional rural banks. Viewed thus, the roles of commercial and regional rural banks were perceived to be complementary by the Working Group. Since large and medium farmers were not entitled to access credit from regional rural banks, the Working Group recommended that the regional rural banks be permitted to set aside a part of their resources for making advances to these categories of farmers; this recommendation, however, was based on the presumption that the norms applicable to RRBs prescribing such restrictions were removed.

Consortium Arrangements

The Working Group examined the suitability of consortium arrangements between commercial banks and the cooperative credit system as an alternative to the area demarcation approach. The operationalization of a consortium arrangement was considered to be beset with operational problems emanating primarily from the heterogeneous character of the concerned credit agencies. However, the Working Group suggested that a consortium arrangement could be tried on a pilot basis in a few selected areas.

Branch Expansion

It was generally perceived that credit gaps stemmed not only from paucity of resources but also from inequitable distribution of the available credit. In this context, the paramount need for regulating the distributive pattern of institutional lending agencies was underlined. Since cooperatives and commercial banks were expected to play a mutually supplementing and supporting role, the Working Group underscored the need for regulating future branch expansion of commercial banks and regional rural banks, so as to prevent multiplication/proliferation of branches in areas characterized by adequate presence of cooperatives. The branch expansion of commercial banks in rural and semi-urban areas was to be geared towards nurturing and strengthening the cooperatives for enabling them to emerge as the primary channel of credit, with commercial and regional rural banks as supplementary agencies. In an effort to curb the phenomenon of overlapping of banking facilities in rural areas, the Working Group suggested a slew of measures that included, among others, effective monitoring by the Reserve Bank in the context of the adoption of a multi-agency approach, strengthening the base level of the cooperative credit structure and encouraging the penetration of regional rural banks in unbanked rural areas.

The Working Group suggested that the Reserve Bank take into account a number of considerations in terms of its policy initiatives. These included, *inter alia*, avoidance of undue concentration of branches of commercial banks in rural and semi-urban centres; credit gaps in the operational areas and the availability of minimum infrastructural facilities; future branch expansion of commercial banks that had a wider base of operations in covering unbanked rural/semi-urban areas; consultations with state governments in regard to branch expansion; and, in the operational areas of existing RRBs, willingness of commercial banks to transfer their rural branches to RRBs through mutual consultation.

Interest Rates

The evolving integrated system of agricultural credit in the context of a multi-agency system brought to fore the issue of interest rates. The rate of interest on agricultural loans varied from 4 per cent to 16.5 per cent per annum. This, quite expectedly, prompted the Working Group to reiterate that a uniform pattern of interest rates be adopted by commercial banks as well as the cooperative credit system. Having taken into account all the relevant factors, the Group suggested the pattern of interest rates given below, for cooperatives and commercial banks:

(1) On short-term loans up to Rs 2,500, not more than 11 per cent per annum.
(2) On loans from Rs 2,501 to Rs 25,000, not more than 13 per cent per annum.
(3) On loans exceeding Rs 25,000, the rates need not be higher than the rates charged on loans for working capital extended to sectors other than agriculture.
(4) On term loans for investment purposes with a repayment period exceeding three years, not more than 10.5 per cent per annum.
(5) On term loans for diversified purposes with a repayment period exceeding three years, not more than 11 per cent per annum.

The suggested structure of interest rates was different from the rates under the Differential Rate of Interest (DRI) Scheme. The Working Group viewed the functioning of differential rates of interest with concern. It recommended a thorough review of the DRI Scheme and suggested putting in place a number of measures, such as a uniform system of interest rates with a concessional rate applicable to small and marginal farmers, and concessions in respect of security for loans, credit guarantee premia and supervision/inspection charges. The Group also underscored the problems associated with the implementation of the DRI Scheme.

Security for Loans

The procedures for lending (including the type of security) to agriculture, quite expectedly, varied from institution to institution. The evolving integrated agricultural credit system warranted uniform security norms. The Working Group underscored the need for a consensus on the fundamental necessity of obtaining land as a security for agricultural advances. The creation of charge in respect of land in favour of any credit institution was easy in states where legislation in line with the model Bill put forth by the Talwar Expert Group had been passed. The problem arose where such legislation had not been passed or had been passed with deviations from the model Bill. Therefore, the Working Group urged the Reserve Bank and Government of India to impress upon the concerned state governments to expeditiously implement the legislation suggested by the Talwar Group. The Group felt that credit should not be denied to an eligible borrower on the ground of his inability to furnish land or other tangibles as security. In such cases, the credit agency should rely on the feasibility and viability of the scheme/project, and the integrity and repaying capacity of the borrower.

Procedures and Systems

The system of an agricultural pass book issued by the concerned state governments, the Working Group felt, could eliminate the possibility of multiple financing of the same borrowers, provided the pass books were treated as authentic legal documents evidencing the ownership of assets and liabilities of farmers. The success of such a system was also contingent on the availability of up-to-date land records. The Working Group further suggested the introduction of a cash credit system in agricultural financing, to minimize the paperwork. It could generally be extended to areas where multiple cropping was practised and the cost of cultivating various crops was somewhat identical.

Inspection/Supervision Charges

The Working Group stressed the need for quality rather than periodicity of inspection, to ensure effective and proper end-use of credit. Recovery critically hinged on the quality of lending. To improve the quality of lending, the Group recommended a regional approach to branch expansion, whereby one or two banks having a strong presence in a particular region were entrusted with the responsibility of opening branches in underbanked/unbanked areas of the region. Moreover, the Group suggested uniformity in the periodicity of inspections, and inspection charges over and above interest charges. It clarified that the actual expenditure incurred by inspecting officials on periodical inspections should be borne by the respective credit institutions and not recovered from the borrowers.

Credit Guarantee Premium

The Working Group recommended that the credit guarantee premium be absorbed by the credit institutions and not passed on to the borrowers. While it did not favour the waiver of premium on small borrowers on grounds of practicability, it felt that reducing the premium rates could be kept in view along with upward revision of the limits of the Credit Guarantee Scheme (CGS) cover. The Group firmly noted that apart from interest and inspection charges, no other service charge should be levied on agricultural borrowers.

The Kamath Working Group report was discussed at the thirteenth meeting of the Agricultural Credit Board, held on 29 August 1978. Initiating the discussion, Deputy Governor Ramakrishnayya (in the absence of Governor I.G. Patel, who was indisposed) observed that while finalizing the branch licencing policy, the Reserve Bank had taken note of the views expressed at the previous meeting of the Agricultural Credit Board and, accordingly, no rigid stand in respect of branch licencing was envisaged in the newly formulated policy. Ramakrishnayya further clarified that a multi-agency approach continued to be the guiding principle, and that no hard-and-fast rule was prescribed relating to the setting up of regional rural banks. RRBs, he added, will have a significant role to play in rural credit and will not supplant the cooperative credit structure. Acceptance and implementation of the important recommendations of the Kamath Committee marked a watershed in the introduction of a multi-agency approach in agricultural financing.

It was against this backdrop that the National Cooperative Union of India organized a conference on ‘Assessment of Multi-Agency Financing of Agriculture' at Srinagar on 14–15 June 1979, which was attended by representatives of Government of India, the Reserve Bank, the Agricultural Refinance Development Corporation, commercial banks, regional rural banks, Ministers of Cooperation for Karnataka and Jammu and Kashmir, and registrars of cooperative societies. The conference, supporting in principle the multi-agency approach, stressed that commercial banks should function so as to supplement and strengthen the cooperative structure and not to weaken and supplant it. It observed that, in view of a certain amount of overlapping of functions, there should be effective coordination among the agencies, governments and the Reserve Bank, to avoid any operational conflict. To address this issue, the conference suggested, though with very little conviction and without providing enough clarification, that the multi-agency approach could be implemented at the macro-level while at the micro-level there should be a single agency, viz. cooperatives. Direct financing by commercial banks and regional rural banks might be continued till cooperatives became a potent force to reckon with. To avoid conflict, adoption of the area approach and programme approach was considered to be effective and purposeful. The conference invited the response of the Department of Banking Operations and Development (DBOD) its recommendations.

Considering the staggering institutional credit requirements of the agricultural sector, the DBOD commented that no single financing agency could meet the total credit requirements of the sector. Credit gaps were especially large in areas characterized by a weak cooperative credit structure at the grassroot level. Demarcation of areas for credit institutions was, therefore, not acceptable. The DBOD felt that under the system of district credit plans (DCP), credit needs could be met by different agencies.

Another recommendation that emerged from the conference was that direct financing should be resorted to by commercial and cooperative banks only where cooperatives were unable to extend the required finance. Responding to this, the DBOD maintained that the suggested route could be considered only when all borrowers were covered by cooperatives, which was not the case at that point of time. The recommendation, in DBOD's view, was not based on economic logic, as cooperatives were not capable of meeting the entire credit requirements.

The conference also underlined the need for exchange of lists of borrowers to curb the phenomenon of overfinancing of any one individual or of a few individuals. It further suggested that commercial banks and RRBs should finance integrated development programmes and projects instead of confining themselves to production finance. The DBOD reacted sharply, and pointed out that commercial banks and RRBs did not extend only production finance. They were, in fact, actively participating in the IRDP and other programmes sponsored by Government of India.

The need for a fresh look at loans extended under the DIR Scheme was also raised by the conference, so as to ensure that the expectations in this regard were met. The Reserve Bank, in its response, pointed out that the DRI Scheme had been reviewed at the Prime Minister's meeting with chief executives of public sector banks on 8 October 1978, and accordingly, the minimum target for loans under the scheme had been stepped up from 0.5 per cent to 1 per cent of aggregate advances.

One of the most important recommendations to emerge from the conference related to the uniform rate of interest payable by ultimate borrowers and the introduction of interest subsidy, if necessary. The Agricultural Credit Department, in its communication to the Ministry of Finance, pointed out that the issue—providing subsidies to cooperatives to enable them to lend at 4 per cent rate of interest under the DRI Scheme in identified areas—had already been taken up with the Ministry of Home Affairs. This was expected to bring about parity in the interest rates charged by the cooperative credit structure and by commercial banks on short-term loans. Following the recommendation of the Madhava Das Committee, the rate of interest on refinance facility from the RBI for medium-term agricultural purposes was reduced to 6 per cent from January 1979, with a view to bringing about parity in the rates charged by cooperative banks on term loans for investment in agriculture and ancillary activities. Moreover, cooperatives were advised to charge ultimate borrowers interest rates of 10.5 per cent for land development purposes and 11 per cent for diversified purposes.

Further Initiatives

In support of the multi-agency approach to meet the requirements of agricultural credit, Government of India asked commercial banks to gear up their administrative machinery and to fulfil two national targets under a time-bound programme. The Reserve Bank directed commercial banks to ensure that their advances to the priority sectors was 33.33 per cent of their total outstanding advances by March 1979. This target was subsequently raised to 40 per cent, to be achieved by March 1985. The second national target set out 60 per cent as the credit–deposit ratio to be achieved by banks by March 1979 in respect of rural and semi-urban branches separately. The underlying rationale of the second target was to ensure that the deposits mobilized by banks in rural and semi-urban areas were not siphoned off to urban and metropolitan areas, but utilized at least to the tune of 60 per cent to meet the credit needs of rural/semi-urban areas. In other words, migration of credit to urban consumers was sought to be curbed by adoption of the 60 per cent stipulation.

The credit–deposit ratios of scheduled commercial banks, population group-wise, is shown in the table below. As it was stable for some time after 1975, the directive that newly opened branches in rural and semi-urban branches should separately achieve a target of 60 per cent by March 1979 was issued in February 1977. It was mainly because of this directive that the ratio touched 58.6 per cent in respect of rural branches in 1981.

TABLE 4 **Credit–Deposit Ratios of Scheduled Commercial Banks**

(As on the last Friday of June)

Population Group	1969	1975	1978	1981
Rural	37.5	52.0	52.5	58.6
Semi-urban	39.7	49.0	46.9	50.0
Urban	59.7	70.5	62.5	61.6
Metropolitan	106.1	88.2	90.1	83.7
All-India	77.4	72.2	69.8	67.2

INTEGRATION OF TERM LENDING AND WORKING CAPITAL FINANCE

In the first two volumes of the history of the Reserve Bank of India, mention was made of the evolution of the cooperative credit movement after the enactment of the cooperative Credit Societies Act, 1904. In the initial years of the movement, there was no distinct institutional agency to cater to the capital resource requirements of farmers. As the debt of agriculturists increased, it became necessary by the time of the Great Depression of 1929–31, to set up a separate wing in the cooperative credit structure to provide resources for redeeming the accumulated debt and for capital investment in agriculture. Till the mid-1950s, long-term capital needs were provided by land mortgage banks, later referred to as land development banks (LDBs), mainly for redemption of accumulated debt. Following the acceptance of the recommendations of the All-India Rural Credit Survey Committee (1952), this changed and long-term development finance needs became the focus of the LDBs.

The setting up of the Agricultural Refinance Corporation (ARC) gave a boost to the long-term cooperative credit structure. The Agricultural Refinance and Development Corporation (ARDC), which came into being in 1968 as an extension of the ARC and with additional activities, provided investment credit in significant measure for agriculture and allied activities. But requests were made to the Reserve Bank for sanction of refinance for medium-term agricultural purposes, partly because of the scheme-based refinancing of ARDC and partly because small farmers needed to invest in certain areas that did not involve large outlays but were not always considered viable. For example, assets that were essentially instruments of agricultural production and marketing, such as farm ploughs, seed drills, sprayers, bullocks/camels, bullock/camel carts, storage bins, pump houses, and *gobar* gas plants, were initially financed by the commercial and cooperative banks because of the availability of refinance facilities for these purposes. By the end of the 1960s it became clear that there had to be access to credit at a single point. The All-India Rural Credit Review Committee (1969), however, did not envisage integrated credit access; instead, it felt that the primary credit society could extend long-term loans on an agency basis.[6]

The Review Committee also thought that it would be useful to avoid 'splitting of security' among lenders, and to enable the lending institution to have complete control over the assets offered by the borrower and help improve his production and income. The Banking Commission's view was influenced by the interim report of the National Commission on Agriculture, submitted in 1971. The interim report noted that in the context of the application of science and technology in agriculture, farmers, be they medium/large or small/marginal, should be provided with resources such as credit, inputs, technical know-how, etc., in order to solve the problems of poverty, unemployment and underutilization of their 'resources and potentialities'. The interim report mooted the concept of farmers' service

[6] 'In each state a limited number of societies satisfying appropriate criteria pertaining to financial strength and operational efficiency be selected for functioning as agencies of the land development banks in their areas of operation and that this type of arrangement be gradually extended to an increasing number of societies after experience is gained as a result of this experiment' (paragraph 41, p. 795). The Banking Commission (1972), on the other hand, was more positive on the issue. It stated: 'It is sound in principle and convenient in practice for both the lender and the borrower to have an arrangement under which as far as possible a borrower gets his entire credit needs satisfied by one single institutional agency. This should be encouraged to the maximum extent possible.' It went on to argue that the rural banks it proposed 'and recognized primary credit societies should be enabled to make long-term loans also as agents of the Land Development Bank'.

societies (FSS) with emphasis on 'integrated credit, input supply and marketing facilities'.[7]

Nothing much came out of the recommendations of the Banking Commission and the interim report of the National Commission on Agriculture in terms of operational initiatives at the ground level. It was only at the suggestion of the International Development Association (IDA), during negotiations in March 1975 in respect of the Agricultural Credit Project, that the government agreed that a study would be instituted to examine the possibility of integration of the two wings (short-term and long-term) of the cooperative credit structure.

The Reserve Bank was consulted and eventually a fifteen-member Committee was set up in September 1975, with R.K. Hazari as its chairman. The terms of reference of the Committee were: to review the position of the two wings of the cooperative credit structure and to examine whether integration of the two wings will be advisable from the point of view of serving the object of lending adequate support to the massive investment programme in agriculture; to examine whether integration may be brought about simultaneously at all levels of the two wings or in a phased manner; and to examine the pattern of organization and staffing required at various levels to handle different types of credit and supplies after integration.

The Committee submitted its report in August 1976.[8] It found that the two wings of the cooperative credit structure were functioning in a mutually exclusive manner in different states, and observed that integration of the credit functions would enable cooperative credit societies not only to have a comprehensive view of the credit needs of farmers, but also to avoid the splitting of security between the two credit agencies and competition between them for realization of their dues. In the process, the primary agricultural credit society's business would go up substantially, improving its viability. Integration would help a common supervision arrangement to be set in place for better utilization of loans and effective recoveries.

[7] The final report (1979) reiterated the same point, and argued: 'There should be a single source of institutional credit that the farmer needs to approach for all his credit requirements. Financing of agricultural entrepreneurs should be done on the principle of viewing the credit needs of individual farmers in their entirety—covering both current as well as investment operations. The local banking unit, which may be either a branch of a cooperative or commercial bank, would deal with short-term, medium and long-term requirements of the local farmers. In addition, it would provide working capital to farmers having medium or long-term loans from land development banks.'

[8] B.S. Viswanathan, chairman, National Cooperative Land Development Banks' Federation, recorded a minute of dissent.

The Committee also considered it necessary to bring about integration of the credit functions of the two wings of the cooperative credit structure at both the intermediate and apex levels. At the intermediate level, if the primary land development banks (PLDBs) were allowed to continue after integration at the base level, they would in due course become unviable, as they would have to share their margin of profit with the primary agricultural credit societies (PACS) without any corresponding reduction in expenses, especially on account of staff. On the other hand, an integrated agency at the intermediate level would become viable and strong with its own staff, and with the benefits of better fund management. At the apex level, too, integration would help the apex agency to manage its resources in a flexible and efficient manner, and to plan and execute lending programmes in a coordinated fashion.

The Committee assumed that the three-tier structure will generally continue to prevail even after integration of the credit functions, although structural patterns could differ in certain states. It recommended the setting up of new institutions at the district and apex levels—the state cooperative development bank (SCDB) and the district cooperative development bank (DCDB). At the primary level there was to be no new institution, but the Committee favoured the PACS taking over the existing as well as the new business of the PLDB. If PACSs were to take over only new business, then the 'existing' business of PLDBs would have to be transferred to the DCDBs. For it to be effective, state governments would have to quickly identify areas where integration could be effected. The Committee favoured the setting up of a Cooperative Personnel Development Board for each state, to handle personnel management functions including recruitment, placement and appraisal.

The Committee suggested that the system of debenture issues be replaced by issue of bonds in the form of promissory notes, transferable by endorsement and delivery and exempted from payment of stamp duty. This would facilitate access to refinance from the ARDC in the form of loans. The Committee also recommended introduction of farmers' pass books for facilitating quick disposal of applications for term loans and preparation of credit limit statements for crop loans. Loans should also be provided against hypothecation of moveable assets where land cannot be offered, and against group securities, say, as in the case of small farmers and landless labourers.

In the view of the Committee, the integrated agency could charge the then existing rates of interest on long-term credit, which were generally lower than the short-term rates of interest, so long as there were no changes in the overall interest rate policy.

The report of the Committee was placed at the eleventh meeting of the Agricultural Credit Board, held on 18 July 1977. The Planning Commission, in a letter of 9 December 1976, urged the Reserve Bank 'not to take a decision in haste and watch the performance of the newly organized primary agricultural credit societies for some time.… At the present stage of multi-sided rural development, there are some advantages in not disturbing the existing arrangement of disbursing long-term agricultural credit.' The minute of dissent by B.S. Viswanathan was essentially an example of the opposition to integration by the National Cooperative Land Development Banks Federation. On the other hand, the All-India State Cooperative Banks' Federation noted that the question of implementation of the Hazari Committee report 'should be based on detailed study of the conditions existing in different states. A Committee consisting of Chairman and Vice-Chairman and a few Chief Executives of the state cooperative banks would undertake studies in a few states and report its findings to the Board.' Among state governments, the ones that favoured integration were Karnataka, Goa, Meghalaya, Punjab, and Jammu and Kashmir. Some states gave conditional acceptance: Andhra Pradesh, Rajasthan, Tripura, Himachal Pradesh and Orissa. The states that did not favour integration were Gujarat, Pondicherry, Uttar Pradesh and West Bengal. Out of the seventeen state land development banks which responded, fourteen were opposed to the proposal. They belonged to Andhra Pradesh, Assam, Bihar, Gujarat, Himachal Pradesh, Karnataka, Madhya Pradesh, Maharashtra, Pondicherry, Rajasthan, Tamil Nadu, Tripura, Uttar Pradesh and West Bengal. Two banks, belonging to Kerala and Punjab, accepted the integration proposal, subject however to certain conditions. The Jammu and Kashmir state land development bank stated that while it opposed integration, it wanted farmers' service societies to be established to cater to all the needs of farmers. Fourteen state cooperative banks agreed with the integration; of these, six banks placed certain conditions for acceptance.

At the eleventh meeting of the Agricultural Credit Board, the chairman observed that as the Reserve Bank was yet to get all the responses to the integration of the two wings of the cooperative credit structure, the Board would take up the Hazari Committee's other recommendations on procedural matters. Professor M.L. Dantwala agreed that since the views received till then on the main recommendation were sharply divided, it was advisable to consider the other recommendations of the Committee. I.J. Naidu, Secretary in the Ministry of Agriculture, proposed that, as the main recommendation was a major policy issue, it be taken up for consideration at the ensuing annual conference of registrars of cooperative societies and state

Ministers for Cooperation. Several other views were expressed at the meeting and no consensus emerged. Summing up the discussion, the chairman felt that consideration of the main recommendation should be deferred. The Reserve Bank then issued the necessary circulars.

In the meantime, the Punjab government forwarded its proposals on the main issue of integration of the two wings of the cooperative credit structure in the state. This, as we shall see, triggered a change in the Reserve Bank's stance on integration.

The Punjab proposal was placed before the thirteenth meeting of the Agricultural Credit Board, held on 29 August 1978. It wanted an integrated credit structure that covered all agricultural credit institutions and that had only two tiers, namely, the SCDB and PACS. The apex bank would deal directly with the 'reorganized' primary credit societies in extending short, medium and long-term loans through its branches.

Section 4 of the Punjab State Cooperative Societies Act envisaged the organization of only the PACS. The secondary level institutions were intended only to facilitate the functioning of these societies. The DCCBs had failed to support the PACSs and also failed to mobilize sufficient deposits. As extension blocks in Punjab were very large, the Punjab government had decided to form small clusters of villages, numbering 500, as focal points for effectively implementing the integrated rural programme at the base level. Each cluster was to be served by a branch of the proposed SCDB such that no village was beyond 3 miles from a branch of the bank. There were to be 700 such branches.

The PACSs at the base level were to be reorganized and reduced from 10,000 to about 2,500. To a question as to whether the proposal had taken into account the performance of the long-term credit wing of the structure, it was explained that while the primary land development banks had in general fared better than the PACS, they accounted for just Rs 20 crore, as against the need to build up capacity for disbursing Rs 300 crore per annum. Overdues were of the order of 15 per cent. It was therefore necessary to dispense with primary land development banks, just as DCCBs were unnecessary.

M. Ramakrishnayya, Deputy Governor of RBI, felt that the high level of overdues alone should not be the consideration for making fundamental alterations in the structural set-up. He enquired as to how the proposed two-tier structure would be immune to pressures that had caused overdues in the first place. E. Chandrasekharan Nair felt that if central cooperative banks were to be amalgamated with the apex bank, then their overdues would be reflected at the apex level, and the best way of tackling the problem of overdues was to revitalize and reorganize PACSs, a task that had not yet been taken up in Punjab. Nair's view was widely supported. Viswanathan, who did not attend the meeting, wrote to the Governor that if the Punjab proposal was accepted, it would more or less mean a state-sponsored cooperative bank centralizing all the powers, like any commercial bank, with no trace of the cooperative character. Professor M.L. Dantwala felt that the proposed institution could well turn out to be bureaucratic in character. As always, the arguments went on without a decision emerging.

At the fourteenth meeting of the Agricultural Credit Board, held on 26 March 1979, the proposal from Madhya Pradesh in regard to the integration was considered. The Madhya Pradesh government proposed that the apex level—the state cooperative bank and state land development bank—be retained but both were to function independently through DCDBs and PACSs in retailing credit. DCDBs would be created by the merger of the existing primary land development banks and DCCBs.

Viswanathan's response was sharp. The state government, he said, had not provided enough evidence to show that farmers would be benefited by the integration scheme. The overdues, both at the level of PACS, and primary land development banks, were substantial and would be reflected in the integrated structure. He also pointed out that the Cooperative Congress, at its seventh and eighth sessions held respectively in February 1976 and March 1979, had unanimously come out against integration. The central government preferred to defer the issue partly because of lack of enough information about what would occur to the economy due to implementation of the proposal, and partly because such proposals should command consensus support within the state. Most of the others also came out with their objections to the Madhya Pradesh proposal. Once again nothing was decided and the state was advised caution in going ahead with the proposal. I.G. Patel said that while the Reserve Bank could not legally block the state government from implementing its proposal, the Bank could exercise its power of giving final approval to the proposal only upon fulfilment of certain conditions.[9]

The fifteenth meeting of the Board, held on 14 December 1979, consi-

[9] The conditions were: (i) the state government should place special funds at the disposal of PACSs to enable them to absorb overdues for which no assistance from RBI would be available; (ii) all reorganized PACSs should be manned by trained secretaries; (iii) state government should provide subsidy to the extent of the deficit if any, in the Cadre Fund maintained for payment of salaries to the secretaries of PACSs; (iv) time limit should be

dered the proposal from Rajasthan for integration of the short-term and long-term credit structures in the state. The proposal envisaged amalgamation of twenty-five district cooperative banks and thirty-five primary land development banks with the state cooperative bank to the extent of residuary assets and liabilities after allocation of individual assets and liabilities to the PACSs. The assets and liabilities of primary land development banks relating to individual borrowers would be transferred to the concerned PACSs of the areas, and the residuary assets and liabilities would be transferred to the Rajasthan state cooperative bank. In the case of central cooperative banks and the state land development bank, all the assets and liabilities would be transferred to the state cooperative bank. Individual allocations of the membership of primary land development banks between different PACSs in their areas of operation and allocations of their assets and liabilities were to be done at the time of implementation of the integration proposal.

Thus there would be only one apex bank, viz. the Rajasthan State Cooperative Bank, operating through its branches at the intermediate level, and PACSs at the base level. Elimination of the middle tier—central cooperative banks and primary land development banks—was proposed because the middle tier was found to be weak. Besides, the proposal was said to provide a 'unified command' in implementing developmental policies.

The proposal was sufficiently elaborate and submitted with a considerable amount of data. Once again, several views were expressed, mostly in opposition. Government of India, it was stated, 'was firmly of the view that any sweeping alterations in the structure would not be conducive to expansion of credit'. Patel reiterated the conditions that needed to be fulfilled if the state government were to go ahead with its proposal—on the lines indicated earlier in the case of the Madhya Pradesh proposal. A letter was sent accordingly by the Reserve Bank to the government of Rajasthan.

The narration of events relating to the idea of integration of long-term and working capital finance shows that after initial active interest in it, both the Reserve Bank and the central government developed second thoughts for reasons not attributable entirely to economic circumstances.

Besides, the Hazari Committee report came out at a time when Hazari

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fixed for holding elections to the Board of Directors of institutions at the primary/district/state levels; (v) state government should provide assistance to district institutions whose level of overdues exceeded 55 per cent of demand, since no assistance for this purpose would be available from the Reserve Bank; and (vi) state government should provide funds to make good the deficit in the bad and doubtful debts reserve.

had lost his strategic position within the Reserve Bank. The conditions and stipulations placed by the Bank if a state government were to go ahead with its integration scheme were essentially to safeguard the apex tier of the cooperative credit structure with which the Bank dealt for refinancing or loaning purposes. Such a framework of conditionality was mooted for the first time by I.G. Patel when the Madhya Pradesh proposal was considered, and reiterated by him with respect to the Rajasthan proposal.

Patel was aware that the Board could not legally stop a state government from changing its cooperative credit structure because cooperation was a state subject. But he could always influence it by placing conditions associated with the financial capacities of the credit institutions in the cooperative fold. A weak apex bank, the Reserve Bank recognized, would mean a lower repayment capacity, and it did not want to be placed in a situation of not being able to recover its loans to apex cooperative banks on the due dates.

The subject did not figure in the subsequent meetings of the Agricultural Credit Board and received a silent burial. The Committee, in turn, felt that the distinction between working capital finance and term lending was blurred over time.

INSTITUTIONS

As was pointed in Volume 2 of the history of the Reserve Bank of India, it had become clear by the end of the 1950s that the problem of rural credit was not going to be solved by the commercial banking system. Nor were the cooperative credit agencies in a position to meet the growing demand for agricultural credit. Opinion therefore veered around to setting up specialized institutions and, eventually, in 1962 Parliament passed the Agricultural Refinance Corporation Bill. The result was the Agricultural Refinance Corporation (ARC), which was set up in July 1963 and in which the Reserve Bank held 60 per cent of the shares. The ARC was to refinance eligible institutions, viz. central land mortgage banks, state cooperative banks and scheduled commercial banks, which were shareholders for building up long-term production capacity in agriculture. In the initial years, it was not to provide working capital finance.

Then, in July 1969, the All-India Rural Credit Review Committee, which had been set up in 1966, submitted its report. The Review Committee had been appointed by the Governor of the Reserve Bank of India, in the context of the Fourth Five Year Plan and intensive agricultural programmes, for reviewing the supply of rural credit. It was headed by B. Venkatappaiah, Member, Planning Commission. In its final report, the Review Committee made the following major recommendations: reorganization of rural credit in the Reserve Bank, involving the setting up of an Agricultural Credit Board; formation of a Small Farmers Development Agency in each of a number of selected districts throughout the country; creation of a Rural Electrification Corporation which, among other things, would be of benefit to undeveloped areas with an agricultural potential; formulation of a more active and bigger role for the Agricultural Refinance Corporation, along with enlargement of its resources; and adoption of various measures for ensuring timely and adequate flow of credit for agriculture through cooperative and commercial banks.

The Review Committee recognized that the demand for rural credit was much larger than in 1951–52, when the Rural Credit Survey was conducted, and that it was bound to expand rapidly as a result of recent developments in agriculture. The growing need was not only for short-term credit to purchase inputs such as fertilizers and pesticides, but also for medium-term and long-term credit for such purposes as land-levelling, minor irrigation and rural electrification. The Review Committee also drew attention to the special credit needs of areas that are not well-endowed by nature, and of classes of farmers not well equipped to take advantage of the new techniques. Special measures, therefore, were to be devised for them.

The supply of credit was found to be lagging in relation to credit demand; nonetheless there was substantial progress. For example, short-term and medium-term loans advanced by cooperatives went up from Rs 24 crore in 1951–52 to Rs 405 crore in 1967–68. While this was the all-India position, there were, however, several states in the country, such as Assam, Bihar, Orissa, West Bengal, Rajasthan, and Jammu and Kashmir, where cooperative credit had made slow or insignificant progress. Besides, there were weaknesses in a number of individual banks and societies, such as relatively low deposits, high overdues and a general lack of professional management. The Review Committee, therefore, emphasized that reorganization of cooperative credit should be pursued with the integrated scheme of rural credit being implemented with vigour. It pointed out that cooperatives would function better, and the farmer would be better served, if other institutions coexisted with the cooperative organization in healthy competition.

The Review Committee re-emphasized the need for viability at the primary stage of the cooperative credit structure. Reorganization of primary societies was, therefore, necessary. Rehabilitation of weak central cooperative banks was another major line of action. Active administrative and policy measures for checking overdues were recommended, including improved arrangements for supervision as also flexibility in the conversion of short-term dues into medium-term loans in the event of severe crop failure. Special measures were proposed for areas where the growth of co-operative credit was sharply constrained. A key role was accorded in this respect to the concerned state cooperative banks.

Two sets of measures were suggested so far as the lending policies and procedures of cooperatives were concerned. One of these included selective relaxation of the condition that a part of the loan should be disbursed in kind, simplification of application forms, reduction of the stages of scrutiny of loan applications, and provision of cash credit facilities on a selective basis to cultivators engaged in multiple cropping. The other set of measures was intended to improve the access of the small farmer to cooperative credit. The Review Committee recommended that while the small cultivator may be granted a loan equal to the full entitlement on the basis of crop-wise scales of finance, the medium cultivator may access credit only to the extent of a specified proportion of the scale, and the large cultivator, an even smaller proportion. This would have to be done gradually and with reference to local conditions. As another measure in the same direction, the Review Committee recommended that the rate of interest charged on large loans by cooperatives may be higher than on smaller loans. It also suggested that large cultivators may be required to make a proportionately larger contribution to the share capital of cooperatives; further, small cultivators may be allowed to make their contribution in instalments.

A series of special pilot programmes were recommended by the Review Committee for a number of areas, of which there would be at least one in each state—namely, the establishment of Small Farmers' Development Agencies (SFDAs). The SFDA was designed to assist cultivators with small holdings who were unable to benefit from the new agricultural strategy because of inadequate inputs and credit, but who could transit from the stage of subsistence agriculture to commercial farming if assured of these supplies and services. The main function of the proposed SFDA was to identify the problems of small but potentially viable farmers in its area, and to help ensure that inputs, services and credit were available to them where possible through existing institutions and where necessary otherwise. For stimulating the flow of cooperative credit to small cultivators, the SFDA would provide grants to cooperative credit institutions, partly to help them build up special funds for covering the risks apprehended in such financing and partly to strengthen their managerial and supervisory staff. The

Review Committee envisaged that the outlay of the SFDA would be based on a substantial contribution from the centre.

Term credit for financing investment in agriculture also received considerable focus in the Review Committee's recommendations. It suggested in respect of all such loans, that: (i) the technical feasibility and economic viability of the schemes should be regarded as a primary consideration; (ii) the period of the loan should be based on repaying capacity; (iii) such lending should be carefully followed up and supervised; (iv) as far as possible, a 'project' approach should be adopted; and (v) such lending should be closely coordinated with the local government authorities connected with the supply of water, electricity and fertilizer. While noting the remarkable progress made by cooperative land development banks in recent years and their large programmes for the Fourth Plan period, the Review Committee suggested measures for reorienting their loan policies and procedures so that they conformed to principles of sound investment credit and helped ensure expedition and flexibility in operation.

In connection with the term credit requirements for investment in agriculture, the Review Committee assigned an increasing role to the Agricultural Refinance Corporation. The Committee expected the ARC, in conjunction with the Agricultural Credit Department of the Reserve Bank, to play an active part as coordinator, adviser and financier of the long-term structure of agricultural credit. It recommended that adequate resources be put at the disposal of the ARC, including Rs 50 crore from the national agricultural credit (long-term operations) fund of the Reserve Bank of India, during the course of the Fourth Five-Year Plan. (This was in addition to the Plan resources of Rs 140 crore already included in the Fourth Plan in the light of the Committee's interim recommendations.) The Review Committee also recommended that the ARC should strengthen its offices in the states in step with the increase in its business, and that measures be taken for expanding the categories of institutions eligible for facilities available from the ARC.

Closely related to these measures for larger credit for investment in agriculture was the Review Committee's recommendation for the creation of a Rural Electrification Corporation (REC). The Committee emphasized that if an estimated 12.5 lakh additional pump sets were to be energized by 1973–74, it was necessary for the state electricity boards to find the necessary resources to extend power lines to rural areas. To meet this requirement and, at the same time, to place the supply of rural electricity on an increasingly viable basis, the Committee proposed the creation of an REC with a fund that would add to the normal provisions available from governments and existing institutions. The nucleus would be contributed by the central government and substantially supplemented from US-Use Funds. The REC would be an autonomous body under the Union Ministry of Irrigation and Power, and would use the fund for: (i) financing rural electrification schemes in priority areas in the states; (ii) subscribing to special rural electrification bonds to be issued by the electricity boards; and (iii) providing block capital loans to rural electric cooperatives to be organized in different states. The Review Committee recommended the adoption of a 'project' approach, which implied that schemes financed by the REC would be examined and selected for their economic viability, and that there would be coordination between this programme and that of project-wise establishment of tubewells and other works of minor irrigation. The Committee also recommended that each state electricity board issue a series of rural electrification debentures or bonds, on the analogy of the rural debentures of land development banks, for financing specific rural electrification schemes.

Another aspect of rural credit that received considerable attention in the report of the Review Committee was the role of commercial banks. It must be noted that the Committee's recommendations in this respect were finalized before the announcement of bank nationalization in July 1969, but as they postulated an active and positive role for commercial banks in the sphere of agricultural credit and dealt with important aspects of procedural reform, they remained relevant even after the nationalization. In fact, in a postscript, it expressed the hope that the policies and procedures urged by it would be all the more readily adopted and speedily implemented in the wake of nationalization. The Committee recommended direct financing of cultivators by commercial banks but did not rule out indirect financing through suppliers of inputs or those engaged in marketing or processing the produce. Apart from agricultural production and investment, related activities that commercial banks were expected to finance were distribution of fertilizer and other inputs; marketing of agricultural produce, including government procurement operations; and the entire expanding infrastructure of processing, storage and transportation. The Committee, at the same time, recommended that state governments should help remove the disabilities that handicap commercial banks and other agencies, including cooperatives—in meeting the credit needs of cultivators, e.g., in the matter of availability of up-to-date land records and the identification of cultivators' rights in land. It recommended, in this context, the constitution of a state-level coordination committee with representation from the relevant departments of the government, cooperative banks and commercial banks.

Even after all these factors were taken into account, the need would remain, according to the Committee, in some areas for supplementary institutions of credit. Legislation already existed for the establishment of agricultural credit corporations. The states concerned should quickly take decisions regarding these corporations. Since the agricultural credit corporations were intended only to meet a transitional need, the Committee emphasized that the cooperative credit structure in each state should be geared to meet the tasks that awaited it.

In the context of a probable increase in the diversity and magnitude of agricultural credit, the Committee reviewed the question of the role of the Reserve Bank in rural credit. It concluded that the various promotional, refinancing and coordinating functions in this field, which the Reserve Bank was discharging, were appropriately located in the central Bank of the country, and that a separate all-India institution would not only be unnecessary but prove inadequate for the discharge of these functions. It would only add to the number of channels through which credit passed and therefore only serve to increase the cost of credit. At the same time, in view of the expanding dimensions and complexity of the role of the Reserve Bank in relation to agricultural credit, the Committee considered it necessary to create an Agricultural Credit Board (ACB) within the Bank. In the Committee's opinion, there was need for a major structural change in the present arrangement so as to ensure that the formulation, review and modification of the Bank's policies in the sphere of rural credit were effectively placed in the hands of a high-powered group of knowledgeable persons. The Deputy Governor in charge of rural credit was favoured to be the chairman of the ACB, which would deal with such activities of the Bank pertaining to agricultural credit and other cooperative credit as the Central Board of the Reserve Bank may, from time to time, delegate to it. The ACB would consist of: (i) six members who may be drawn from different parts of the country and represent the interests of cooperative as well as commercial banks, as also persons with special knowledge and experience in regard to rural economics or agricultural credit; (ii) three members from among the directors of the Central Board; and (iii) two members who would be officials of Government of India from the relevant ministries. The ACB would set up one or more standing committees to advise it on implementation of policy, and to provide a forum for representatives of state governments and cooperative institutions to put across their points of view.

Another aspect of the role of the Reserve Bank examined by the Review Committee related to the refinancing facilities offered by the Bank. On a review of the degree of dependence of cooperative banks on accommodation from the Reserve Bank, the Committee came to the conclusion that, on the one hand, positive efforts should be made to step up deposit mobilization by banks, and, on the other, measures should be taken that will restore to cooperative banks the incentive to raise more deposits. The Committee suggested that commercial and cooperative banks should make active efforts to mobilize deposits by offering efficient and varied banking services to potential depositors, opening branches, etc. In particular, drew attention to the large deposit potential of rural areas and suggested that an offer of higher interest rates on deposits in rural centres may be actively considered wherever appropriate. Correspondingly, in the Committee's view, there should be a willingness to raise lending rates where necessary.

So far as the Reserve Bank was concerned, the measures proposed sought to correct the present inclination of cooperative banks to borrow more from the Reserve Bank since such accommodation, at a concessional rate of 2 per cent less than the Bank rate, was less costly than funds raised in the form of deposits. The Committee suggested that the Reserve Bank should set a target for each central cooperative bank in respect of the amount by which it should increase its deposits during a year on the basis of all the relevant data available, and with special consideration for banks that were at a relatively early stage of growth. If this target was reached or exceeded, the concerned bank should be charged on its borrowings from the Reserve Bank during the year, a rate of interest that is 0.5 per cent below the concessional rate charged for such finance. On the other hand, if the bank failed to achieve the target and the shortfall was less than 50 per cent, it would be charged an additional rate of 0.5 per cent above the concessional rate. If the shortfall was more than 50 per cent, the additional rate would be 1 per cent from the then 2 to 1.5 per cent so that, given the Bank rate of 5 per cent, the effective rate would be 3.5 per cent instead of 3 per cent. The Committee felt that, ordinarily, apex and central banks should be able to absorb in their margins the small increase in rate paid to the Reserve Bank, if at all it resulted from a shortfall in reaching the deposit targets. Another important recommendation of the Committee was that, with a view to enabling the Reserve Bank to provide resources to the ARC, the annual contribution from the Bank's net profits to the national agricultural credit (long-term operations) fund should be stepped up from year to year so as to reach Rs 20 crore in 1972–73. It also suggested that, in order to promote the observance of seasonality in cooperative agricultural credit, the Reserve

Bank may sanction separate credit limits for seasonal agricultural operations and marketing of crops, and, further, specify for each central bank certain months in the year during which no drawals on its credit limits would be permitted.

Among other recommendations of the Review Committee were those concerned with credit facilities for animal husbandry and allied activities. The Reserve Bank of India Act should be amended suitably so as to make it possible for the Bank's accommodation to be provided for financing animal husbandry activities even when undertaken independently of agriculture. The scope should also be extended to the financing of fisheries.

On the important question of recruitment and employment, the Review Committee drew attention to the need for cooperatives to attract competent personnel in adequate numbers. It was also necessary to evolve correct conventions in regard to demarcation of responsibilities between elected boards of management and paid executives and other managerial personnel. The institution of cadres for key personnel of cooperative credit institutions was recommended as a measure that would help tone up their administration and give a new dimension to cooperative employment. The Committee also recommended that steps should be taken to improve the existing training arrangements by placing greater emphasis on the institutional and practical aspects of cooperative credit, and that the Reserve Bank should play an active role in this sphere in close coordination with other agencies.

The Reserve Bank of India Act was accordingly amended in August 1971. The ARC Act was also amended to enable the Corporation to borrow from the national agricultural credit (long-term operations) fund maintained by the Bank. This amendment was critical as it enabled the ARC to access resources supplemental to those available from the central government and the open market. The ARC was enabled to meet the enhanced demands for funds emanating from eligible institutions, and to provide financial assistance for all activities connected with the development of marine and inland fisheries.

The Committee also suggested the incorporation of an enabling provision in the ARC Act to access foreign currency loans, and borrowings from the World Bank and other multilateral agencies, for financing the purchase of tractors and equipment for rigging, fishing, dairying, etc. This acted as the trigger for the ARC to access funds from the World Bank and the IDA. The first such loan was availed in 1969–70.

The ARC Act underwent further amendments in subsequent years. Commercial banks had opened a sub-mortgage or sub-hypothecation of the security obtained from their constituents in favour of the ARC. As this was neither necessary nor costless, the ARC Act was amended in 1973 empowering the Corporation to waive security or government guarantees. Following this, the security requirements for commercial banks for refinance were removed.

In 1975, the ARC Act was amended again to eliminate the provision prohibiting the Corporation from extending working capital. This was done to ensure that the long-term capital that was being made available from the World Bank for agriculture was effectively utilized. Without such an amendment, the Corporation would have been compelled to arrange for short-term working capital from other institutional sources to support its long-term financing. This would have been administratively cumbersome. With this change, and with the extension in the scope and coverage of its long-term capital financing to include financing of minor irrigation channels including bore wells, bamboo wells, fisheries, poultry farming, etc., the ARC became a truly development-oriented organization. The Corporation was converted into the Agricultural Refinance and Development Corporation (ARDC) in 1975.

The ARDC's role was not to supplant cooperatives, land mortgage banks, and commercial banks including RRBs but to supplement these agencies, and to work in concert with the AFC to provide consultancy services regarding the viability of agricultural and other rural projects. The ARDC was managed by a board comprising nine directors, with a Deputy Governor from the Reserve Bank as its chairman. Underlining the organic link between the RBI and the ARDC, the Bank nominated one director, apart from appointing a managing director. Three directors were nominated by the central government and the remaining three directors were selected by the state land development banks, the state cooperative banks and other categories of shareholders. The authorized share capital of the ARDC, which was fully guaranteed by the central government, was Rs 100 crore. The Reserve Bank was statutorily required to hold not less than 50 per cent of the share capital. The Bank sanctioned a credit limit to the Corporation to facilitate drawals from the national agricultural credit (long-term operations) fund. The amount withdrawn from this fund carried a rate of interest of 6 per cent and was repayable over ten years in equal annual instalments. On a few occasions, the Corporation also availed of short-term credit to meet temporary shortage of funds.

In April 1968, the collective efforts of commercial banks in extending rural credit culminated in the setting up of the Agricultural Finance Corporation (AFC). The AFC was an institutional device to create an enabling environment for banks to participate actively in the financing of agriculture and rural development. Registered under the Companies Act, 1956, the Corporation had an authorized capital of Rs 100 crore, and subscribed capital and paid-up capital of Rs 10 crore. With the nationalization of fourteen major commercial banks in July 1969, the AFC took a conscious decision not to undertake direct lending. Its role, in the words of its chairman, was to be 'somewhat like a Research and Development wing servicing the commercial banks, rather than an independent financial institution. It seeks to do collectively for the member banks what each of them would have been required to do individually.' In the years that followed, because of its nebulous role, there was always uncertainty about its future.[10] The AFC, as it eventually turned out, could not be anything more than a consultancy organization.

Consultancy services by the AFC for projects did not, however, get automatic acceptance from the financing banks or from the ARDC. They wanted to have these projects independently evaluated to satisfy their own sanctioning authorities. This aspect appears to have weighed with CRAFICARD when it observed: 'There appears to be a good deal of avoidable duplication resulting from the lack of fuller coordination between the AFC on the one hand and the banks/ARDC on the other.'

CRAFICARD had reviewed projects appraised by the AFC involving an estimated loan requirement of Rs 745 crore. An inquiry made by the Committee of banks for ascertaining the progress of implementation of the projects appraised by AFC showed that out of twenty-six projects prepared for three banks which responded, only nine could be operationalized; the others had failed to get off the ground due to a variety of reasons. Looking at the future role of the AFC, CRAFICARD observed that despite the consultancy assignments undertaken by it all these years, the bulk of the Corporation's earnings was contributed by interest on deposits and only about 20 per cent of its earnings emanated from consultancy work. The message underlying the Committee's observation was that even in its

[10] The National Commission on Agriculture (NCA), in its interim report submitted in 1971, said that it might be ultimately necessary to set up an agricultural development bank by consolidating the expertise and experiences of various agencies such as the ACD of the RBI, the ARC and the AFC into a single national organization directing the flow of credit according to needs, for full utilization of land and manpower. In 1972 the Banking Commission held that there was a strong case for combining the Agricultural Refinance Corporation and the Agricultural Finance Corporation. The Commission felt that the new institution formed by merging the two Corporations could serve the purpose of an Agricultural Development Bank of India.

chosen role of consultancy, the AFC was not able to make any perceptible dent on the farm front.

CRAFICARD's views on the future role of the AFC was based on the feedback received from twenty-five banks in response to a set of questions addressed to them. One aspect that surfaced prominently from these replies was that the schemes prepared by AFC should be accepted for automatic refinance by the ARDC. However, the majority of the owners of AFC took the view that Corporation could retain its separate identity and specialize in certain fields. CRAFICARD came to the conclusion that an independent, all-India body like the AFC could coexist with regional or specialized consultancy agencies.

Towards the National Bank for Agriculture and Rural Development

It was noted earlier that the National Commission on Agriculture (NCA) had recommended the setting up an apex bank for agriculture, but the Deputy Governor of the Reserve Bank was not enthusiastic. The Bank, however, never expressed its view on the matter openly. Nor did it react to the NCA's recommendation in its interim report of 1971.

The Banking Commission, too, did not recommend the creation of a development bank for agriculture on the lines of the Industrial Development Bank of India (IDBI). It merely suggested the merger of ARC and AFC to serve the interests of development financing of agriculture. It is relevant to ask why the Banking Commission did not pursue the idea thrown up by the NCA. Since the Commission was serviced by the Reserve Bank, could it be that the Bank's opposition got reflected in the Commission's report?

A secret internal note written by B. Venkata Rao (deputy chief officer of agricultural credit development, working in the secretariat of the Banking Commission) had suggested a comprehensive scheme for consolidating, restructuring and developing a cooperative banking structure, and for promoting coordination between the cooperative and commercial banking sectors, including the setting up of RRBs. The note had also suggested the setting up of a national bank for cooperative banks, to which the state cooperative banks, the state land mortgage banks, etc., would be affiliated, and which would raise funds in the money market. The note envisaged a credit guarantee system to be operated by the local associations that would be provided counter-guarantees by the Credit Guarantee Corporation of India Ltd.

The proposal was logically consistent with the Banking Commission's recommendation for setting up rural banks. It also gave the Reserve Bank a greater role. The Bank would transfer its responsibilities of sanctioning credit limits to individual banks and of laying down detailed loan policies for co-operatives to the suggested national bank, and would concentrate on policies relating to credit allocation among different sectors in rural areas, development of cooperative banking and rural banking, formulation of principles of coordination between cooperative commercial banks, and helping the national bank to raise resources from the market through issuance of bonds/debentures.

The Banking Commission did not entirely share Venkata Rao's views, in that it did not recommend Rao's comprehensive scheme. But it accepted most of its components. This was perhaps because the scheme was not in the mould of a 'classical' development bank that would cater to the needs of an economic activity-oriented sector, and, perhaps, also because a national bank for cooperative banking was not regarded as viable. In oral discussions with Rao, it appears that the Banking Commission felt that its recommendation could serve as a first tentative step towards the eventual establishment of an agricultural development bank in India. The Bank kept its own counsel.

The submission of its final report by the NCA in 1976 triggered the government's interest. It recommended the creation of an all-India institutional framework that could take an integrated view of agricultural and rural credit needs. A Cabinet Committee was set up in September to look into this, with the Minister for Agriculture as chairman. The Department of Banking, in a note to the Cabinet Committee, submitted that in light of the views expressed by the Banking Commission, it was perhaps not necessary to set up a separate agricultural development bank at this stage, and that the purpose could be served by as well broadbasing the board of directors of the ARDC.

In a separate note, the Secretary of the Department of Banking observed that while the merger of ARDC and AFC could serve the need of the time and could be a part of the agricultural development bank, the Agricultural Credit Department of the Reserve Bank need not be merged with it because the time was not yet ripe for divesting the Bank of its short-term credit function in regard to agriculture.

But the Department of Agriculture emphasized the need to have an agricultural development bank comprising the ARDC, AFC and ACD of the RBI, in order to provide the larger volume of resources needed for investment in the rural sector. The Department of Rural Development agreed with this view. The differences in opinion arose mainly from the fact that agriculture required substantial investment, as well as policy and institutional support. The Reserve Bank was involved in agricultural credit mainly in the form of refinancing and in terms of strengthening the cooperative credit structure. The Agriculture Ministry's concerns were more broad-based.

The Cabinet Committee considered the various notes submitted to it on 21 January 1977 and came out in favour of setting up an agricultural development bank with ARDC and AFC merged in it initially. At a later stage, it felt, the short-term needs that were not met by the ARDC could be brought under its purview. Besides, it said, 'agriculture' should include dairy farming, poultry, fisheries, etc. It also decided that a Working Group of secretaries of the concerned departments should go into the scope and functions of the proposed agricultural development bank within the framework of the parameters indicated by it, and submit to it a paper along with a draft legislation. Soon, general elections were called and the Congress included the proposed apex agricultural development bank in its election manifesto.

The Working Group met once, on 3 March, and favoured the creation of agricultural development bank. In so far as short-term credit facilities were concerned, the Group took the view that in the existing framework, the Reserve Bank should continue to provide short-term credit through the cooperative credit structure. Once the agricultural development bank gained experience, the question of gradually transferring short-term credit from the RBI to it could be considered. The Group was to meet again later that month but the second meeting did not take place as the government was defeated and a new government came into office. The agricultural development bank proposal receded to the background.

The Department of Agriculture, however, would not give up. It resurrected the proposal in September. A note was prepared by the Department's credit expert (who, incidentally, was none other than B. Venkata Rao). The Minister took up the matter with the Finance Minister who, however, preferred to defer it. According to oral accounts, his view was based on the premise that establishment of the agricultural development bank was not a part of the election promise of the new government. It was only after he was replaced by Charan Singh, known for his strong pro-farmer views, in early 1979, that the proposal was revived.

What happened next is captured by the Deputy Governor of RBI in charge of rural credit, M. Ramakrishnayya, in his book, *Two Administrators: Interaction between ICS and IAS*. He wrote that he was instructed in January 1979 to visit Delhi and meet the officials of the Agriculture and

Finance Ministries, because Charan Singh wanted 'to do something spectacular for satisfying the farm lobby'.

> Bhanu Pratap Singh, the influential Minister of State in the Ministry of Agriculture and G.V.K. Rao, the Secretary, were vigorously pushing the proposal to set up an Agricultural Development Bank, separate from the RBI. Although the proposal was said to be based on the recommendation of the National Commission on Agriculture in one of its Interim Reports and a brief but favourable decision taken thereon in principle by the Indira Gandhi government during the Emergency, the details had not been worked out by its advocates. The Bank had grave doubts, and was not willing to shed its role in agricultural credit in a hurry in favour of a new and half-baked institution. Dr Patel was ready to get the experts to study the proposal, but this did not satisfy Charan Singh who wanted something done at once. (p. 107)
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> Soon I produced a scheme for lowering the rates of interest on loans to farmers. The essential precondition of the scheme was that the cost of funds to ARDC should be brought down partly by exempting it from income tax and partly by reducing the rate of interest charged by government on the loans against the World Bank's line of credit. This scheme was promptly approved, as it had a superior message than the establishment of a separate Agriculture Development Bank. Charan Singh also agreed to get the latter idea examined by an expert committee, to be appointed by the RBI, provided it included G.V.K Rao, the nominee of Bhanu Pratap Singh. Sivaraman was chosen as the chairman by unanimous consent. Other members were L.C. Jain, Manu Shroff and myself. Patel and I deliberately widened the scope of the committee to include non-farm activities and rural development in its widest sense. (p. 107)

This Committee was, as already mentioned, CRAFICARD. Ramakrishnayya's observation as to why the Reserve Bank was sceptical was perhaps a refined version of the fears within the Bank that its hold on agricultural credit would slip if such an apex bank were established. The widening of the scope of the Committee to include non-farm activities and overall rural development was an admission of the thrust of the argument of the Departments of Agriculture and Rural Development Sivaraman, as chairman of the Committee, favoured the approach. So did G.V.K. Rao.

The Committee, under the chairmanship of B. Sivaraman, Regarding the Arrangements For Institutional Credit for Agriculture and Rural Development (CRAFICARD), constituted on 30 March 1979 by the Reserve Bank of India, had H.B. Shivamaggi, then Adviser, Economic Department, as member-secretary. The Committee submitted its interim report to the Governor, on 28 November 1979, suggesting the establishment of the National Bank for Agriculture and Rural Development (NABARD) as a step forward in the organizational evolution of the Reserve Bank itself.

The Committee strongly endorsed the recommendation of the Dantwala Committee for transferring the entire control, regulation and promotional/developmental responsibility relating to regional rural banks from the central government to the Reserve Bank, with the suggestion that NABARD should replace the Reserve Bank in the restructured set-up. However, the inspections of these banks, was recommended, should be carried out by the Reserve Bank itself, with a view to ensuring that their operations were being carried out in conformity with the provisions of banking laws. The Committee sought to ensure the organic link between the Reserve Bank and NABARD by suggesting, among other things, that a Deputy Governor of the Bank should be the chairman of the board of directors of NABARD.

The Committee was in favour of continuation of the Agricultural Finance Corporation (AFC) as a separate entity, with a close link with the ARDC/NABARD to facilitate foreign consultancy assignments. In the Committee's view, ARDC/NABARD needed to extend finance to the AFC. In this connection, the Committee suggested that ARDC/NABARD, as a financing agency, should prescribe: (i) certain basic parameters for the programmes that had hitherto been developed; (ii) in new areas, fix in advance, in consultation with the AFC, criteria that will satisfy them.

The Committee was informed by the RBI Governor in January 1980, that Government of India had, in consultation with the Reserve Bank, accepted in principle the setting up of NABARD as an apex-level institution, as recommended by it in its interim report. With a view to assisting the Committee in the preparation of the draft Bill on NABARD, a Working Group was set up by the RBI with the member-secretary, CRAFICARD, as its convenor, and representatives of ARDC and concerned departments of the RBI as the other members. The draft Bill on NABARD was submitted to the Governor in April 1980.

Acceptance of the recommendations of CRAFICARD culminated in the separation of the Agricultural Credit Department (ACD), which used to handle refinance for the cooperative credit system, from the RBI, and its merger with the ARDC, which had earlier been set up by the RBI to handle investment finance for agriculture. The Bank undertook its own organizational restructuring, as reflected in the setting up of the Department of Urban Cooperative Banks and the Rural Planning and Credit Department to oversee and monitor the broad policies of the RBI and the working of NABARD.

NABARD would continue to have organic links with the Reserve Bank by virtue of the latter contributing half of its share capital (the other half was contributed by the central government) and three members of the Central Board of Directors of the Reserve Bank being appointed on its board besides a Deputy Governor of RBI as chairman. The links were provided to enable the Bank to give continued guidance and financial assistance to NABARD in the years to come.

The final report of CRAFICARD was discussed at the seventeenth meeting of the Agricultural Credit Board held on 7 May 1981 and presided over by the Governor, I.G. Patel. M. Ramakrishnayya, Deputy Governor, reported to the Board that the Union Ministry for Planning proposed to convene a conference of all concerned union ministries, state ministers and other concerned institutions like the Reserve Bank of India, ARDC and IDBI, in the first week of January 1982, for formulating an action plan based on the recommendations of CRAFICARD.

NABARD came into existence on 12 July 1982 as an apex bank to serve the financing and technical needs of agricultural and rural development activities.

7

Promoting Institutions

A significant development of the early 1960s was the establishment of the Industrial Development Bank of India (IDBI) and the Unit Trust of India (UTI) in 1964. The former was intended to provide long-term capital to industry; the latter was designed to provide a safe haven for small savers. The Reserve Bank's initiative in setting them up is discussed in Volume 2 of the history of the Reserve Bank of India. By the end of the 1960s both institutions had begun to function well. In the 1970s, a certain amount of tension developed between the Bank, these institutions and the government. Coordination was the major irritant and the eventual consequence of this tension was the 'delinking' of IDBI and UTI from the Bank in 1976. It is to that story that we now turn.

There were four areas of linkage in the relationship between the Reserve Bank and the two financial institutions. From the Bank's point of view, these were: management participation, staff and organizational support, financial support and policy support. The first two of these were not critical and were taken for granted since IDBI and UTI, after all, had been set up by the Bank. It was in respect of the latter two that the relationship became a little fraught owing to their flexible nature. This happened despite the fact that the Bank's participation at the highest management level in the two institutions differed. The RBI Governor was ex-officio chairman of the IDBI, and a Deputy Governor acted as vice chairman. The Bank and the IDBI had an identical board of directors. In the case of UTI, although the chairman, executive trustee and four other trustees were nominated by the Bank, the chairman was not from the Bank. Also, the executive trustee was of the rank of Executive Director of the Bank. This created some anomalies. The financial and policy support, also, was influenced by the culture that the Bank exported to the institutions via its clerical and officer-level staff.

THE RESERVE BANK AND IDBI

The relationship between the Reserve Bank and the IDBI was unique. As a promoter, the Bank was responsible for developing IDBI. Besides providing infrastructure support, the Bank subscribed to the capital of IDBI, and provided loans and advances by setting up the national industrial credit (long-term operations) fund, with allocations from the profits of the Bank. As a lender of last resort, it provided accommodation to the IDBI against eligible securities to meet shortfalls in its resources. Since their board of directors was identical, the IDBI derived the benefit of the Bank's perceptions about industrial finance. The authorized capital of IDBI was Rs 50 crore and the issued capital Rs 10 crore. Its authorized share capital remained unchanged at this level up to the time of its delinking from the Bank in February 1976. Its issued capital, however, increased from time to time and at the time of delinking was Rs 50 crore. Apart from share capital, the Bank also provided funds to IDBI from the national industrial credit (long-term operations) fund, for the purchase of and/or subscription to eligible financial institutions.

When the IDBI was established, the Reserve Bank created an additional post of a Deputy Governor to focus exclusively on its operations and on matters relating to industrial development. It did not, however, interfere in the day-to-day work of the IDBI. The Bank also played the role of a regulator. As interest rate determination was under its jurisdiction, the interest rate structure of IDBI was guided by the instructions and directives that were periodically issued by the Bank.

The operations of IDBI, in terms of its statutory provisions, had two aspects: assistance to other financial institutions, and direct assistance to industrial units either singly or in participation with other financial institutions. After the devaluation of the Indian rupee in June 1966, IDBI decided to give priority to import-substituting and exporting industries. But when, in 1967–68, the economy went through a recessionary phase, the IDBI altered its earlier set of priorities and cooperated with government policies for promoting industrial revival. It therefore relaxed its policy of selectivity.

It decided to give immediate attention to large projects because of their employment potential and high forward and backward linkages, and to finance medium and small–medium projects on a more liberal scale. No 'worthwhile' project was to languish for want of finance. The IDBI also liberalized its refinance policy and, in consultation with the Reserve Bank, lowered the interest rate. It started providing assistance to small-scale units at concessional interest rates.

During 1968–69, IDBI added a new dimension to its policies when it began to provide loans for the expansion and diversification schemes of public sector undertakings, as long as they qualified under certain general and specific criteria. It also widened the scheme of rediscounting machinery bills to include machinery sales to public sector industries, electricity undertakings and road transport corporations. It persuaded banks to cut their discounting rate by 1 percentage point and to pass on the benefit to purchasers of machinery.

In December 1968 there was another important development relating to export credit. Since 1964, IDBI had been administering refinance for medium-term export credit by commercial banks. The scheme was introduced by the Refinance Corporation for Industry Ltd in January 1963. Under this scheme, the risk was borne by the borrowing banks for a period of up to ten years. With a view to increasing its involvement in export credit, the IDBI formulated a new export credit scheme. Under the new scheme, the IDBI entered into a participation arrangement with eligible commercial banks for providing term finance and guarantee facilities to industrial concerns both in the public and private sectors, for export of capital and engineering goods and services. Export credit was provided at both the preshipment and post-shipment stages for periods exceeding six months, and performance and financial guarantees were provided on behalf of exporters. IDBI charged a concessional rate of 4.5 per cent on its portion of credit, while participating commercial banks charged their own rates on their portions, not exceeding 6 per cent—the ceiling rate prescribed by the Reserve Bank. Table 1 provides information about IDBI's direct financial assistance under various facilities during the period 1964–76.

The IDBI, apart from being a financial institution, assumed developmental and promotional functions as well, as envisaged in the IDBI Act. An important focus area was balanced regional development. The government had consulted the National Development Council on the subject, as well as the Planning Commission, which had appointed two Working Groups with the objective of locating industries in backward regions. In this, IDBI played an important role by providing consultancy and cheaper finance. It also formulated schemes for the development of entrepreneurial and managerial talents, particularly for small-scale industries, and agreed to refinance at a concessional rate to financial institutions for their lendings in specified backward regions. In line with the recommendation of the Industrial Licensing Policy Enquiry Committee, IDBI introduced a

Table 1 Direct Financial Assistance (July 1964 to June 1976)

	Number		Amount (Rs crore)	
	Total	Backward districts	Total	Backward districts
1. Assistance to new projects	252	103 (85)	319.4	131.8 (95.0)
2. Assistance for expansion/ diversification	91	26 (10)	115.6	32.6 (15.9)
3. Assistance for modernization/ rationalization	16	6 (2)	36.7	26.8 (14.4)
4. Supplementary* assistance to industrial concerns	84	20 (11)	67.4	21.5 (8.8)
5. Subscription to right issues of assisted concerns	–	–	1.5	06
Total	363	130 (93)	540.5	213.3 (134.1)

Note: Figures in bracket indicate assistance sanctioned at concessional rates.
*Assistance for (i) meeting over-runs in project costs arising from delays in implementation, rise in cost of machinery and building materials, shortfall in estimated cash resources, etc.; (ii) relieving strain on cash resources of companies which had earlier utilized working capital funds for acquisition of fixed assets; (iii) financial reorganization, etc.

Source: *Annual Reports* of IDBI, vrious issues.

provision for converting loans into equity, and actively participated in the management of industrial concerns that received substantial term loan assistance. IDBI thus started appointing its nominees on the boards of the assisted companies.

In 1972, the IDBI Act was amended to widen the definition of an industrial concern, so as to include concerns engaged in the maintenance, repair, testing or servicing of machinery, vehicles, vessels, motor boats, trailers or tractors and fishing. The amendment brought within the purview of IDBI's assistance, small concerns engaged in these activities. It also enabled the IDBI to extend refinance facilities to state finance corporations (SFCs) and banks that provided assistance for setting up of industrial estates. IDBI thus enlarged its role in the development of small-scale industrial units.[1]

[1] After the amendment, the IDBI was allowed to provide direct finance (i) to export houses or any person exporting products of industrial concerns even though the exporter might not be an industrial concern; (ii) to any person in India for the execution of turnkey

In November 1972, IDBI approached the International Development Agency (IDA) for a line of credit that would enable it to meet the requirements of rupee finance as well as foreign exchange required for purchasing capital equipment from abroad. The IDA sanctioned credit worth US$ 25 million on 9 February 1973. This was utilized for refinancing loans granted by SFCs to industrial concerns for setting up new industrial projects and also for the expansion, diversification, modernization and renovation of existing units in cases where a portion of the loan was for financing import of equipments from abroad/or technical know-how in special cases. The total project cost, however, was not to exceed Rs 1 crore.

One of the major functions assigned to IDBI was coordination with other financial institutions. Accordingly, it set up the Inter-Financial Institutions Committee, which met once a month. But until IDBI was delinked from the Reserve Bank in 1976, the Industrial Finance Department of the Bank more or less ran the show the through annual conferences of SFCs.

It is worth dwelling on this subject because of its importance and the persistent problems faced by the SFCs. In July 1969, Deputy Governor Bakshi had submitted a comprehensive memorandum to the Bank's Central Board on the subject.[2] As follow-up, the Bank issued some guidelines.

L.K. Jha, in his inaugural address at the fourteenth conference of representatives of SFCs on 17 March 1970, outlined the Reserve Bank's approach to industrial finance in general and SFCs in particular. He emphasized that it was necessary to clearly identify 'possibilities and constraints' in the development of backward areas and of small-scale industries, and that SFCs should 'pay heed to social problems which could to some extent be redressed by the right pattern of development'. He suggested the setting up of industrial estates in industrially backward regions with a view to attracting industries. The conference proved to be a lively one, with several divergent views being expressed. But nothing significant emerged from it.

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projects outside India; (iii) to extend credit directly to foreign buyers of Indian engineering goods; (iv) by way of offering lines of credit to foreign financial institutions to be utilized for import of capital goods from India; and (v) to extend refinance of term export credit granted for exporting eligible products manufactured by other concerns and to Indian residents executing turnkey projects outside India. The period of export credit was raised from ten to fifteen years, and the IDBI was allowed to subscribe to shares, bonds and debentures of financial institutions outside India. The amendment also enabled IDBI to assist in the setting up of development finance institutions in developing countries.

[2] 'State Financial Corporations: A Brief Assessment of Their Performance, Problems and Prospects'.

The issue of coordination between SFCs and commercial banks was again raised at a conference of chairmen and managing directors of SFCs convened by the Finance Ministry in November 1971. It recommended the setting up of a Working Group headed by R.K. Talwar, chairman, State Bank of India (SBI), to examine various issues. Based on its suggestions, the Reserve Bank issued a circular in December 1974 to banks and financial institutions, stressing the need for working out mutually acceptable arrangements to avoid unhealthy competition in granting term loans. Coordination in respect of financial assistance to industrial units facing financial difficulties had been examined in detail. Two state-level coordination committees were constituted at the instance of the Finance Ministry, one of which was concerned with sick small industrial units and the other with modernization of small-scale industries. By 1976, these committees were set up in most of the states/union territories.

The Reserve Bank was concerned about the deterioration in the working of the SFCs. It kept stressing the need for strengthening their financial viability and operational efficiency. This issue came to the fore again when IDBI started negotiating the line of credit from IDA. In his inaugural address to the sixteenth conference of SFCs, Governor Jagannathan referred to the World Bank's conditionality attached to lines of credit and observed that certain measures of financial discipline stipulated by the World Bank were 'anyhow ones that we should be attaining in the interest of our own institutions'.

But the RBI was fighting a losing battle. Its involvement in the coordination of operations and policies of financial institutions was mainly to ensure that its credit policy as applicable to commercial banks would enable an extension of working capital by banks that would be consistent with the term financing that financial institutions provided. But its warnings and exhortations only succeeded in causing irritation in the circles of power, and after the delinking of the IDBI from the Bank in 16 February 1976, the functions were transferred to IDBI. IDBI then assumed the full-fledged responsibility for policy coordination work relating to SFCs and other financial institutions.

The IDBI's interest rate structure was different for different types of loans. Direct finance, refinance and export credit were linked to the Bank rate and other guidelines and directives issued from time to time. The IDBI's interest rate structure typically reflected its developmental and promotional function since it stipulated concessional rates for small-scale industrial units that were covered by the guarantee of the Credit Guarantee Corporation, and for loans provided in specified backward regions and backward districts of developed states. The interest rates on export credit were fixed with a stipulation that the primary lenders did not charge more than the ceiling rate prescribed by the Bank from time to time. Thus, the IDBI's interest rate structure was a part of the framework of the monetary policy of the Reserve Bank and special concessional elements within it were a part of its promotional function.

The Break

The idea of delinking of IDBI from the Reserve Bank was first mooted by a study team headed by C.H. Bhabha of the Administrative Reforms Commission in 1966. It stated that 'in the long run, specialized institutions like the IDBI, Agriculture Refinance Corporation, Unit Trust of India and the Deposit Insurance Corporation of India should build up their own managerial and technical competence. It will then be worthwhile to separate from the RBI altogether.'

A one-man working group under Manubhai Shah, who was a member of the Administrative Reforms Commission, also recommended delinking. Shah visited the Bank, had detailed interactions with officers of the Bank on the subject and went to elaborate his suggestions in his book, *The New Role of the Reserve Bank in India's Economic Development*. He wanted the Bank to concentrate on monetary management and the formulation of credit policy. He also thought that development would be considerably facilitated if there were specialized institutions for different sectors. Jha was against delinking, so the Bank did not take any action on Shah's report. The Administrative Reforms Commission also rejected it, saying, 'In our view, the necessary coordination in the field of credit is best done by the Reserve Bank of India itself. We, therefore, feel that it would be a far better arrangement to set up the banks and organization suggested in the report as subsidiaries of the Reserve Bank.'

But things changed after nationalization in July 1969 and delinking again became a live issue, partly perhaps because the Reserve Bank was seen as being overly conservative. Delinking would provide the government with control over long-term funds and the capital market. With nationalization it had already gained control over short-term funds but the Bank was seen as something of a stick-in-the-mud. Eventually, legislation in the form of the Public Financial Institutions Law (Amendment) Bill was introduced in the Lok Sabha on 22 December 1973. The Joint Committee of both Houses of Parliament to which the Bill was referred submitted its report on 25 July 1975 but not before making some very scathing criticism. It took about a year to finalize its report and invited memoranda from economists, administrators and bankers to express their views about the Bill. It also recorded the oral evidence of S. Jagannathan, R.K. Hazari, C.V. Nair of the RBI Officers' Association, and others.

The Bank very clearly did not approve of delinking. While giving oral evidence before the Joint Committee, Jagannathan said:

> Broadly, in the Reserve Bank and in the IDBI, we were not very clear as to the specific objectives which government had in mind and we expressed the view that we were not able to see much advantage in reconstitution proposed. We also thought that there were some substantial disadvantages in the delinking. We expressed the view, which I still hold, that the Reserve Bank no doubt has a lot of work to do, but delinking will not be helpful because the coordination task would become more difficult. The UTI and IRCI have got their own Boards, but, of course, IDBI has a common Board with the RBI. We advised that IDBI might be reconstituted with a separate Board but not necessarily delinked from the Reserve Bank.… It was our view that there was not any substantial advantage but there could well be many disadvantages.

Jagannathan also said that after delinking, the Bank would have no responsibility; or, as one member put it, the buffer may not be there. 'The buffer, I think, is not meant to slow down. The buffer is meant to coordinate and I do think there would be some practical difficulties'. Jagannathan's predecessor, L.K. Jha, had also not been in favour of delinking. According to Jha, 'the Reserve Bank was adequately staffed and can tackle the task that it has'.

R.K. Hazari, Deputy Governor of RBI opposed the proposal but suggested changes in the IDBI's management. He said:

> As the head of the Agricultural Refinance Corporation, which is one of the institutions of the Reserve Bank, I do feel that the ARC pattern is perhaps much more suitable for a development bank than the present pattern of the IDBI. I think the Governor need not be Chairman of the IDBI; the Governor should be above institutions other than the Reserve Bank. It would be quite sufficient if the Deputy Governor of the Reserve Bank can be Chairman of the IDBI while ownership continues to vest with the Reserve Bank and he can have easy access to the resources

> and staff. Certainly, it would be useful to have people other than the Directors of the Reserve Bank as Directors of the IDBI. I think the Board of Directors of the IDBI should be more broad-based than it is now.

C.V. Nair highlighted the performance of IDBI as an associate institution of the Reserve Bank and cautioned that after delinking 'there will be a higher degree of bureaucratization and a higher degree of non-professionalized management controlling the new IDBI'. Ashis K. Sen, general secretary of the All-India Reserve Bank Employees' Association, said that 'the purpose for which IDBI was set up has been served … there is no need for separating this institution from the Central Bank of the country. This will only jeopardize the progress of our country.'

Four members of the Joint Committee also recorded minutes of dissent. K. Mathew Kurian and Dinen Bhattacharya described the Bill as a retrograde piece of legislation.

> The proposal to delink IDBI from the RBI and to convert the IDBI as an apex financial institution, separated from the RBI and functioning as a parallel institution under the administrative control of the finance ministry, will destroy the very foundation of the credit structure which has been built up during the last two decades.… The evidence before the Committee very clearly indicate that the Bill has been misconceived and should therefore be scrapped. The evidence further indicate that there is no valid economic or administrative reason for delinking the IDBI from the RBI. The reconstitution of the IDBI as proposed in the Bill will not improve the operational efficiency of the IDBI, nor will it create better machinery for developmental financing, better coordination of credit operations etc.

The two other dissenting members of the Committee, Indrajit Gupta and Bhupesh Gupta, said:

> This Bill, in our opinion, being limited to the question of certain structural changes only in the relationship between the IDBI and the RBI, begs the main question viz. the credit policies of the public financial institutions vis-à-vis various sectors of industry and areas of industrial development. The Bill does not at all venture into any reformulation or redefinition of government's basic policies in the matter of financing, promoting and developing industries. To that extent, the Bill is quite

TABLE 2 **IDBI's Borrowings from Reserve Bank of India**

(Rs lakh)

Year	Purpose	Sanc-tions	Utili-zation	Repay-ment	Rate of interest (%)
(1)	(2)	(3)	(4)	(5)	(6)
1964–65	For subscribing to bonds of				
	SFCs and other eligible	200	100	100	5
	financial institutions	–	92	92	5.75
	For subscribing to shares of SFCs	25	25	25	3
1965–66	Bonds of SFCs	200	127	127	5.75
	Shares of SFCs	25	25	25	3
	Shares of SFCs	15	15	15	5
1966–67	Bonds of SFCs	250	108	108	5.75
	Shares of SFCs	25	25	25	3
	Shares of SFCs	6	6	6	5
1967–68	Shares of SFCs	150	63	63	6
	Shares of SFCs	100	22	22	5
1968–69	Bonds of SFCs	350	18	18	6
	Shares of SFCs	100	–	–	–
	Concessional borrowings	250	–	–	4.50
1969–70	Bonds of SFCs	300	–	–	6
	Shares of SFCs	100	–	–	5
	General business of Industrial				
	Development Bank of India	2000	2000	2000	6
1971–72	Bonds of SFCs	100	99	99	6
	Shares of ICICI	250	180	180	6.25
	Shares of SFCs	275	70	–	3.50
	Shares of IFCI	41	41	–	4.50
	Shares of IRBI (2)	275	125	125	3.50
	General business of IDBI	3200	3200	3200	6
	Temporary borrowings against				
	security of machinery bills	1150	–	–	–
1972–73	Bonds of ICICI	320	126	126	6
	Shares of SFCs	41	41	–	4.50
		101	101	–	3.50
	Shares of IRBI (2)	130	–	–	–
	General business of IDBI	3400	3400	3400	6.50
	Shares of SFCs	120	9	–	3.50

Table 2 (*contd*)

Year (1)	Purpose (2)	Sanctions (3)	Utilization (4)	Repayment (5)	Rate of interest (%) (6)
1973–74	Bonds of ICICI	560	494	494	6.50
	Shares of SFCs	300	25	–	3.50
	Shares of IRBI (2)	140	125	125	3.50
	General business of IDBI	3000	3000	3000	6.50
	General business of IDBI (3)	1304	1304	1000	6.50
	Temporary borrowings against security of machinery bills	2000	2000	2000	6.50
1974–75	Shares of SFCs	250	279	–	3.50
	Shares of IRBI (2)	140	125	125	3.50
	Bonds of ICICI	610	190	190	7.50
	Bonds of ICICI	150	138	138	6.25
	General business of IDBI	5000	5000	–	7.50
	General business of IDBI	2000	2000	–	7.50
	General business of IDBI	900	900	–	7.50
	Temporary borrowings against security of machinery bills	5000	4279	4279	–
1975–76	Bonds of ICICI	500	474	426	7.50
	Shares of SFCs	500	329	–	3.50
	Shares of SFCs	–	50	–	3
	General business of IDBI	11500	11500	–	7.50
	Temporary borrowings against security of machinery bills	6500	5440	5440	7.50
1976–77	Bonds of ICICI	600	600	480	7.50
	Shares of SFCs	1000	567	–	3.50
			100	–	3
	General business of IDBI	13400	12654	–	7.50
	Temporary borrowings against security of machinery bills	5000	1877	1877	7
1977–78	Bonds of ICICI	600	600	420	7.50
	Shares of SFCs	1000	390	–	3.50
			100	–	3
	General business of IDBI	16400	7910	–	7.50
			7420	–	6.50

TABLE 2 (*contd*)

Year	Purpose	Sanc-tions	Utili-zation	Repay-ment	Rate of interest (%)
(1)	(2)	(3)	(4)	(5)	(6)
1978–79	Bonds of ICICI	1300	350	245	7.50
	Shares of SFCs	725	559	–	3.50
			100	–	3
	Shares of IFCI	125	125	–	6
	Shares of IRBI	250	250	250	3.50
	General business of IDBI	18850	18550	–	6.50
	Temporary borrowings against security of machinery bills	9000	8500	8500	9
1979–80	General business of IDBI	20000	20000	–	6.50
		7000	6993	6993	6.50
	Temporary borrowings against security of machinery bills	8000	2984	2984	9
1980–81	General business of IDBI	27000	24000	–	6.50
	Temporary borrowings against security of machinery bills	5000	5000	5000	9
1981–82	General business of IDBI	26500	26500	–	6.50
	Temporary borrowings against security of machinery bills	19000	1967	1967	10
1982–83	General business of IDBI	24500	24500	–	7.50
	Temporary borrowings against security of machinery bills	22500	4806	4806	10

Notes: (1) Limits allowed for subscriptions to bonds of SFCs, etc., were utilized for purchase of debentures of ICICI.

(2) No interest would be charged by RBI for a period of five years from the date of disbursement.

(3) Amortization period varies with the purpose of borrowings as follows:

(a) Subscription to bonds of SFCs: within 12¼ years (lumpsum)

(b) Subscriptions to shares of SFCs, IFCI and IRBI: within 20 years (lumpsum)

(c) Subscriptions to special debentures of ICICI: ten equal annual instalments commencing from the sixth year.

(d) General business of IDBI: within 15 years (lumpsum).

Source: IDBI, *Operational Statistics, 1964–89* (1989), pp. 356–57.

> inadequate and will have little or no impact on the actual credit map as it has emerged over the years.

The Bill was passed, as expected, by both Houses of Parliament, and IDBI was delinked from the Reserve Bank on 16 February 1976. The Bank's holding of IDBI's share capital was transferred to the government and its holdings in UTI were transferred to the IDBI. Thus UTI was also delinked from the Bank.

A new chairman, Raghu Raj, took over the IDBI and a new board was constituted. The interest rate structure of the IDBI, however, continued to be regulated by the Bank, which also continued to provide resources to the IDBI and act as a lender of last resort to meet financial requirements (Table 2). The government had won another battle—it had had its cake and eaten it too.

THE BANK AND UNIT TRUST OF INDIA

The Unit Trust of India (UTI) was a wholly owned subsidiary of the Reserve Bank but the Bank maintained an arm's length relationship with it. It also avoided making general regulations that would hamper the growth of UTI.

UTI launched its operations with the Unit Scheme 1964 (US 64). To ensure that it could offer more schemes, a Committee was set up in 1965 consisting of a chairman, executive trustee, and trustees.[3] On the basis of the Committee's report, proposals were sent to the government through the Bank for amending the UTI Act. The amendments helped to diversify the schemes of saving.

In order to cater to different types of investors, the UTI introduced three saving plans. The first was the Reinvestment Plan (from 1 July 1966), the second was the Voluntary Savings Plan (introduced in July 1969) and the third was the Children's Gift Plan (introduced in 1970). The Reinvestment Plan facilitated automatic reinvestment of income that was distributed to investors. The Voluntary Savings Plan facilitated investment in units by small investors through periodic contributions; as this scheme did not flourish, it was terminated in June 1974. The gifts of money made under the Children's Gift Plan were invested in units and income on them was reinvested. For income tax purposes, this income formed part of the donors' income.

On 1 October 1971, another scheme, namely, Unit Scheme 1971, was

[3] N.M. Wagle, H.T. Parekh, P. Bhinappa and V.G. Pendharkar were the trustees then.

launched in association with the Life Insurance Corporation of India (LIC). This was essentially the Unit-Linked Insurance Plan—a ten-year contractual plan under which a small part of the contributions was paid in half-yearly or annual instalments to the LIC and the balance was invested in units.

The investment policies of the UTI were promoted by securing the necessary support from banks or through amendments to the original UTI Act. In the initial years, when the UTI found it difficult to invest in the narrow share market, it had to invest in preference shares and debentures or in government securities in a manner that would give reasonable returns to unit holders. Although 'reasonable returns' was not defined, the fact that the UTI maintained a dividend rate of 7 per cent implied that the rate of return on the Trust's investments would have to be higher than 7 per cent a year.

The original Regulation 36(1) of the UTI's General Regulations placed a limit on UTI's investments in the securities of any one company of 5 per cent of the total investible funds of the Trust, essentially to minimize risks in investment and to spread investments over a fairly large range of securities. Secured debentures, which gave assured yields and carried much less risk than ordinary shares, were issued in the 1960s and 1970s, mainly by well-established companies. Even though the debentures did not give voting rights, any investment in debentures by the Trust implied, given the overall limit on investments, a restriction in the Trust's investments in preference and ordinary shares of the concerned company.

The overall limit on investment was considered a hindrance to achieving a balanced portfolio, and the UTI therefore suggested to the Reserve Bank to exclude 'debentures' from the word 'securities' in Regulation 36(1). Governor Bhattacharya was not happy with the suggestion because it sounded too general. The Trust, after a discussion with the Governor, decided to have a sub-regulation to Regulation 36(1). This exempted two types of secured debentures from the limits on investment: those that were issued by a company that had declared dividends on its equity shares for at least five years immediately preceding the year of UTI's investment in them, and had declared a minimum of 6 per cent dividend on the paid-up value of equity shares in the year immediately preceding the year of Trust's investment.

Governor Bhattacharya's help to UTI came in another form as well. Faced with large borrowings by banks from the RBI to meet the demands for commercial credit, and with the inflationary pressures and deteriorating external payments position, the Governor was keen on tightening bank credit. He therefore advised banks, at an annual dinner of the Bombay Bankers' Association in 1966, to sell some of their debenture holdings to the UTI to meet their cash needs rather than borrow from the Bank. This seems to have worked since debenture holdings at end-June 1967 showed an increase of Rs 3 crore over the level of Rs 10.9 crore a year earlier, and as against a rise of Rs 1.6 crore in 1965–66 (July–June).

Regulation 36(1) required further modifications when, in 1969–70, the sales proceeds of units increased sharply. As noted by V.G. Pendharkar, during the first four months of 1969–70, sales amounted to about Rs 17 crore—almost as much as the total sales in the whole of the preceding year, and, despite UTI investing the proceeds through market purchases and subscriptions to new issues, there was still a balance of Rs 6 crore left by October 1969. This was temporarily invested in government securities that yielded a return of about 5.5 per cent against the Trust's dividend rate of 7.1 per cent. Pendharkar noted that the situation warranted investment in higher-yielding industrial securities but new issues of preference shares and debentures were far lower in 1969 than in the earlier years. The UTI management, therefore, proposed to the Reserve Bank that its investment problem would be eased if the overall limit (i.e. of 5 per cent of total investible funds of the Trust or 10 per cent of the securities issued and outstanding of the company, whichever was lower) on investment in shares could be relaxed.

The modification it sought was the following: investment by UTI in the securities of any one company shall not exceed 4 per cent of the total investible funds of US 64 or 15 per cent of the securities issued and outstanding of the company, whichever was lower. The UTI also suggested that since the original UTI Act allowed only one unit scheme, it was necessary to add the words 'in respect of every unit scheme', as the 1966 amendment allowed the UTI to introduce more schemes.

R.S. Bhatt, chairman of UTI, sought the approval of Governor L.K. Jha on this amendment and spoke to him on several occasions on the matter. The Governor's views on the subject were reflected in his noting to Executive Director R.K. Seshadri.

> Basically we must accept the proposition that Unit Trust cannot afford to lower its returns and therefore it must be able to invest the bulk of its funds in channels which should give a higher dividend than the return which the Unit Trust gives. In the past, there was an abundance of new issues and the inflow of funds (to UTI) was also not particularly large. The position

> now is different. So the plea for this relaxation is understandable.

However, Jha felt that by applying the regulation separately to each scheme the UTI might even own the majority of shares of any company if there were a number of schemes. While the suggested investment limit of 15 per cent for the securities issued and outstanding of any company would be quite a safe one for UTI as a whole, it might be too high if it is reckoned scheme by scheme. Jha's noting helped the UTI to modify its proposal regarding Regulation 36(1) thus: 'Investments by the Trust from the funds of Unit Scheme of 1964 in securities of any one company shall not exceed 5 per cent of the total amount of the said funds or 15 per cent of the securities issued and outstanding of such company, whichever is lower.' This modification was duly accepted by the Reserve Bank.

Besides seeking the Reserve Bank's advice on matters relating to its investment policy, the UTI sought its financial support in order to maintain its repurchases at a 'stable' level. The Trust repurchased units mainly to provide ready liquidity to investors. The repurchase price was always lower than the sale price. The Trust fixed the price differential each year. Till 1967–68, the maximum differential was fixed at 50 paise per unit; it was reduced to 40 per cent in 1968–69 and in 1972–73, the differential was further reduced to 30 paise per unit. Stability in the amount of repurchases was maintained partly through the method of fixing the sale and repurchase prices, and partly through short-term accommodation (for a maximum of 90 days) from the RBI. Governor Jha, in his response to a query from B.K. Nehru, Governor of Assam, in December 1968, enunciated the stability principle thus: 'In its actual working the Unit Trust has maintained its repurchase stable, though to enable it to do so the Reserve Bank has had to make some small contributions which the law provides for.'

The Reserve Bank's financial support to UTI in 1974–75 was a classic case of protecting the Trust from any financial crunch. When the government, as a part of an anti-inflationary package, restricted the rate of dividends to be paid by companies to shareholders to 4 per cent, the stockmarket fell into a deep depression. Repurchases of units exceeded their sales, causing a financial problem for the UTI. The RBI bridged the financial gap by making special financial arrangements for the purpose. This action on the part of the Bank was not merely that of a major contributor to the initial paid-up capital of UTI, but also that of a central Bank which believed in fostering and promoting the institutional infrastructure and maintaining the public's confidence in the Trust at a high level.

The relationship between the Reserve Bank and UTI was terminated by the Public Financial Institutions Laws (Amendment) Act of 1975. The Act placed the Trust under the IDBI and transferred to it all the powers that the RBI had with regard to UTI. The formal delinking from the Bank took place on 16 February 1976. With this development, the chairman of UTI was appointed by the government in consultation with the IDBI and the executive trustee was appointed by IDBI. The Bank appointed only one trustee under the amendment, in place of the four trustees it had appointed under the original UTI Act.

The delinking of UTI from the Reserve Bank took place during the Emergency. There was no internal noting in the Bank to show its views on the matter. There was also no record in the Bank to show whether it had been consulted before the Public Financial Institutions Laws (Amendment) Act was brought before the Parliament in 1973. V.G. Pendharkar, a former Executive Director of the Bank and one-time executive trustee of UTI, expressed his views on the delinking of UTI from RBI and placing it under the care of IDBI in his book, *Unit Trust of India: Retrospect and Prospect* (Mumbai, 2003), thus:

> I think this transfer was a grave mistake. After all, the IDBI is a lending institution and, as such, a borrower-oriented institution. It is not a lender of last resort. Also it does not have the comprehensive knowledge of the economy and the kind of research capability which the Reserve Bank has and which is necessary to give guidance to an investor-oriented institution like UTI. Even more important, the Chairman of IDBI does not have the wide experience in administration and understanding of public interest, which Governor of Reserve Bank has. Nor he has their eminence and authority. By placing the UTI under IDBI the valuable personal link between the Chairman of UTI and the Governor of Reserve Bank was broken, much to the detriment of the UTI. Moreover, since IDBI was now under the direct control of the Finance Ministry, this transfer meant that Government could, if it chooses, influence UTI through IDBI. The original idea of the Trust being free from control of Government was whittled down somewhat with this transfer.

The central Bank being the agency to coordinate the activities of all financial institutions, and to ensure the availability and use of funds for developmental needs, an effective link would have been beneficial, till the market was around to play the allocative role. However, things were vastly different from a political standpoint. K.S. Krishnaswamy, Deputy Governor, in an address on 19 October 1979, remarked:

> Clearly, after nationalization, it has willy-nilly been subjected to political influences of various kinds and this is a situation that we have to accept because I do not think it is correct for anybody to imagine that in a modern society, he can live outside of politics; it would be wrong for us to argue or behave as if we can live outside of politics. So for better or for worse, banks will function in a political climate and their decision-making will be influenced by political considerations—some of which are legitimate and some not so legitimate.

THE BANK AND NON-BANKING FINANCIAL COMPANIES

India has always had a thriving money market. Until the development and growth of modern banking in the nineteenth century, the money market was mostly in what would be today described as the informal sector. Ordinarily, the importance of this sector should have gradually diminished with the expansion of modern banking. But that did not happen. To the extent that banking consists of taking deposits and giving loans, at the time of independence, there were a large number of what came to be called non-banking finance companies (NBFCs). Basically, these were banks that were not banks under the law. Although the size of each individual NBFC was small, together they controlled sizeable sums. It became necessary, therefore, to protect their depositors, most of whom were gullible persons attracted by the high rates of interest offered on deposits. The first step in this direction was taken in 1963, with the incorporation of Chapter IIIB in the RBI Act, 1934, and its effective operation from 1 February 1964. This enabled the Reserve Bank to control NBFCs. In March 1966, a Department of Non-Banking Companies (DNBC) was set up in the RBI. A few months later, a Directorate of Inspection and Investigation was set up in the Department of Company Affairs (DCA), for proper coordination.

In 1966, the Reserve Bank issued two directives, requiring all NBFCs to provide the Bank with audited balance sheets every year, as well as interim half-yearly accounts. The companies were also required to provide information on their management and finances in their advertisements soliciting deposits. The directions restricted the volume of deposits of financial companies other than those in the housing finance and hire purchase sectors (i.e. loan companies, investment companies, *nidhis*, mutual benefit funds, non-chit financial businesses of chit funds, and non-financial companies that collected public deposits including those belonging to government) to 25 per cent of their paid-up capital and free reserves; for hire purchase and housing finance companies, they prescribed liquidity requirements (i.e. cash, current account balances in scheduled or notified banks, and central, state and trustee securities) of 10 per cent of their outstanding deposits. Any excess deposit was to be adjusted/liquidated over five years.

By 1967, the Reserve Bank's responsibilities had grown manifold, both because the number of companies covered by it was large and because the business of these companies had grown substantially. The DNBC had a working arrangement with the Directorate of Inspection and Investigation, according to which inspection of financial companies was carried out by the Bank, while the inspection of non-financial companies was mainly carried out by the Directorate. It was not easy to get the exact details of the number of companies taking deposits or the number of financial companies that were actually working. Even so, an attempt was made to estimate the number of non-banking financial intermediaries that might be carrying on at least some business, and the turnover of their business.

It was estimated that about 2,700 companies (about 450 financial companies and about 2,250 non-financial companies) had received or might be receiving deposits from the public, and that about 1,750 financial companies might be transacting at least some nominal business. But their volume of deposits in the non-banking corporate sector as a whole and the volume of funds handled by all the NBFCs together was not such as to justify an elaborate system of regulations or an intensive system of inspection, scrutiny and control. So the Reserve Bank tried to frame policies within the framework of certain guiding principles, namely:

(i) To extend and modify the provisions relating to the acceptance of deposits in the non-banking corporate sector, so as to minimize the immediate difficulties, without prejudice, however, to the ultimate objective of reducing the extent of reliance by industrial and commercial companies on this mode of raising finance.

(ii) To divert the lending of non-banking financial companies into useful and productive purposes and to link them, if possible, with the commercial banking system, through a system of refinance and assistance.

The directives in regard to deposits of 1969 required an NBFC to disclose particulars regarding its management, business, profits, dividends, capital, reserves, deposits and other liabilities in its advertisements soliciting deposits from the public. The periods of deposits differed by type of non-banking company. Hire purchase finance companies were prevented from accepting short-term deposits for periods of less than six months, whereas other companies could not accept deposits for less than one year. All companies were required to furnish proper receipts for deposits, maintain deposit registers, and include in their annual reports particulars regarding overdue deposits if the overdues were, in the aggregate, in excess of Rs 10 lakh.

Except in the case of hire-purchase and housing finance companies, which were free to accept deposits without any limit but were required to keep 10 per cent of the deposits invested in approved forms as a liquid reserve, NBFCs were required to limit the total volume of deposits to 25 per cent of their paid-up capital and free reserves. The development rebate reserve was counted as a free reserve for this purpose. This ceiling was imposed from 1 January 1967 and the excess deposits were to be adjusted by the end of December 1968. However, in the case of industrial companies, the time limit for adjustment of excess deposits was up to the end of 1971, subject to certain conditions.[4]

In 1966, the exempted unsecured loans and deposits of financial and non-financial companies grew by about Rs 75 crore. In 1967 they increased by Rs 100 crore. But the ceiling was not in force at that time. The Reserve Bank believed that the rate of growth since then had been moderated, mainly because of the easier availability of bank credit. Another factor retarding growth could have been the requirement to deduct tax at source in respect of any interest payment in excess of Rs 400. This would have had some deterrent effect on investment of unaccounted money. Moreover, many important companies in Bombay had also reduced rates of interest by one half of 1 per cent from March 1968, and some of the companies had stopped accepting deposits either because they had reached the ceiling or because they did not find it necessary.

The explanation of the rationale for the imposition of a ceiling on deposits was that unrestricted short-term borrowing in the form of deposits, merely because it was not covered by the definition of 'debt' for purposes of the Capital Issues (Exemption) Order, could not be permitted without causing detriment to the interests of the borrowing company. Certain exemptions in favour of unsecured loans, such as those obtained from shareholders, directors, managing agents or secretaries and treasurers, or

[4] The companies had to have declared a minimum equity dividend of 6 per cent in the five years preceding 1 January 1967 or had to have unencumbered fixed assets of book value more than twice the volume of deposits as on 1 January 1967.

guaranteed by directors, managing agents or secretaries and treasurers, had been provided as a transitional measure.[5]

In relation to the total amount of bank loans to industry, the exempted loans were not seen to be large. The Reserve Bank hoped that it would be possible to withdraw the exemptions before the end of 1971, by when industrial and commercial companies would have had adequate time to make more permanent and satisfactory arrangements for meeting their financial commitments. It also hoped to refix the ceilings in terms of unsecured debt for short-term periods, to the extent that such debt was not covered by the definition of 'debt' in the Capital Issues (Exemption) Order, 1969.

There were two important concerns that drove both RBI and government policy at the time. One was the possibility that the deposit-taking company would not be able to repay its depositors; the other was the apprehension that the company would lend to its own directors, who could then vanish. The Bank tried to respond to the oft-repeated demand that it should be in a position to intervene more effectively in cases where deposits could not be repaid by non-banking companies belonging to any category, and that, in particular, provision should be made for the liquidation or winding up these companies and for prohibiting loans by private companies to their directors and their concerns so long as these companies accepted deposits from the public.

The RBI memorandum said that even though the government had the necessary powers, under Section 439(5) of the Companies Act, 1956, to apply for winding up of a company if it was unable to pay its debts, it was not realistic and might not be even in the interests of the depositors to use those provisions extensively. The reason was that liquidation proceedings tend to be protracted and very expensive. In the case of banking companies, the law provided for exclusive jurisdiction of the court that would be in charge of matters relating to winding up, determination of the rights of secured creditors within a reasonable period, and settlement of the list of debtors of the company and realization of the debts due. Such a simplified procedure was not available in the case of non-banking companies.

On the other hand, elaborate procedures, as laid down in the Companies (Court) Rules, 1959, would have to be followed, and various items of expenditure, including the cost of preparing a financial statement, audit fees, payment to the central government in accordance with the prescribed

[5] The total amount of exempted loans that were excluded from the definition of deposits was Rs 136 crore on 31 March 1967; this was perceived to be 'a considerable figure' and large in relation to deposits, placed at about Rs 250 crore.

rates and legal expenses, would have to be debited to the assets of the company.

The prohibition of loans by private companies in certain circumstances was seen to be administratively inconvenient and unworkable, besides dislocating the business of a large number of holding companies to the detriment of business and industry generally. A number of private companies were holding companies serving one or more subsidiaries, and arranging for funds or guarantees for companies within the group in the event of sudden or emergent needs.

The Reserve Bank was also concerned that the money garnered by the financial companies should be directed into more productive channels and linked to the organized business system. The memorandum stated that a beginning had been made in the case of hire-purchase finance companies, which were the most important among the financial intermediaries. These companies, apart from the liquidity requirement in respect of deposits, were required to collect their outstanding hire-purchase debts within a specified period. In 1967, commercial banks were asked to accord priority to the refinancing of hire-purchase transactions relating to commercial vehicles. The Bank indicated that unsecured loans granted for financing the purchase of commercial vehicles would not be taken into account for the purpose of the ceiling for unsecured advances and guarantees.[6]

The Study Group of the National Credit Council (NCC) anticipated a gap in the institutional framework for the provision of loans to individual road transport operators in the private sector. For filling this gap, the Group recommended that a dozen or so medium-sized hire-purchase finance companies should be formed; that the rate of interest to be charged by the hire-purchase finance companies should be restricted to a certain ceiling under certain conditions; and, finally, that the Credit Guarantee Scheme for small-scale industries should be extended to cover all loans granted under hire-purchase terms. The Bank proposed to examine these recommendations.

There were also the chit fund companies, which operated mainly in Madras, Kerala, Delhi and Greater Bombay. The total turnover and balance-sheet assets of 194 chit fund companies as on 30 June 1966 were about Rs 80 crore and Rs 10 crore, respectively. Their methods of working, however, were a cause for concern. The Reserve Bank forwarded to the

[6] IDBI announced a scheme for discounting of promissory notes relating to the purchase of commercial vehicles under hire-purchase contracts and, subsequently, granted limits amounting to Rs 3 crore under this scheme in favour of five banks. These limits, however, were not utilized and lapsed.

government a draft consisting of directions to be issued to all chit fund companies. The objective was to ensure, firstly, that their funds were invested in approved securities and, secondly, that these funds would not be diverted.

The government, while approving the proposals, favoured further stringent provisions and suggested that the commission payable to the foreman should be reduced and that the amount of security demanded from him should be increased. The Bank believed that as the new directions would be unpopular with many of the foreman companies, the cooperation of state governments would be necessary. It also felt that it would be desirable to have a model Chit Funds Act, incorporating the provisions regarding the investment of funds in liquid and approved forms and prohibiting diversion of these funds for financing the requirements of foremen (see Appendix 1). The Bank was also of the view that formulation of schemes for the development of other financial intermediaries, namely, loan, investment and housing finance companies, had been rendered difficult by the fact that the number of such institutions of a minimum size, say, Rs 25 lakh, which were either public companies or dealt mainly with the public, was quite limited.

In early 1970, the Finance Ministry was mulling over the desirability of amending Section 2(12) of the Companies Ac to include fixed deposits in the definition of debenture. The idea was to introduce some amount of control over the deposit-raising activities of companies. But the Reserve Bank, both on legal and practical considerations, did not see merit in this proposal. It pointed out that in law there was a clear-cut distinction between deposits and loans, including debenture loans—a depositor was expected to seek the deposit-taker and to ask for repayment of the amount due to him, while a debtor was expected to seek the creditor and offer to repay the loan irrespective of any demand from the creditor.

This distinction was considered important in the context of the application of the rule of period of limitation for enforcement of the claims. In support of this reasoning, the Reserve Bank cited Section 26 of the Protection of Depositors' Act, 1963, of the United Kingdom, which treated deposits and debentures as being mutually exclusive. On the principle of *ejusdem generis,* the Bank was in favour of interpreting Section 2(12) in such a manner as to include negotiable stocks or bonds and to exclude fixed deposits—which were not negotiable instruments. In another context, the Bank decided, on administrative grounds, that the word 'securities' as used in Section 11(2) of the Income Tax Act, 1961, could not be held to include fixed deposit receipts in accordance with the well-settled and well-understood commercial practice, and on the basis of three other considerations.

First, the provisions of the Companies Act in regard to the prospectus would be suitable in relation to the raising of resources in bulk through the issue of shares and debentures at fairly long intervals but would not be suitable in relation to deposits that would be received throughout the year. In particular, the provisions relating to allotments, commissions and discounts and the return of amounts received in excess would not be applicable so far as deposits were concerned. Second, there were some companies, like the Madras Industrial Investment Corporation, which depended on public deposits to a very substantial extent. Third, there were *nidhis* in Tamil Nadu and Andhra Pradesh which received deposits only from their own members and generally managed their business on sound and efficient lines, and chit fund companies which ran a number of chits or *kuries* at the same time and received deposits attributable to each chit or *kuri*. A general restriction of all deposits (as proposed in the amendment) would be either undesirable or unworkable in relation to these institutions.

The Reserve Bank felt that, even without the envisaged amendment, the restrictions imposed by its directives, on the one hand, would be adequate to ensure disclosure of all reasonable information to the public, and, on the other hand, the quantum of deposits would also be limited and would bear some reasonable relation to the paid-up capital and free reserves of the companies, given the provision for deduction of income tax at source (vide Section 194A of the Income Tax Act, 1961). In the circumstances, it said, inclusion of deposits in the definition in Section 2(12) would create some avoidable hardship to the companies concerned and it was therefore not in favour of the amendment.

In an effort to protect the unwary public and gullible depositors, the Department of Company Affairs proposed amendments to the Companies Act, 1956, such as a new Section 149A[7] and a new Section 58A. The latter was intended to prohibit any company to accept or invite deposits from the

[7] 149A (1) Where the memorandum of any company specifies the acceptance of deposit of money from the public repayable on demand or otherwise as one of its objects, the company shall not give effect to such object and shall not commence such business unless a prospectus in such form as may be prescribed has been issued, and a copy thereof filed with the Registrar, by such company.

(2) If the company accepts any deposit of money from the public in contravention of the provisions of sub-section (1), every person who is responsible for the contravention shall, without prejudice to any other liability, be punishable with fine which may extend to five hundred rupees for every day during which the contravention continues.

public without a prospectus in the prescribed form. In addition, no company would be allowed to accept, without prior approval of the government, deposits which in the aggregate exceeded 50 per cent of the paid-up capital of the company.

The Reserve Bank's response was prompt, comprehensive and full of reservations. Its basic objection was that what was being proposed would amount to parallel control. Deputy Governor S.S. Shiralkar reiterated the contents of the Bank's letter of 4 April to Kelkar, adding that the provisions as worded would deem to apply to banking companies also, which would be 'wholly inappropriate'. Secondly, he pointed out, the Bank's current powers were adequate and the new powers would amount to parallel control. By virtue of the powers vested under Chapter IIIB of the RBI Act to regulate deposits with non-banking companies and partnership firms with paid-up capital exceeding Rs 1 lakh, the RBI had already issued directions to companies regarding the amount of deposits, the information to be given in any advertisement calling for deposits, the minimum period for which these deposits might be accepted, etc. These powers had recently been extended to unsecured loans taken from the public. Third, and most importantly, as a ceiling had been laid down in the Bank's directions (i.e. deposits should not exceed a limit of 25 per cent of the company's paid-up capital plus free reserves less accumulated losses shown in their balance sheets), and unsecured loans guaranteed by directors as well as loans taken from shareholders were also subject to a similar ceiling, the proposal in sub-clause (2) of the Section 58A would 'conflict' with this direction. Shiralkar who had had a long stint in the Finance Ministry, suggested that V.M. Bhide, Additional Secretary in the Department of Banking, also be consulted.

The press reported that the Law Ministry was in the process of finalizing the matter. At a meeting of the Consultative Committee of the Department of Company Affairs held on 17 May 1972, under the chairmanship of the K.V. Raghunatha Reddy, a member pointed out that a number of companies accepted deposits far in excess of their capital reserves, which amounted to a 'fraud'. The member asked for some legal protection to be afforded to these 'trusting depositors'. The Minister responded that his Department was seized of the matter and that some suitable amendments to the relevant provisions of the Companies Act were under contemplation.

The Reserve Bank recognized that there were quite a few important and far-reaching implications in the administration of the proposals, namely, the compulsory issue of a prospectus by a company before it invited or accepted deposits of money from public, and the restriction on the total amount of deposits taken from the public to 50 per cent of the paid-up capital of the company. Shiralkar therefore considered it necessary to have them examined internally. As a consequence, an eight-page note emerged, dated 22 May 1972, the burden of which was, don't do anything without consulting us. The note was handed over to Bhide.

Events moved quickly thereafter. In June 1972, a sub-committee of the Cabinet took up for consideration the proposed draft Bill amending the Companies Act. The Finance Ministry sought the views of the Bank. Shiralkar pointed out that the Bank's comments were indicated in the paper sent to Bhide but, nevertheless, repeated its gist.

In late August, Bhide informed Shiralkar that the Companies Amendment Bill, 1972, had been introduced in the Lok Sabha on 11 August and that the Bill had been referred to a Joint Select Committee. The 'Statement of Objects and Reasons' in the Bill stated that some practices prevalent in the corporate sector—one of which was invitation of deposits from the public by non-banking companies—in so far as they might prove injurious or undesirable, were sought to be checked. The Finance Ministry also forwarded to the Bank copies of the correspondence between the Department of Banking and the Department of Company Affairs, on clause 6 of the amendment Bill seeking to introduce the new Sections 58A and 58B to the Companies Act. It showed that there was a strong difference of opinion between the two Ministries on this issue and that the DCA was determined to implement the proposal.

The Bank sent a detailed rejoinder on 8 September, together with the study of the provisions of the draft Bill by its Legal Department. The letter covered two aspects—the policy angle concerning supervision and control, and various legal issues arising out of the proposed statutory amendment of the Companies Act. Shiralkar, who had been conducting the exchange throughout, drew the specific attention of the Ministry to the Bank's firm conviction that it would not be desirable to have more than one authority to deal with deposits of non-banking institutions as this was likely to cause confusion. The government had two options: either the entire administration of non-banking companies' deposits could be taken over by the DCA, or the DCA could deal with the deposits of the non-financial companies while the Bank continued to deal with the financial companies. 'On the whole,' wrote Shiralkar, 'it seems better if the entire administration of control regarding deposits accepted by companies is taken over by Government as the Department of Company Affairs would be better equipped to deal with companies because of their larger field organization.'

The Legal Department's study showed that it was not desirable to have a provision that if a deposit had been accepted before the commencement of the Companies (Amendment) Act, 1972—that would not be deemed to have been accepted by the company in terms of rules made under sub-section (1)—such a deposit would have to be refunded within thirty days or any further extension that may be given by the government. Shiralkar was not convinced of the practical utility of this provision and highlighted the adverse implications of the proposed stipulation.[8]

Another problem was the manner in which the refund was to be made to the depositors. This was because the directions did not specify that a refund should be made in similar circumstances but that the deposits should be brought down so as to conform to the requirements of the directions. This left the choice open to the company, which could include the possibility of converting some deposits into equity capital. By prescribing a straight direction that there should be refunds, the question might arise whether the refunds should be made in any particular order or on a pro-rata basis. The depositor would face the prospect (although this might be already implied) of having to accept the refund even if it might be premature in terms of the contract between him and the company.

In view of these drawbacks, Shiralkar considered it advisable to deal with these two types of cases separately, i.e. by ad hoc orders to be made as and when necessary in consultation with the Reserve Bank, thus making for flexibility as different types of cases might require different periods for adjustment.

The third point of divergence was the protection afforded by Section

[8] 'I wonder if it is desirable to have such a provision involving almost certainly innumerable individual extensions or even whether such a provision is defensible unless the period of adjustment is adequate (which the period contemplated is not). Although the law may not be susceptible to challenge, it would seem to be a bad law, since the company would be penalized for an action which was perfectly valid when it was taken and which it could not know would be illegal in terms of some rules to be made several years thereafter. The new rules are intended to promote the public interest and we have considered them solely from that point of view and *not* from the interests of any one class. On the one hand, it is considered necessary to protect the depositors by limiting the volume of unsecured loans that a company may take from the public but on the other hand, a reasonable period of adjustment would be very desirable so that the legitimate manufacturing and other business activity is not suddenly crippled for lack of time for adjustment to new regulations.'

616(d) of the Companies Act, 1956. The Bank was not sanguine whether such protection would indeed be available. The scheme of Section 616 was to exclude companies like banking companies as they were covered by a separate statute, whereas Chapter IIIB of the RBI Act dealt with only a particular activity of all sorts of companies (excluding banking companies) and not a particular type of company, and, as such, it might not be possible to hold that Chapter IIIB was a special statute governing special types of companies as in the case of other types of companies enumerated in Section 616. Even if it was assumed that Chapter IIIB was a special enactment for the purpose of Section 616(d) of the Companies Act, it was arguable whether protection was available only in respect of Acts of Parliament or directions and rules issued under such enactments also; furthermore, a fundamental question arose, namely, why was such an enactment necessary at all if it was to be rendered impotent whenever it was in conflict with the directions issued under Chapter IIIB of RBI Act?

The Legal Department also suggested minor changes in the wording of some of the sub-sections to make them less susceptible to challenge on the ground that the central government had been clothed with arbitrary powers without any guidelines, which were conveyed to the government. Shiralkar took the opportunity to remind the government of the Bank's earlier suggestion about making it obligatory for statutory auditors of companies to furnish information regarding deposits taken by them. He reiterated that if the Bank was to continue to deal with financial companies, such a provision in the Act would be essential so that the Bank might get full information even in cases where the companies omitted to send a return to the Bank. In October, the Department of Banking conveyed the Bank's strong opposition to the DCA, to the idea of regulation over the acceptance of deposits from the public or shareholders by companies being dealt with coextensively under the Companies Act and under the RBI Act. It also pointed out that if the provisions contained in clause 6 of the new amendment Bill incorporating Section 58A were allowed to stand, the Reserve Bank would ask for repelling Chapter IIIB of the RBI Act altogether. Thus a stalemate developed.

To sort it out, R. Prasad, Secretary, Department of Company Affairs, convened a meeting on 9 October with top officials of the Department of Banking (N.C. Sen Gupta, V.M. Bhide, D.N. Ghosh and M.K. Venkatachalam). The latter pointed out that Chapter IIIB of the RBI Act and the directions issued thereunder regulated the acceptance of deposits from the public by all financial and non-financial companies and clause 6 of the new amendment Bill covered the same ground; therefore, they were in effect parallel provisions. The representatives of the Department of Company Affairs did not agree; it argued that these were complementary and that there were no inconsistencies. Nevertheless, in order to achieve the objectives underlying the new provisions, the meeting discussed the possibilities of harmonization of any conflicts that might arise out of the operation of the two sets of provisions. The Department of Banking felt that since, from the point of view of monetary and credit policy, financial companies had a large role to play and since the question of control over financial companies had been reviewed extensively by the Banking Commission, the proposed Section 58A might be amended to exempt these classes of companies and such other classes of companies as the government might, after consultation with the Bank, specify in this regard. This would mean that as a result of the amendment, non-banking non-financial companies alone would be left within the purview of the proposed Section 58A (see Appendix 2).

The Department also pointed out that if the deposits were to be refunded after thirty days, as provided for in the Section, there would be demand for additional funds from the banking system to preserve the liquidity of the corporate sector and banks might not find it possible to meet the demand. Therefore, after considering the pros and cons of the problem, it was agreed that sub-section (3) might be made applicable only to deposits accepted after the commencement of the Companies (Amendment) Act, 1972. Further, the time within which deposits were to be refunded was to be left to be governed by rules to be prescribed so that there would be sufficient flexibility and it would not operate as an onerous burden on the finances of companies in general.

The DCA then suggested that the objective of the Department of Banking could be served by amending sub-section (5) of the proposed Section 58A. This would enable NBFCs to be notified as a class exempt from the provisions of Section 58A in the same manner as banking companies, except in regard to the obligation of publishing advertisements, which they had to comply with. Regulations on non-banking non-financial companies would be made in consultation with the Reserve Bank. D.N. Ghosh forwarded the agreed minutes of the meeting to Shiralkar. Shiralkar, in his reply, desired to have the redraft in due course and suggested that a private company which accepted deposits from the public might be subjected to the same restrictions as applied to public companies as long as such deposits were outstanding. This stipulation should apply to financial as well as non-financial companies. Reference was made to the British Protection of Depositors Act, 1963, which had a similar Section. Shiralkar also suggested that an obligation might be imposed on the statutory auditors of companies to report on the extent to which the rules regarding deposits were being complied with by the company concerned. Towards the last quarter of 1973, the Joint Select Committee of Parliament *inter alia* accepted the amendments as suggested above to the Companies (Amendment) Bill.

The Finance Ministry advised the Bank on 28 September 1973, that the DCA had suggested that RBI should start drafting the rules under the said clause of the Bill for consideration by them. The Department of Non-Banking Companies began drafting the new rules, which was generally on the lines of the existing directions issued by the Bank to non-banking non-financial companies. Meanwhile, the Bank continued to harbour reservations on certain provisions: on the definition of a deposit, repayment of deposits, and the time allowed for repayment of unauthorized deposits.[9] These were conveyed to the government on 2 November 1973.

In the end the Bank lost the battle. The Companies (Acceptance of Deposits) Rules, 1975, made under Section 58A of the Companies Act, 1956,

[9] (i) *Repayment of deposits*. In terms of the new rule every deposit accepted by a company before the commencement of the Companies (Amendment) Act, 1973, in accordance with the directions made by the Reserve Bank of India under Chapter IIIB of Reserve Bank of India Act, shall be repaid in accordance with the said directions. The Bank felt that the scope of this clause was 'not very clear', as the Bank's directions merely laid down certain restrictions about acceptance of deposits, such as their nature and quantum, and did not provide any conditions subject to which the deposits should be accepted and repaid. The Bank's conjecture was that the total quantum of deposits might be brought down to conform to the ceiling in instalments as laid down in the directions.

(ii) *Time allowed for repayment of unauthorized deposits*. Under the Bank's existing notification, non-financial companies holding unsecured loans specified therein in excess of the prescribed ceiling or holding irregular deposits had to work off the excess in three annual instalments before 1 April 1975. In contrast, the proposed Section 58A provided for time till 1 April 1976 for repayment of any deposit accepted in contravention of the directions issued by the Reserve Bank. The Bank surmised: 'The reasons which weighed with the Government for laying down a period longer than that specified in the directions is not known. Perhaps the intention is that reasonable time, after the commencement of the proposed provision, should be given for repaying such deposits. Presumably, this provision was considered necessary in the Act itself so as to enable the companies to repay the excess deposits within three years notwithstanding the fact that the relative individual contracts provide for longer periods of repayment. If so, we agree with the provision. Our directions, as you are aware, are with reference to the total quantum of deposits as a proportion of paid-up capital and free reserves rather than individual deposits. (This approach has its own disadvantages but was unavoidable as there is some doubt whether subordinate legislation can supervene pre-existing contractual obligations.)

(iii) *Definition of 'deposit'*. The Bank suggested that the term 'deposit' in the Explanation to the proposed Section 58A might be defined more comprehensively.

came into force on 3 February 1975. As a result, control over the deposit acceptance activities of non-banking non-financial companies was transferred to the DCA. The Bank's directions to such companies were withdrawn from 3 June. It retained only a nominal link in the form of consolidating the data relating to non-financial companies for the purpose of annual surveys carried out by it.

Henceforth, the primary responsibility of the Reserve Bank was to administer the scheme of control over financial companies. Here, too, since the Department of Non-Banking Companies was not involved in the registration of financial companies, the only method by which it could extend its control over all the functioning financial companies not already on its list or those that were incorporated subsequently, was through maintenance of close liaison with the DCAs and the various Registrars of Companies who actually administered the provisions of the Companies Act. By arrangements entered into with them, the Registrars were furnishing to the Department of Non-Banking Companies, periodical lists of companies newly incorporated. Based on a scrutiny of the lists received from time to time, the Department called for the necessary documents from the companies to classify them and thereafter bring them within the ambit of the directions. As the gap between the number of companies as appearing in the records of the DCA and the list maintained by the DNBC was sizeable, the Raj Study Group suggested that vigorous steps should be taken to bring all the functioning of financial companies within the purview of the scheme of control, through close liaison with the Company Law authorities.

SELECTED POLICY ISSUES EXAMINED BY THE BANK

Company Deposits versus Bank Deposits

During this period, the Reserve Bank examined several new policy issues. One of these was the question of company deposits versus deposit mobilization by banks. The point for determination was whether acceptance of deposits from the public by the corporate sector to meet part of the project cost impacted on the deposit mobilization efforts of banks, in the context of a query raised by a chartered accountant, M.P. Chitale. What happened was as follows.

In November 1972, the IDBI took up for consideration a proposal of Gujarat State Fertilizers Company Ltd (GSFCL), to raise deposits from the public to the extent of Rs 1 crore, carrying interest at 8 per cent for one-year deposits and 8.75 per cent for two years and above. In December, Chitale wrote to V.V. Chari, Deputy Governor of RBI, that even though the company's proposal would provide depositors a more attractive alternative, it would hamper the development of institutional credit and attempts to integrate the unorganized capital market with the organized market. State financial corporations and nationalized banks, respectively, offered interest at rates of 6 per cent and 6.5 per cent on deposits for one to two years and two to three years. Further, in order to improve their average yield, commercial banks themselves would be 'willing and happy' to advance a crore to GSFC for two years or more at 8.5 per cent. Chitale argued that when banks were expected to provide assistance at cheaper rates to some sectors and they happened to be the only convenient outlet for investment for persons situated away from urban centres, it was desirable to adopt practices that would improve their earning yield. In short, he was arguing for increasing intermediation.

The points he raised of considerable importance, not least because if everyone started borrowing directly, it would mean great hardship for the banks, which were expected to perform a social role as well. There was also the question of the viability of other all-India term-lending institutions. So the matter was discussed at a joint meeting of these institutions in March 1973, where it was agreed that company deposits were a normal means of financing to a limited extent, but they had to be raised at reasonable rates of interest and should be for relatively small amounts as compared to the project cost. Moreover, the acceptance of deposits from the public was not viewed with disfavour in cases where the promoters' contribution was low and where they were not in a position to bring in additional share capital. But a proviso was added, namely, that such deposits had to carry a 'reasonable' rate of interest, and were to be repaid only with the prior approval of the financial institutions. The meeting also decided that the institutions might continue to follow the existing policy of treating each case on merits and accept this source of finance if the quantum, as part of the financing scheme, was moderate.

The Reserve Bank decided to examine this issue in terms of its wider policy aspects. In June 1973, a note was submitted by the Department of Non-Banking Companies (DNBC), which pointed out that the Banking Commission had examined the issue and felt that company deposits did not compete with banks so far as short-term deposits were concerned but did compete in regard to fixed deposits. A comparative study of accretion of deposits with banks and NBFCs during 1969, 1970 and 1971 revealed that, in spite of the high rates of interest offered by the latter, growth with commercial banks was much faster, which meant that deposit growth with an institution did not necessarily depend only upon the level of rate of interest offered by it, but also upon the confidence it commanded with the investing public. Moreover, advances by commercial banks were generally security-oriented or purpose-oriented and it was doubtful whether they would have been in a position to make available amounts raised as deposits on commercial considerations, given the pre-emptions for priority sector lending or the prescriptions relating to minimum lending rates laid down by the Reserve Bank. The note said that the existing ceilings for acceptance of deposits by companies *ipso facto* circumscribed their accepting deposits without limit.

The note also pointed out that control over deposits of non-banking companies had two main objectives, namely, as an adjunct to monetary policy and as protection of depositors' funds. Another purpose that the RBI was suggested 'modernization' of the capital structure of the borrowing companies by indirectly inducing them to broaden their capital base and reduce their reliance on public deposits by prescribing a ceiling on borrowings.[10] The note said, 'thus our directions provide for a built-in mechanism whereby an excessive reliance by non-banking companies over deposits as a source of financing their operations is prevented', but admitted that the directions did not stipulate the rates of interest payable on deposits, except in the case of premature repayment of deposits. On the whole, therefore, the Department was in favour of a 'more reasonable approach' to the question and 'a pragmatic view' of the matter. It did not think that acceptance of deposits by companies from the public would have a sizeable impact on the deposit mobilization efforts of commercial banks or that the earning capacity of the latter would be materially affected.

Shirlakar then spoke to Chitale, who reiterated that GSFC, instead of being allowed to raise deposits, should have been asked to approach banks who would extend loans at 8.5 per cent because they were flush with funds, and that depositors would tend to withdraw deposits from banks where they got only 6.5 per cent and put the money in GSFC. Shiralkar, in turn,

[10] Since 1967, the Reserve Bank had allowed companies to accept deposits only to the extent of 25 per cent of their paid-up capital and free reserves. By an amendment of the directions, from 1 January 1972, unsecured loans taken by companies (other than hire-purchase finance and housing companies) from their shareholders, and loans taken from any other person or party against guarantees issued by their directors, ex-managing agents, secretaries and treasurers, which were till then treated as exempted loans, were brought within the scope of the directions and subjected to the same sort of regulation as was applicable in respect of deposits since January 1967. A separate ceiling of 25 per cent of the net owned funds was prescribed in respect of these unsecured loans.

expressed his doubts as to whether banks, even though flush with funds, would lend at 8.5 per cent, which was the State Bank of India's prime rate, and told Chitale that banks would in any case recoup their withdrawn deposits when the companies or their contractors redeposited the funds with them. Finally, with the minimum lending rate ruling at 10 per cent on 16 July 1973, the point had lost its validity. Chitale agreed and that was the end of the matter.

Ceiling on Interest Rates

Another issue examined by the Reserve Bank was prescription of a ceiling on interest rates. The credit policy for the slack season 1977 had reduced interest rates on fixed deposits for periods ranging between 91 days and five years. As a follow-up, the DNBC examined whether a similar type of ceiling could be prescribed on company deposits.

The key point to note here was that the interest rates had been reduced primarily to rationalize the cost structure of banks and were confined to certain categories of fixed deposits. The cuts did not reflect a basic change in the interest rate policy because the Bank rate remained unchanged at 9 per cent. Nor had any change been made in the rates offered for other competing instruments, such as postal savings certificates. This led to the view that any imposition of a ceiling on interest rates of company deposits might induce undue suspicion about the Bank's interest rate policy. Since the interest rate offered by non-banking companies generally varied within the maximum interest rate on deposits paid by banks and the minimum lending rates charged by them, the Bank expected the rate of interest offered by non-banking companies to come down to some extent as a result of the recent changes.

Reference was also made to the Raj Study Group on Non-Banking Companies to show that the rate of interest paid by banks acted as a barometer for the rate offered by non-banking companies. Based on this logic, some of the bigger companies had already reduced their deposit rates from 0.5 to 2 per cent, and a few companies had announced that they would accept deposits only up to three years and not five years as in the past.

On the other hand, the Reserve Bank conceded that some of the medium-sized companies or those with a weak financial base might try to attract deposits by offering slightly higher rates of interest. To that extent, a shift in movement of deposits could take place from the banking to the non-banking segment, which, however, was subject to the limits prescribed by the RBI. But the shift would be insignificant.

Above all, it was considered extremely difficult to watch over the implementation of the ceilings since the machinery of the Reserve Bank and the Company Law authorities was not adequately geared for this purpose. As the Bank's scheme of control over acceptance of deposits by non-banking companies stood at that time, it did not include a watch over their methods of operation, management, etc., as was the case with supervision of commercial banks. If a ceiling was imposed, the companies could circumvent it by offering incentives like bonus, gifts or even cash compensation. All things considered, the Bank decided not to regulate interest rates on deposits. Governor Narasimham conveyed this to Manmohan Singh, Secretary, Department of Economic Affairs, in November 1977.

Alteration of Terms and Conditions by Companies

Two other issues that the Bank took up were the unilateral alteration of the terms and conditions by companies and a proposal for setting up a committee to look into the causes for default in payment of interest or repayment of deposits.

In 1979, the Department of Company Affairs pointed out to the Reserve Bank that Mohta Alloys & Steels Ltd had armed itself with the power to alter any term and condition agreed to at the time of acceptance of deposits without notice to the depositors. It said that the Companies (Acceptance of Deposits) Rules, 1975, should be amended to provide that the terms and conditions of deposits cannot be changed by a company, especially in respect of the interest rate payable. After making the necessary enquiries, the Department of Non-Banking Companies found that the companies were not altering the terms. The RBI then told the government that *prima facie* it was not in favour of amending the Companies (Acceptance of Deposits) Rules. But the DCA remained unconvinced and persisted. The Bank was asked to reconsider its decision and agree to the proposed amendment. It did not resile from its stand but, with a view to put an end to the controversy, it concluded its letter saying, 'government may take such decision as might be deemed necessary and appropriate'.

The Finance Ministry took up the matter with Deputy Governor Krishnaswamy in a strongly worded letter. A.K. Ghosh, the Special Secretary, wrote:

> I must confess I am unable to appreciate why the Reserve Bank of India is reluctant to agree to the proposed amendment. It is also not clear why it is necessary for a company to arm itself

> with a specific provision to alter the terms and conditions after it has obtained deposits.

Krishnaswamy, apparently in view of the government's persistence, sent a guarded reply, leaving it to the government to go ahead with the proposal provided certain difficulties anticipated in its implementation, as pointed out by the Bank's Legal Department, were taken care of. The Bank thus gave in.

Committee to Look into Default Cases

The other proposal, for setting up a committee to look into causes default, came from the Reserve Bank itself. In July 1980, the chief officer of the DNBC suggested to the government that a committee be set up to probe defaults by non-banking companies. For some reason, never fully understood, this reasonable suggestion upset the Finance Ministry.

In a letter addressed to I.G. Patel dated 19 August 1980, A.K. Ghosh opposed the proposal tooth and nail. He cited a recommendation of the James Raj Study Group, which favoured a gradual reduction in the limits of deposits accepted by each company since the main cause for such defaults was their acceptance of deposits out of proportion to their capacity to repay them at maturity, and, in several cases, the deposits were found to have been used for purposes of fixed capital formation. The Companies (Acceptance of Deposits) Rules, 1975, had been amended in April 1978 to give effect to this recommendation but the enforcement of the reduced limit of 25 per cent was to become effective from 1 April 1981 instead of 1 April 1980. He also recalled that the government had implemented another recommendation of the James Raj Study Group, viz. disclosure of information about the management and financial position of companies in the advertisements issued by them inviting deposits. The objective was to assist the intending depositors to assess the risk attendant on their deposits and thus serve as another safeguard for the depositors. The Sachar Committee had pointed out in its report that public deposits with companies primarily established a relationship of creditor and debtor *inter se* and in case of default there existed provisions in general law for enforcing the right of a creditor, including the right of filing a petition in a court of law for winding up of the company. Despite the view of the Committee that it was not possible to give full protection to depositors, the government at that time was considering certain measures to extend more protection to them.

Therefore, Ghosh wrote:

> There does not appear to be any need for setting up any Committee at this stage to probe into causes leading to defaults by companies in repaying deposits, or to suggest measures, legislative or otherwise, to prevent such defaults. The setting up of any such Committee will not serve any useful purpose. Indeed, other than arousing false expectations in the minds of the investing public—that the Reserve Bank and/or the Government are going to take steps for ensuring refund of their deposits, which is not actually possible under the law—no benefit is likely to emerge. The law does not empower Government to direct any company to refund deposits. Any probe into the causes leading to defaults in repayment of deposits would necessarily require detailed investigation into the affairs of the company concerned, and no Committee can undertake such an enquiry.

All this led to a minor panic in the Reserve Bank and when it enquired into the matter, it found that the chief officer may have exceeded his brief. Krishnaswamy and Patel were satisfied with this elucidation and the former replied to Ghosh that the Bank saw no need to set up a committee for the purpose, thus soothing the ruffled feathers.

The initiative towards conversion of certain types of NBFCs into commercial or cooperative banks subject to Reserve Bank's conditions, case by case, could provide some motivation for desirable deposit acceptance activities and operational aspects relating to the working of financial companies.

ANNEXURE 1

Prize Chit and Money Circulation Schemes (Banning) Act, 1978

The Miscellaneous Non-Banking Companies (Reserve Bank) Directions, 1973, issued on 23 August 1973, covered companies conducting conventional chits as also prize chit schemes. While the subscriptions received under conventional chits specified therein were exempt from the purview of the directions, those collected in respect of prize chits, mentioned therein, were treated as deposits for the purposes of the directions, and the restrictions regarding tenure, ceiling and advertisements were made applicable to them.

It came to the notice of the Reserve Bank that companies conducting prize chits—as distinguished from conventional chits—which are essentially in the nature of lotteries, were recording a mushroom growth, especially in big cities like Ahmedabad, Bombay, Calcutta and Delhi. (The company acts as the foreman or promoter and collects subscriptions, in one lump sum or by monthly instalments spread over a specified period from the subscribers, to the scheme. Periodically, the numbers allotted to members holding the tickets or units are put to a draw and the member holding the lucky ticket gets the prize either in cash or in the form of an article of utility such as a motor car, scooter, etc. Once a person gets the prize, he is very often not required to pay further instalments and his name is deleted from further draws. The schemes usually provide for the return of subscriptions paid by the members with or without an additional sum by way of bonus or premium at the end of the stipulated period, in case they do not get the prize.)

The Study Group on Non-Banking Companies, with a view to examine in depth the adequacy or otherwise of the provisions of Chapter IIIB of the Reserve Bank of India Act and the directions issued thereunder, looked into the various aspects of the working of such companies and recommended, *inter alia*, the banning of prize chits only. The Study Group observed that prize chits, as distinguished from conventional chits, were schemes essentially in the nature of lotteries, and they benefited primarily the promoters and did not serve any social purpose; in the circumstances, it recommended that the conduct of prize chits, by whatever name called, should be totally banned in the larger interests of the public and that suitable legislative measures should be taken for the purpose, if the provisions of the existing enactments were considered inadequate. The Reserve Bank accepted these recommendations and, in consultation with the government, the Prize Chits and Money Circulation Schemes (Banning) Act, 1978, was enacted, to prohibit the promotion and conduct of prize chits and money circulation schemes. The Act came into force on 12 December 1978, and applied to all types of organizations, viz. companies, firms, individuals, etc., throughout the country, except Jammu and Kashmir. Although the state governments and union territories were responsible for administering the Act, the Bank was assigned a certain advisory role in the administration of the Act, namely, tendering advice to them in framing Rules under the Act, in the disposal of winding up plans submitted by promoters of prize chits and money circulation business, and in granting exemption to charitable/educational institutions to conduct prize chits, etc.

Incidentally, thirty companies with registered offices in West Bengal filed writ petitions at the Calcutta High Court against the application of the Act to them, contending that the Act did not apply to the types of business being carried on by them. The petitioners included The Peerless General Finance and Investment Co. Ltd, Calcutta, and Favourite Small Investments Ltd, Calcutta, two leading companies. The Union of India, Government of West Bengal and Reserve Bank of India were the respondents. The cases were pending at the time of the third quarter of 1981, i.e. towards the close of our reference period of study.

Chit Funds Act

Chit funds are indigenous financial arrangements that facilitate the pooling of resources of a limited number of members with limited investible funds, for meeting, to the extent possible, the needs of the other members of the group who may be in need of funds, and thus constitute convenient instruments combining saving and borrowing. The mechanism of the conventional chit fund schemes involves the pooling of resources of a group of individuals, the loaning out of amounts thus collected, and the continuance of this process of collection and distribution till the completion of the stipulated period of the schemes.

The success of chit funds largely depends upon regularity in the payment of subscriptions by prized as well as non-prized subscribers, and the utilization of these monies only towards the chit business. However, several of the chit funds, whether conducted by individuals, partnerships or even joint stock companies, sooner or later were beset by various types of irregularities, resulting ultimately in delay or default in disbursement of the prize amounts. This could be on account of misutilization or diversion of funds by the foreman or on account of default in the payment of subscriptions by prized or non-prized subscribers. In order to save the business from disaster, the foreman was often tempted to start fresh chit fund schemes to enable him to roll over the funds. In cases where enrolment of the required number of members was not possible, the foreman himself subscribed to a number of tickets, sometimes in *benami* names. Quite often, the foreman also opened places of business for conducting the chit business. Manipulation of draws and commission of other types of malpractice to the detriment of the subscribers were also reported. The financial management or overtrading thus set in motion adversely affected the financial position of the foreman and ultimately put the interests of the subscribers in jeopardy.

On the question of the end-use of the funds, the Banking Commission had pointed out that the likelihood of the prize monies being put to productive uses was small. But the Raj Study Group on Non-Banking Companies, which went into the question, felt that whatever be the position, the savings mobilized and disbursed by chit funds by way of prize amounts satisfied the felt needs of a section of the community (even though the needs may be consumption needs dictated very often by social customs, such as moneys required for celebrating marriages and observance of religious ceremonies.). The Group also pointed out that since chit funds had come to stay, ways and means should be found to regulate their working so as to ensure that they functioned on sound lines, and that the malpractices usually observed in their conduct were obviated to the extent possible. In order to prevent any abuse by the foreman who might resort to unfair methods for securing illegal gains, the Study Group expressed the view that there was a need for regulating the activities of such chit funds.

Legislative measures to regulate chit funds were introduced in the erstwhile state of Travancore as far back as 1918 and by the 1950s many other states, like Tamil Nadu, Andhra Pradesh, Maharashtra, Uttar Pradesh and the union territories of Goa, Daman and Diu, Delhi and Pondicherry, had enacted legislation to regulate chit funds in their respective territories. While reviewing the position of the chit business as prevalent in several states vis-à-vis the legislation in the concerned states, the Banking Commission had recommended, *inter alia*, that it was essential to have a uniform chit legislation applicable to the whole country and, as such, either an all-India Act may be enacted or a model law prepared for adoption by all the states. At the instance of the government, the Reserve Bank drafted a model Bill to regulate the conduct of chit funds, for adoption by state governments. The draft Bill was also referred to the Study Group on Non-Banking Companies for comments. It was unanimously of the view that the Bill should be enacted as a central legislation as such a step, besides ensuring uniformity in the provisions applicable to chit fund institutions throughout the country, would also prevent such institutions from either taking undue advantage of the absence of any law governing chit funds in any state or exploiting the benefits of any lacuna or relaxation in any state law by extending their activities to such states. The Reserve Bank also recognized the need for a uniform central legislation, mainly because of the growth in the number of chit institutions, which was of a mushroom character, and the tendency of foremen to expand their business quite out of proportion to their stake in the business by a proliferation of branches or otherwise.

Contrary to the view expressed by the Banking Commission that it would be desirable to provide in the legislation that only public limited companies might run chit funds, the Raj Study Group observed that there was no objection, in principle, to chits being conducted by private limited companies also, and, on a limited scale, even by unincorporated bodies such as individuals/sole proprietorships or partnership firms. The Bill was drafted taking into account the views expressed by the Raj Study Group, by the various state governments to whom it was circulated for comments and some of the points made in representations received by the government from time to time. While making provisions for regulating chit funds on the lines of the chit regulation in force in some states, certain new provisions, such as minimum capital requirements for companies conducting chit business, prohibiting chit fund companies from doing any other business, placing a ceiling on the aggregate chit amount or chits that might be conducted at any one time, providing a self-contained machinery for settlement of disputes between a foreman and a subscriber by means of arbitration, found a place in the Bill. Though the administration of the proposed Bill vested in the state governments, the Reserve Bank was given powers to inspect the chit books or records of any foreman and to forward a copy of the inspection report or extracts thereof to the foreman concerned for rectification of any undesirable features that might be observed in the working of the foreman or institution. The Reserve Bank was also empowered to forward a copy of the report to the state government concerned for such action as might be deemed necessary. These provisions were intended to enable the Reserve Bank, as the central banking authority of the country, to oversee the business of chits as obtaining in the various states, besides enabling it to fulfil its role of tendering appropriate advice to state governments on questions of policy. Thus, the enactment of the Bill would be conducive to the conduct of chit funds on sound and healthy lines, and would minimize the malpractices indulged in by foremen to a large extent and thereby protect the interests of subscribers to chits.

As regards the other activities which these companies were authorized to undertake under their memorandums of association, under the then existing state enactments regulating the conventional chit fund business, there was no restriction on carrying on other activities. However, once the model Bill came into force, companies conducting conventional chits would be prohibited from carrying on any other type of business except with the general or special permission of the state governments concerned. As regards companies conducting prize chit schemes which were also engaged in other activities, they would be required to eschew the business of prize chit under the new dispensation.

The Chit Funds Bill was drafted by the Reserve Bank in consultation with the central government. The Bill was introduced in the Parliament in February 1979, but lapsed on account of the dissolution of the Lok Sabha. After its reintroduction on 20 November 1980, the Bill was referred to a Select Committee constituted by the Lok Sabha for further examination and report. The Bill, as revised by the Select Committee, was again referred to a Select Committee of the Rajya Sabha for quick examination. In terms of the provisions of the proposed Bill, the state governments/union territories were required to make Rules in consultation with the Reserve Bank for effective administration of the Act. Further, the Bank may be called upon to perform certain other advisory roles. The Act also required the state governments/union territories consulted the Bank before granting exemption from any of the provisions of the Act. The Chit Funds Bill, 1982, having been passed by the Parliament, received the President's assent on 19 August 1982, and became an Act.

ANNEXURE 2

Insertions to the Companies (Amendment) Act, 1973

6. After Section 58 of the principal Act, the following sections shall be inserted, namely:

58A. (1) The Central Government may, in consultation with the Reserve Bank of India, prescribe the limits up to which, the manner in which and the conditions subject to which deposits may be invited or accepted by a company either from the public or from its members.

(2) No company shall invite or allow any other person to invite or cause to be invited on its behalf any deposit unless—

(a) such deposit is invited or is caused to be invited in accordance with the rules made under sub-section (1), and

(b) an advertisement, including therein a statement showing the financial position of the company, has been issued by the company in such form and in such manner as may be prescribed.

(3) (a) Every deposit accepted by a company at any time before the commencement of the Companies (Amendment) Act, 1973, in accordance with the directions made by the Reserve Bank of India under Chapter IIIB of the Reserve Bank of India Act, 1934, shall, unless renewed in accordance with clause (b), be repaid in accordance with the said directions.

(b) No deposit referred to in clause (a), shall be renewed by the company unless the deposit is such that it could have been accepted if the rules made under sub-section (1) were in force at the time of the acceptance of the deposit.

(c) Where, before the commencement of the Companies (Amendment) Act, 1973, any deposit was received by a company in contravention of any direction given under Chapter IIIB of the Reserve Bank of India Act, 1934, repayment of such deposit shall be made, without prejudice to any action which may be taken, under the Reserve Bank of India Act, 1934, for the acceptance of such deposit in contravention of such direction, in the manner specified in clause (d).

(d) Repayment of one-third of the deposit referred to in clause (c) shall be made, unless it is repayable earlier under the terms of the deposit, before the 1st day of April 1974: repayment of another one-third of the said deposit shall be made before the 1st of April 1975 and repayment of the balance of the said deposit shall be made before the 1st day of April 1976.

(4) Where any deposit is accepted by a company after the commencement of the Companies (Amendment) Act, 1973, in contravention of the rules made under sub-section (1), repayment of such deposit shall be made by the company within thirty days from the date of acceptance of such deposit or within such further time, not exceeding thirty days, as the Central Government may, or sufficient cause being shown by the company, allow.

(5) Where a company omits or fails to make repayment of a deposit in accordance

with the provisions of clause (c) of sub-section (3), or in the case of deposit referred to in sub-section (4), within the time specified in that sub-section,

(a) the company shall be punishable with fine which shall not be less than twice the amount in relation to which the repayment of the deposit has not been made, and out of the fine, if realized, an amount equal to the amount in relation to which the repayment of deposit has not been made, shall be paid by the court trying the offence to the person to whom repayment of the deposit was to be made and on such payment, the liability of the company to make repayment of the deposit shall, to the extent of the amount paid by the court stand discharged.

(b) every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to five years and shall also be liable to fine.

(6)(a) Nothing contained in this section shall apply to—

(i) a banking company, or

(ii) such other company as the Central Government

may, after consultation with the Reserve Bank of India, specify in this behalf.

(b) Except the provisions relating to advertisement contained in clause (b) of sub-section (2), nothing in this section shall apply to such clauses of financial companies as the Central Government may, after consultation with the Reserve Bank of India, specify in this behalf.

Explanation: For the purpose of this section, 'deposit' means any deposit of money with, and includes any amount borrowed by, a company but shall not include such categories of amount as may be prescribed in consultation with the Reserve Bank of India.

58B. The provisions of this Act relating to a prospectus shall, so far as may be, apply to an advertisement referred to in section 58A.

8

Monetary Policy and Market Borrowings

The period under study in this volume witnessed dramatic changes in the institutional setting in which monetary policy was conducted. To a considerable extent, the Reserve Bank's policy focused on bank credit as an indicator of its policy. Emphasis on demand management through control of money supply was not in much evidence throughout the 1970s. There were also occasions when senior staff of the Bank themselves appeared to question the efficacy of monetary policy as an independent variable in macroeconomic management. In some ways, this approach tied the hands of economists in the government who had a better understanding of the issues. The Bank was often in a dilemma, sometimes self-created, regarding the choice of policy instruments—statutory cash reserve ratio (CRR), direct flow of credit and interest rates—in that order. Not to put too fine a point on it, its freedom to influence the key variable of monetary policy, namely, the interest rate, was severely abridged, largely on account of the directives from the Finance Ministry and because of the ever-increasing government borrowing. This latter, as we shall see, was basically non-negotiable.

Overall, it is evident that the formulation and conduct of monetary policy by the Reserve Bank was mainly guided by developments on the supply side, most particularly the persistent shortfalls in agricultural production, the resulting inflationary pressures (see Annexure 3), and developments in the management of government finances, namely, the size and mode of financing of the fiscal deficit and the external sector. This was a period of directed lending and credit rationing, which sought to replicate the methods of physical planning in the financial sector. The most significant shift that took place—bank nationalization in 1969—was the fundamental driving force, as well as the instrument, because public sector banks now had a preponderant share in both bank deposits and bank credit, ranging between 85 to 90 per cent. A number of other financial institutions also came under the jurisdiction of the public sector during the period. Several other institutional mechanisms were also evolved. All this altered the nature of the relationship between the government and the Bank, which was left with little say on the structure of the financial system[1] and its most potent weapon, the interest rate.

The market was captive, and consisted of commercial banks, the Life Insurance Corporation (LIC) and other insurance companies, and Provident Funds (PFs). Besides the Centre and state governments, a number of institutions borrowed from the market by issuing 'approved' securities. The overall public borrowing requirement thus represented the requirements of governments and institutions. In general, the government followed a 'requirements' or 'needs' approach while estimating their borrowing requirements on the basis of their perceived needs, whereas the Bank viewed 'market absorption' as the basis for estimating borrowing requirements. The difference in approaches had to be reconciled by appropriate movements in both fiscal and monetary policy strategies. The Bank's influence over movements in foreign exchange assets that impact on money supply was also severely curtailed. Exchange controls were in place and the institution of the Foreign Exchange Regulation Act, 1947 (and the subsequent 1973 Act) ensured that remittances out of the country were severely constrained and closely monitored. Besides, the exchange rate regime was 'fixed' and was rendered inflexible.

The Reserve Bank's other objective of promoting price stability was addressed by controlling money supply but only within the limits permitted, albeit indirectly, by the government's borrowing requirement. If, therefore, there was one basic characteristic of the period, it was the diminution of control by the Bank on the sources of change in money stock. This happ-

[1] The Bank had to agree to the creation of a new institution for rehabilitation and reconstruction of sick industrial units, called the Industrial Reconstruction Bank of India (IRBI), in early 1972, essentially in deference to the wishes of the government. The Bank's two subsidiaries, viz., the Industrial Development Bank of India (IDBI) and the Unit Trust of India (UTI), were hived off from the Bank and taken over by the government in 1976, over-riding the views of the Bank. At the end of the 1970s, a decision was taken, again against the Bank's point of view, to merge the ARDC and ACD of the Bank into a new development finance institution, owned by the government and the Bank on an equal basis, for meeting the needs of agriculture and other rural sector economic activities. In addition, new subsidiaries of public sector banks in the form of regional rural banks emerged beginning 2 October 1975. The banks' managements, on their part, looked up to the Government of India rather than the RBI in support of their actions. In one extraordinary instance, the Reserve Bank had to oblige a commercial bank's request for credit authorization in 1976 when the upper limit for credit for a manufacturing concern that had affiliation with the political party in power was exceeded and the limit raised as a result.

ened because there were no institutional limits on the government for issuing securities and availing of credit from the Bank. The system of issuance of ad hoc treasury bills that had begun so casually in 1956 virtually became the norm and central variable of monetary policy. These bills were issued on tap at a determined discount rate. The Bank was also required to accommodate the public borrowing programme by suitable policy adjustments.

The question may well be asked if the Reserve Bank could have done more than to caution and advise the government. Given the circumstances, perhaps no—because, in the final analysis, the Bank saw itself as a partner, rather than as an adversary, of the government. The fact that its Governors during this period, with one exception (K.R. Puri), had served in the government for long years in highly responsible positions added a complication that was not easy remove. There were, of course, times when senior staff at the Bank showed an inadequate appreciation of the political issues involved. On such occasions they were over-ruled even when the advice they were tendering and the course of action they were suggesting was sensible.

PHASE I: 1967–70

The Scene Is Set

This was a period of severe economic and political stress. The monsoon had failed in 1965 and 1966 but revived well in 1967. Foodgrains production declined from 89 million tonnes in 1964–65 to 72 million tonnes in 1965–66. Industrial production was also down. Money supply was increasing at hitherto unprecedented rates. The budget deficit was high and the current account deficit was higher still. The rupee was devalued in 1966 by 36.5 per cent.[2]

[2] I.G. Patel describes it as follows in his *Glimpses of Indian Economic Policy: An Insider's View*: 'The (1965) war had made it even more urgent to come to terms with the (World) Bank and the (International Monetary) Fund; and this was not possible with T.T.K. (T.T. Krishnamachari who was the Finance Minister of India) around. The choice of Sachin Chaudhuri (a distinguished lawyer from Calcutta as the Finance Minister) was strange, but clever. As a political lightweight, economic illiterate, a thoroughly pleasant and agreeable professional with impeccable manners, he would be pliable and do what he was told, by the PM and by his advisers. To add to all this, he was a personal friend of Bhattacharya (Governor of the Reserve Bank) so that he would be pliable not just to the PM but to the RBI Governor as well . . . within days of his joining the Ministry, I was asked to join Bhattacharya on a visit to Washington. I was given hardly a day to get ready. I was to catch an Air India flight from Delhi and Bhattacharya was to join the same flight from Bombay. A few hours before I left Delhi, Chaudhuri himself handed over to me a small envelope when no one else

1967 began with expectations of some economic recovery. Monetary policy was therefore not as tight as before. But with inflationary pressures continuing, the RBI told banks that 80 per cent of their seasonal credit expansion should be directed to industry. This came to be known as the 80 per cent rule, or the 80:20 rule. Predictably, credit expansion in the first half of the busy season of 1966–67 was high. In April 1967, therefore, there was some tightening leading to complaints from industry, which the government disregarded, because inflation remained at an unacceptably high level.

The tight money policy continued throughout 1967, although it was decided that some businesses would be entitled to lower rates of interest. In a critical editorial titled 'Half-way House', the *Economic Times* of 2 August 1967 welcomed the package of measures in general. But it surmised that the Reserve Bank had decided to select only a few priority sectors for the benefit of a lower rate of interest—which was advocated by a school of thought in the Bank—instead of a formal revision of the Bank rate for passing on the benefit to all sectors. It said that the introduction of dual rates of lending and dual rates of refinancing by the Bank, even within the specified sectors, could be termed as a *de facto* reduction of the Bank rate or an experiment in a dual Bank rate system. 'Such an approach is fraught with danger which the Reserve Bank had evidently not thought about. The policy of liberal industrial licensing and foreign exchange allocation for priority sectors has taught us the bitter lesson of lopsided industrial development.' The editorial pointed out that the Bank's actions for reviving the economy might not prove effective unless there were complementary measures by the government to revive industrial production. More importantly, it foresaw the backlash of the policy of directed credit at costs lower than normal rates over a period of time. The main lesson to emerge from this episode, of prescribing a distribution ratio of seasonal credit expansion, was that the RBI might use priority financing as the main instrument of credit regulation.[3]

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was present. If I remember right, I was sitting in my car on the North Block ramp and he drove up to me to give the "brief" which I was to hand over to Bhattacharya on the plane in Bombay. I was not told what the "brief" contained or what our Mission was about. I learnt about it from Bhattacharya on the plane.'

[3] Acidly commenting on the increasing budget deficit, the same editorial said that: 'The Bank lacks the necessary courage. Its policy will remain timid so long as it remains an appendage of the Finance Ministry and so long as it refuses to recognize that it is an independent central banking authority.'

It was not that Governor Jha was not clear in his mind about what he wanted. But, for some inexplicable reason, the impression had gained ground that commercial banks could grant credit to the priority sectors only if there was adequate deposit growth, and that the banks would, in any event, have to fulfil the credit requirements of medium and large industries. There was also a perception that the credit policy measures were essentially incentives for banks to ensure that they lent to the priority sectors. However, if the banks were induced by the incentives, it would require the central government to come out with a package of incentives for promoting industries other than those in the priority sector. But this was not easy because of the high budget deficit. These concerns were articulated by I.G. Patel, who was the Chief Economic Adviser then, in a letter to Jha in August 1967.

Patel told Jha that in case deficit financing was 'ruled out' and an increase in foreign exchange assets was also not possible, the only way of expanding 'primary money' (that is, the cash base or reserve money) was through the Reserve Bank lending to the private commercial sector and to financial institutions. Patel wondered whether there could be an increase in primary money through the Bank's lending to some newly created financial institutions 'steadily from year to year rather than in a sporadic manner', so that a part of the load on the government budget could be shed and the RBI would have a greater say in the conduct of financial policies of such institutions. Patel also felt that the financing of State Electricity Boards, which was a major and growing proposition, could be taken out of the purview of the government and placed in the hands of a newly created holding company that could be provided finance by the Bank. Patel then mooted the idea of setting up a 'credit council' that could be 'serviced' by the Bank for assessing the credit requirements of the economy and for channelling credit to different sectors. 'The type of arrangement I am contemplating', he wrote, 'would pave the way not only for reasonable expansion in money supply without deficit financing by the government but also for a more rational coordinated credit policy.'

Jha wrote back that restraint on monetary expansion could be better exercised by making the Bank responsible for taking care of the working capital needs of industry as well as agriculture, whether in the private or in the public sector—provided deficit financing was completely eliminated in the budget. 'A transfer of certain financial obligations from the exchequer to the Bank will not generate more resources for the economy and it was especially important that the relief which the budget got should not result in the amounts being spent in other ways.' In the event, nothing happened and none of these ideas were formally implemented because the government was willing to tie its hands on the Fourth Five Year Plan by agreeing to reduced or zero deficits. By the last quarter of 1967, which had seen a normal monsoon, things eased a bit. Even so, monetary policy continued along the old lines.

The monetary stance for 1968 was discussed in January when it had become clear that a recovery was underway. The majority of banks did not favour a reduction in the interest rates on savings bank accounts. Following these discussions, the Reserve Bank announced in February that it would charge a concessional rate of 4.5 per cent to scheduled commercial banks in respect of their borrowing equivalent of the increase in banks' advances to the priority sectors over the average of such advances in the slack or busy season, as the case may be. The refinance at the Bank rate or at a rate lower than the Bank rate under various special schemes was to be additional to what a bank was entitled to obtain on the basis of excess of its NLR (net liquidity ratio) over 30 per cent. The RBI considered it essential to provide refinance at the Bank rate to cover specific purposes such as advances to state governments and their agencies, as also to the Food Corporation of India (FCI) for food procurement operations and for financing (as recommended by the Karve Committee) the distribution of fertilizers and pesticides. Refinance for these purposes was made available in the same way as under the Bill Market Scheme facilities that had been reintroduced in November 1967.

As 1968 progressed, credit off-take increased and inflation began to abate. To further stimulate the incipient recovery, the government announced some fiscal measures in its budget for 1968–69. The Reserve Bank then came out with a cheap money policy by announcing a cut in the Bank rate from 6 per cent to 5 per cent. It took some other collateral steps as well. The discount rate on treasury bills sold on tap was reduced for the first time since the instrument was introduced in July 1965, in place of weekly auctions.

On 6 March, the RBI Governor met bankers to explain the rationale of these changes. The reduction in deposit rates by one half of 1 per cent only was mainly because the RBI feared that there could be diversion of money away from banks if the reduction was larger. The cut in the Bank rate was relevant for banking operations when the bank in question borrowed from the Reserve Bank during the busy season. The Governor, however, hoped that the reduction in rates would permeate through the entire structure of interest rates, especially the advances rates other than those that were placed at over 9.5 per cent per annum. The advances rate (the PLR as it was then referred to) of the State Bank of India (SBI), which was 7.5 per cent in 1966–

67, moved down, as a result to, 7 per cent. Credit during the slack season of 1968 (April–October) was also made less stringent. This liberalization was not confined to only short-term or working capital advances. Since the Bank's objective was to bring about economic recovery, it pursued its liberalization policy to promote term loans as well.

Towards the end of August, the Economic Department of the RBI undertook a review of credit and deposit trends in the slack season and found that all was well. As a result, it favoured continuance of the liberal policy. The only concern was about the slower build-up of investments of banks. But this was mainly due to the State Bank of India not being in a position to extend its investments in the presence of large food procurement operations. Jha met bankers at the end of October and said that the Reserve Bank 'did not propose to make any radical changes in the policy' but proposed a review at the end of January 1969. He did not, however, agree to removal of the ceiling on the advances rate. Instead, he showed an inclination to look into the issue of banks' profitability. Overall, the easy money policy was continued.

By February 1969, it was clear that a good recovery was underway and that inflation was coming down. So the Reserve Bank did not make any changes in the credit policy. In the slack season for 1969, the objective was to build up liquidity in the banking system in order to utilize the available resources in the following busy season. Jha 'requested' banks to invest their surplus funds in government and other approved securities. For the first time, the RBI provided a rationale for this 'request'. It felt that if banks invested larger amounts in securities of state governments and other associated bodies, such as Electricity Boards, State Transport Corporations and Finance Corporations, there would be build-up of infrastructure that would enable banks to provide a larger amount of credit to agriculture and small-scale industries than hitherto.

No policy measures were taken between May and June 1969, and in July, the government, without warning and for political reasons, nationalized fourteen large banks. This created further difficulties for monetary policy as the RBI's autonomy was abridged even further because of what may be termed fiscal dominance.

For the rest of 1969, the easy money policy continued. On 1 November, the RBI Governor met the SBI chairman and the custodians of nationalized banks (the group called the 'Standing Committee of Bankers'), and everyone agreed with the Reserve Bank's suggestion that banks should not compete with one another in lowering interest rates on advances to priority sectors, and that banks could, if necessary and without jeopardizing their profitability, give concessions on interest chargeable for particular 'borrowers', meaning thereby 'small' borrowers.

The end of the 1969–70 busy season coincided with the end of the governorship of Jha. He had presided over a period marked by state activism which moved from social control to state ownership of almost all the major Indian banks. The period is important because it marked the beginning of 'credit planning' as an approach to monetary and credit policy. Analytically, credit planning was envisaged as a framework within which credit policy should be pursued, and credit planning itself should be dovetailed with physical planning so that it became a part of overall monetary budgeting. But, in reality, given the interest rate stipulations, the policy was more oriented towards credit policy than monetary policy. Indeed, monetary policy became a non-factor, so to speak.

The Reserve Bank, recognizing the changing political economy dynamics, attempted to pursue a pragmatic credit policy, adjusting the instruments at its command to the given objectives and the institutional structure. It was during this period that concerns about output, as much as about price inflation, came to the fore in a focused manner. The approach followed until then of a 'controlled expansion' of money supply and credit suited the strategy of financing large-scale public investment, whereas credit planning was geared to meeting the financing requirements of all sectors of the economy, whether or not they were under public ownership. The emphasis placed on priority sector financing through organized credit sources was not only to eliminate the hold of moneylenders and informal credit markets on agriculture and small-scale industries, but also to promote such activities pursued by private individuals for expansion of both output and employment. Few doubted that these methods would work.

At this point, it is useful to refer to the single most important factor that came to influence monetary policy and, indeed, became its only determinant—the government's borrowing requirement. One simple fact tells the whole story. This is that net market borrowings by the government, which amounted to a mere Rs 94 crore in 1967–68, would eventually rise to Rs 2,903 crore in 1981–82, representing an annual compound growth rate of 27.76 per cent. The change in net bank credit to government proxies the financing gap of various governments. It would move up from Rs 247 crore in 1967–68 to Rs 4,915 crore in 1981–82. The change in RBI credit to government was Rs 167 crore in 1967–68. It went up to Rs 3,208 crore in 1981–82.

The low net market borrowing of the Centre in 1967–68 was not only because the amount of loans that matured during the year (Rs 254 crore) was, in relation to the market absorptive capacity, high. It was also because the central government followed the fiscal discipline associated with the logic of the devaluation of the rupee of June 1966.

In 1968–69, the central government approached the market twice — in May 1968 and July 1968, through the issue of long-dated and short-dated securities. Approaching the market more than once in a year replaced the hitherto followed practice of approaching the market only once. During the three annual Plan years that had come to represent a 'Plan holiday', (1966–67, 1967–68 and 1968–69), net market borrowing of the Centre amounted to Rs 256 crore. This low net borrowing needs to be viewed in the context of the low and constrained development activity in the public sector during those years, and the associated effect on private sector industrial activity, which exhibited recessionary tendencies. It was against this background that the Working Group on Resources placed an estimate of Rs 750 crore to be raised through market loans in net terms by the central government during the Fourth Plan. This meant that, on an average, net market borrowings would be Rs 150 crore in each year of the Fourth Plan period.

The amount of maturities of central loans was large (Rs 394 crore) in 1969–70. So, the Bank, in consultation with the central government, agreed to issue on behalf of the government, gross loans worth Rs 500 crore split into two phases of Rs 250 crore each. A long-dated loan of thirty years maturity in the first phase with 5.5 per cent coupon rate at par and a loan of seven years maturity in the second phase with a coupon rate of 4.75 per cent were issued. The first instalment of the loan floated in April 1969 was well received, as there was no fear of depreciation of the scrip and investors were convinced that they could unload the scrip at a convenient time. The second instalment issued in July 1969 was also well received by the market. After adjusting for conversions and providing for cash payments on account of maturing loans not tendered for conversion, the net borrowing of the Centre in 1967–70 amounted to Rs 141 crore. The Bank supported the central loans with cash subscription of about Rs 58 crore.

PHASE II: 1970–73

The Scene Unfolds

It was with a sigh of relief that the country saw off the 1960s. It had been a particularly bad decade, with three wars, two droughts, the death of two Prime Ministers, a massive devaluation of the rupee, political stress and, the most unthinkable of all, the division of the Congress party. By the start of 1970, although a new political equilibrium was still to be found, the economy had settled down, albeit in a new and uncertain domestic environment. The government was convinced that radical measures were required to tackle the endemic problem of poverty. In the growth versus distribution debate, distribution increasingly occupied the government's attention. This meant new ways of doing things, including how to run the financial sector. The nationalization of fourteen banks had left no one in any doubt as to what the government had in mind, namely, credit rationing via fiat, rather than monetary instruments. The government wanted to claim the political credit for allocating commercial credit and not leave it to the impersonal forces of the market. This approach entailed significant consequences for the Reserve Bank, which became a framer of rules for credit allocation and a supervisor of their implementation. The other aspect of its functions, namely, of a framer of monetary policy, shrank to virtual insignificance.

With the 1960s safely behind it, political change was in the air and economic growth was picking up. India prepared to settled down to a period of stability. But, as things turned out, the 1970s were to be worse than even the 1960s. The turbulence continued—one war with Pakistan in 1971 which India won, two droughts in 1973 and 1979, two oil shocks in the same years, high inflation, the breakdown of the Bretton Woods system, and, above all, the Emergency that derailed democracy for twenty months.

Where the RBI was concerned, the main challenge was inflation. From May 1970 up to the middle of 1975, prices would simply not stop rising. Thus, in 1972–73 inflation was 10 per cent, followed by 20.2 per cent and 25.2 per cent in 1973–74 and 1974–75, respectively. This was partly on account of the sharp increase in the prices of petroleum crude and crude oil products, and partly due to relatively low supplies of essential consumer goods. Monetary and credit policy thus came under severe test. Money supply growth was high, and through the first four years of the 1970s, the annual average growth was 15 per cent. It had rarely crossed the 10 per cent mark before. By mid-1974, the price situation had become a major political issue and led to rioting. The government was forced to take drastic steps. It brought down money supply growth to 6.6 per cent via a series of strong anti-inflation measures. Inflation was quickly checked and, by mid-1975, turned negative. Monetary policy increasingly took the form of administrative controls on the cost of credit with supportive refinancing and other direct quantitative controls. There were frequent changes in the statutory and net liquidity ratios. The Bank rate was kept at a high. The cash reserve ratio was used for the first time and frequently during this period. The Bank prescribed a ceiling rate of 15 per cent in the inter-bank call money rate in December 1973 and fixed the treasury bill rate at 4.6 per cent in July 1974.

The slack season of 1970 started with the introduction of Participation Certificates (PCs) in April, and a move towards 'credit planning' in terms of 'planned allocation' of the resources of banks that was to be dovetailed with physical planning. These developments were expected to improve the use of credit, enable an increase in the domestic supplies of goods and services, and result in price stability.

In 1970, two months after L.K. Jha left the Bank, Y.B. Chavan took over as Finance Minister. A cautious person by temperament, he was expected to move carefully. He met the custodians of the nationalized banks on 22 July, and declared that deposit mobilization was 'a matter of supreme importance' and constituted the 'first strategy in the war on poverty'. He was also critical of the tendency among banks to depend on the RBI for refinance for long periods.

By June 1970, it became apparent that bank credit expansion had been larger than in any of the corresponding periods of the previous slack seasons. The Reserve Bank instructed the commercial banks that they should obtain information for credit appraisal from their borrowers on the utilization of existing credit limits, total working capital requirements, and bank finance permissible together with the borrower's ability to meet the gap and comparative financial position for the last three years, as well as cash flows. It was concerned that any sharp reining in of credit might adversely affect select areas of activity. So it continued the refinancing facilities under the Bill Market Scheme beyond the stipulated date.

By the end of August, when credit expansion continued to be high despite the tight credit policy and the price rise did not abate, the Bank raised the minimum net liquidity ratio (NLR). It also introduced measures to regulate bank advances against shares with a view to preventing the use of bank finance for speculative purposes, and raised the statutory liquidity ratio (SLR) from 27 per cent to 28 per cent. But these measures did not help contain credit expansion, which stood at nearly Rs 226 crore during the slack season as compared to Rs 31 crore in the 1969 slack season. This was mainly due to a large increase in credit for enhancing production of non-seasonal items, continued large amount of lending against some seasonal commodities such as sugar, and sharp increases in lending to agriculture and small-scale industries. Credit growth was enabled by the sharp rise in aggregate deposits.

The busy season of 1970–71 started with the outstanding level of banks' borrowing from the RBI at Rs 150 crore, compared to Rs 34 crore in the corresponding month of the preceding year. Jha's successor, Governor S. Jagannathan, observed that:

> while it is appropriate that banks should extend their assistance to hitherto neglected sectors, it is equally important for them to ensure that there is an adequate turnround of funds lent to these sectors. The return of the funds lent to agriculture should, if the credits are based on proper assessment and are followed up with adequate supervision, normally take place in the traditional busy season . . . when the producer should be in a position to repay the funds earlier borrowed.

The monsoon having been good, a bumper crop was expected. It turned out to be 108.42 million tonnes, the highest ever. It was estimated that credit would expand by Rs 600 crore as against Rs 560 crore in the busy season of the previous year. Deposit growth was expected to be at the same level as in the previous busy season, around Rs 350 crore. 'The financing gap', said the Governor, 'would thus appear to be substantial and additional recourse to the Bank might even be as high as Rs 250 crore—more-or-less the order of increase as last year.' The RBI, therefore, impressed upon the banks the need to finance the bulk of the additional credit demands out of their own resources. Recourse to the Bank for finance would only be in the nature of an 'ultimate resort', and that too only for short periods. A new Bill Discounting Scheme for evening out the liquidity pressures within the commercial banking system and for bringing about a measure of discipline in the matter of borrowing by banks' customers, was also announced. The refinancing system was also changed. The base period was moved forward. When the banks protested, Hazari told them that individual banks should get involved in making busy season forecasts and that bank credit expansion could not be made dependent upon 'created money from the Reserve Bank'. Exercise some restraint in providing credit, he said, and pleaded for a genuine bill market—not merely as a facility for borrowing from the Bank. The banks ignored him, of course, largely because RBI funds could be tapped at a relatively low cost.

By the end of 1970, it became clear that credit expansion was too rapid. Money supply was going up at 23 per cent. Prices, too, were rising at over 6 per cent. But before embarking on any harsh credit control measures, the Reserve Bank thought it prudent to consult the government. In response, I.G. Patel, who was the Chief Economic Adviser, wrote a secret letter, dated 7 January 1971, to Jagannathan, to the effect that the government did not propose to interfere in whatever the Bank considered as an appropriate course of action. But he emphasized the need not only for urgency but also for caution in the Bank's actions. Patel's main concern was that nothing should be done that would provoke a reaction that the economic situation was far more serious than was apparent. The Bank got the message and on 9 January, it raised the Bank rate from 5 to 6 per cent, and the minimum NLR from 33 to 34 per cent, effective 29 January. The SLR and the CRR were left unchanged. The Bank also continued with the existing refinance facilities to banks for financing priority sectors.

In order to improve deposit mobilization, the Reserve Bank raised the ceiling on interest rates on different categories of deposits. The savings bank deposit rate was increased from 3.5 per cent to 4 per cent. The rate of interest on deposits of maturity of 15–45 days was stepped up from 1.25 per cent to 2 per cent, and that on 46–90 days was increased from 2.5 per cent to 3 per cent. The Bank also announced an increase of one quarter to 1 percentage point in respect of other maturity periods of deposits up to one year, and an increase of 0.5 percentage point in respect of deposits of maturity of one year and over and up to five years. The maximum interest payable on deposits for periods of over five years was fixed at 7.25 per cent. Smaller banks, however, were, as before, allowed to quote slightly higher rates of interest than those offered by larger banks. The selective credit controls on specific commodities were also modified wherever necessary, keeping in view the changes in their supply and price situation. These measures eventually helped to restrain the year-on-year growth rate in M_1 and the price situation in the months of February and March 1971. Several other collateral measures were announced as well, pertaining to the new Bill Rediscounting Scheme, multani *hundis*, a maximum penal interest rate of 15 per cent for excess borrowings by banks, and so on. The result was a curtailing of bank lending during the busy season of 1970–71. Things came under control.

In spite of the problems on the eastern border with Pakistan and the prospect of war with that country, the summer of 1971 was a relaxed one. The price index went up by September to record a year-on-year increase of about 5.8 per cent. The Reserve Bank kept up a process of fine-tuning, mainly with a view to keeping credit expansion under restraint. By the end of October, deposit mobilization, credit expansion and recourse to the Bank were looking reasonably good. But there was an element of doubt about adequate lending to the priority sectors. This became an issue, partly because of a note by SBI. The note said that the cost of servicing priority sector advances was too high, and that it would not go beyond 20 per cent of the advances because of the impact on profitability. M. Narasimham, Secretary of the Bank, questioned this. He pointed out that in many rural and semi-urban branches, the marginal cost of servicing a few more loans was virtually nil. The Governor then went on to over-rule SBI.

The policy announcement for the busy season of 1971 was a continuation of the fine-tuning vis-à-vis the banks. It was (perhaps correctly) interpreted as conforming more to a seasonal ritual than an enunciation of a perspective on monetary and credit policy. Certainly, there was a problem, because a major portion of the credit was going to the Central and state governments through deficit financing. The Reserve Bank was faulted for not being serious in charging penal rates on the latter's overdrafts. But the growing volume of deficit financing was occasioned by the disturbed situation prevailing on the eastern frontier and the burden on the economy due to the foreign refugee influx. As the Indian army's involvement on the eastern border increased, the Bank extended in December 1971 the scheme of full refinance facilities at the Bank rate, irrespective of the NLR, against defence packing-cum-supply credit limits arising out of confirmed defence orders and acceptance of tenders.

The mid-busy season review of February 1972 showed that the expansion in both food procurement advances and credit for priority sectors was lower than in the first three months of the preceding busy season. There was no pressure on liquidity, in spite of the expected revival of industry. The call money rate ruled at around 7.5 per cent, down from double digits around the same time in the previous year. But the Bank continued to worry about inflation, which, as we shall see, lay just round the corner.

Inflation Control

Prices had been moving up continuously since January: from 4.4 per cent in January to 6.2 per cent in May. The Reserve Bank's approach was to continue with the policy of credit restraint but price increases continued unabated: 6.8 per cent in June, 7.7 per cent in July and 8.4 per cent in August. The budgetary position also began to show further deterioration and the government began to increasingly take recourse to the Bank, which, realizing the need for keeping reserve money growth under check, raised the SLR from 28 to 29 per cent in August. The minimum NLR for application of a higher rate of interest on banks' borrowings from the RBI was placed at 34 per cent. Money supply increased only by Rs 40 crore during the 1972 slack season, whereas broad money increased sharply by Rs 500 crore owing to a large expansion of time deposits.

By October 1972, the RBI was under pressure to ensure that the banks had enough to lend not just to industry but also to the government. A certain sophistry was resorted to then. Commercial banks would, according to the Reserve Bank, still be able to add to their investments in government securities since they could borrow from it at the Bank rate to meet contingencies! The RBI Governor informed the banks in November that a third tranche of central government loans, equivalent of Rs 100 crore, would be issued. To facilitate this, the Bank raised the SLR from 29 per cent to 30 per cent. Simultaneously, the NLR relevant for determining the rate of borrowing from the Bank was raised from 34 per cent to 36 per cent. The existing refinance facilities were continued with the usual adjustment in the base period.

In the meantime, the wholesale price index was increasing at 10 per cent. The huge increase in money supply, over which the Reserve Bank appeared to have lost control, was the cause. It rose by 20 per cent between October 1969 and October 1970, by 11 per cent between October 1970 and October 1971, and by 12 per cent between October 1971 and October 1972. The increase in net bank credit to the government was the major reason. There was nothing the Bank could do about it except monetize the deficits—and vainly exhort industry to produce more.

The high level of deficit financing and the resultant rise in prices had an unanticipated consequence: some politicians wanted to initiate a probe into the working of the Reserve Bank! Babubhai Chinai, M.P., representing the industrialist faction, felt that the Bank had not given 'timely advice' to the government on the expansion of credit or on the limits on deficit financing. Chavan rejected the demand and affirmed the government's sovereign right in economic policy formulation. C.T. Dandapani, M.P., felt that the Bank was merely following the government's decisions and had no independent role of its own. Two economists, C.T. Kurien and V.K.R.V. Rao, also endorsed the demand for an enquiry into the working of the Bank. Rao, an eminent economist and a former Minister, went to the extent of declaring that the Bank's association with developmental activities was neither in consonance with the statute, nor in line with the practices followed by Central Banks in other countries.

These questions were never satisfactorily resolved.

Meanwhile, government borrowing was increasing at will. For 1970–71, the work on how much should be the market borrowings began as early as September 1969. The Secretary's department assessed the availability of funds from major institutional investors, namely, banks, LIC and PFs. The Reserve Bank's estimate was for a gross borrowing of Rs 650 crore and a net borrowing of Rs 480 crore. Narasimham, however, took the view that banks' investments in central government securities could be increased if the SLR was raised from 25 to 30 per cent, in case the RBI's estimate was exceeded. He also felt that banks' investments could be increased since bank branch expansion would help raise larger amounts of deposits, whereas lending opportunities were not rising sufficiently quickly.

Executive Director R.K. Seshadri, however, thought that it might be premature to think that the sharp increase in bank branches following the nationalization of fourteen major Indian banks in July 1969 would help to mobilize large deposits and facilitate the raising of SLR to mobilize additional resources for the government. He took the opportunity to stress that public borrowing would need to be limited since resources were anyway provided to the government by the RBI through the mechanism of automatic creation of ad hoc treasury bills. The concept of deficit financing, as understood then, was represented by holdings of treasury bills (irrespective of who held them) net of deposits of the Centre with the Bank and not all market borrowings. Seshadri's concern was that, logically, the Bank could not abandon the practice of limiting central government borrowings or at least attempting to do so.

It needs to be noted here that the implications of nationalization for market borrowing attracted considerable attention within the Bank. In December 1969, Governor Jha wrote to I.G. Patel, Special Secretary in the Finance Ministry, that, while nationalization helped to complete public market borrowing successfully, LIC and the Employees' Provident Fund (EPF) had been seeking higher yields. Jha saw merit in the requests of LIC and EPF. Banks, too, in the light of the step-up in SLRs, would need to have profitability. He also raised the question of working out a better method of allocation of available resources between the states, given the high degree of activism being shown by the Finance Ministry and the Planning Commission in fiscal and financial matters. Jha, however, did not favour the idea of centralizing all market borrowing and apportioning a fair share to the central government.

Notwithstanding these reservations, the Reserve Bank had helped to secure larger banks' subscriptions to government securities by raising the SLR from 25 per cent to 26 per cent in February 1970, from 26 per cent to 27 per cent in April 1970, and again from 27 per cent to 28 per cent in August 1970. The NLR, as a consequence, was raised by 100 basis points in each of these months to reach 33 per cent by August 1970. Yet, the net amount raised by the Centre, of about Rs 135 crore in 1970–71, was lower than the amount budgeted. The Bank raised the coupon rate for medium-term central loans by 0.25 per cent in view of the preference revealed by banks in favour of such securities.

In 1971–72, however, perspectives about the Centre's borrowing were influenced by the fact that large expenditures were incurred by the Centre for the rehabilitation of refugees from the then east Bengal, and on account of the war with Pakistan. Early in March 1971, I.G. Patel wrote to Jagannathan seeking 'cooperation' of the RBI in raising the Centre's net borrowing by Rs 150 crore. Jagannathan responded positively to provide full cooperation but observed that with the steps already taken by the Bank to safeguard and improve the Centre's ability to borrow, there was no scope for increasing net borrowings to the extent sought by Patel. He suggested that he could agree to the government raising gross borrowings up to Rs 490 crore, which would amount to Rs 158 crore of net borrowing. The budget provided for gross borrowing of Rs 500 crore (and net of Rs 168 crore), close to the figure suggested by the Governor. But when the year ended, the Centre borrowed a net amount of Rs 295 crore—Rs 127 crore in excess of the budgeted amount. This was inclusive of three National Defence loans for a total of Rs 111 crore. The entire borrowing was completed in two instalments.

In 1972–73, with a substantial rise in the deposits of commercial banks, the Reserve Bank felt that the Centre's envisaged net borrowing of Rs 215 crore and gross borrowing of Rs 515 crore in two tranches in July and October could be exceeded by Rs 100 crore. It raised the SLR from 28 per cent to 29 per cent in August 1972. The Centre then decided to raise Rs 615 crore by way of gross borrowing (instead of the originally planned Rs 515 crore) to meet the need of bearing the burden of drought relief. The planned October tranche loan issue was brought forward to September in view of the excess liquidity prevailing with banks. The Centre wanted to raise a further tranche of loans of the order of Rs 100 crore in October 1972. The Bank thereupon reassessed the deposit growth of banks and the busy season requirements, and concluded that there would be no additional resources for the Centre. However, to ensure that the government did not have to pay out in cash on account of the two loans maturing in October and November 1972, Seshadri informed the government that the Bank would examine the feasibility of borrowing at the time of funding of ad hocs in January. I.G. Patel felt that Seshadri's assessment of resources was a bit conservative, and that the government's proposal would involve an additional borrowing by the Centre of barely Rs 30–45 crore.

Governor Jagannathan mentioned the uncertainties regarding the busy season requirements and that, therefore, the Reserve Bank needed some time to decide. Patel agreed with the Governor's suggestion and assumed that the Bank would implement the government's proposed action if it was found feasible. In November 1972, however, Chavan announced in the Parliament the government's decision to raise a further market loan of Rs 100 crore to mop up excess liquidity with banks. The Bank had little option then but to raise the SLR from 29 per cent to 30 per cent and NLR from 34 per cent to 36 per cent in the same month. The Centre, on its part, issued a third tranche of two loans for Rs 100 crore in December 1972. The subscription to this issue amounted to Rs 110 crore, with the Bank investing Rs 46 crore.

The government, not satisfied with its fiscal position, created a fourth tranche of three loans aggregating Rs 45 crore on 1 February 1973 to be taken up initially by the Bank, which would subsequently make the loans available to investors. The Bank was left with no choice in the matter. The Centre, during the year, raised a net amount of Rs 478 crore against the budgeted Rs 215 crore.

PHASE III: 1973–75

The Problem with Prices

By January 1973, the relentless increase in prices was resulting in considerable criticism in financial circles. The Reserve Bank was caught in a dilemma. It could neither check government borrowing, nor, therefore, provide for credit to industry. In the circumstances, it postponed the mid-busy season review that was due in January 1973. In effect, it sought to buy time and then, a little later, went on to make announcements designed to slow down credit expansion that would add to money supply. A series of announcements were made but no one was satisfied. The Bank was also under attack for being too accommodative of the government and ignoring industry's needs, which was not wholly true. Credit expansion to the commercial sector also continued to rise.

The Finance Secretary, M.G. Kaul, wrote to Jagannathan asking whether there could be any further action to moderate credit expansion without adversely affecting genuine productive credit needs. He suggested a minimum lending rate in respect of large loan accounts of over Rs 25 lakh, and said the Finance Minister wanted the Bank to act. Jagannathan replied that greater control over public expenditures seemed necessary. There matters rested.

On 30 May 1973, the Reserve Bank did what it had to. It raised the Bank rate from 6 to 7 per cent and the CRR from 3 to 5 per cent. The NLR and the minimum lending rate of banks were also raised. In general, interest rates were raised as well. But credit demand by the commercial sector did not fall by as much as was anticipated. Nor was there much impact on prices. In June, inflation climbed to 20.6 per cent, even though the 1973–74 crop was anticipated to be reasonably good. Everyone knew where the real problem lay: in massive deficit financing. But the Bank felt compelled to support the government and it was credit to the commercial sector that bore the brunt. On 12 July, more stringent measures were announced.[4] The measures did not go down well with banks and exporters. There was some discussion and, eventually, the government's view prevailed, since the Bank did not take any action in support of its own initial preference for raising rates of interest on export credit. It had become clear to the Bank that the government was not going to budge. So it was forced to focus on the commercial sector. Various options were discussed internally to check the contra-seasonal growth in credit. Some of them were quite bizarre, including an overall ceiling on credit, and indicated how worried the Bank was.

Even as these proposals were being internally discussed, the chairman of SBI, R.K. Talwar, wrote a 'private' letter to Jagannathan, forwarding a note prepared by his economists. The note said that a high degree of correlation existed between excessive money supply expansion over real income growth and price increase, and, in the given context of a year-on-year inflation of 22.3 per cent in July 1973, money supply could increase only at an average rate of increase in real income in the preceding three years together with a margin for monetization. This exercise, as the note observed, yielded an M_1 expansion of only 4 per cent a year. For such an outcome to materialize, the note suggested a number of measures—reduction in the government's budget deficit, mobilization of savings, impounding of banks' deposits and raising of both deposit and lending rates. Talwar said that there were practical problems in reducing credit sharply overnight, and remarked that while it was difficult to forthwith bring down the money supply expansion to 4–5 per cent a year, the 'central bankers' knowledge and insight would no doubt bring themselves to bear on the judgement to be taken'. The Governor wrote on the letter that the difficulty mentioned by Talwar in bringing down M_1

[4] The then existing concessionary refinance facilities at the Bank rate or below it were withdrawn with immediate effect with some exceptions, the exceptions being in respect of: (a) the limited amount of refinancing of export credit, and (b) the refinancing of amounts lent by commercial banks to primary credit societies and farmers' service societies in regard to which there were ceiling limits applicable. Borrowings equivalent of 10 per cent of the annual average export credit was made available at the Bank rate. Such borrowings were not allowed to impair the NLR. The implication of the change in policy was that the existing refinance facilities at the Bank rate or below relating to the (a) increase in short-term lending to small industrial and short-term direct lending to agriculture, (b) food procurement advances, and (c) export credit, excepting those mentioned earlier, would not be available to commercial banks.

growth to the suggested level was a 'gross understatement' and, as such, the note would be of mere 'historical interest'.

By 3 August, M_1 growth had touched an annual rate of 17 per cent. Deeply worried, on 10 August Chavan announced that steps were being taken to cut government expenditure by about Rs 400 crore. The Reserve Bank seized the opportunity to announce a dearer monetary policy on 14 August. These measures were far more stringent. CRR was raised from 5 per cent to 7 per cent in two stages. The minimum NLR at which banks could borrow from the RBI at the Bank rate was raised from 39 per cent to 40 per cent. Even so, given the growth in deposits—time deposits were growing at 22 per cent a year—the banks were left with sizeable funds.[5] The Bank recognized that its measures did not have the expected impact in slowing down monetary and credit expansion and inflation, which refused to abate.

The busy season policy for 1973–74 was announced in this context in November. It was formulated in the background of the Yom Kippur and the resulting oil crisis. The cost of imports of fertilizers and petroleum crude was expected to go up sharply. Jagannathan wanted that credit expansion for the non-food sector should be within Rs 400–450 crore. This was the first time that a ceiling credit was being prescribed by the Bank. The Governor also indicated that lending to commercial banks by the Reserve Bank would not be automatic but discretionary, and that supplementary measures could be taken to restrain credit expansion if found necessary. He asked banks to depend on the New Bill Market Scheme. Some fine-tuning was also done. The banks were not unhappy, and Talwar contended that there was no

[5] Hardly a week after Governor Jagannathan's announcement, appeared a book entitled *Inflation and India's Economic Crisis* by six distinguished economists led by a former Union Minister and a reputed economist, V.K.R.V. Rao. The authors were V.K.R.V. Rao, A.M. Khusro, C.H. Hanumantha Rao, P.C. Joshi, K. Krishnamurty, and Ajit K. Dasgupta. The book was published by the Institute of Economic Growth and Vikas Publishing House (P) Ltd., Delhi. The Preface to the book was written by V.K.R.V. Rao and it was dated 20 August 1973. *The Times of India* carried two articles in September 1973 under the title 'How to Control Inflation' based on this book, expressing the concern of the economists over the deteriorating situation. Pointing out that the increase in money stock was about 38 per cent between 1970–71 and June 1973, as against an increase in real output of less than 5 per cent, owing to 'deficit financing incurred by government', the authors argued that a change was needed in monetary policy on the part of the Reserve Bank by limiting the expansion of currency on government account to a level that will keep the money stock 'somewhat above the level of the growth of real output. When this level has to be exceeded on account of emergency requirements, there should be provision for the automatic extinction of such exceptional additions by suitable surplus budgeting on the part of government'. The authors also recommended other measures outside the purview of the Bank for controlling inflation.

evidence that bank credit had contributed to inventory build-up, and that the major reason for the rise in credit was the cost escalation of both raw materials and wages. Two weeks later, at the end of November 1973, the Bank came out with yet another set of measures. These measures related mainly to SLR and refinance facilities. SLR was raised to 32 per cent. This was the first time two policy announcements took place for the same season, the second very obviously not being a part of the review of the policy.

There is nothing on record to show why the Reserve Bank had taken such a step so quickly and risked giving the impression that the 16 November measures were not well thought out. There is, however, circumstantial evidence that, notwithstanding the government expressing an opinion in favour of cutting government expenditures, deficit financing and net RBI credit to it went on increasing unchecked between end-March and mid-November 1973. What was more surprising was the fact that the rise in net RBI credit to government took place for no good reason.

It was this reality and the inability to influence the movements in the net foreign exchange assets position of the banking sector that forced the Reserve Bank to strive harder for restraining bank credit to the private or commercial sector. Besides, the prospects of improvement in agricultural production during 1973–74 and the strong emphasis on realization of targets of priority sector advances implied a likely increase in credit to commercial sector. By the middle of November 1973, there were also clear indications of a further rise in the inflation rate. Notwithstanding the new data that had become available to the Bank, it is likely that it was compelled to do so by the government, which was very sensitive to public criticism of being a silent spectator to the growing inflationary situation. The truth, as everyone in RBI knew, was that the Central Bank had not acquitted itself well.

The second set of measures met with considerable opposition. There were an unusually large number of representations from industry and trade circles to the Bank and the Finance Ministry. But Chavan came to the Bank's rescue and justified the stringent credit policy.

The Indian Banks' Association (IBA) pleaded with the Governor as well as with Hazari that they were not able to raise enough resources to meet the rising demand for bank credit. The banks, therefore, sought a relaxation in the refinance policy. They went further to suggest that in case general relaxations in refinance policy were not feasible, the RBI could consider providing discretionary refinance 'liberally'. They complained that institutions like the LIC and UTI were taking advantage of the tightness in the call money market by lending at very high interest rates, and sought the Bank's approval for an agreement to have a ceiling of 15 per cent on call rates. They then held out a veiled threat: they would not be able to subscribe to new central government loans that were opened for subscription in December.

In reality, there was no credit squeeze. The banking data collected in December by the credit planning cell showed large expansion of credit even after the 16 November measures. The Reserve Bank felt that while credit expansion in much of December was due to large quarterly tax payments and the normal year-end adjustment of books,[6] banks did not do enough to implement the measures announced by it in November. In fact, some banks had allowed their cash balances to fall below the statutory cash reserve requirement of 7 per cent, and a few of them were yet to maintain the prescribed SLR of 30 per cent.

The question, however, remained as to why banks were not able to contain credit expansion. The public sector banks were obviously under pressure from the government to provide credit to a number of sectors that were considered important from the point of view of output and employment generation. This was evident from the letter that Sen Gupta wrote to the RBI Governor almost immediately after the Governor's communication to banks that the share of priority sector advances to total bank advances, then estimated at 24 per cent, should not be allowed to come down, and that it should, in fact, be increased progressively to 33.3 per cent. He suggested to the Governor that a clarification was needed over his December letter to banks to indicate that the restrictions on credit did not apply to the priority sector. What was significant was that Sen Gupta's letter was not an isolated one. It was followed by letters from M.G. Kaul and M. Narasimham. The Bank eventually decided to go along.

Its efforts had much effect on inflation.[7] The 'all commodities' index of wholesale prices increased inexorably from 14.5 per cent in March 1973 to 24 per cent in December 1973, and further to 26.7 per cent in January 1974. Increases in money supply (M_1) went up from 16.4 per cent in March 1973 to 18.3 per cent in January 1974. By the end of 1973, the oil price shock was so severe that the quantum of credit advanced in nominal terms to take care of cost increases had gone up.

[6] Scheduled commercial banks' annual and half-yearly closing was in December and June, respectively.

[7] The persistence of inflation led Professor V.K.R.V. Rao and a small team of economists to send a memorandum to the Prime Minister on behalf of 140 economist-signatories underscoring the policy to contain inflation. The memorandum was followed by a supplement which the 140 economists did not sign. The supplement was entitled the 'Scheme of the Economists for Monetary Immobilization through Bond-Medallions and Blocked Assets', more widely known by the acronym, SEMIBOMBLA.

The discussions on monetary policy at a Cabinet meeting and at the post-budget meeting of the Central Board of Directors on 1 March 1974 had little impact on the Reserve Bank's perspectives on credit policy. The budget had proposed a manageable uncovered deficit of Rs 125 crore. In March, the Bank provided temporary accommodation to banks to enable them to tide over immediate needs. It was aware that there would be a number of factors that needed to be carefully considered. After taking into account everything, it directed banks on 30 March to pay higher rates of interest on deposits from 1 April without raising the Bank rate. Bank credit during the busy season of 1973–74 had risen sharply by Rs 1,111 crore—the highest till then for any season earlier. Bank deposits had grown only by Rs 677 crore. Borrowings from the RBI rose sharply by Rs 253 crore as against a meagre Rs 18 crore in the preceding busy season. In short, the credit squeeze was not working.

Towards the end of March, M.G. Kaul sent a note to the RBI Governor to the effect that while the credit control measures were announced, the Bank should operate the refinance and CRR with flexibility to avoid severe credit stringency that might lead to a slowdown. The Bank then allowed banks to default on CRR maintenance and permitted them to fully use the bill market facility by rediscounting the bills by what was, in effect, a 'concessional rate', given the NLR positions. The Bank's refinance, the note said, exceeded the ceiling of 2 per cent of total liabilities. As a result, the money supply expansion was largely on account of credit extended to the commercial sector rather than from net bank credit to the government. The Ministry, in effect, suggested tightening of refinance facilities and the Bills Rediscounting Scheme to moderate credit expansion. The note also referred to LIC pumping in funds by exchanging securities in the call money market. Banks were using PCs and call money to sustain their credit expansion. This, as the note observed, 'was not in the spirit of the measures to create a bill market and encourage the use of instruments such as participation certificates'.

Stung by the Finance Ministry's homilies, Jagannathan wrote a rebuttal on 3 April, namely, that if the large credit extended to the public sector and exports were 'excluded', credit expansion availed of by the commercial sector was very different from what was perceived in the Ministry's note. He also pointed out that the Ministry's note had not mentioned the increase in credit to the priority sectors. On the role of LIC and UTI in providing funds in money market operations, Jagannathan said that commercial banks accessed the call money market and approached the Bank only after they had exhausted their own resources and other sources of funds. Had the LIC and UTI been out of the call money market, the RBI would have been forced to lend much more to the banks than what it did, with a large expansionary impact on money supply.

This experience provided two valuable lessons to the Reserve Bank. First, it recognized the limitations of pursuing a macro-approach to credit squeeze via overall credit ceilings, a point that had been underscored by Talwar who had complained that banks did not have sufficient time to prepare detailed credit plans for adhering to the ceilings. Second, it realized that as the year-on-year rise in the wholesale price index was over 25 per cent (it was 28.8 per cent by March 1974), it was necessary to limit credit expansion with some modicum of increase in the lending rate structure in areas where credit demand was more or less insensitive to interest rate variations.

On 18 April, the Reserve Bank announced the slack season policy for 1974. It showed that between September 1973 and March 1974, the share of food procurement credit, export credit, credit to public sector undertakings and credit to priority sectors together amounted to 54.7 per cent of gross bank credit, up from 32.3 per cent. The share of the 'residual' sector thus fell from 67.7 per cent in the 1972–73 busy season to 45.3 per cent in the 1973–74 busy season. The policy made it clear that the refinance and rediscount policies would continue to be selective and discretionary, and the Governor advised banks that net expansion of bank credit during the 1974 slack season could constitute 33 to 35 per cent of incremental deposits. CRR was fixed at 5 per cent but SLR was raised from 32 to 33 per cent.

The policy was generally endorsed but the Department of Banking seemed annoyed. N.C. Sen Gupta wrote on 16 May 1974 to Jagannathan that a 'side effect' of the policy was neglect of small borrowers in the priority sector, particularly agriculture. Sen Gupta's letter followed after his intervention at the meeting of the Central Board of Directors on 10 May, wherein he observed that there was a need to 'urgently' formulate some scheme, especially for banks whose performance in respect of priority sector lending was good and required to be encouraged. Sen Gupta also handed over a note from the Finance Minister to Jagannathan. It said small borrowers and priority schemes like the half-a-million jobs programme and the DRI scheme were being denied credit while the organized sectors received enough funds, especially through relaxations in individual cases and by way of the New Bill Market Scheme.

It is not clear why Chavan chose to write on the issue, having all along supported credit restraint as an important vehicle through which inflation could be contained. The provocation might have been the tone of the reply of Jagannathan to the Finance Ministry note of 3 April. The Minister's letter forced the Reserve Bank on the defensive. The credit planning cell (CPC) of the Bank prepared a detailed note on the issues that were likely to figure in the Governor's meeting with Chavan. The note discussed various issues and options, and explored the feasibility of placing a ceiling on money supply expansion, an idea that was originally advocated by economists such as V.K.R.V. Rao, C.N. Vakil and P.R. Brahmananda. It might be pointed out here that the IMF also favoured money supply ceiling as an important measure to contain inflation. The government, on its part, was seriously considering the arguments of economists that a comprehensive anti-inflation package, rather than a mere focus on containment of money supply growth, was necessary to end inflationary expectations.

Another interesting aspect is that the Economic Affairs Department of the Finance Ministry was in agreement with the Bank. This difference in perception between the two departments within the Finance Ministry came into the open during the discussions on inflation control measures. The Governor met the Finance Minister and other officials such as Manmohan Singh, who was the Chief Economic Adviser, M. Narasimham, Additional Secretary, N.C. Sen Gupta, Banking Secretary, as also Sukhamoy Chakravarty, Member, Planning Commission, and G. Ramachandran, Joint Secretary in the Prime Minister's Secretariat.

The meeting did not produce any concrete results, although the viewpoint of the Department of Economic Affairs seems to have received the favourable attention of the Minister. This meeting was followed by another with representatives of banks on 5 June 1974 at Lucknow, along with senior officials of the Finance Ministry, Jagannathan and K.S. Krishnaswamy. The slack season policy was explained at the meeting and the Finance Minister urged the banks to think of credit planning as the issue of the day rather than 'credit squeeze'.

In the meantime, the pressure exerted by economists for inflation control mounted. C.N. Vakil wrote letters to the Prime Minister on 14 May and 12 June urging policy action for fighting inflation. *The Economic Times* of 11 June reported that the Prime Minister had charged the Planning Commission with the responsibility of devising anti-inflation measures. The news item also stated that a low rate of 5 per cent in money supply expansion was ruled out because of the dependence of central and state governments and other public sector undertakings on bank subscription of their market floatations of loans. The Reserve Bank then set in motion some initiatives but it was clear that this was an exercise aimed at building up credibility for the credit plan, rather than to bring about any serious measures to contain inflation. The plain truth was that without control over government expenditures and the external payments situation, with the rules about priority sector lending and the compulsions to raise the SLR to support government financing gaps, the quantity of money could not be brought down, except marginally. The Bank kept saying as much to the government but nothing was written down.

Eventually, when inflation became the key political issue after the riots in Gujarat, the government decided that the time had come for it to take the initiative to work out an anti-inflation package.[8] This was announced in July 1974. Accordingly, three ordinances were issued on 7 July 1974.

The Additional Emoluments (Compulsory Deposit) Ordinance, 1974, provided for compulsory deposit of the whole of additional wages and salaries, and half of additional dearness allowance. This covered, according to the estimates then made, nearly 18 million employees in the government, the public and private industrial sectors, and was expected to result in an accretion of Rs 450 crore in 1974–75 and about Rs 550–600 crore in the subsequent year. These funds were to be frozen with the RBI and would be repaid in five annual instalments (together with interest due thereon) from the expiry of the period for which the respective deposits were required to be made.

The Companies (Temporary Restrictions on Dividends) Ordinance, 1974, was the second of the measures. It provided for limiting the after-tax profits distributed by companies to 33.3 per cent of such profits or to 12 per cent of the face value of the equity shares of the company and the dividend payable on its preference shares, whichever was less. It was estimated that this would lead to a reduction in dividend payments to the tune of Rs 60 crore and this amount would be available to the companies for expansion or diversification. Following the curb on dividend distribution, the government found it

[8] The package itself was framed, according to G. Ramachandran, then a Joint Secretary in the PMS, by a group with P.N. Dhar, Secretary to the Prime Minister acting as an important motivator of ideas. He was supported by Manmohan Singh, Chief Economic Adviser at the Ministry of Finance, Cabinet Secretary B.D. Pande, and G. Ramachandran himself. Ramachandran, in his oral discussions, stated that the Bank did very little in the matter, and had also not reacted on the interest rate tax that clearly fell in the Bank's jurisdiction. The proposals were first put up before the Cabinet Committee on Political Affairs and subsequently to the Cabinet for its approval.

K.S. Krishnaswamy, in his oral discussions, admitted that the Bank was not involved in the working out of the government's July 1974 measures. He, however, presented an interesting perception on the interest rate tax and the anti-inflation package. Krishnaswamy observed that as inflation could not be contained by the Bank alone, the government had to strongly intervene. On the interest rate tax, he said that the Bank did not protest since the idea behind it was to make credit expensive, which was exactly the spirit behind the series of measures taken by the Bank right from November 1973.

necessary to impose certain restrictions on the frequency of issue of bonus shares. Accordingly, the time-lag between two successive announcements of bonus shares by a company was increased from eighteen to forty months.

The third ordinance, a Compulsory Deposit Scheme, was introduced covering all income tax payers whose aggregate net annual income exceeded Rs 15,000. The rate of compulsory deposit prescribed was: 4 per cent of aggregate net annual income up to Rs 25,000; Rs 1,000 plus 6 per cent of the excess over Rs 25,000 in the income slab of Rs 25,001 to Rs 70,000; and Rs 3,700 plus 8 per cent of the excess over Rs 70,000 in cases where net income exceeded Rs 70,000. The amount of compulsory deposits expected under the Scheme was placed at Rs 50 crore for 1974–75 and Rs 55 crore in the subsequent year. These deposits too would be frozen with the Reserve Bank of India and would be repaid in five annual instalments (together with interest due thereon) commencing from the expiry of two years from the end of the financial year in which the deposit was made.

The government also raised the rates of union excess duties on a number of items. What was more novel from the monetary–fiscal angle was the imposition of a tax at the rate of 7 per cent on the gross interest earned by scheduled banks on loans and advances made in India. It was left to the banks to pass on the incidence of this tax, which, as the Economic Survey indicated, would imply an increase in the rate of borrowing by 1 per cent on an average, to their borrowers. The revenue from the interest rate tax was estimated at Rs 25 crore in the months remaining in 1974–75 and at Rs 60 crore for a full year. As part of a package of anti-inflationary measures, the government intensified its operations against smugglers, hoarders and blackmarketeers in order to immobilize a part of 'black money' used hitherto, in the words of the Economic Survey, 'to finance an undue accumulation of inventories'.

The ordinances were criticized by many trade union leaders and Members of Parliament belonging to the opposition parties. The Federation of Indian Chambers of Commerce and Industry extended qualified support. The economists were conditionally pleased.

The Prime Minister, in a speech at Bangalore on 11 July, referred to the credit squeeze and said:

> It may be that the policy was a little late or relaxations were allowed. Perhaps credit curbs were not selectively applied, with the result there were irresistible pressures from the priority sectors. . . . I have asked the Ministry of Finance to undertake strict scrutiny in respect of the top accounts in all the banks. In

> particular, the use of bank credit to build up inventories will be severely discouraged.

The press interpreted the PM's speech as an expression of displeasure at the Reserve Bank's policy. In popular perception, the Bank was seen as the guilty party, whereas the fact was that it was the government that had been holding it back.

On 22 July 1974, the Bank announced stringent measures that raised the cost of funds. The Bank rate was hiked from 7 to 9 per cent. Interest rates on various categories of commercial bank deposits were increased to encourage greater deposit mobilization. Accordingly, the minimum lending rate was raised from 11 per cent to 12.5 per cent except in the case of exempted categories. The minimum rate of discount on bill finance for drawers' bills was refixed at 11 per cent as against 9.5 per cent till then, while the rate on drawees' bills was raised from 11 per cent to 12.5 per cent. The minimum lending rates on advances against commodities covered under selective credit controls were also increased: the increase was as much as 2 percentage points depending on the commodities and parties. On 31 July, the government came out with a supplementary budget. Additional taxes, levies and duties were to fetch Rs 232 crore. A number of goods including petroleum products were subjected to additional levies. Rail fares were increased and administered prices hiked up.

There were many within the government who considered the measures to be too rigid and harsh. T.A. Pai, Minister of Industry, wrote to Chavan of the problems faced by heavy industries due to the lack of selectivity. The Cabinet Secretary, B.D. Pande, wrote to M.G. Kaul in August that a committee might examine the top twenty-five to thirty accounts of each bank. Kaul replied that the formulation and administration of guidelines should be left to the Reserve Bank.

The key question was whether these measures would suffice, or if something more was required. The Bank was clear:

> It is clearly important that non-monetary policies are also implemented to ensure a better flow of goods and discourage stockpiling. Since in the Indian context, the primary element in any concerted action against inflation is the control of wage-goods prices, especially prices of food articles, vigorous steps have to be taken by the authorities to secure an efficient functioning of the public distribution system for such commodities.

But credit rationing needed to be tackled, and a note on credit policy setting out the objectives and guidelines was prepared by the Bank in September. The Prime Minister chaired the meeting. It was felt during the discussions that while the government should observe discipline by lowering deficit financing, the private sector's access to credit needed to be reduced. The Prime Minister wanted to know whether the policy of credit restraint was pushing the economy towards a recession. It was generally agreed at the meeting that big farmers had staying power and it therefore did not matter as to whether the credit curbs were severe. The more important issue was whether there should be a definition of priority within the priority sector such as size-wise classifications of advances. A view was also expressed that it would not be desirable to set up an elaborate system of centralized control for allocation of credit to individual borrowers. In general, the meeting provided useful insights about the Prime Minister's thinking on the subject. In most cases, it converged with the Bank's viewpoints.

By the end of October 1974, inflation had climbed to 27.4 per cent. The package was taking time to take effect. On 10 October, C. Subramaniam, who had taken over as Finance Minister, met bankers and representatives of the financial institutions, and made it clear that there would not be any departures from the existing credit policy. The credit policy for the busy season also did the same thing. The Reserve Bank decided to continue with selective credit controls in respect of sensitive commodities such as foodgrains, cotton, oil seeds and oil, sugar and textiles, to discourage speculative hoarding of these commodities with the help of bank credit. Banks were cautioned that refinance accommodation from the RBI could only be minimal and temporary, consistent with the objective of limiting the pace of monetary expansion. Some respite was in the offing from December in the form of reduced CRR, but that was about all.

On 4 November 1974, within days of unveiling the busy season policy that was orchestrated in advance by the Finance Minister, Jagannathan, for some inexplicable reason, wrote to H.N. Ray, the Finance Secretary, with a copy to the Finance Minister: 'We in the Reserve Bank would like to convey our congratulations to the government and the Ministry of Finance in particular, on their success in bringing down the government deficit.' He added that he was encouraged by the substantial improvement in cutting down the budget deficit in the first half of 1974–75, and emphasized that 'there is no doubt that fiscal correctives are essential and monetary measures can only support but cannot wholly substitute for action in the fiscal field'.

The government was not impressed. It continued to impose its authority on the Reserve Bank in a number of subtle ways. It informed the Bank on 11 November of its acceptance of the Estimates Committee's recommendation of a minimum of 33.3 per cent of lending to the priority sector, and sent letters to that effect directly to the chief executives of public sector banks. Ordinarily, the Bank would have been asked to send these letters. There is no evidence of the Bank making any formal protest at such a development. The Bank followed up the government's directive with its own advisory to keep up the pretence of giving directions to banks on matters relating to monetary and credit policies.

By the end of the year, inflation showed signs of abating. By February 1975, it became clear that money supply with the public had expanded at a much lower rate. The year-on-year growth by February 1975 in narrow money was only 8.26 per cent, as against 17.27 per cent in the year ending February 1974. Aggregate monetary resources (broad money) also decelerated. By the end of the fiscal year 1974–75, the inflation was down to only 8.9 per cent.

But in April prices again began to shoot up due to seasonal pressures. The Reserve Bank, therefore, continued with the tight credit policy for the slack season of 1975. In Annual Report for 1974–75, it declared that interest rate had emerged as an important instrument of monetary management: the demand for credit was sought to be restrained not only by limiting recourse to the Bank but also through an increase in the cost of credit. Furthermore, evaluating the main features of credit policy implementation over the past two years, it identified three areas, namely, the emergence of interest rate as an instrument of credit policy, better inventory control and the discretionary element in the Reserve Bank lending to banks.

While the continuance of credit policy was logical, considering the uncertainty of permanence of the reprieve from severe inflationary pressures during most of the months of 1974–75, it had also to do perhaps with the fact that the Governor's tenure was to end soon, in any case by 15 June. Everyone had expected Hazari to be the next Governor but, in the event, N.C. Sen Gupta was appointed for a three-month period. He was followed by K.R. Puri in August, who continued until the new Janata government took over in March 1977. M. Narasimham was made Governor for six months and in December 1977, eventually, I.G. Patel took over. The latter half of the 1970s thus saw as many as four Governors.

The economic situation of 1973–74 proved to be difficult, partly because of intense inflationary pressures engendered by oil price hikes and partly owing to the unsatisfactory supply position in regard to agricultural goods. The Reserve Bank estimated the Centre's gross market borrowing to be Rs 880 crore for 1973–74. Net market borrowing was placed at Rs 326 crore, after taking into account the maturity of two loans in May and July 1973 aggregating Rs 554 crore. The Bank proposed a notified amount of

Rs 450 crore in the first tranche in May 1973 and Rs 350 crore in the second tranche in July 1973. The government suggested Rs 500 crore for the May issue, with which the Bank agreed, subject, however, to a review of the position in July 1973.

Following strong monetary policy measures such as the raising of the Bank rate from 6 to 7 per cent and the hike of CRR by 200 basis points to 5 per cent in May 1973, the Reserve Bank assessed the resource availability position and allocated Rs 525 crore to commercial banks for investment purposes so as to reach an overall gross market borrowing of Rs 880 crore. The Bank's earlier estimate of commercial banks' investments was Rs 425 crore for the year. Following the increase in the Bank rate, the government unilaterally raised the treasury bill rate from 3.5 per cent to 4.0 per cent—a measure that did not get the Bank's prior approval. The government perhaps thought that this would act as an incentive for investment in treasury bills. In Seshadri's view, the connection between the Bank rate and the yield on government securities was not direct, given the captive nature of the Indian market. While agreeing that the government's borrowing rates cannot be wholly divorced from the market rates of interest in general, he argued that the increase in coupon rates would result in a large depreciation of securities that could be higher than the increase in income to investors. Seshadri also maintained that the exemption granted to banks not to provide for the depreciation of government securities in their balance sheets was not sound. Governor Jagannathan agreed and did not find that any purpose was being served by the Centre raising coupon rates. The government agreed with the RBI Governor's ideas on interest rates in July 1973.

The Governor also suggested that the Finance Ministry should examine the Centre's expenditure and revenue receipts in order to contain the order of the deficit. M.G. Kaul described the steps being taken to bring about economies in expenditure and stated that the government was anxious that market borrowings be exceeded by Rs 200 crore in 1973–74. Jagannathan was agreeable to a figure of Rs 100 crore but Kaul did not relent. Instead, he argued that the deficit, as defined in the budget, could be reduced if the impounded reserves were invested in dated securities because market borrowings were treated as a normal budgetary source. He suggested to the Governor to consider the possibility of either funding the treasury bills held by the Bank to that extent or raising the SLR to enable commercial banks to invest in dated securities. He added that this matter had been discussed with Chavan who, however, indicated that the Governor's views on the suggestions be sought. Jagannathan discussed the issue with Chavan and explained to him that increasing RBI credit to government was not helpful since this information, published every week, would be compared with the government's budgetary deficit. Jagannathan also held the view that larger banks' investments in government securities by raising the SLR would not be practical. As he did not offer any alternative, his proposal that the government agree to limit the excess of borrowings to Rs 100 crore was belied. On his return to Bombay, the Governor wrote to the Finance Minister that banks could make a larger contribution to market borrowings of the Centre, so that the Bank's monetization of the government deficit could be kept under check. On 30 November 1973, in line with this thought, the Bank announced the stepping up of SLR from 30 to 32 per cent, effective 8 December 1973.

In the third tranche of loans issued in December 1973, the Centre raised Rs 117 crore. There was, in addition, funding of treasury bills to the extent of Rs 100 crore. Overall, during 1973–74, the Centre's net borrowing amounted to Rs 472 crore, as against the initial target of Rs 326 crore. The gross market borrowing of the Centre amounted to Rs 1,026 crore. RBI credit to the government turned out to be high, at Rs 764 crore during the year.

The 1973–74 experience was unusual in that the Bank had to carry over unsold subscriptions to the central loans floated during the year to the subsequent year. This carry-over amounted to Rs 187 crore. To facilitate the 1974–75 central government borrowing, the Bank raised the SLR from 32 per cent to 33 per cent in June 1974 and proposed to issue loans with somewhat shortened maturity periods (of five years, eleven years and twenty-four years). The shortening of the maturity pattern was a deviation from the past and was justified on the ground that interest rates had been on the rise and gilt-edged yields were poised to move up. Besides, the shortening of maturity would reduce the extent of depreciation in the prices of securities and enable the government to replace the maturity loans at more frequent intervals.

The Bank cautioned that the government should keep net borrowing during 1974–75 at Rs 498 crore, partly because there was some evidence of a slack in deposit growth. The Bank, in fact, had to reduce the cash reserve ratio thrice—from 7 to 5 per cent as of 1 July 1974, from 5 to 4.5 per cent as of 14 December 1974 and from 4.5 to 4 per cent as of 28 December 1974. Deputy Governor Seshadri wrote to the government in October 1974 about the difficulty in raising resources for the central loans in one instalment. The second tranche was accordingly split into two. In the three tranches, thus, the Centre managed to borrow Rs 495 crore in net terms during the year. The Bank's cash subscription amounted to Rs 211 crore.

PHASE IV: 1975–77

The Emergency

N.C. Sen Gupta's short stint as Governor had an ironic start. Until then he had been in the Finance Ministry and therefore in a position to instruct the Reserve Bank. But within two days of taking over, the boot was somewhat on the other foot. He had to face the government's displeasure at the Bank's announcement of the slack season policy of 1975 without consulting it. What had happened was that Jagannathan, smarting under the criticism that he was soft and at being asked to leave before his term was over, had announced the policy, perhaps as a final act of defiance, just before he relinquished his post and Sen Gupta took over. It may be recalled that just before the Bank's scheduled announcement of the busy season policy for 1974–75, C. Subramaniam practically upstaged him by informing the heads of Indian public sector banks that there would not be any departure from the policy that was being followed. Jagannathan did not, perhaps, want to have a repeat of the same situation.

Sen Gupta's tenure of three months was uneventful. By the time he took charge, the slack season policy for 1975 had been announced. His governorship, as a result, was conspicuous by the absence of any policy initiative. The only reason he had been appointed was that the Prime Minister and the Finance Minister could not agree on who should succeed Jagannathan.

On 22 May, Manmohan Singh arrived in Bombay and bluntly informed the Bank's top executives that the government felt that there could have been 'prior consultation' with them before announcing the credit policy on 8 May. Sen Gupta and Hazari responded that there was no intention to bypass the government and that, in any case, there was no change in the stance of policy. Manmohan Singh utilized the opportunity to discuss the projection made by the Bank of a little less than 10 per cent increase in money supply during 1975–76, as against the actual increase of only 6 per cent in 1974–75. He also said that he thought the projected growth rate in money supply was on the high side. Hazari and Krishnaswamy explained that it was a preliminary projection on the basis of available indicators at that time, and was a 'rough estimate' of the situation that took into account the 'plausible level' of the factors affecting money supply. But the objective remained the same as before, namely, to keep the growth rate of money as low as feasible. In other words, the estimate of about 10 per cent growth should not be treated in any sense as a 'target'. They also doubted whether all the favourable circumstances that helped to achieve 6 per cent money supply growth in the previous year would be repeated in the ongoing year.

It was agreed that further work on the preparation of projections of monetary budget for 1975–76 would continue and that estimates of expansion in currency corresponding to budgetary deficits would be attempted. It was also agreed that the Bank and the Department of Economic Affairs would have further discussions on these matters in late June or early July.

This meeting was followed by another between the senior officials of the government and the Bank on 4 June in Delhi, with C. Subramaniam in the chair. The price situation and credit availability were discussed in detail. The Bank's preference was for moving the Bank rate up but the Finance Ministry countered that such a move might have unfavourable effects on the climate for investment. Narasimham suggested that if interest rates had to be raised, a much better method would be to raise the rate of tax on the interest income of banks. This idea, however, was not pursued.[9]

But eight days late came the Allahabad High Court's judgment that unseated the Prime Minister for electoral malpractice and, on 26 June, after the Supreme Court had stayed the High Court's order, came the Emergency. On 1 July, at the instance of the Prime Minister, a Group was formed under the chairmanship of M. Narasimham to examine the possibility of opening a few regional banks with branches in rural areas. On the same day, the Prime Minister announced a 20-point economic programme. The next day, Subramaniam voiced concern at a press meet that industrial production and credit expansion did not move positively and in full measure. On 3 July, the Bank issued guidelines for term financing by banks for projects of high priority. It also took up the working out of the operational aspects of the 20-point programme in concrete terms. In mid-August, K.R. Puri took over as Governor. His appointment was seen as political.

By mid-September 1975, the economy was showing signs of a revival. But businessmen were still complaining and it was in this context that the busy season credit policy for 1975–76 was framed. Hazari and Krishnaswamy met C. Subramaniam on 1 October and briefed him on the monetary and credit trends during the first half of 1975. Krishnaswamy said it had been difficult to contain the expansion of M_1 at about 7.5 per cent, as envisaged in June 1975, without sharp reductions in bank credit to the government and to the commercial sector. The Finance Minister did not disagree. An internal note prepared by A. Raman, Adviser, credit planning cell, shows that

[9] The real message that was sought to be impressed upon the new Governor was that he should not initiate any policy action on his own without consulting the government. In other words, policy-making had been shifted out of the Bank.

there were four rounds of discussions with senior officials of the Finance Ministry. Eventually, a meeting was held with C. Subramaniam.

These discussions threw up a number of disturbing questions on the autonomy of monetary authority, which left in no doubt as to where it took its orders from. In the event, monetary policy stayed tight.[10] On 6 November 1975, the Finance Ministry formally conveyed the decision to transfer the responsibility of financing food procurement and fertilizer transactions to the banking system from the then existing practice of providing funds under the budget. The Bank then wrote to the Ministry that it was working on the extent to which deployment of credit could be restructured, since it would call for greater selectivity in the financing of public sector trading corporations. The point made was that it would be difficult to spare commercial bank funds for purposes other than minimum price support operations. The Governor also mentioned that, as discussed at the meeting with the Finance Minister on 25 October, the Bank would, at an appropriate stage, consider making suitable adjustments in cash and liquidity requirements in order to ensure that the stresses and strains on the banking system were moderated.

This letter is important because it implied that 'credit planning' should not be construed as allocation of resources of banks for activities that properly fell within the purview of budgeting and involved trading by the government agencies. Through this letter, the Reserve Bank signalled its preparedness for a departure in its policy framework by shifting away from projections of 'sources and uses of funds' of banks and setting out credit plans, to the preparation of monetary budgets for setting out the desirable rate of monetary expansion and a 'safe limit' of deficit financing.

[10] An interesting development that took place along with the Governor's announcement of the busy season policy on 1 November was the introduction of a scheme to provide non-resident Indians (NRIs) a facility to place deposits in designated foreign currencies on a fixed term basis, with exchange risk being borne by the Reserve Bank of India. The balances and the interest thereon could, on maturity of the deposit, be repatriated abroad in the designated foreign currencies. This scheme, known as the Foreign Currency Non-Resident Account [FCNR(A)], was distinct from the one that did not provide for protection of exchange risk and that helped increase deposits in rupee terms. To the extent the scheme attracted foreign currency deposits, the capacity to absorb additional imports for investment purposes improved and growth stimulus enhanced. While the FCNR(A) deposits reduced the liquidity constraints on the system and led to monetary expansion, the exchange risk cover associated with this type of deposits in the long run implied imposition of considerable stress on the balance sheet of the Bank.

To buttress its viewpoint, the Bank attempted, in January 1976, monetary projections for 1976–77 on the postulate that real income growth would be 5 per cent. Three alternative projections of money supply growth—7.5 per cent, 8 per cent and 10 per cent—were worked out for 1976–77. The monetary projections were discussed at a meeting with Subramaniam and the Revenue and Banking Minister, Pranab Mukherjee. The former took the view that the increase in money supply should be worked out by excluding food credit. Although this was not possible both at the theoretical and empirical levels, there is nothing on record to show that other participants in the discussions pointed this out to him.

The meeting led to two general agreements. First, the government's commitment to the IMF for availing of the oil facility in the Letter of Intent regarding the permissible expansion in credit to domestic sector would be borne in mind while working out monetary projections. Second, there would be a close watch on non-food credit expansion in 1975–76. Both the government and the Bank benefited from this exercise, as it helped the fiscal and monetary authorities to work in tandem and avoid the misunderstandings of the past.

Meanwhile, the Industry Minister, T.A. Pai, was getting exercised over the persistence of high interest rates. Most banks were charging interest of over 16 per cent on approximately 15 per cent of total bank credit. The incidence of such high rates thus fell on a relatively small number of borrowers. But the remaining borrowers, too, could not escape the high interest burden. In Pai's view, with monthly rests the interest rates charged amounted to compound rates. He felt that this was because banks wanted to cover their ever-increasing expenses over which there was no control. Even the term lending institutions were charging higher interest rates for small-scale industry. Pai suggested that a more pragmatic view should be taken on interest rates. An exercise was thereupon undertaken in the Bank on the cost of funds and return on funds of banks. It was found that with the changing mix of deposits and the higher cost of refinance from the Bank, the average cost of funds to banks shot up by almost 1 percentage point, from 3.6 per cent in 1973 to 4.5 per cent in 1974. It was expected to be still higher in 1975. Establishment expenses as a proportion of the total working funds remained by and large stable during the four years 1971–74.

On the earnings side, about two-thirds of banks' funds were pre-empted by low-yielding assets—cash and reserves kept with the RBI, pre-emptive investments in government and other approved securities, and financing of a series of priority sectors (including small industrial units with credit limits not exceeding Rs 2 lakh) which were exempt from the minimum lending rates prescribed by the Bank. The amounts equivalent of 1 percentage point of the statutory CRR of 4 per cent kept with the Bank earned an interest of 5.5 per cent. The interest on treasury bills, on the other hand, was lower, at 4.6 per cent, and other investments in government and other approved securities earned around 6.6 per cent. 50 per cent of bank credit was given at a concessional rate below the minimum lending rate of 11 per cent. As a result, the spread between the interest rates paid on deposits and borrowings and total earnings from loans and investments in relation to the total working funds did not move disproportionately.

There were, according to the Reserve Bank, wider considerations in framing interest rate policy. Interest cost formed only a small part of the value of output varying from 2 to 4 per cent for different industries. The Bank was of the view that with better inventory management, the interest burden could be lower. A study of the finances of public limited companies showed that despite a sharp increase in interest rates, the interest cost as a percentage of the value of output increased only marginally, from 2.6 per cent in 1973–74 to 2.7 per cent in 1974–75.

In December, Krishnaswamy wrote to the Joint Secretary in the Department of Banking that interest rate policy was based on a number of considerations, such as to provide incentives to savings, to discourage excessive inventories of goods and other physical assets and generally to induce a more rational application of scarce funds as between long-term and short-term requirements. These objectives continued to be relevant and the Bank was of the view, under the circumstances at that time, that it was not advisable to make any basic change in the structure of interest rates. He then explained the position regarding the cost of and return on funds to banks, and added that the policy of low interest rates created distortions in the use of short-term and long-term funds—larger inventories, general laxity in cost consciousness, use of capital-intensive technology replacing labour even in areas where economies of scale did not call for such substitution. Krishnaswamy remarked that it was wrong to consider the recession as one requiring a relaxation in interest rates particularly in regard to commercial bank lendings, a substantial part of which was for inventory financing. The allusion here seems to be that if inventory financing is undertaken at low interest rates, there could be speculative tendencies. Krishnaswamy reasoned that it would be necessary to limit inventory financing by determining beforehand the size of term loans that would help to promote fixed investments and stimulate long-term demand. In line with this thought, the Bank advised commercial banks to keep the term loans at around 15 per cent of total advances to benefit the industry.

The economic prospects at the beginning of fiscal 1976–77 appeared promising. The budget deficit for 1976–77 was placed at a somewhat lower level than in 1975–76. The state governments' budgetary position, however, showed deterioration. The Reserve Bank envisioned that the economy would post a growth of 5.5 per cent with industrial production increasing by about 8 per cent. Liquidity was expected to be fairly comfortable. This overall situation resulted in a good deal of internal debate in the Bank about how to proceed with monetary and credit policy.

On 29 April, Krishnaswamy apprised Manmohan Singh over the phone of the measures proposed to be announced at the Governor's meeting with bankers on 7 May. The latter shot back that the 'Secretary desired that such matters from the Reserve Bank should be in writing'. A chastened Krishnaswamy duly wrote to Manmohan Singh on 30 April, setting out the proposed measures. The government did not react to the letter, implying that they had no serious objections to the proposed measures. This episode was a rude reminder that the Bank's policies could be formulated only with government's concurrence.

For most of the rest of 1976, monetary restraint continued. Prices had begun rising in the first half and the problem was not seasonal. Some of the problem, at least, was caused by speculative activity in cotton. Manmohan Singh pointedly told the Bank: 'Government would like the Reserve Bank to examine the matter on a most urgent basis for such action as it is considered appropriate in the direction of tightening credit against cotton.' R.M. Honavar, Economic Adviser, also wrote to Krishnaswamy on what he called the government's 'decision' that in order to keep check on the prices of raw cotton, the earlier relaxation on margins for credit for holding stocks of cotton should be withdrawn immediately, if not already done. The RBI issued a directive to banks on 8 July 1976, raising the margins on raw cotton.

This was not the only instance where the government's influence on the Reserve Bank's selective credit control mechanism was visible. Yet another example was when T.A. Pai suggested a review of the position in regard to advances to gur and vegetable oils, especially for use by vanaspati manufacturers. In deference to the wishes of Pai, the Bank raised the margins on vegetable oils and oilseeds on 15 July.

In the internal assessment of the price and monetary and credit situation in the months of July and August 1976, the credit planning cell had taken the view that the increases in the prices of sensitive commodities such as raw cotton, fibres and oilseeds should be viewed as requiring the creation of a commodity buffer to be financed by means that were not necessarily through resort to the banking system. The assessments showed that monetary expansion in the first months of 1976–77 was higher than initially expected, and that the price situation reflected an underlying 'psychology regarding price expectations' fed by several factors such as the large monetary expansion, some speculation in the commodity markets, delay in the onset of monsoon, the absence of any contingency plan to improve availability of commodities despite a good foreign exchange reserve position, the announcement about the release of impounded dearness allowance payments and the abolition of dividend restrictions. The evaluation further revealed that the money supply growth should be seen against the large expansion of food procurement credit at the expense of non-food credit and the increase in net foreign exchange assets. The implication of the study was that non-food bank credit as such might not have had any significant role in encouraging speculation. The assessments formed the basis of the Governor's discussions on the price situation at the Finance Ministry on 21 August.

By then, Hazari had been divested of the responsibility relating to economic policy matters, and the monetary and economic research departments were placed under the charge of Krishnaswamy who, as Executive Director, had been overseeing these areas even earlier. Nevertheless, Hazari must have been cogitating on the disturbing macroeconomic trends. So, in a note prepared in August, he predicted that there could be a spurt in bank credit during September and October. To counteract the situation, he suggested a hike in CRR from 4 to 5 per cent (which was eventually implemented), a phased reduction in Bank refinance by end-October (which was taken up in September) and a rise in the Bank rate from 9 to 10 per cent. He proposed that ceilings on lending rates and inter-bank rates should be either lifted or revised suitably upwards.

Around this time, serious thinking was afoot within the Bank to have a hard look at the concept of money supply (M_1) and how far it was a reliable guide for analysing the price situation. With time deposits becoming relatively sizeable, it had become imperative to examine the relevance of M_1 and its correlation with output and prices vis-à-vis that of broad money. The monetarists' preference was to use the concept of broad money. But the Bank, although it had devised the broad money concept under the nomenclature 'aggregate monetary resources', had never used it till then for policy purposes. It was against this backdrop that a Working Group under the chairmanship of M.L. Ghosh was set up to examine the concepts and compilation of money supply. The Working Group—the second on the subject, the first having been in 1961—submitted its report in January 1977.

The report brought out four money supply measures and extended the coverage to the cooperative credit system by including the major liability and asset items of district (central) cooperative banks, urban cooperative banks and salary earners' societies in the compilation of money supply data. It favoured the broad concept of money in order to gauge better the liquidity in the economy. The report contained monthly series of the four measures of money supply right from March 1970 onwards. The Bank accepted the recommendations and began to publish in its monthly *Bulletins* the new series of money stock measures (M_1, M_2, M_3 and M_4) along with sources of change in broad money (M_3) from March 1980. Till then, the sources of change in money supply were viewed only from the viewpoint of M1 (narrow money). Although the statistical data were furnished in the monthly *Bulletins* from March 1980, for policy purposes the focus was mainly on M1 during almost the entire period of our study. M_2, which included M_1 and post office savings deposits, and M_4, which incorporated M_3 and deposits with post offices, were not used in policy formulation at all.

Along with the efforts to have a more meaningful concept of money supply, the Reserve Bank also made its periodical assessment of the credit situation. The Governor wrote a letter to scheduled commercial banks on 25 August about the need to tighten credit. Taking into consideration the liquidity position and the need for further regulating the lendable resources of the banks, the Bank raised the cash reserve ratio from 4 per cent to 5 per cent from 4 September. Following this hike, the minimum cash and liquidity requirements went up from 37 to 38 per cent. In early September, the Bank made yet another assessment and tightened things further.

But none of this helped. Money and credit kept expanding, and annual inflation was of the order of 11 per cent. On 1 November, two days before the meeting of the Governor with the Finance Minister, Hazari, in an internal note, expressed concern that the expansion in M1 was beyond the safe level. He observed: 'It is not appropriate to say that the growth of money supply would have been negative but for the growth in food credit and increase in foreign exchange reserves.' He argued that in any arithmetic there were several components in every equation, and a change in some of the components did not justify the conclusion that the outcome of the equation would be all right if some of the components were left out. Hazari's note was a muted insider's criticism of the manner in which non-food credit trends were shown by the credit planning cell as not having an impact on prices. The discussions with the Minister resulted in a consensus view that further policy restraints should be introduced.

The Governor then wrote to the banks that the CRR would be raised from 5.0 per cent to 6 per cent, effective 13 November, in order to regulate the lendable resources of banks. The cash balances maintained with the Bank in excess of the statutory minimum were to be paid the same interest (of 5.5 per cent) as prevailing at the time. As a result, the minimum cash and liquidity ratio had gone up to 39 per cent from 38.

By the middle of November 1976, it became apparent that at 10.9 per cent the annualized rate of M_1 expansion would turn out to be much higher than the 12.1 per cent recorded for the full year 1975–76. The large non-food credit expansion of Rs 880 crore, as against an increase of Rs 402 crore in the comparable period of 1974–75, was also viewed as a disturbing development. It resulted in more directives from the Governor to the banks. All in all, during the first nine months of 1976–77, credit growth was strong, and was fortunately taken care of to a substantial extent by a robust growth in deposits. Money supply rose sharply by 13.9 per cent, as compared with the increase of 6.5 per cent in the corresponding nine-month period of 1975–76.

The raising of the CRR to 6 per cent and the exhortations of the Governor to banks for putting in place strict credit discipline should be viewed in the context of the limited capabilities of banks to adhere to them. A development in December 1976 revealed the presence of what economists in later years have described as the 'time inconsistency problem'. Some banks found it difficult to maintain the minimum CRR of 6 per cent, with the result that the CRR for the entire banking system, which was 6.11 per cent of total net liabilities for the week ended 3 December 1976, declined to 5.91 per cent for the week ended 17 December 1976. Banks fully used the basic refinance limits—and one bank, in fact, came close to maintaining negative balances.

The Reserve Bank provided special refinance assistance to that bank to make good the minimum level of cash reserves. It had a high credit–deposit ratio of 80 per cent and the Bank therefore asked it to bring it down in order to match the asset liability structures. M. Narasimham, who became the Banking Secretary in November 1976, wrote a letter to Deputy Governor Krishnaswamy on 23 December 1976 raising this issue and the large utilization of food refinance by banks that appeared to be higher than the permissible limit. He also remarked that the basic refinance amount was higher than the limits fixed and wanted to be informed of 'what the Reserve Bank proposed to do by way of corrective action'.

At the suggestion of Krishnaswamy, Raman wrote on the subject to Manmohan Singh on 26 December 1976, saying that quarterly income tax payments fell due during the first fortnight of December, the month when credit expansion would normally be substantial. He pointed out that in the past many banks used to approach the Reserve Bank for refinance facilities, especially for financing income tax payments. But in order to minimize such recourse, the Bank had advised them to plan their resources for the purpose. This, however, was not feasible. The commercial banks resorted to available refinance entitlements, particularly against food procurement, and made some draft on the statutory cash reserve requirements. Governor Puri then wrote to Subramaniam on 11 January 1976 explaining the measures taken by the Bank to contain non-food credit expansion.

There was no formal response. Puri was so sure that there would be no opposition to his proposals that on 13 January he announced the Reserve Bank's decision to impound 10 per cent of the incremental demand and time liabilities from 14 January to April. These balances were to be deposited with the Bank. Puri informed banks that there could be no shortfall in this regard and any adjustments that might have to be undertaken would need to be carried out before 9 April 1977.

A week later, the Finance Minister called for a meeting of senior officials of the Finance Ministry and the Bank. There was a general recognition that the growth of money supply should be limited. However, there was a difference of opinion on the amount of regulation of non-food credit at the peak of the busy season. The restrictive policies pursued so far by the Bank received support from the Finance Minister who also suggested that it should not yield to pressures to relax the policies.

But pressures existed and surfaced in different ways. The statutory liquidity ratio was structured to meet the needs of public borrowing, and the burden of food procurement credit was passed on to the banking system. In addition, as the Finance Minister himself stated at the January meeting, the 'genuine needs' of seasonal industries such as sugar, jute and cotton textiles and priority sectors should be met by redeployment of credit within the framework of the overall credit discipline. He did not, however, spell out how credit redeployment could be effected in the short run.

Earlier, Manmohan Singh had written to Krishnaswamy that as the FCI could not repay about Rs 250 crore to the government, and as the budget for 1976–77 took credit for this amount, the Reserve Bank could arrange to provide FCI additional credit of Rs 250 crore. He felt that an 'exaggerated picture' of the budgetary deficit would be conveyed in the revised estimates for 1976–77 in the event of the FCI's failure to honour its commitment. Krishnaswamy thought it fit to pass on the letter to J.C. Luther, newly appointed as Deputy Governor, who was widely regarded as having gained the confidence of the Governor. The needful was done.

The government's deep concern about money supply expansion and price increases was reflected in an unusual manner when, in the last week of January 1977, the Joint Secretary in the Banking Division, Kusum Lata Mittal, wrote to Raman about the interest shown by the Cabinet Secretary, B.D. Pande, in having a preliminary paper on how to contain money supply growth to 8 per cent in 1977–78. The paper was to be prepared by Narasimham and Manmohan Singh in consultation with the Governor.

Pande held the meeting on 9 February. Raman represented the Reserve Bank. According to him, Pande complained that while the government had taken all necessary measures to keep inflation in check, including the use of foreign exchange through import liberalization, the inflationary tendency at the macro level resulted from large monetary expansion. As Raman put it, Pande's grouse was that 'the fly in the ointment was monetary policy', which was inconsistent with the policies of the government. Pande wanted to limit money supply growth to not more than 7 per cent to 8 per cent.

Manmohan Singh raised the point as to 'how they could reconcile the objective of containing money supply with the directive given by the Department of Banking regarding the minimum share of priority sector advances at 33.3 per cent by March 1979'. Narasimham argued that the 33.3 per cent of loans as priority sector lending was a 'commitment given by the Minister for Revenue and Banking to the Parliament', and added that there should be no difficulty for banks to comply with the target if only the excess credit that was already in the pipeline could be redeployed by banks. Pande endorsed Narasimham's view and, at the same time, suggested that the Bank should evolve a positive programme of measures to restrain money supply expansion during 1977–78.

The Reserve Bank should have been able to stave off criticism from the government that it was not able to restrain money supply. That it was not able to do so underlined its dilemma of having to reconcile the need to limit money supply expansion to 9 per cent with the need to provide for priority sector advances to the tune of 33.3 cent of total advances. It was never clear how these ratios were to be defined and there were divergent opinions between the Bank and the Finance Ministry. In the final analysis, the Bank could not oppose the government, for two possible reasons. One was the Emergency and the sudden sidelining of Hazari. The other was that even though the government knew what the Bank had done to tighten money supply, it needed to have the Bank take the blame. In the event, the Bank allowed itself to be passively led by the government and hoped for the best possible outcome.

There is nothing on record to show that the Bank took a definite stand as to how the monetary policy should deal with inflation and growth under the constraint imposed by the government's seemingly insatiable thirst for larger and larger amounts of public borrowing. All it could do was to suggest that the government reduce its fiscal deficit and give in to the government's demands for credit when its suggestion was turned down.

The helplessness of the Reserve Bank found an echo in the presidential address given by Krishnaswamy at the 59th Annual Conference of the Indian Economic Association held at Mysore on 28 December 1976. Krishnaswamy's personal view on the causes of inflation and distribution of income ran thus:

> . . . in my judgement the lack of resolution of such problems is not due to non-availability of relevant or sophisticated economic analysis. Rather, it is because of implicit and explicit value judgements. Hence it is necessary that the economist keeps in mind a variety of para-economic elements that impinge on operational decisions. At the present juncture there is some danger that an unusually large expansion in money supply with the public or aggregate monetary resources accompanied by a general increase in prices will either be unduly played down or unduly played up, depending on one's role in the economic system and one's political or economic ideology. There is undoubtedly need for exercising great restraint but not, in my view, for panic or scare-mongering. While the general policy of avoiding cheap credit and moving towards better planning of its use are parts of the desiderata, the basic solution to the problem of concurrent price increases and demand inadequacies has to be found elsewhere, namely, in the resolution of conflicts on the plane of objectives and sectional interests. Inflation, in other words, is not so much a monetary as a social phenomenon; and its nemesis has to be sought at a fundamental level, that is the changes reflected in the socio-economic structure.

In a sense, Krishnaswamy's view reflected the position that money supply expansion or even credit expansion cannot be controlled by the Central Bank of the country alone. Implicitly, it meant that the Central Bank could do little unless the government as a 'group' cooperated with it. In so far as 1976–77 was concerned, there was a marked slowdown in the expansion of credit to the commercial sector during the last quarter but was neutralized by large monetary expansion following the accretion in foreign exchange assets and high net bank credit to the government. As a consequence, M_1 growth was 19 per cent in 1976–77 compared with 10 per cent in 1975–76.

On 22 March, the government was defeated in the general election. Morarji Desai became Prime Minister and H.M. Patel, a retired career bureaucrat who belonged to the Indian Civil Service, became the Finance

Minister. Patel presented an interim budget on 28 March 1977 projecting an overall deficit of Rs 632 crore.

The new government was greeted with a number of representations to reverse the stance of the then extant credit and monetary policy. Kusum Lata Mittal forwarded one such representation on 18 April to Raman, pleading for reduction in the Bank rate first by a minimum of 3 percentage points and thereafter by some more margin, as well as for relaxing the credit squeeze. The telex, being an open communication, caused concern in the Reserve Bank. Raman wrote to Mittal that she should not send such open communications. Krishnaswamy also told Manmohan Singh that the Bank did not appreciate communication of sensitive matters by telex, and that credit policy matters should preferably be discussed by the Department of Economic Affairs with the Bank.

In regard to the reduction in interest rates, he said that in an environment of an imbalance in the overall supply and demand, any downward revision of interest rates could aggravate the inflationary situation. Moreover, a reduction in lending rates would have to be accompanied by reduction in deposit rates as well, which might dampen mobilization of savings. He also said that there was no evidence that the credit policy had stifled trade and industry, and that, on the other hand, the policy of credit discipline had resulted in credit flows in line with the 'priority indicated'. Manmohan Singh agreed and assured him that it was not the intention of the government to consider changes in interest rates at that point of time. Encouraged by the change in the stance of government, Krishnaswamy told Manmohan Singh that the incremental CRR of 10 per cent need not be renewed beyond the end of April. Manmohan Singh's response, however, was typical. Yes, he said, unless the government suggested otherwise.

Soon thereafter, K.R. Puri, who was seen as having been 'too close' to the Gandhi family, was removed from his post. His place was taken by Narasimham.

Against the background of the reductions in CRR and increase in SLR in the face of the expected slowdown in deposit growth in 1974–75, the Sixth Finance Commission had recommended repayment by states of loans taken from the Centre in 1963 amounting to Rs 100.21 crore. In view of this recommendation, the Bank suggested a reduction in the Centre's borrowing in 1975–76 to the tune of Rs 100 crore from out of the Centre's net borrowing, initially fixed for the year at Rs 400 crore. In other words, net borrowing should, according to the Bank, be Rs 300 crore. However, as the Bank earned higher profits during the accounting year 1974–75 (July–June) because of a number of factors such as the holding of a larger amount of foreign exchange reserves, the increase in the Bank rate as well as in the treasury bill rate, and rise in gilt-edged rates and yields, it was in a position to transfer a slightly larger amount of Rs 150 crore to the government in the financial year 1975–76 compared with the transfer of Rs 145 crore in 1974–75. The Bank made a further assessment and suggested that the Centre's net borrowing could be higher, at Rs 350 crore.

But M.G. Kaul wrote in July 1975 to Governor N.C. Sen Gupta to consider increasing the government's borrowing in view of the expected increase in deposit growth or to consider other agencies to come to the market to relieve any excess liquidity that banks might have. Sen Gupta wrote back that Kaul's proposal implied excess liquidity, which would bring down the lending rates. He felt that there was no need to reconsider the Centre's borrowing programme at that juncture. Since there existed uncertainties in anticipating deposit growth and credit demands, he observed that it was necessary to review the Centre's borrowing programme from time to time rather than pitch the borrowing amount at a level where the Bank would have to hold on to unsold central loans in the event of low deposit accretion with banks. As Seshadri made clear to Kaul, the only consideration on which the borrowing programme had to be based was that 'it should not be necessary for the Reserve Bank to print money' to sustain the programme. Later, in September 1975, the Centre's borrowing programme was enhanced by Rs 100 crore. In the event, it raised a total net amount of Rs 452.7 crore in 1975–76. The Reserve Bank's cash subscription to the loans was Rs 203 crore.

The high growth in bank deposits and the slack in the demand for bank credit enabled the Reserve Bank to propose a larger market borrowing for the Centre for 1976–77. The Centre approached the market thrice—in July, October and December 1976. In addition, the Bank subscribed to central loans of Rs 100 crore and Rs 85 crore respectively in February 1977, and March 1977 on the understanding that they would be made available to investors at prices notified by the Bank from time to time. The Bank raised a net amount of Rs 849 crore and a gross amount of Rs 1,124 crore. This was the highest amount of borrowing by the Centre in any one year till then. Besides, CRR was raised from 4 to 5 per cent on 4 September 1976 and further to 6 per cent on 13 November 1976. Moreover, an incremental CRR of 10 per cent of the increase in net demand and time liabilities over the base period was imposed for the first time effective 24 January 1977. The impounding of resources, however, did not come in the way of banks subscribing to the expanded market borrowing programme.

During the year, the Reserve Bank made a proposal that long-term government securities should have higher rates of return than what were then obtained, as the cost of funds of banks had been rising and was estimated to be as high as 5.7 per cent a year. In 1974, as against the Bank rate of 9 per cent, the yield on long-dated (twenty-eight years) central loans was 6.5 per cent and on a four-year loan, the coupon rate was 5.25 per cent. Seshadri, therefore, suggested that a rate of 7.5 per cent to 8 per cent for long-dated security with a maturity of twenty-five years should be obtained over a period of four to five years. During this period, as Seshadri argued, the average maturity of outstanding debt should be contracted and the rates and yields should be increased by about 0.25 or 0.5 per cent at a time at reasonably spaced intervals. Seshadri proposed that the rates and yields for long-dated central loans from 1993 to 2003 should be adjusted to provide for increase of 0.25 per cent to 1 per cent in the case of loans with maturity in each year, and all other rates and yields should remain unchanged. Seshadri's proposal, however, was not considered by the Centre, which preferred to maintain status quo in regard to borrowing rates.

The trend of high market borrowing that was set in 1976–77 was continued in 1977–78. The exercise for the market borrowing programme for 1977–78 was taken up by the Reserve Bank in November 1976. Before the figures were firmed up, a turf war as to who should be in charge of market borrowings took place in the Finance Ministry. Since this had some implications for the Bank, it would be useful to elaborate on it. In December 1976, the Banking Secretary, M. Narasimham, wrote to Governor Puri and the heads of the central financial institutions that since the Banking Department had been planning the devolution of available resources, the issues relating to market borrowing should be first referred to it before a reference was made to any other agency. The Bank, therefore, advised the Department of Expenditure to obtain the view of the Banking Department in regard to the Centre's market borrowing programme. The Department of Economic Affairs, sensing that there could be a 'crossing of lines' between the departments, asked the Bank to address such letters to it since it was most concerned with the coordination of the public borrowing programme. It is not known how the issue was resolved.

The Reserve Bank, aware that the earnings of banks were sharply reduced by the increase in CRR in 1976–77, wanted the government to raise the yields on government securities. In January 1977, Deputy Governor K.S. Krishnaswamy suggested to the Ministry that the yield on long-dated securities should be raised from 6.5 per cent to 7 per cent in 1977–78. He did not suggest any change in the yield on short-dated securities. The yields on medium-term securities could be, according to Krishnaswamy, between 5 per cent to 7 per cent.

The change of government at the Centre in early 1977 made very little difference to the size of market borrowings. In the interim budget for 1977–78, the government made a provision for net borrowings by the Centre of Rs 889.75 crore and gross borrowings of Rs 1,019 crore. In May 1977, the Centre raised Rs 100 crore in cash through a private placement with the Bank over and above the market borrowing allocation for the year. The amount was shown as a special issue to the Bank available for sale to the public as and when necessary, and was included as part of market borrowing in the budget. The net receipts from borrowings during the year were Rs 1,183 crore, showing an increase of Rs 334 crore. The Centre approached the market twice and made sales to the Bank thrice. The gross amount mobilized was Rs 1,312 crore. Thus, during the first year of the new government, there was larger resort to private placement of loans with the Bank.

PHASE V: 1977–79

The Janata Period

Soon after the new Janata government took over, N. Narasimham was appointed RBI Governor. He decided to continue the 10 per cent incremental CRR requirement until further advice and thus clearly signalled that an easy money policy was not in the offing. He told bankers that the monetary and credit policy should continue to restrain monetary expansion. The SLR was kept unchanged at 33 per cent.[11] Several measures were taken to rationalize the interest rate structure and some rates were lowered.

But C.N. Vakil and P.R. Brahmananda were not happy. On 2 July, they wrote to the Prime Minister that the Reserve Bank should have raised interest rates in order to douse inflationary expectations, and argued that interest payments formed a small part of production costs and therefore were not important to industries. From the past experience of companies in India, they said, rising interest trends would turn firms away from banks to other sources, leading to less bank borrowings. They suggested that monetary expansion should be reduced to a five-year linear trend in real output growth, and urged the government to reduce its borrowings from the Bank. The letter also suggested that strict fiscal discipline be enforced.

[11] An interesting sidelight to Narasimham's tenure was that H.M. Patel happened to be in Bombay on 27 May when the slack season credit policy for 1977 was announced. He took the opportunity to address the chief executives of major banks at the headquarters of the RBI. This had never happened before. The Bank was rife with speculation as to the significance of this. What did it really mean? The puzzle was never solved and no comments were made on the autonomy of the Bank in the press or in the academic writings of the time.

The interest rate reduction captured the attention of political leaders as well. Chandrashekhar wanted to know why the Reserve Bank or the government had not made any statement. He said the reduction in interest rates would act as a disincentive to savings. The rationale of the distinction made in the savings accounts was not clear to him. He also expressed the view that cheaper credit would provide an incentive for hoarding of commodities and for inventory build-up, leading to price increases. He argued that a reduction in deposit rates would imply less income for a large number of small savers while a reduction in the lending rate would help a few large borrowers, especially those in the private sector. He feared that this could lead to a shift of resources from public investment to private investment. Narasimham wrote to Manmohan Singh setting out the Bank's views on the points raised by Chandrashekhar.

The Bank's stand was that there was no need for a general reduction in interest rates. The emphasis was on rewarding the savings character of term deposits and on promoting capital investment by reducing loan rates only for term loans of over three years. Narasimham also wanted, as he mentioned in his address at the thirteenth annual general meeting of the Indian Banks' Association on 28 May, banks to frame their own code of conduct on payment of interest, competing for deposits and other issues, and ensure that business ethics and practices were adhered to.

The Reserve Bank also initiated discussions with the Planning Commission on the monetary budget and other aspects of credit policy. The meeting took place on 25 July. It reflected Narasimham's conviction that credit planning should be dovetailed with physical planning. In the past, although there had been some dialogue between the Bank and the Planning Commission, there had been no such meetings at the highest level. Narasimham wanted to impress upon the Planning Commission a simple fact: thanks to the mandated lending to various sectors, the Bank's room for manoeuvre was very limited. He also pointed out that the enormous increase in food credit in recent times had created distortions and wanted the budget to finance food stocks. Krishnaswamy spoke about credit allocation.

The Members asked several detailed questions and the meeting was a generally successful one to the extent that the Reserve Bank received a patient hearing for the first time. Restricting money supply growth, everyone agreed, was a common objective. But it was clear that the methods were less easy to agree upon. For example, regarding Raj Krishna's suggestion to empower the Bank to put a ceiling on monetary expansion, Narasimham said it could be done only if the Bank refused to honour governments' payments! The final takeaway from the meeting was that Narasimham did not commit himself to the use of M3 for policy purposes, even though Raj Krishna explicitly favoured it.

Two other developments during Narasimham's tenure are worth recounting here, as both had considerable policy implications from the point of view of conduct of monetary and credit policy. One of these took place in June 1977 in connection with the financial assistance for monopoly procurement of cotton in Maharashtra. The outcome of this development was significant in that it nipped in the bud the possible emergence of such schemes from different states, at least for some time.

The Maharashtra State Marketing Federation wanted to have a monopoly over the purchase of cotton and to trade in that commodity primarily for making profits rather than for stabilization of raw cotton prices or for equitable distribution of incomes among cotton growers. The monopoly character of the operations was not in line with the policy of support of the Reserve Bank to state cooperative banks. The Bank, therefore, suggested that the monopoly scheme be converted into a normal marketing scheme financed by funds from state cooperative banks. It also clarified that it would not provide any direct refinance assistance to the monopoly procurement scheme, since there had to be a national policy for a commodity like cotton.

At a meeting with the ministers of the government of Maharashtra on 19 July 1977, the RBI Governor pointed out to the decline in the acreage under cotton because of the monopoly scheme. He reiterated the Bank's unwillingness to finance such a scheme. The Bank was also not inclined to permit the Maharashtra State Cooperative Bank to lend the funds for the purpose. The ministers appreciated the logic but they nevertheless took it up with the Prime Minister. Narasimham informed Morarji, at the latter's enquiry, of the Bank's viewpoint, and explained that the resources of the State Cooperative Bank, already overburdened, should be more appropriately directed to assist productive credit through the cooperative system. The Prime Minister agreed with the Bank.

The other development was in regard to the bifurcation of savings deposits into a demand liability and a time liability portion. Under Regulation 7 of the Reserve Bank of India's Scheduled Banks' Regulations 1951, the maximum amount that was permitted to be withdrawn from savings bank accounts without previous notice was regarded as a demand liability, and the excess over the maximum amount as a time liability.[12]

[12] The Regulation read: Every scheduled bank shall calculate the proportion, as at the close of business on the 30th June and the 31st December of each year, of its demand liabilities to its total liabilities on the above basis and proportion so calculated shall, until

As the Regulation gave freedom to banks to decide on the maximum amounts of withdrawal from savings accounts, several banks reported all or a larger part of their savings deposits as demand liabilities, resulting in distortion in compilation of data. In October 1977, the Reserve Bank suggested that this method was not realistic. Instead, the average monthly minimum balances arrived at for crediting interest should be treated as 'time' liabilities and the rest of the amount as 'demand' liabilities. The Bank's suggestion for an amendment of Regulation 7 was consistent with what the Working Group on Money Supply had stated with regard to the measurement of money supply in early 1977. It also heralded the beginning of the efforts to phase out M_1 to broad money as the main indicator of policy analysis or as a policy target.

It is not clear from the files as to whether Narasimham took the initiative in the matter of amending the above-mentioned Regulation. However, his strong preference for classifying savings accounts into chequable and non-chequable deposits gives a clue that he must have paved the way for evolving more meaningful concepts of money supply into those that consisted of interest-bearing assets as against those that did not. Anyway, he left soon thereafter to make way for I.G. Patel who took over as Governor on 1 December. Under his governorship, in 1980, six more banks were to be nationalized by Indira Gandhi.

Patel unfolded an approach towards 'growth with social justice'. As he put it,

> the real test of our success does not lie merely in opening new branches in the rural areas, or increasing the proportion of credit that goes to agriculture or other priority areas . . . our efforts have to be directed more specifically towards the poorer strata even in priority sectors and second, our objective is not just to give credit to the poor but to make them more productive and in the true sense of the word, creditworthy.

Patel said he was determined to simplify and rationalize the regulatory mechanism.

While this was important, the urgent as usual came to dominate the Reserve Bank's attention. In January 1978, it was noticed that while deposit

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the date of the next calculation, be used for determining the demand and time liabilities for the purpose of these regulations. The amount so calculated shall be included in the total of 'Demand Liabilities' and 'Time Liabilities' respectively in the form specified in Regulation 6 and shall also be set out separately in the footnote to that form.

growth was slackening, food credit and net foreign exchange assets had increased more sharply than expected, with the result that the money supply increase would have been 13.9 per cent in 1977–78 as against the 11 per cent projected in December 1977. Governor Patel wanted to have a look at the projections for 1977–78 starting from 'before the year began' to January 1978, in order to make a determination as to whether the projections were in any sense 'budgeting' or merely 'extrapolating the trends'. He also desired that the reserve money implications of the credit budget should be worked out, thereby indicating that the credit planning cell was not projecting the growth in money supply on the basis of any money multiplier. When the cell actually attempted such an exercise, money supply (M1) growth was to be about 17 per cent on the basis of the incremental money multiplier (of 1.8), and about 15 per cent on the basis of the average money multiplier (of 1.6).

There was also a large expansion in the net foreign exchange assets of the banking system. So Patel was concerned about the interpretation that was needed to be provided for 'net bank credit to government'. He asked whether government borrowings from commercial banks should not be regarded as effective mobilization of liquidity created by the inflow of funds from abroad, and wondered whether the government's budgetary performance could be viewed purely in terms of net RBI credit to government, excluding, in the process, the credit taken by the banks through sale of government securities including treasury bills.

These queries resulted in a detailed analytical note being prepared in the division of monetary economics. The note said that by viewing government deficit in the broad terms of net borrowings from the Reserve Bank and other banks, the liquidity effect of the government's fiscal operations would get subsumed into the liquidity effect of the normal central and commercial banking operations. This arose, as the note reasoned, mainly because government securities were an important medium of investment for the banking system. Besides, banks acquired government securities because they were in excess of what the public could hold and the RBI was committed to a policy of supporting the gilt-edged market. Whether or not it lent support to government securities, the best solution to knowing the extent of government deficits was to measure the net absorptive capacity of the public for government securities, and to treating the excess of securities sold to it by the government as equivalent of the financing of deficit. Since the public held only meagre amounts of government securities, it would be useful to treat the increase in government borrowings from the Bank and other banks as net bank credit to the government, and as a measure of deficit financing.

The note also maintained that while commercial banks' credit to the government would be, analytically speaking, related to the deposit resources of the banks and the banks' own calculations of their portfolio management, it was difficult to satisfactorily quantify the extent to which banks' investment in government securities was derived from resources arising from inflows from abroad. Nonetheless, the impact of the increase in net foreign exchange assets of the banking system on the increments of deposits was relatively small.[13] The calculations showed that an increase of one rupee worth of NFA would give rise to a substantially large proportion of rise in currency in circulation and relatively small increase in deposits. In other words, the large increase in investments of the banks would have been accounted for to a substantial extent by the increase in their deposit resources.

The money supply projection made for the May slack season policy announcement was based on the information available with the Reserve Bank up to the end of March 1978. The projected large money supply expansion indicated that there was no room for further liberalization of credit, especially since it was not clear that there would be a repeat of the high agricultural growth of 1977–78. The demand for credit was therefore expected to be subdued, while there was uncertainty about deposit growth in view of the reduction in deposit rates in March 1978. On the other hand, the restrictions on company deposits could imply that deposits with banks would increase sharply. In such an event, there would be a need to immobilize excess liquidity through larger government borrowing and larger impounding of deposits. The siphoning off of excess liquidity in the slack season would be facilitated if the demand for credit picked up. All things considered, therefore, no major modifications were made in the broad structure of credit regulation.

By the middle of 1978, the Bank was under increasing pressure from the government to permit larger credit flows to the priority sectors, in particular to small farmers, and to let financing be undertaken for procurement/purchase and stocking of agricultural commodities. But Patel held firm. He was worried that the anticipated national income growth during 1978–79 was between 3 to 4 per cent. He believed that it was necessary to contain credit expansion. The busy season credit policy reflected this. It turned out to be the right thing to do, as by February 1979, it became apparent that M_1 growth

[13] This result was obtained by finding out the cash leakage from the banking system (that is: 1–DRM/ DMS where RM-reserve money and MS = narrow money) and juxta-posing it with the incremental ratio of NFA to RM.

at 14.7 per cent was way ahead of the increase of 9 per cent during the period April 1977–February 1978. Bank credit expansion to the commercial sector was the main source of M_1 expansion during 1978–79. It was facilitated by the rise in the banks' own resources, and their recourse to the call money market and to sale of participation certificates to other financial institutions. Banks did not increase their investment in government securities despite the SLR stipulation of raising such investments by 100 basis points, to 34 per cent.

On 15 March 1979, the Reserve Bank reduced the interest rates charged by banks on loans to farmers for minor irrigation and land development, and diversified purposes, to be in line with the reductions by the Agricultural Refinance and Development Corporation (ARDC) of its refinance rates on term loans with a maturity of not less than three years. These measures were framed against the background of expectations about inflation, which were driven by the large uncovered budgetary deficit of Rs 1,355 crore proposed in the 1979–80 budget, feeding on the sharp rise in non-food bank credit during the course of the fiscal 1978–79. The budget deficit itself was the result of a change in Finance Ministers, H.M. Patel having been replaced by the populist Charan Singh who, a few months later, in July, would bring the government down.

In April 1979, meanwhile, the RBI was worried about other things. The year-on-year increase in the wholesale price index was over 7 per cent. With M_1 having gone up by over 18 per cent in 1978–79 against the 14 per cent projected in May 1978, and with uncertainty about agricultural output prospects in 1979–80, it became necessary for the Bank to focus its attention on restricting banks' credit to the commercial sector as much as possible and, if feasible, to the levels achieved in 1978–79. Growth was not expected to be high either, and money supply was expected to increase by 17 per cent.

Difficult times lay ahead, but in May 1979, no one had an idea yet of just how difficult.

PHASE VI: 1979–81

Into the Storm

Continuously increasing prices from February 1979 signalled the first signs of trouble. The Department of Economic Affairs prepared a paper entitled 'Prices and Production: The Economic Outlook for 1979', and, based on it, the Cabinet decided in late May to curb the growth of bank credit to the commercial sector, especially for those commodities that were vulnerable to hoarding. But Patel received the Cabinet decision only on 5 July. There had also been an exchange of letters between Morarji and Charan Singh, who had become Finance Minister in January.

Manmohan Singh then wrote to Patel saying that he did not find any deceleration in non-food credit till the week ended 8 June. He wanted to know what the Reserve Bank was doing about it. Patel wrote back on 16 July. He conceded that despite the restrictive measures, money supply expansion between end-March 1979 and 22 June 1979 was as much as that during the corresponding period of the previous year. But he pointed out that in the current year thus far, the principal forces driving M_1 expansion were the net bank credit to government, placed at Rs 1,406 crore against Rs 434 crore in the same period of 1978, and credit for food procurement. He also said that there was not much more that the banks could do as far as credit restrictions were concerned.

> My assessment of the current situation is that further intensification of quantitative restraint on banks is undesirable and probably infeasible. Likewise, while we would continue to press for reduction in the relative share of large and medium industry and trade in bank credit, it would be unrealistic to expect a large change in a matter of months. Draconian measures to restrain credit further will inevitably have to be applied across the board; and at least in particular areas, this could well result in disruption of productive activities and creation of shortages.

Patel then suggested two courses of action, both of which, as he himself hastened to add, were 'unpalatable' and 'not mutually exclusive'. One was that the restraint on credit could include, if necessary, even the preferred sectors, that is, priority sectors and 'sick units' where the norms for credit entitlements were generally tight and delegation down the line was restricted. The other was that the cost of credit to borrowers could be raised, especially 'as expectations of further inflation gain strength' either by raising the ceiling on interest rates or by making only a part of the interest cost a deductible expense in computing the income tax liability. The government did not respond.

In mid-July the Morarji government fell, and on 17 July Charan Singh became the Prime Minister and H.N. Bahuguna, the Finance Minister. The new government also soon fell and became a caretaker one until the next general election was held in December.

That summer, which had witnessed a political crisis, the monsoon also failed. India experienced the worst drought in a century with seventeen out of thirty-five meteorological sub-divisions recording deficient or scanty rainfall by early July. Prices began to gallop. And to deliver the final blow, the second oil crisis broke with the ouster of the Shah of Iran and quadrupling of crude oil prices.

In August, Patel called upon the banks to restrict non-food credit in such a manner that overall credit to the commercial sector would be significantly lower than in the preceding year—in absolute terms. The letter referred to the need to restrict advances to traders and manufacturers utilizing stocks of sensitive and scarce commodities. No new advances were permitted to traders/manufacturers, against sensitive commodities, especially sugar, oilseeds and vegetable oil. But there was not very much the Bank could do. From the last Friday of September 1979, the extent of Bank refinance made available by it against food procurement advances by banks was sharply reduced from 50 per cent to 30 per cent of the increase in food credit over the level of Rs 2,000 crore. Banks were urged to reduce their dependence on refinance support of the Bank. The second measure was to limit the effective drawing power of cash credit and inland bill limits of large borrowers with aggregate limits of Rs 25 crore and above, to 80 per cent of the peak levels of actual utilization reached in the two-year period ended June 1979.

But nothing seemed to help. When the data on the year-on-year increases in money supply (M_1) and in the wholesale price index in August 1979 were shown to be 26 per cent and about 17 per cent, respectively—higher than what was recorded a month earlier—the Reserve Bank thought it necessary to raise the cost of credit. Effective from 13 September, the maximum lending rate was increased by 300 basis points, from 15 per cent to 18 per cent in the case of large banks and from 16 per cent to 19 per cent in the case of small banks. The interest rate on advances against commodities subject to selective credit controls was raised to 18 per cent (with lower rates for cotton and sugar mills). In order to improve the resource mobilization of banks and to enable them to give incentives to savers in the context of the enhanced bank earnings that accrued to them by the rise in lending rates, the RBI increased the interest rates on deposits. The increases in savings deposits and term deposits with a maturity of nine months to one year were of the order of 50 basis points, and those in fixed deposits of one year and over were to the extent of 100 basis points; the five-year deposit rate, as a result, moved up from 9 per cent to 10 per cent in September 1979.

But this also did not help. The year-on-year increase in the wholesale price index was 18.5 per cent in September as well as in October 1979.

The Reserve Bank redid its sums and concluded that the expansion in bank credit to the commercial sector should be contained within the availability of the banks' own resources and that the existing credit restriction measures should be continued. This is what the busy season credit policy for 1979 did, again to no avail.

In January, Indira Gandhi and her new Congress party were voted back to power. R. Venkataraman became the Finance Minister. He was expected to adopt a pragmatic approach to the handling of fiscal and monetary affairs. But no one expected an overnight miracle. The Indian economy was in deep trouble and there was no easy or quick way out if it. The key lay in controlling money supply growth by curbing the budget deficit and by restraining commercial credit. Supply side factors would have to wait. By February 1980, the Bank took the view that M_1 expansion in 1980–81 should be brought down to 8–11 per cent, partly because of the expected sharp decline in net foreign exchange assets and partly because of the anticipated reduction in bank credit to government.

By the end of March, the true extent of the problem was revealed. The overall budget deficit of the Centre had more than doubled. The revenue deficit had tripled and the capital account deficit rose from Rs 1,168 crore in 1978–79 to Rs 1,829 crore in 1979–80. A good portion of the deficit was attributed to larger assistance to state governments, relief expenditures of an exceptional nature in the context of the severity of the drought, shortfall in capital receipts as well as reduced generation of surpluses by public sector undertakings. The high budget deficit had a strong impact on money supply in 1979–80, notwithstanding the decline in net foreign exchange assets. The reason for the fall in foreign exchange assets was the sharp increase of 22.4 per cent in imports, particularly of crude oil and oil products.

The government approached the market four times for raising loans during the year and sold to the Reserve Bank initially twice for subsequent release to investors. Such initial contribution of the Bank to the Centre's market borrowing amounted to Rs 1,042 crore in 1979–80 compared to Rs 642 crore in 1978–79. Although the Bank sold a good portion of central government securities to banks and other financial institutions, it was still left with a sizeable amount of government securities at the end of March 1980. Net RBI credit to government in 1979–80 was as high as Rs 2,989 crore compared with Rs 1,772 crore in the preceding fiscal year.

At the end of March 1980, the wholesale price index recorded a rise of 23.3 per cent over March 1979. The inflationary pressure was mainly 'imported' due to oil price shock, the second after the first oil shock in 1973–74. What gave the 1979–80 inflation a distinct character compared with the inflation episode of 1973–74 was that the drought situation that prevailed in 1979–80 was addressed by releasing a substantial amount of foodstocks built over the past years. On the other hand, the 1973–74 inflation was in the background of an overall scarcity of essential goods and weak industrial performance. Again, the inflation in 1979–80 was characterized by large government expenditures uncovered by receipts. Typically, the large fiscal deficit brought about by government dis-savings reflected the high external current account deficit.

The government did very little to keep in check the fiscal deterioration. It also did not seem to appreciate the limitations of monetary policy in the presence of a weak fiscal situation. This became evident when it suggested amendments to the projections of money supply for 1980–81 as prepared by the credit planning cell, which were sent by the Deputy Governor to R.M. Honavar on 18 March.

The 1980 slack season for policy was announced on 27 June 1980 after the government had presented a full-fledged budget for 1980–81 a few days earlier. The budget reimposed the 7 per cent tax on interest income of banks. The budgetary deficit was placed higher than in the preceding year. The budget took credit for sizeable borrowings from the IMF trust fund and other external sources (details of which are given in the 'external sector' portion of this volume), to tackle the anticipated large trade deficit. Patel, in a meeting with bankers on 27 June 1980, disclosed that the IMF mission that was in India some time earlier had indicated that the money supply growth should be reduced by about 3–4 percentage points during 1980–81. Significantly, he did not elaborate whether by money supply he meant M_1 or M_3!

As part of policy, he underscored the need for continuation of the credit restraint in 1980–81, and urged the banks to keep their lending within their own resources. The requirement that banks confine their credit expansion during a future period to the quantum extended during a comparable past period was allowed to lapse. Instead, the banks were allowed, on an annual basis, to increase credit by about 10 per cent over the incremental credit recorded during the past twelve months, provided there took place during the slack season a return flow of credit. The key approach of the RBI was that banks should manage within their own resources.

Ironically, Patel agreed to authorize the Maharashtra State Cooperative Bank (MSCB), to give a hypothecation cash credit limit of Rs 15 crore to the Maharashtra State Cooperative Marketing Federation (MSCMF) for financing the latter's cotton monopoly procurement operations. This decision was a reversal of the stand taken by Narasimham that the Reserve Bank would not agree to finance monopoly procurement operations. It was not clear as to why this decision was taken despite the fact that it would weaken the restrictive credit policy. In particular, it would imply weakening of the extant policy of restricting refinancing or financing of the State Cooperative Bank beyond what was the position till then. There was also not much evidence of the State Cooperative Bank having become stronger than before.

During the next eighteen months, credit and monetary policy were much of a muchness. The attempts to finetune credit rationing and to curb money supply expansion continued. Notwithstanding the restrictive credit and monetary policy measures of May and July 1981, the monetary and credit trends in the first half of 1981–82 indicated disturbing signs of overheating of the economy. M_3 expanded by 5.9 per cent in the first half of 1981–82 that is, as much as that during the first half of 1980–81, while the growth in real national income was expected to be 4.5 per cent.

For 1978–79, the government had budgeted for a gross borrowing of Rs 1,830 crore and a net amount of Rs 1,650 crore. The Reserve Bank discussed the terms and conditions of issue of market loans with the Finance Ministry in light of the fact that banks' profitability had declined on account of the relatively high CRR and SLR stipulations. The discussion resulted in raising the coupon rates on government securities by 0.25 percentage point. Accordingly, the coupon rate was prescribed at 6 per cent on ten-year security, 6.25 per cent on seventeen-year security, and 6.75 per cent on twenty-eight-year security. This move removed the anomaly between deposit rates and coupon rates on government securities to an extent. Although the deposit rates were reduced in July 1977, banks' earnings did not improve due to low interest income from their investments in government securities. Press reports in July 1978 quoted Patel as stating that the increase in long-dated government issues was a correction of the long-standing maladjustment, and the consequential fall in the prices of government securities would not therefore result in any effective losses. The losses were notional since the gilt-edged market was captive. The RBI raised the SLR from 34 per cent to 35 per cent in December 1978. The government approached the market thrice during 1978–79 and made sales to the Bank thrice for subsequent release to investors. The gross amount of borrowings was Rs 1,833 crore as against Rs 1,312 crore in 1977–78. Net market borrowings of the Centre amounted to Rs 1,653 crore in 1978–79 as compared with Rs 1,183 crore in 1977–78. The cash subscription by the Bank to the central loans amounted to Rs 641.97 crore.

For 1979–80, the Bank assumed a 20 per cent growth in bank deposits. It also took into account the change since January 1979 in the investment policy of EPF, whereby the corpus of funds for investment in government and approved securities was reduced from 80 per cent to 40 per cent in 1979–80. It placed the estimate of net market borrowings at Rs 1,450 crore.

The government, obviously, was not pleased with the estimate. It was discussed with Patel, who recorded that the Finance Secretary wanted net borrowings to be as much as Rs 1,950 crore. He added that the 'utmost' he could agree to—and that too 'with reluctance'—was Rs 1,850 crore. The Centre accordingly budgeted for this amount during 1979–80. In reality, the Centre's net borrowings amounted to Rs 1,961 crore, with the Bank's cash subscriptions amounting to Rs 1,042 crore as against Rs 642 crore in 1978–79. The Bank could manage to resist the government's pressure to increase the SLR from 35 per cent to 36 per cent during the year, but agreed to increase its subscription to central loans when the market absorption was lower than anticipated. As a result, at the end of the fiscal 1979–80 it was left with a sizeable amount of government securities. The one consolation was that the Centre hiked (on the recommendation of the Bank) the coupon rates during the year on the loans—6.25 per cent on a ten-year loan, 6.5 per cent on a sixteen-year loan, and 7 per cent on a thirty-year loan.

With the change of government at the centre in early 1980, the appetite for larger borrowings increased sharply. The interim budget for 1980–81 placed the net borrowing of the Centre at Rs 2,500 crore, over Rs 500 crore higher than what was recorded in the previous year. The Planning Commission, on the other hand, placed its estimate of Centre's net borrowings at a still higher level of Rs 2,650 crore, based on a 22 per cent growth in deposits as against the Bank's initial assumption of 18.6 per cent in deposit expansion. The Centre approached the market four times and made sales twice to the Bank during 1980–81. Its net borrowings amounted to Rs 2,605 crore, higher by Rs 644 crore than in 1979–80. The Bank's initial cash contribution to central loans amounted to Rs 1,377 crore as against Rs 1,042 crore in 1979–80.

Then some controversies arose in 1981–82, between the Bank on the one hand, and the Finance Ministry and Planning Commission on the other. The differences in the estimates of the Centre's borrowing arose because the Sixth Five Year Plan (1980–85) placed the borrowing at Rs 21,500 crore, that is, Rs 4,300 crore a year. Deputy Governor Krishnaswamy, after discussions with the Member Secretary of the Planning Commission, Manmohan Singh, agreed to the figure, apparently after expressing his misgivings on the assumptions of the Planning Commission while making the estimate. But the Bank worked on the basis of net borrowing of the Centre in 1981–82 at the same level as in the preceding year, and cautioned that this would entail the Bank providing large support to the government. The Ministry felt that net borrowings should be higher at Rs 2,800 crore, with an accommodating hike in SLR.

A Finance Ministry official seems to have quoted the Prime Minister as saying that in the case of a trade-off between public and private sectors, the public sector should always be given preference in terms of resources. When the matter was brought to the notice of Krishnaswamy by Secretary Hasib, he clarified that while the amount of Rs 21,500 crore of resources for the Sixth Plan was agreed, he had stressed, at the same time, that the phasing of the programme would have to be related to developments from year to year. Subsequently the Finance Secretary, R.N. Malhotra, wrote to Patel that there were many compulsions that required an increase in market borrowing of the order given. If it was not possible to have market borrowing to the tune of Rs 4,300 crore as implied in the plan, the Bank might have to consider raising SLR to 36 per cent because of discontinuance of impounding of 10 per cent of increase in deposits as additional cash reserves.

The differences between the Bank's estimates and the Planning Commission's estimates arose because of differences in perceptions, particularly in regard to the growth of bank deposits. The Planning Commission assumed a rate of growth of 19 per cent for 1981–82 against the 16 per cent assumed by the Bank. If the total borrowing programme was to be taken as per Malhotra's suggestion, the Bank's support would have to increase by Rs 1,000 crore. Such an increase was not felt desirable by the Bank in view of the prevailing inflationary conditions. Increasing the SLR to 36 per cent would have an impact similar to one of reducing bank credit to the medium and large commercial sector and priority sectors.

Patel, therefore, wrote to Malhotra that the proposed borrowing of Rs 4,300 crore in 1981–82, on top of the high borrowing in 1980–81, would amount to front-loading in relation to total market borrowing of Rs 22,500 crore for the plan period as a whole. He felt that any front-loading would become a basis for ultimately exceeding the plan target. So, he said, total market borrowing would have to be necessarily kept somewhat below the figure suggested by the Finance Ministry from the point of view of 'protecting and preserving' the instruments of monetary policy, and also that the instruments of reserve requirements should not be rendered ineffective. The increase in SLR over time from 25 per cent to 35 per cent was for budgetary reasons, and SLR for budgetary reasons could only be one way change. The choice had a bearing on the negotiations with the IMF which were to commence then. Finally, the Governor wanted to put on record that the Economic Affairs Secretary's sentence on CRR could convey the implication that, in his judgment, the decision to discontinue the impounding of 10 per cent of additional CRR was not a sound one, and could, in fact, be reversed without any adverse consequences. Patel stated that in view of the needless controversy created around the subject and the clarification to him (the Secretary) in writing, any such inference would be clearly unfortunate, at least from his (Governor's) point of view. Patel said that he was glad Malhotra was good enough to dispel the doubts.

Not unsurprisingly, the Planning Commission adopted the same approach as the Finance Ministry in regard to absorption of government securities by the Bank against impounded deposits. Krishnaswamy wrote to Manmohan Singh that the Commission's estimates continued to suffer from basic errors from 'unjustifiable assumptions like the growth in bank deposits in 1981–82, demand and time liabilities of banks and investment patterns of PFs'. He further stated that he was 'baffled' by the Planning Commission's statement that the absorption of government securities by the Bank might be set off against the resources available from the elimination of impounding incremental deposits by an additional 10 per cent. In the past, the essential difference between the impounding of deposits by the Bank and raising the SLR was well appreciated. The withdrawal of incremental CRR in November 1980 was to ensure that banks met the legitimate increase in credit demand during the busy season out of their own resources. The step enabled the Reserve Bank to cut back or terminate its refinance facilities, a step that was necessary in view of the already high and growing levels of Bank credit to the government. Krishnaswamy also expressed the view that he would 'summarily reject the Planning Commission Adviser's proposition that lifting of government/government guaranteed securities by the Bank could not be equated with "deficit financing"'. The alarming increase in the absorption by the Bank of government securities was very much the result of unrealistic estimates.

In his reply Manmohan Singh felt that the Bank was being 'pessimistic' about the growth of deposits in 1981–82 and suggested that market borrowing might be kept at Rs 4,000 crore for 1981–82. How the gap in the availability of resources from the requirements—raising SLR or 'impounding incremental deposits' or any other—was met, was for the Bank to decide.

The Reserve Bank finally sent the proposals for market borrowing in 1981–82 to the Finance Ministry in March 1981. As in the past, it prepared a tentative schedule of the market borrowing programme keeping in view the large market borrowing, the proposals of some financial institutions, the maturities of central and state government loans, and the possibility that state government loans might have to be issued twice to accommodate additional borrowing of Rs 150 crore for backward states. The central government budgeted for a market borrowing of Rs 2,800 crore net or Rs 3,087 crore gross. It approached the market five times during the year and also made sales to the Bank once for subsequent release to investors and realized net market borrowing to the tune of Rs 2,903 crore in 1981–82, exceeding the budget estimate of Rs 2,800 crore. The Reserve Bank's cash subscriptions to the central loans amounted to Rs 1,565 crore in 1981–82.

A word about the prevailing economic conditions is necessary here. The economy, thanks to the oil shock and the drought of 1979 was not in good shape. Inflation was high, foreign exchange reserves low and growth was faltering. It had become evident at the start of 1981 that the IMF would have to be approached for a loan. It was recognized that this would severely restrict the scope of the Sixth Plan. Many influential advisors to the Prime Minister were arguing that growth should be revived, if necessary, by large doses of deficit financing. They wanted the cautious fiscal stance of the 1970s to be replaced by one that pursued growth more aggressively. The Bank, however, was worried about the consequences of such policies. Its assessments were spelt out candidly and explicitly by Deputy Governor C. Rangarajan in the draft of the Annual Report of the Bank for the period 1 July 1981–30 June 1982, discussed by the Board in early July 1982. It pertained, essentially, to the period after the IMF loan was contracted and referred to the situation in the latter half of 1981–82. The loan required a severe contraction in credit expansion, to the government of course but to industry as well. His draft was adopted with some minor alterations.

Rangarajan wrote that 'the behaviour of banking variables during the financial year 1981–82 had a traumatic impact with serious repercussions', in the draft Annual Report.

> It is hence necessary to go beyond a mere recording of the events and to attempt an evaluation of the experience in order to draw some lessons from it, exploiting the advantages of hindsight. Such an exercise may not necessarily yield results in the shape of suggestions immediately translatable into concrete actions. But it can promote a better understanding of the behaviour of a system that is as yet not tightly integrated and help in the formulation and implementation of policy in the somewhat longer run.

The assessment started off by noting that non-food credit expansion had been contained. But this had been possible because of a large decline in credit to the petroleum industry. If allowance were made for this, the expansion in non-food credit was substantially higher during 1981–82. So, the Bank said, it was wrong to conclude that there had been a drastic reduction in the flow of credit to industry. It then went on to point out that the ratio of total bank credit to the commercial sector to GNP moved up fairly significantly from 28.87 per cent in 1980–81 to 30.18 per cent in 1981–82.

Therefore, the Bank concluded, 'the difficulties that developed in 1981–82 were not so much related to the quantum of credit as to its distribution over the year, which followed the pattern of deposit growth. This suggests an almost automatic link between deposit accretion and credit expansion without any reference to an overall plan.'

Then it made two sharp points.

> In the first place, the internal information system of banks is obviously not adequate to support the type of planned deployment that is now expected of them. Second, it is not a commercially viable proposition for banks to retain funds in low yielding short-term securities, pending their deployment according to a seasonal or sectoral plan. The introduction of a sufficiently attractive instrument for short-term investment by banks has hence to be seriously considered. . . . It would appear that the stringency of the credit cuts that banks had to impose has led to some unexpected reactions. While it might be an exaggeration to view this as a loss of faith in the banking system, recent developments suggest that the banking system can be bypassed to some extent, the sluggishness in deposit growth being symptomatic of this process. It is vital that the influence of the banking system should not be allowed to be thus eroded.

It raised a more general question: whether the credit tightness had led to recessionary conditions in the economy. Pointing out that growth had been satisfactory, it said that there was no generalized demand recession.

> However, it is to be expected that under a regime of credit restrictions, industries which depend to a greater extent on credit either for purposes of production or for the sale of their products are affected more. Tractors and trucks are examples of this class of industries, reporting decline in demand. The symptoms currently exhibited by these industries are perhaps a part of the process of adjustment to a reduction in credit support to sales. In fact, heavily credit supported sales might have concealed the shifts that were occurring in the demand pattern which perhaps became obvious with the withdrawal of easier credit conditions. Imbalances between supply and demand may have also occurred in some specific sectors because of factors such as increased access to imports.

It then said that price expectations had led to some pile-up of stocks, which were now being reduced. 'Such de-stocking may in turn result in some production cuts.' But it saw no decline in aggregate demand and concluded that: 'What is, therefore, important under the present conditions is that the slackness in demand exhibited by some of the industries should not be allowed to become more general and widespread and that overall demand is sustained at a high level through fiscal and other policy measures.'

THE GOLD AUCTIONS: ERRORS OF JUDGEMENT?

New dispensations are more prone to try new things. And so it was that, in order to reduce gold smuggling, it was decided to auction gold. Patel was not very keen and sought to dissuade the government but to little avail. He has written in his book *Glimpses* cited earlier:

> I tried to dissuade H.M. Patel from pursuing this path. But he was obviously under pressure and had to do something. To import gold on a scale large enough to make smuggling redundant was inconceivable in the strained circumstances of the time. Ultimately, I insisted that the RBI would undertake the selling of gold only as an agent of the Government and not on its own account. It would also not advise using our scarce foreign exchange reserves for the purpose of importing gold. (p. 159).

But there is nothing in the files to show the Bank's unwillingness to support the sale of gold.

In view of the perception about the criticality of gold in the Indian economy, the demand for gold has always been high. On the other hand, domestic supplies of gold are negligible. This has resulted in a high price differential between prices in the international and domestic markets. The gap between the demand for and supply of gold being very large, the government had introduced gold control in 1962 as ceilings on individual holdings, a ban on the holding of primary gold, and restrictions on the functioning of private gold refineries. These measures were intended to not only curtail demand but also augment availability by mobilizing private hoardings of gold.

Gold prices in Indian bullion markets had been ruling high right through the 1960s and 1970s. To reduce the price differential between the international and domestic markets, the Janata Party—when it came to power in March 1977—decided to make a radical departure from the existing policy. Its new gold policy was unveiled in the budget on 28 February 1978, when Finance Minister H.M. Patel stated:

> Despite the utmost vigilance of the customs authorities and considerable seizures and confiscations of smuggled gold, it is an unfortunate and distressing fact that gold smuggling has to some degree continued. The substantial difference between Indian gold prices and international gold prices has served as a temptation to smugglers. Gold smuggling is not only illegal but has helped to sustain black money operations and foreign exchange racketeering. It is, therefore, necessary for us to think of economic measures in addition to preventive measures to tackle this evil of gold smuggling. We have given very careful thought to the question and have decided to commence the sale of gold from the stocks held by Government. The details of the scheme are being worked out and will be announced shortly.
>
> There is an excellent market for Indian gold jewellery abroad which would not only enable us to earn a significant amount of foreign exchange but also gainfully employ the undoubted craftsmanship of Indian jewellery. Hitherto the export of gold jewellery has been inhibited by the high local price of gold, restrictions placed on such exports and the complex and cumbersome bonding procedures. The Government has, therefore, decided to introduce a simplified scheme for the encouragement of the export of gold jewellery. Such exports will be facilitated either by allowing importation of gold or by the sale of Government gold stocks at international prices. The details of the scheme will be announced very shortly.

Immediately, standard gold declined to Rs 650 for 10 grams in post-budget dealings. It had opened officially at Rs 691 on 28 February and closed at Rs 689, against Rs 694 on 27 February and a high of Rs 702 on 21 February. Buyers withdrew completely and sellers were preponderant.

It is clear that the government had planned to sell gold from its holdings of confiscated gold and the gold supplied by the government-owned Bharat Gold Mines at Kolar. The decision to sell gold out of its own stocks to improve supply and bring down the difference between domestic and international gold prices was expected to reduce the incentive for gold smuggling. Besides this, the revenue arising from the sale was expected to be helpful in meeting the deficit of Rs 1,050 crore for 1978–79. The government wanted to sell about 25 tonnes of gold per year through fortnightly auctions, viz. about 2 tonnes of gold per month.

A committee was formed to advise on gold sales. Taking all factors into consideration, the committee opted for the method of auction to licensed dealers by tender system as the most practical one for disposal of government gold. But it expressed itself against having a system of distribution all over the country at a fixed price to licensed dealers on a quota basis. Also, the auction system provided the government the flexibility to vary and contain the supply to the market, and gave the necessary feedback as regards demand and price movements. The uncertainties and vagaries of the market made determination of the fixed price a very difficult exercise. It was also not the intention of the government to peg down the price at any point but to let the market price find its own level with regular supplies from it.

Based on the committee's findings and views, on 19 April 1978, the government decided on gold auctions by the Reserve Bank of India at Bombay. Accordingly, the Bank was asked to conduct gold auctions on a regular basis by tender system at Bombay, roughly twice a month. It was decided that dealers licensed under the Gold (Control) Act, 1968, including cooperative societies of goldsmiths having dealers' licence, could participate in the gold auctions. The gold to be sold was to be in bars of 100 grams with 0.995 fineness, and was on the basis of 'as is' without any warranty from the Reserve Bank or the government mint in respect of weight, fineness or otherwise. No physical inspection was allowed. No bid was permitted for a quantity less than 1 kilogram or more than 5 kilograms.

There would be a reserve price fixed by the government from time to time, which would be a certain percentage above the international gold price. The quantity of gold to be sold and the reserve price would be kept secret and not made known to the public. It was also decided that in the initial two sales, the quantity of gold for sale could be higher than the 2 tonnes depending on the quantity of gold available in 100 grams bars and that the reserve price be fixed at about 30 per cent above the international price of gold.

The Bank held a press conference on 22 April 1978 and announced gold auction programmes for three months, and issued an invitation for tender for the first auction scheduled for 3 May 1978. On the eve of the Bank's announcement, the prices had been rising, reflecting speculative fervour. Although the initial impact of the decision was a slight softening of the price of gold from the high level prevailing in February that year, the delay in the announcement of the gold sale scheme, and the realization that parity between the international and domestic prices of gold would involve massive trading in gold by the government, led to gold prices rising sharply. The gold price climbed to a record high of Rs 724 for ten grams on 18 April against the early March price of Rs 635. In other words, the time was not so propitious for launching the scheme, nearly three months after its conception.

The first auction conducted on 3 May 1981 resulted in a decline in gold prices in the bullion market to Rs 640 from the previous day's closing rate of Rs 690, and prices were expected to fall further. Nevertheless, since the domestic price of gold was about Rs 200 per ten grams higher than the international price, one of the objectives of the government's gold policy, namely, to squeeze out gold smuggling, was considered unlikely to be achieved.

After the second auction on 16 May, gold prices did not come down. This, it was explained by the Finance Ministry, was because of several reasons. First, the tight anti-smuggling measures had resulted in limiting illegal arrival of gold to a trickle. Second, the seasonal demand for gold normally experienced at that time of the year. Third, rich farmers, richer by the procurement money in their pockets, were going in for purchase of gold in a big way. The Minister for State in the Ministry threatened that gold prices might be statutorily fixed to curb the rising price and control its smuggling. There were also alarming reports that some gold dealers were confident that the price would cross Rs 1,000 for ten grams with the onset of the festival season after the rains. The government was clearly perturbed over the failure of the auctions to achieve the objectives. Satish Agarwal, Minister of State, disclosed at a conference of Collectors of Customs and Central Excise in New Delhi on 26 May 1978, that some speculators were in a position to hold gold to ensure that it did not find its way in the market.

After two auctions, the Gold Sales Policy Committee made some minor changes in the auction scheme. The minimum and maximum quantity for bids was reduced respectively to 500 grams and 2,500 grams, and a joint bid by small dealers and goldsmiths not exceeding five was allowed. A notification was also issued on 3 June 1978 by the Finance Ministry banning the resale of gold obtained by a dealer through the auction to another dealer. Such licensed dealers, however, could use the gold in the making or manufacturing of ornaments. The notification observed that the restrictions had been imposed with the intention that the gold sold by the government through the Bank reached goldsmiths and the actual consumers at a reasonable price. At the time of the imposition of the ban, there was appreciable difference between the market price of gold and the price at which it was sold in the auctions. The bullion dealers protested against the ban. In fact, some dealers even went to court for removal of the ban. Many dealers adopted a novel way to overcome the ban. They converted the standard gold bars purchased in the RBI auctions into bangles of 24-carat purity and sold such bangles to other dealers in the trade. There was a regular price quoted for what came to be known in the marketplace as 'RBI bangles'. Under the Gold (Control) Act, sale of such bangles in finished form, though of 24-carat purity, was permissible, since they were considered as ornaments.

Contrary to market expectations, the Bank sold a much smaller quantity of gold of smaller value in the third auction. In the fourth auction, 1504.9 kilograms of gold worth at Rs 970.55 lakh were sold to 1,004 bidders. The fifth auction topped all the preceding auctions in respect of the number of successful bidders, and the quantity and value of gold sold. The Bank sold to 1,193 parties 1618.9 kilograms of gold valued at Rs 1047.08 lakh. The market welcomed the development, since the Bank had received fewer bids but gave away a greater amount of gold to more persons.

In the eighth auction, on 8 August, the RBI, for the first time, rejected all the 1,822 bids, as none of the bids came up to the minimum reserve price fixed by the auction committee. On account of this development, the price of standard mint gold soared to a record Rs 750 per 10 grams on 10 August. The Bank's press note announcing the total rejection did not detail the bid prices and quantum sought at each price. The marketmen were perplexed and a host of questions were raised. Was there a concerted attempt at price-rigging? Was the reserve price for the eighth auction the secret it was supposed to be? Was there not need for an inquiry since the failure of the auction meant a bonanza for gold dealers? To pre-empt such questions, the Bank announced that the next auction would be held on 17 August.

Realizing that the scheme was not proving as successful as anticipated, the government informed the Bank that it would take a fresh view about future gold sales. The Bank was advised, therefore, not to make any public announcement in advance of a programme for auction sales for any period of time, as was done earlier. The date for the next auction could be fixed at the time of announcement of the results of each auction. The government also gave a hint about some changes in the parameters for fixing the reserve price in its letter of 17 August 1978. According to the guidelines on reserve price, the reserve price could be either 30 per cent above the international price or the average of the market price of gold prevailing in the preceding five working days to the date of auction, less 3 per cent, whichever was higher.

In the eight auctions, a total quantity of 9286.8 kilograms of gold were sold, fetching nearly Rs 60 crore. From 17 August to 23 October 1978, six auctions took place, accounting for 3604.1 kilograms of gold being sold at a total cost of around Rs 27 crore, indicating a more rigorous scrutiny of the bids by the authorities. In fact, no bid was accepted in the thirteenth auction held on 12 October. The Bank hiked the minimum reserve price for the sale of gold in the ninth auction held on 17 August to Rs 711 for 10 grams. The maximum price quoted and accepted came to Rs 721. The minimum reserve price in the first auction of 3 May was Rs 620. Till the ninth auction, the minimum reserve price had been advanced by as much as Rs 91. Even though the Bank had increased the number of auctions from two to three per month, from the tenth auction scheduled on 30 August, market circles were not sure of the success of the government in bringing down the gold price and checking smuggling if it continued its policy of rejecting all the tenders or selling less than a tonne of gold per auction at rising prices. Standard mint gold touched an unprecedented level of Rs 757 for 10 grams officially on 21 August in the Bombay bullion market, a level not reached so far by the metal in India, mainly due to an acute shortage of gold and increasing offtake from upcountry centres on account of the festive season.

In the eleventh auction held on 13 September, the Bank sold less gold both in terms of quantity and value than in the previous auction. In the next auction, even though fewer bids were received, a higher quantity of gold of a larger value was sold to a larger number of successful bidders. The Bombay bullion market showed no abatement in its buoyancy: both gold and silver prices continued their relentless upward movement. The Reserve Bank announced rejection of all the bids in the thirteenth auction held on 12 October since 'none of the bids came up to the reserve price'. The Bank did not divulge the bid prices but market circles said they ranged from Rs 801 to Rs 851, and with the market price opening at Rs 913, naturally, no bid could have been expected to be accepted by the Reserve Bank. The gold market closed at Rs 910 for 10 grams on 13 October, due to acute shortage of floating stocks in the markets, lack of fresh supplies from outside sources, and unabated offtake on account of festival and marriage seasons.

By about the beginning of September 1978, serious doubts were expressed about the efficacy and wisdom of persisting with the gold sales. Sensing the public criticism of the auctions and noting the market price increases, the government, by its letter of 28 September 1978, sought Patel's views about lifting the ban on inter-dealer sale of RBI gold. He conveyed to the government that since the entire question of continuing the gold auctions was being reviewed, it would be best if the question of removal of this ban was considered in case a decision was taken to continue the auctions on a reasonably long-term basis.

On 14 October, H.M. Patel indicated at a news conference in New Delhi (after the thirteenth auction in which no bids were accepted), that after an assessment of the gold auctions and watching its impact, the government would decide whether it should go ahead with the auctions even by importing gold, if necessary, at a later date. At the same time, he claimed that the auctions had met the objective of curbing smuggling of gold into the country and even met part of the demand for gold at home, and that gold prices ruled high internally because the international prices of gold were also high.

The Prime Minister, Morarji Desai, who had been a courageous crusader against the addiction of masses to gold, disclosed at Ahmedabad on 19 October that the government might have to stop the gold auctions as it did not possess limitless stocks of the metal. He also pointed out that the auctions were undertaken as a measure to help the Indian economy and that it could not be continued indefinitely. The only way to dampen the price spiral in gold, he said, was for the people to stop buying it. This pretty much sealed the fate of the auctions; the last auction was held on 23 October 1978, in which a small quantity of 19.2 kilograms of gold were sold. The Bank had conducted fourteen auctions accounting for a total sale of 12.95 tonnes of gold that yielded a revenue of Rs 86.69 crore for the government. A review was ordered and entrusted to a committee headed by Patel.

But that was not the end of the story. In January 1980, after a general election, the Congress returned to power. Barely three days after taking over, on 18 January 1980, the new government suspended the operation of the gold jewellery export replenishment scheme. The decision was taken as it was no longer possible to replenish gold at international prices, which were substantially higher than the domestic prices. Therefore, a strong feeling gained ground that the scheme for sale of gold through auctions was not likely to be revived. During January and February 1980, there was persistent demand in the Lok Sabha from members of the treasury benches that the Janata government had squandered gold reserves and that the government should look into the matter. Sanjay Gandhi, son of the Prime Minister, asked in the Lok Sabha on 1 February whether the confiscated gold was not kept separately, and whether the auctions included gold that had been donated by the public towards gold bonds. He also asked if the Janata Party allowed its own members to take part in the auctions. The Finance Minister replied that he had no information at that moment on the member's query.

The government then constituted a one-man committee of K.R. Puri, a former RBI Governor and then chairman of the Public Enterprises Selection Board. Not only was the composition of the committee extraordinary but also the terms of reference and powers vested with it. Dr Subramniam Swamy, MP, wanted to know whether it was proper to appoint a man to probe the action of a government that had removed him from office. Venkataraman, however, was quick to point out that Puri was not removed but had sought retirement. The terms of reference of the committee did not permit it to summon witnesses. It was purely an administrative committee.

It could call for the relevant information and files from the government, the Reserve Bank of India, the officers of the mint master, and take into account points raised during discussions in the Lok Sabha. The committee was not, however, empowered to call for or enforce the production of any documents.

Puri submitted a 200-page report in early 1981. The report was placed in the Parliament Library on 11 March. It came to the conclusion that the gold auctions during the Janata regime were conceived neither in the public interest nor on sound economic considerations. The committee indicted the previous government for 'undue haste' and the Reserve Bank for 'undue anxiety' to carry out 'the government's wishes' without any legal authority. The clubbing of gold sales with other budget proposals was 'an ingenuous way to obtain the approval of the Cabinet', observed the committee. It also observed that the committee set up under Patel 'was perhaps done with a view to extricating the government from the adverse effects of an ill-conceived plan'.

Puri was also intrigued by the fact that the Gold Auction Review Committee, headed by Patel, had submitted its report after the fall of the Morarji Desai government and dissolution of the Lok Sabha. He pointed out further how the same persons happened to be members of the two committees. The report also came to the conclusion that the Cabinet was not kept fully in the picture about the whole matter and that the gold auction scheme had been discussed by the Cabinet a few months after Morarji Desai became Prime Minister but had found little support. The panel had also examined whether there was any *mala fide* intent concerning the scheme and was reported to have expressed the view that such a conclusion was inescapable. It concluded that a syndicate of twenty individuals and firms with the active connivance of strong and powerful bullion merchants of Bombay financed the purchase of around 4 tonnes of gold valued at Rs 26.7 crore, which, in all likelihood, was cornered by them. This group advanced not only large sums of money, to the tune of several crore, to the syndicate just prior to and after the auctions, but also assisted the manipulation of the market prices of gold before and after the auctions, as was evident from the daily market prices. The report further said that the efforts of the syndicate to corner the gold auctions appeared to have remained unabated, as was admitted by the Gold Sales Policy Committee at its meeting held on 30 May 1978.

Indira Gandhi constituted a four-member Cabinet Committee headed by Venkataraman to examine the Puri report on gold auctions. The other members of the Committee were Pranab Mukherjee, Commerce Minister, P.V. Narasimha Rao, External Affairs Minister, and Shiv Shankar, Law

Minister. The Committee was advised to complete its work at the earliest and entrusted with the task of recommending action to be taken against those found 'guilty'. This controversial issue came up in Parliament on 16 September 1981. Venkataraman stated in the Lok Sabha that the government might order an enquiry by the Central Bureau of Investigations or even appoint a commission to probe into the gold auctions carried out by the previous Janata government. He also informed the House that Puri had forwarded a 'secret note' to the government on 20 April 1981 to enable it to make further investigations. The information furnished in the note had been passed on to the investigation agencies of the Department of Revenue for further action. On 18 September, he told the Rajya Sabha that the Cabinet Committee had not yet arrived at any final conclusions about the Puri Committee report, and therefore rejected a demand made by a member that the government should pursue H.M. Patel and I.G. Patel who were responsible for the 'illegal' sale of gold. He rejected a demand from certain opposition members during the course of a calling attention motion on the subject, that the confidential report should be made public. He also did not concede to the demand that the names of the twenty persons who had bought the auctioned gold should be disclosed. He concluded that a final decision would be taken only when the Cabinet Committee had finalized its line of action. In conclusion, he told the House that it might be that the auction was 'just an error of judgment'.

There the matter ended.

ANNEXURE 1

Funding of Treasury Bills

Funding of treasury bills, which was resorted to in 1958–59, continued during the period of the study since it helped to supply the Reserve Bank with enough securities for open market operations, and banks with securities to fulfil their SLR obligations. Funding was undertaken every year, and the amount of funding increased from Rs 50 crore to Rs 100 crore during the period. In 1981–82, treasury bills of the face value of Rs 3,500 crore were funded into special securities.

Prior to July 1965, treasury bills were sold on a weekly auction (tender) as well as fixed discount rate basis on tap. Fixed discount rate bills were issued on all working days of the week, to enable banks to invest temporary cash surpluses, and to foresee with certainty the rate of return on such investments. While the treasury bills were sold to banks, state governments and other specified entities in the form of entries in the subsidiary general ledger (SGL) accounts at the Reserve Bank, the treasury bills issued to individuals were in scrip form. The RBI rediscounted treasury bills for state governments and other institutional investors. In general, the Bank held most of the treasury bills outstanding.

The fixed discount rate on bills sold on tap was fixed in July 1965 at 3.5 per cent per annum. In March 1968, the rate was reduced to 3 per cent following the reduction in the Bank rate. It was raised to 3.5 per cent in January 1971, 4 per cent in May 1973, 4.25 per cent in April 1974, and further to 4.6 per cent in July 1974. These changes were mainly in response to changes in the Bank rate and to the need to ensure that they reflected the evolving inflationary situation. However, the discount rate remained static at 4.6 per cent after July 1974, irrespective of the level of the Bank rate during the rest of the period under study.

The Reserve Bank's Open Market Operations (OMO)

OMO was not used as a prime instrument of monetary policy. However, the RBI ensured that as a net purchaser, it would not absorb the outstanding public debt and would not subscribe to central loans in cash form if it could not subsequently resell them in the market. OMO was used mainly to facilitate government borrowing operations. The RBI's net sale position improved in most years. But as the RBI was a purchaser of new loans, its net absorption of central government securities increased over time with implications of rise in reserve money.

The RBI allowed banks and financial institutions to improve returns on their investments by switching from low-yielding Government of India securities to high-yielding ones. Till July 1973, there were no quantitative restrictions on the amount of switch operations that banks and other financial institutions could undertake. The need for placing quantitative restriction came when LIC and other financial institutions, in anticipation of an increase in the Bank rate (which, however, did not materialize eventually), unloaded large amounts of long-dated Government of India securities on the Reserve Bank of India in switch operations. The Bank, therefore, fixed a limit of Rs 5 crore for each bank and financial operation for switching in July 1973. As banks could utilize the switch facility at more than one place, the Reserve Bank advised its offices that offers for switch on account of banks should be referred to the Secretary's Department at Bombay or should be permitted only after obtaining a declaration from the banks that the Rs 5 crore limit would not be exceeded on an all-India basis.

Uniformity in the application of the limit on switching operations for all banks placed the larger ones among them at a disadvantage. While the uniformity principle was not disturbed initially in order to avoid controversies about discriminatory treatment, the Reserve Bank viewed the problem faced by the larger banks as one that could be taken care of by raising the limit to Rs 7.5 crore. The RBI brought about this change in November 1975, effective fiscal 1975–76. But with the volume of switch operations increasing sharply in 1976–77, the Bank issued a circular to all brokers on its list that switching would not be allowed for taking advantage of the 'tax voucher' benefit of the sales of loans on which half-yearly interest payment was due, and that it would insist on SGL delivery as far as possible . However, smaller banks which had limited securities made use of the limits by passing on the securities to bigger banks and making profits. Foreign banks too indulged in such practices. In July 1977, the Reserve Bank, therefore, changed the switching limit rules. It fixed the limit (or quota as it was referred to in the Bank's internal noting) at Rs 15 crore for SBI and LIC. For other banks there was to be a gradual increase in the size of the quota according to the size of deposits from Rs 1 crore to Rs 12.5 crore, from 4 July 1977. The RBI followed this up by raising the margins on loans with different maturities sold/bought from the Bank's purchase list in January 1978. This was done to curb the banks from obtaining tax voucher benefit by buying securities nearer the date of half-yearly payment of interest and holding them for a few days after realizing the half-yearly interest benefit. The margin on loans with maturity up to ten years was raised from 5 to 10 paise, while that on loans with longer maturities was placed at 20 paise. After this, switch operations declined considerably.

In 1980, some banks and the LIC switched long-dated securities to short-dated securities following rumours that the RBI would be entering the market with a higher coupon rate. To check this, the Bank decided to sell the securities up to 1993 against cash and not in switches. The Bank also decided that banks could pass on the quota to any other bank only by entering into deals with the RBI on their behalf against its own quota.

Brokers

The Reserve Bank had a list of brokers to conduct OMO since this helped to widen the government securities market. The brokerage was 5 per cent. The All-India State Cooperative Banks' Federation felt that the amounts spent on brokerage were high. It therefore requested the Reserve Bank in June 1976 to sell government securities directly to State Cooperative Banks. The RBI did not agree that brokers should be completely eliminated. However, it allowed scheduled banks to deal directly with it for transactions of Rs 1 crore or more on their own account. This was done essentially because public knowledge of large transactions could affect the market and banks in abnormal ways. But the RBI charged rates that were higher than its selling price according to the size of the amount, so that banks did not resort to direct dealing only to get securities cheaper.

Bank Receipts

The Reserve Bank granted the facility of bank receipts to brokers against its purchases on its investment account. The facility was purely temporary since it provided brokers with some time to procure and deliver the scrips in question to the Reserve Bank whenever such scrips were under issue or were lodged with Public Debt Officer of the Bank for renewal. Brokers were found to have misused the facility by not delivering the contracted scrips for a number of months. In May 1972, the Bank cautioned brokers that it was not bound to accept bank receipts as a matter of course and would withdraw the facility if the brokers did not ensure prompt delivery against bank receipts. This warning was not heeded. The same caution was issued again in March 1973. This too did not have the desired effect. Therefore, in December 1973, the RBI revised the format of the bank receipt. It also decided to have, in the case of some of the purchases, particularly of government-guaranteed bonds/debentures, confirmatory letters from the selling banks at the time of delivery of the scrip either in settlement of the contracts or in exchange for bank receipts in connection with the purchases of bonds/debentures not managed by the Reserve Bank.

Debt Management in the Face of Weak Fiscal Position and High SLR

While the RBI accommodated the growing needs of the government by either subscribing to its loans or ensuring that other institutional investors absorbed them, it still faced the persistent problem of providing requisite assets eligible under the RBI Act to serve as a cover for note issue to the Issue Department. The Banking Department required Government of India securities to conduct OMO, and this, at times, impinged on the total supply of eligible assets available for currency backing. The problem of the Issue Department when required to expand currency was addressed by resorting to the only eligible asset that could be issued without constraint, namely, *ad hoc* treasury bills. In 1978, *ad hocs* had to be created solely to meet the requirement of eligible assets although the government had sufficient balances in its deposit account with the Bank. This led to a waiver of the standing instruction that *ad hocs* should be automatically cancelled when the government balances exceed Rs 65 crore. Such a situation recurred often and excess *ad hocs* were a common feature towards the end of the 1970s and early 1980s. This, however, implied that the government had to incur additional interest liability.

To address the issues of debt management, the RBI constituted in 1980 an internal Working Group with D.C. Rao, Special Adviser on deputation from the World Bank, as chairman, to examine (i) the rules and procedures followed in connection with the issue of government loans, as well as the arrangements for issuing and discounting treasury bills; (ii) the practices and norms relating to purchase and sale of government securities by the Bank; and (iii) the desirability of having separate Issue and Banking Departments.

The Working Group recommended that the proportion of dated securities (i.e. bonds) to total government securities (bonds and treasury bills) should be increased with substantial funding of *ad hocs* and discounted treasury bills into dated securities with maturities varying from five to thirty years. Recycling of treasury bills could also be tried to solve the budgetary problem on an experimental basis. Once turnover in treasury bills was reduced, recycling could be given up. Also, the value of eligible assets could be significantly increased by revaluing the gold held by the Bank. Besides, the Group recommended merger of the Issue and Banking Departments for gaining operational advantage. The Group suggested that the facility of direct dealing in government securities with the Bank at the notified selling and buying prices could be provided to LIC and other insurance companies and their subsidiaries. To eliminate 'tax voucher' benefits, the interest paid on government securities could be exempted from the statutory requirement of deducting tax at source. The Group felt that quotas for switch operations might be substantially liberalized and eventually abolished. It noted that purchase and sale lists could be dispensed with, and the Reserve Bank should be ready to purchase and sell all securities that were normally dealt with as part of OMO. As regards valuation of securities, the Group suggested that the Banking Regulation Act could be amended to change the basis of valuation for SLR purposes from current market prices to the lower of the cash price and face value. This, in its view, would resolve the problem of depreciation of the value of government securities consequent upon the hike in coupon rates.

The Group also observed that debt management would be effective only in an environment of fiscal discipline. The Bank should, while continuing with judicious use of reserve requirements, have more realistic and flexible interest rates on public borrowing. The Group also felt that the interest rate on dated securities could be raised by 3 percentage points to bring it in alignment with other rates in the economy. The Bank, on its part, took the recommendations into account and felt that they needed to be implemented over time.

ANNEXURE 2

Semibombla

The memorandum was more comprehensive than the supplement that focused, as already stated, on only one scheme. As the memorandum dealt with the 'monetary' issue that forms the main domain of interest for the Reserve Bank, it requires to be elaborated upon here in some detail. Terming the 'extraordinary rate of increase in the price level of commodities, and in particular of consumption necessities', 'a serious economic distortion', the memorandum argued that it is 'the outcome of an excessive imbalance between the annual rate of growth in the stock of money and in the stock of basic consumption, and related production, necessities'. It cited the increase in bank credit to government as a reflection of step-up of government outlays far beyond the sum of non-inflationary receipts, and the upsurge of credit to commercial sector as augmentation of the liquidity base of banks. The expansion in the liquidity base of banks was, in the memorandum's view, a result of a combination of factors—the secondary impact of the rise in bank credit to government, the rising base for borrowing due to increase in collateral values, and the rising ratio of inventories to sales of large and medium-sized private firms and public sector undertakings. The slow growth in production of necessities was attributed to 'the slowdown in the pace of basic capital accumulation' and 'the fall in the incremental ratio of output of basic necessities to investment'. The memorandum, therefore, recommended that in 'the absence of a national ceiling, an effective target-ceiling' on money supply (M_1) be set 'between 2 per cent and 4 per cent, and substantial reduction in the government's borrowing target from commercial banks during the Fifth Plan period (1974–79).'

Dealing with credit planning, the memorandum observed: 'The policy of the RBI should be to plan for the busy season targets, by explicitly taking into account global considerations, concerning the desired priority growth rates and the price level chosen as a norm'. The memorandum then added: 'Collateral values or creditworthiness at the micro-level *cannot be* the basis for sanctioning credit limits. The micro limits must be encased in a macro-ceiling of permissible increase in money supply in each season, in the light of the goal of obtaining and ensuring price stability. *In the operation of the credit policy, there is bound to be a conflict between the micro claims of expansion and the macro need of containment. In details there should be discretion to the Monetary Authority*, though there has to be an overall ceiling' (italics added). Arguing that bank credit for financing inventories should decline, the authors of the memorandum suggested that the increase in the liquidity ratio and CRR should be complemented by hikes in lending rates. As a first step, they recommended a sharp hike in the Bank rate to say 10 per cent, which, in their view, will lead to an upward movement in the deposit rates.

They followed this viewpoint with a specific argument for a kind of demonetization of the currency thus: 'To bring about a substantial drop in the price level, such a cut will have to be say 30 per cent of the nation's money stock. The proposal is as under: (a) All the outstanding currency with the public and the banks as well as all bank deposits (current accounts only) should be reduced in value by 30 per cent. This should not apply to low denomination notes. (b) Holders of currency notes of high denomination may be given special savings certificates of the value of the cut for obtaining which no time limit need be imposed. (c) Holders of bank accounts should be credited with blocked accounts of the value of the cut. (d) The above certificates and blocked accounts will be cashed or released after 20 years and should carry an interest of 5 per cent which can be taken in cash or credited to the amount of the parties each year. In this way a significant part of the money supply will be immobilized, though an interest charge of about Rs 100 crores may have to be paid on the same each year'.

The memorandum also dealt with issues such as expenditure, tax and trade policies, labour relations, income freeze, public distribution system and strategies to augment agricultural and industrial production. It was sceptical of the empirical validity of the structuralist explanation of inflation in terms of cornering of bank credit through controls over the levers of economic and political power by affluent classes, but wondered whether their recommendations would not tilt the balance of distribution of economic power in favour of the poor. The reference to the 'structuralist' explanation is important because it seemed to fit in with the Bank's approach to the problem, as may be seen subsequently. But the memorandum itself did not create ripples although it was widely debated when its main plank of 'immobilization' of money was detailed through a specific scheme of issue of bond medallions and blocked assets in May 1974 by Professors C.N. Vakil and P.R. Brahmananda, under the acronym, SEMIBOMBLA.

The *Economic Times,* in an editorial of 20 June entitled 'SEMIBOMBLA', stated that while the scheme looked attractive, 'it is beset with a number of practical difficulties'. First was the question of transferability of the indexed bonds that, once allowed, could be misused by those operating in the parallel economy. Again, the scheme focused on individuals who had more than Rs 10,000 in high denomination notes, thereby opening the distinction between money that was earned honestly and money that was not. *The Hindu* on 21 June 1974 came out with an editorial entitled, 'Wanted, a Fullbombla', containing criticisms that elicited a response from Vakil and Brahmananda. Stating that the distinction between the value of money and volume of money was not maintained in the scheme, the editorial argued that a great deal of inflation in India had been induced by government expenditure, and that the scheme will hit hard low income groups whose purchasing power would shrink. The editorial argued: 'The level of prices is a myth. The so-called level is a concoction of official statisticians.' It also stated that the scheme did not foresee any change in the external value of the rupee or specifically deal with black money.

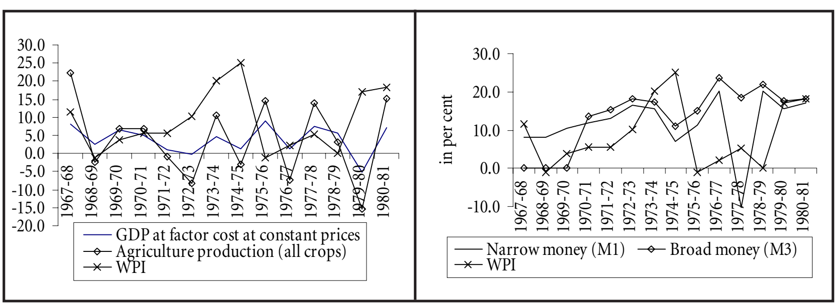
The authors of SEMIBOMBLA, Vakil and Brahmananda, wrote a letter to the editor of *The Hindu* which was published on 3 July 1974. It argued that when money prices of goods and prices come down owing to a reduction of money stock by about 30 per cent under the scheme, the value of money would go up. According to Vakil and Brahmananda, the 'rise in the value of money is the end effect of the initial stock of a reduction in the volume of money. Between the volume and the value are capsuled the forces of the effects of (a) a fall in nominal cash balances and hence in money command over goods with all parties including public undertakings and other government spending bodies; (b) pressure on available liquidity leading to sales of physical assets and commodities; (c) reversal of price expectations leading to dishoarding of inventories; and (d) revision in administered prices and factor incomes.' They agreed with the editorial that the government's spending power should be reduced. They also stated that the fall in agricultural and other prices occurred in the First Plan period due to 'a large drop in the supply of money'.

ANNEXURE 3

Annual Growth Rates (per cent): Some Macro Variables

Year	GDP at factor cost at constant prices	Agriculture production (all crops)	Narrow money (M_1)	Broad money (M_3)	WPI
1967–68	8.1	22.4	8.1	–	11.6
1968–69	2.6	–2.3	8.0	–	–1.2
1969–70	6.5	6.8	10.5	–	3.8
1970–71	5.0	6.8	11.8	13.7	5.5
1971–72	1.0	–0.8	12.9	15.2	5.6
1972–73	–0.3	–8.2	16.5	18.3	10.1
1973–74	4.6	10.6	15.5	17.4	20.1
1974–75	1.2	–2.9	6.9	10.9	25.2
1975–76	9.0	14.5	11.3	15.0	–1.1
1976–77	1.2	–7.2	20.3	23.6	2.1
1977–78	7.5	13.8	–10.2	18.4	5.2
1978–79	5.5	3.3	20.2	21.9	0.0
1979–80	–5.2	–15.5	15.7	17.7	17.0
1980–81	7.2	15.1	17.1	18.1	18.2

Source: *Hand Book of Statistics* and *Reports on Currency and Finance*, RBI.



9

Currency Management

One of the core central banking functions enjoined on the Reserve Bank is the regulation and issue of bank notes and the keeping of reserves, with a view to securing monetary stability in the country and operating its currency and credit system to the country's advantage. The public's impression of the Bank is largely based on its perception as to how best this responsibility is discharged.

The main responsibilities of the Reserve Bank during the period 1967–81 included: (i) finalization of the design, form and material of the new denominational bank notes and reviewing the design, etc., of existing bank notes for the purpose of suggesting to the government, the necessary changes to be incorporated in the new notes to be issued; (ii) establishment of new issue offices and branches or agencies in India for efficient management of the currency system; (iii) ensuring smooth distribution of notes and coins to meet the requirements of government departments, banks and the public; (iv) withdrawal of defaced or excessively soiled notes and their eventual destruction; (v) prescribing from time to time the conditions under which the value of any lost, stolen, mutilated or imperfect currency notes would be refunded as a matter of grace, and formulating rules for the purpose with the sanction of the central government; (vi) establishment and inspection of currency chests; and (vii) security arrangements in the issue offices of the RBI.

The Bank had to function in an environment of short supply of notes from the presses owned and managed by the government against its indents. The lack of availability of note paper hampered the production capacities of printing presses and severely impacted on the note supply position; the shortage was particularly acute in the lower denomination notes. While the Reserve Bank as well the government recognized the need for augmenting the production of notes and coins as a long-term solution, it was not possible to do so mainly due to foreign exchange and budgetary constraints. The Bank had to grapple with problems arising from accumulation of soiled notes, limited vault capacity, space shortage in chests, chests being choked with soiled notes, etc., for which short-term solutions were not possible. On the positive side, however, the government went ahead with modernization of the security paper mill at Hoshangabad, besides augmenting the production capacities of the two currency note Presses at Nasik Road and Dewas to meet the ever-increasing demand for notes. It was expected that with the issue of more and more of Re 1 and Rs 2 coins (in substitution of notes) the burden on the presses would be reduced. A beginning was made in 1982 by the issue of Rs 2 coins, on the occasion of the IX Asiad Games. But even on the coin front, the picture was one of recurrent shortages due to a number of reasons, namely, inadequate supplies from two of the four mints, poor performance of the mints on account of labour problems and temporary closures, negligible return flow of coins from circulation, and the pre-occupation of the mints with the minting of Asiad commemorative coins and medals till November 1982.

A DIFFICULT YEAR

From the beginning of 1973, the Reserve Bank faced the grim prospect of the currency note press (CNP) not supplying note forms in full against the regular indents. The CNP had its own difficulties that came in the way of it working to full capacity and increasing the production levels.

In January 1973, the Reserve Bank, while placing the indent for note forms for the first half year of 1973 (i.e. indent no. 1973-A), was dismayed to learn that the CNP would be able to supply only a much reduced quantity (that is, as against 3,275 million pieces indented in various denominations, only 2,300 million pieces were to be supplied). In a letter dated 25 January 1973, the Bank pointed out that, 'owing to the continuous inadequate supplies' made by the CNP during the previous years, its reserve stocks stood considerably depleted. It feared that even this reserve stock might be completely wiped out, 'exposing the Bank to a vulnerable situation' in the face of increasing normal requirements of note forms. Moreover, the Bank had been compelled to curtail supplies to currency chests and to banks to the extent of 50 per cent of their indent/demand for fresh notes, which had resulted in growing resentment and criticism from the public. The Bank hoped that with the installation of two imported super simultan machines, the press would be in a position, by June 1973, to increase output per annum.

As the CNP would not be in a position to meet in full the periodical indents, the Reserve Bank advised its offices to mitigate the situation by resorting to maximum reissue of notes. In a circular letter dated 12 February 1973 to the managers of offices, the chief accountant suggested various steps to conserve the stock of fresh notes: by larger 'reissue' of notes, by discontinuing the practice of discarding soiled notes as non-issuable merely because they bore some writing (political slogans excepted), impressions of stamps, etc. The managers were asked to arrange a meeting with the concerned officials and explain to them the urgency to sort and cancel only those notes that were badly soiled and could not stand further handling, and thereby accumulate larger quantities of reissuable notes to make up for the shortfall in the supply of fresh notes against indents from the press. To ensure that maximum reissuable notes were sorted, treasurers were asked to closely supervise the performance of the note examiners; assistant treasurers in charge of the sections were to go round each group several times each day during the course of the work and suitably advise the note examiners; in addition, the treasurer was to not only pay his usual surprise visits to each section at least once a day but also ensure compliance with the above instructions. Likewise, assistant currency officers were instructed to pay surprise visits to the sections allotted to each of them at least once a week. The central office desired that currency officers should pay periodical visits and also supervise the visits of other officials to each of the note examination sections at least once a week.

Further instructions were issued with a view to retrieving a larger number of reissuable notes through a circular dated 16 March 1973. To reduce frequent replenishment of the balances at various chests from the offices of the Reserve Bank, chest officers were asked to build up a sizeable stock by sorting out maximum reissuables from their receipts, and to keep a careful watch on the performance of each chest in regard to the sorting of notes. The central office also made it clear that frequent demands made by offices for additional supply of notes over and above the supply of fresh notes allotted to them from the Nasik press during the 'indent period' would not be entertained since the supply of notes from the press had become restricted.

In an internal note prepared in the chief accountant's office (dated 23 May 1973), the difficult position was reviewed. It was noted that there had been an aggravation in the situation because, in addition to the requests from offices for additional supplies of fresh/reissuable notes or to advance the date of despatches by the Nasik press during the months of May and June 1973, the nationalized banks that were operating currency chests had been making frequent demands for provision of additional amounts.

During that year the demand for lower denomination notes, in particular, had increased considerably due to: (i) the government's programme for procurement of foodgrains; (ii) the nationalization of collieries; (iii) the payment for scarcity/drought relief works in several states; and (iv) the cumulative effect of putting more reissues in circulation in the past two to three years when the supply of fresh notes from the press was short of demand. The situation was further compounded when the press advised the Bank that, as against its commitment to supply 1,150 million pieces, it was in a position to supply only 1,004 million pieces during April to June 1973.

An attempt was made to work out the actual quantum of shortage of notes by estimating the gap between the demand and the stock available for distribution, when the proposals for the 1973-A indent were being finalized. The findings were 'very much alarming' as the total requirement for notes indented by offices was nearabout 5,180 million pieces for the half year, as against the production capacity of the press of 2,300 million pieces. The Reserve Bank's efforts to close the wide gap between the demand and supply of notes by salvaging the maximum number of reissues and maintaining a tight supervision in the note examination sections did not prove adequate. The offices were generally in a position to meet only 40 to 50 per cent of the actual demand made on them by the chest officers. The situation became more and more critical, as was evidenced by the frantic calls made by the offices for increasing the allotments of lower denomination notes.

On the supply side, the installation of two super simultan machines at Nasik press, which was expected to be commissioned in June 1973, had been further deferred. In the assessment of the government, the Dewas press was scheduled to be commissioned by December 1973, but the Bank felt that the prospect was bleak. The office note concluded that, in the circumstances, some ad hoc arrangements for meeting the needs of the offices had become imperative. J.X. Lobo, chief accountant, while conceding that the availability of small denomination notes was becoming 'precarious', stated that National and Grindlays Bank had informed the Reserve Bank that due to the acute supply position their branches were facing agitated customers and even demonstrations.

The Kanpur office of the Reserve Bank had sent an urgent request for additional allotment of fresh notes and, according to the information received from the Bangalore office, some of the chests had expressed their inability to make Government payments unless immediate supplies were made. The chief accountant admitted that the efforts towards retrieving reissuable notes from inward remittances were not sufficiently encouraging, and that the Bangalore and Madras offices had reported a decrease in the percentage of reissuable notes salvaged during March and April 1973 as compared to the earlier period. Another alarming development was that practically no reissues were being taken out from the chest remittances of 1 and 2 rupee notes, due to the wrong interpretation of the general instructions given for sorting notes of these denominations. The respective offices had not been putting to judicious use the provision that permitted the rate of examination of pieces to be reduced up to 8,000 pieces (as against the limit of 10,000 pieces), if there was a possibility of salvaging reissuable notes in large numbers. Lobo proposed issuing suitable instructions to the currency officers to make liberal use of the discretion vested in them. To reduce the pressure on stocks of Re 1 and Rs 10 notes, the Bank proposed to instruct all the offices to meet the demands for these denominations in Rs 2 and Rs 20 notes.

The general manager of the India Security press was also sounded as to whether, in the current indent, production of Rs 2 notes and Rs 20 notes could be stepped up by the corresponding reduction in Re 1 and Rs 10 notes. The objective was that while the production of the number of notes by the press remained unchanged, there would take place a substantial increase in the monetary value of the notes put into circulation to meet increasing demands. The press, after ascertaining the position from the Security Paper Mill, Hoshangabad, replied that the latter was in a position to supply paper for Rs 2 notes. Lobo was frank enough to admit that the problem was not likely to be solved by this, and that more drastic steps were called for, such as getting a portion of the requirements for the next twelve months printed abroad till the presses in India were in a position to meet the demand for notes. Executive Director Seshadri recorded, after nearly four months, that the government had arranged for the import of certain limited supplies of paper from the portals, and that he was writing to the government in detail pointing out that a critical position might be reached if there was any more delay in the implementation of the various suggestions made by the Reserve Bank.

The RBI had been continuously impressing upon the India Security press, the need to maintain the supplies as per the indent. In June 1973, the press unequivocally informed the Bank that unless certain minimum infrastructure requirements were put in place, the position was unlikely to improve. N.D. Prabhu, general manager of the press, in a letter dated 23 June 1973, explained that for meeting the increased requirements, more machines and more space would have to be arranged, and that it was up to the government to sanction the necessary funds and foreign exchange for additional machinery besides extra space in the former distillery area owned by the government of Maharashtra as part of the Fifth Plan budget.

Prabhu commiserated with the Reserve Bank's predicament arising from the continuous short supply of notes but expressed helplessness until machinery and more space were made available. With the press already working eleven hours per shift (including an eleven-hour night shift) there was no immediate scope for augmenting the supply. There was further delay in the installation of the two super simultan machines and they were to come into operation only in April 1974. An additional critical factor highlighted by Prabhu was that, after the printing stage, complex control operations had to be gone through, like examination, counting, etc., which impacted on the time taken for rolling out the final output. The limited space available with the press precluded employment of more men on the control part of the operations to increase the output.

Another important point he made was regarding adequate supply of paper from the Security Paper Mill, Hoshangabad. The press was not in a position to commit any increase in the supply of Rs 2 and Rs 20 denomination notes by proportionate reduction in the printing of Rs 1 and Rs 10 denominations since it depended on the supply of necessary paper by the paper mill. To add to its woes, the currency note press had not received any supply of paper during April 1973, only 8,000 reams were received in May as against the normal requirement of 12,000 reams, and for the month of June they had been promised only about 3,000 reams of paper. Due to the uncertainty in the timely supply of paper, the press had already cut down the hours of working on the printing side to nine hours and a further cut might have to be resorted to if the situation at Hoshangabad did not improve by 1 July 1973.

Finally, the press cautioned that the supply of notes could be curtailed further during August and September 1973 if the situation did not improve beyond 1 July 1973. In the circumstances, the press indicated its ability to supply only 2,300 million pieces against the 1973-B indent, and that too, provided the Security Paper Mill, Hoshangabad, functioned normally from the next month and supplied about 13,000 reams per month.

Seshadri requested the government to accord top priority to the planning and erection of a second security paper mill, if necessary, by including it in the Fifth Five Year Plan. Assuming that imported paper was made available, the Reserve Bank hoped that there would be no delay in erection and commissioning of the super simultan presses at Nasik by the end of March 1974. Commencement of production at Dewas as scheduled on 1 April 1974 was considered critical. The Bank wrote to all the state governments asking them to urgently consider the question of extending the system of payment by cheques in all the larger cities and towns to begin with. The Bank also took up with the Department of Revenue the question of withdrawing some of the exemptions that had been granted permitting payment in cash.

The supply position of currency notes from the presses did not improve in the months that followed; in fact, it turned precarious enough for Governor Jagannathan to address a letter directly to Y.B. Chavan, Finance Minister, on 9 October 1973. Pointing out that the problems faced were more important and critical than apparent at first glance, Jagannathan averred that 'the maintenance of satisfactory quality of currency notes supplied to the public and adequate in all the desired denominations was the need of the hour'. At the outset of the letter, he focused on the peculiar set-up prevailing in the manufacture, supply and distribution of currency notes to the public. The government was directly in charge of the production of currency note paper at Hoshangabad and the printing of currency notes at Nasik, whereas the Bank was responsible for the issue of currency as also the withdrawal of soiled notes and their replacement with new notes. 'In the public mind therefore the Bank is naturally thought of as the agency concerned with currency notes.' The fall in the level of production of currency note paper at Hoshangabad had aggravated the situation.[1]

[1] To drive home the point, Jagannathan enclosed a letter received by him from a disgruntled member of the public. The letter read as follows:

N. Akhileshwar
9, Parekh Niwas, 135-Telang Road
Matunga, Bombay-19

The Reserve Bank Governor
Bombay-1

Damn Your
You and your officers deserve to be shot dead for your bungling. For our convenience we bank our money in nearby banks. They give me soiled and torn notes. They say the money has been got from Reserve Bank. So they won't give good notes. If we go to shop or hotel, we cannot exchange the notes for our necessities. What the hell do you want me to do with the notes? Neither the bank which gave me would accept them nor shopkeepers. So we have to come all the way to your stupid office and wait in queue?

Why the hell can't you withdraw old notes at source itself, i.e. in your office itself.

For your mismanagement, you should be given a garland of torn notes.

Sd: N. Akhileshwar

He then reiterated some of the important recommendations made in the past by the Reserve Bank, such as import of currency note paper, minting of rupee coins of higher denominations, resin coating of currency paper enabling them to retain good condition for a longer time, and establishment of another paper plant in a different geographical region. Jagannathan strongly advocated increased use of coins to ease the situation. He referred to the case of the United Kingdom issuing a coin of the value of 50 new pence—equivalent to the old 10-shilling note after decimalization. It was a cupro-nickel coin, and not unduly heavy or big.

In India, too, it was the smallest denomination notes (1, 2 and 5), which accounted for the highest percentage of notes in circulation, that were the most quickly soiled and damaged (more than 60 per cent of the circulation). Jagannathan pointed out that the average life of a currency note in circulation in India was less than a year and, consequently, the maintenance of paper currency in smaller denominations cost much more than coinage if one took into account the overall cost involved in withdrawing soiled notes from circulation, examining and replacing them. Further, it was envisaged that minting of Re 1 coins and coins of higher denomination (even if they were only up to Rs 5) would be sufficient to make up at least for the annual increase in circulation of currency, and would thereby immensely diminish the extent of burden on commercial banks and the Reserve Bank for the replacement of rupee notes and notes of smaller denominations.

The Bank's expenditure on note examination was already above Rs 4.25 crore per annum and this could be curtailed by adopting the steps suggested by the Bank to control this expenditure from rising to spectacular and unreasonable levels. Concluding the letter, Jagannathan stressed that the main recommendations listed above were 'very important and urgent', not the least the recommendation for a new paper plant; a second plant was inescapable and it took four to five years to plan and get such a plant operating in full production. A copy of the letter was endorsed to M.G. Kaul, Economic Secretary, Ministry of Finance. The government responded promptly.

M.G. Kaul, in his reply of 27 October 1973, outlined the various measures initiated by the government to improve the situation. Since 10 October the Security Paper Mill (Hoshangabad) had recommenced production and for the present the outlook was 'reasonably bright'. An import order for note paper had already been placed with the portals and the shipment was expected to commence from the end of October 1973; additional imports to augment the supply of security paper was under active consideration. The question of minting of one rupee coins in cupro-nickel alloy was under examination. And, during the Fifth Five Year Plan period, a new security paper mill with a capacity of about 2,000 tonnes per year was proposed to be set up.

Regarding the Governor's suggestion of resin coating of currency paper, he pointed out that the results of similar experiments in some foreign countries were not satisfactory. He expressed the view that, despite limitations, the currency note press at Nasik was doing its utmost to meet the Bank's indents for fresh currency notes, and its annual production capacity had been enhanced from 3,600 million pieces in 1970–71 to 4,600 million pieces. The printing capacity was expected to be further increased to 500 million pieces annually when the new super simultan printing machines (then on their way to Bombay) were installed, and the government was making arrangements to provide two additional examination bays in the spare land available with the press. The Governor seemed to be satisfied with the reply.

The supply position did not improve much during the remaining part of the period of our study. In November 1978, in view of the deteriorating situation, the government was requested to consider replacement of old machines at the Nasik press with sophisticated machines of higher capacity; introduction of an additional shift at the Dewas press, operationalized at the end of December 1974 on the Bank's proactive proposal of 1964 for setting up a second currency note printing press using the direct plate (intaglio) process instead of the existing offset lithographic method; and setting up an additional press, if necessary. The matter was also discussed with the Finance Secretary by Governor I.G. Patel and Deputy Governor Ramakrishnayya on 27 August 1980. The government, on its part, hoped that, with the introduction of a second shift at the Dewas press and some improvements at the Nasik press, the demand for notes could be fully met in the next four to five years.

SOME RELATED ISSUES

Some issues relating to currency distribution, coinage and replacement of notes by coins, security features, note paper quality and design also came up during the period of the study. On 20 August 1969, after fourteen commercial banks had been nationalized, the Reserve Bank informed I.G. Patel, Special Secretary, Ministry of Finance, that a large number of currency chests (and in some places more than one currency chest) would need to be opened, as the volume of transactions had risen sharply. The Bank proposed that the nationalized banks be allowed to be appointed as agents of the RBI. The government did not immediately respond to the Bank's proposal but, after a few reminders, agreed to it. By April 1971, the Bank formulated its policy regarding placing some currency chests at the disposal of the nationalized banks.

From 1975, currency notes were considerably redesigned incorporating new security features that would make forging or counterfeiting difficult. The Re 1 note was reduced in size and issued in 1966, followed by Rs 2, 5, 10 and 100 notes in April 1967. The reduction in size yielded an annual saving in paper costs of almost 17 per cent. The currency notes not only served as a medium of exchange and represented fiat money, but also (through the motifs printed on the obverse of the notes) acted as a powerful medium to make known among the masses the country's rich cultural heritage, the diverse flora and fauna, and achievements in economic and scientific sectors. The motifs on the notes were therefore largely retained with some modifications. The table on the following pages gives the changes in the pattern of notes that took place during the period of this study.

In 1973–74, Government of India decided to reintroduce the Rs 50 note, as it was expected to reduce the relative demand for other denominations such as Rs 10 and Rs 100. The government agreed to the Bank's recommendation to bring out a Rs 20 denomination note around the same time. The Rs 20 note was released in March 1975 and the Rs 50 note in May 1975. The currency notes released after the mid-seventies carried motifs that highlighted India's progress on the agricultural front and advances in science and technology. The Ashoka pillar as the watermark and the thread running through the notes continued to be the main safety features of the currency notes issued during the period. Besides, there were watermarks denoting the RBI monogram and the denomination.

Apart from the short supply of currency notes, the Reserve Bank had to fight with some irregularities and frauds within its offices. A group supervisor in the note examination section of the Kanpur office of the Bank was found in possession of a punched Rs 100 note on 27 June 1974. The employee was arrested and the hearing scheduled in the Kanpur court on 1 September 1977. The Bank suspended five other employees, while five more were chargesheeted. Disciplinary proceedings were initiated against the employees concerned.

In August 1974, an assistant treasurer, in charge of one of the note examination sections in New Delhi was found to have passed some cut/mutilated notes in a fraudulent manner in excess of the authority granted to him. Enquiries revealed that, in collusion with some professional dealers in defective notes, he was bringing in torn/mutilated notes, substituting them for good notes in the course of note examination and taking out good notes. It was found that even though there was no actual loss to the Bank and the notes in question were otherwise payable under the relevant rules, the conduct of the concerned official was not in keeping with the Bank's service rules and regulations. He was, therefore, dismissed from the Bank's service on 27 September 1976.

In regard to coinage, so far as the Bank was concerned, three interesting issues arose during the period of the study: the question of treating ten-rupee coins as eligible assets of the Issue department, the estimation of requirement of small coins, and the policy about change-over from notes to coins. There was also a proposal for introduction of thirty-paise coins, about which the Bank's views were sought.

Ten-Rupee Coins as Assets of the Issue Department

Government of India issued the Mahatma Gandhi Centenary one-rupee and ten-rupee coins on 3 October 1969. The Reserve Bank (its Legal Department) had to, occasion on this consider whether the ten-rupee coins should be treated as 'assets' in the Issue Department for the purpose of note issue. The confusion arose because rupee coins were defined differently under the Reserve Bank of India Act and the Indian Coinage Act, 1906.

Examining the question from the legal position as it stood at the time when the RBI Act was passed, the Legal Department took the view that the one-rupee coin and the new ten-rupee coin would be 'rupee coin' under Section 33 (1) of the Act and hence eligible to be held as an item of asset of the Issue Department. When the RBI Act was passed, 'rupee coin' was defined as 'silver rupees', which was legal tender under the provisions of Indian Coinage Act. Section 4 of the Coinage Act provided that only 'a rupee to be called the Government rupee', 'half rupee' and 'a quarter rupee' shall be coined at the mint and that a rupee and half rupee shall be legal tender in payment or on account; the quarter rupee was to be legal tender in payment of any sum not exceeding one rupee.

Moreover, the standard weight of the government rupee was to be 180 grains troy. In other words, under the Indian Coinage Act the term 'rupee' was applicable only to the one-rupee coin. The RBI Act defined a 'rupee coin' as a silver one-rupee coin of standard weight of 180 grains. After 1949 the aforesaid provisions underwent extensive changes and as the Indian Coinage Act stood in 1969, it did not refer to a rupee, half rupee or quarter rupee but only to a 'rupee coin', half-rupee coin and any other coin.

TABLE 1 Motifs on Currency and Bank Notes: Major Changes, 1967–81

Denomination	Pre-1967		1967		Changes subsequent to the Gandhi Commemorative issue, 1969 up to 1981
	Size (mm/ inches)	Motif	Size (mm)	Motif	
Re 1	63x101	Coin on the reverse	63x97	Coin on the reverse	'Sagar Samrat' year 1981 on the one-rupee decimal coin design and authentic rendering of value in fourteen Indian languages on the reverse
Rs 2	63.5x114.3 2.5x4.5	Tiger facing right	63x107	An illustration of a tiger standing near a waterfront displayed prominently	Tiger standing near a waterfront Aryabhatta orbiting the earth 1976
Rs 5	2.2/8"x5"	Buck and doe	63x117	Family of bucks displayed prominently	Family of bucks (motif varied). The picture of a farmer operating a tractor against the background of the setting sun, 1975
Rs 10	3.25x5.75"	Indian sailing boat	63x137	An illustration of a seascape with a country craft in the centre	Seascape with a country craft. Circular design containing a picture of two peacocks perched on the branches of a tree. This circle is flanked by pictures of deer, horses, a bird in flight and designs of the lotus, 1975
Rs 20	–	–	–	–	Parliament House, New Delhi, 1972 (Size: 14.7 CMs.X 6.3 cms) subsequently. The chariot wheel of Konark Sun Temple 1975
Rs 50	–	–	–	–	Parliament House, New Delhi 1975 (Size: 147 mm X 73 mm)
Rs 100	107.9x 171.4 mm 4¼x6¾"	Hirakud Dam with reservoir power	73 x157	The illustration of the Hirakud Dam	Change to incorporate white vertical panel in 1970 A composite vignette appears below depicting a

Table 1 (*contd*)

Denomination	Pre-1967		1967		Changes subsequent to the Gandhi Commemorative issue, 1969 up to 1981
	Size Mm/ inches	Motif	Size Mm	Motif	
		house and switch yard			sheaf of corn in the centre of the note and stylised reproductions of agricultural operations, a tea plantation and a hydro-electric power project 1975
Rs 1000	8" x 5"	Tanjore Temple	–	–	Demonetised on 16 January 1978
Rs 5000	8" x 5"	Gateway of India	–	–	Demonetised on 16 January 1978
Rs 10000	8" x 5"	–	–	–	Demonetised on 16 January 1978

Note: Gandhi Commemorative notes issued in October 1969 were discontinued subsequently and the earlier notes with the then existing designs were brought back.

After a detailed examination of the provisions of Section 39 of the RBI Act (obligation to supply different forms of currency) and Section 13 of the Indian Coinage Act (legal tender characteristic of the rupee coin), the Legal Department was of the opinion that the term rupee coin in the RBI Act referred to the coin that was unlimited legal tender as distinct from other coins that were not such legal tender, and the proposed ten-rupee coin being unlimited legal tender fell within the term 'rupee coin' under the Act and was hence eligible to be classified as an asset of the Issue Department.

Estimate of Requirements of Small Coins

In May 1973, the Ministry of Finance requested the Reserve Bank to provide a projection of the requirement of small coins till the end of the Fifth Plan. R.K. Seshadri, Deputy Governor, in a letter dated 1 August 1973 to A.K. Mukherjee, Deputy Secretary (referred to earlier), outlined the various factors and assumptions taken into account in evaluating the likely demand for small coins from the public, the necessity for putting into circulation more metallic rupee coins, and, finally, the need to augment the capacity of the mints. Seshadri observed that, contrary to the general impression that coin shortage had virtually disappeared, there were still complaints being received from some important cities, the state of Jammu and Kashmir, and remote, underdeveloped districts in Uttar Pradesh and eastern India. Seshadri added: 'It has also been proved by recent experience that in a situation in which there is shortage of small coins, unscrupulous middlemen corner such supplies as may be available and create a psychology of scarcity, leading to increased additional demands for small coins.' The Reserve Bank felt that the only effective method of dealing with such a situation would be to flood the concerned area with supplies of small coins, if necessary by creating small coin depots at all places where currency chests had been sanctioned for the nationalized banks. The Bank proposed, as a matter of policy, to increase the number of currency chests and, as a corollary, the number of small coin depots, which called for additional production by the mints.

The Reserve Bank's projection showed that at the end of February 1973, the effective circulation of small coins might be only Rs 76.90 crore as against the value of Rs 148.23 crore net (by value) issued by the mints on the basis of the following assumptions.

(i) Allowing for a further increase in the price of nickel, copper and brass in the next six years, it would be desirable to replace entirely the nickel 50 and 25 paise, the cupro-nickel and aluminium-bronze 10 paise, the cupro-nickel 5 paise, the cupro-nickel 2 paise, and the bronze and nickel brass 1 paisa coins.

(ii) The other coins in metal of a lower value needed to be replaced, to the extent that normal wear and tear and wastage had to be provided for. For this purpose, it was assumed that 3.33 per cent of the cupro-nickel 50 paise and 25 paise coins, and 10 per cent of the aluminium magnesium 10, 5, 2 and 1-paise coins in circulation would have to be replaced every year.

(iii) The total replacement requirements (on the above assumptions) would be of the order of Rs 44.67 crore and Rs 15.23 crore, respectively, by value.

(iv) The additional demand for small coins owing to the growth of the economy was estimated at Rs 98.77 crore.

(v) In addition, a provision was made for Rs 15.38 crore worth of small coins to be supplied in areas where shortages were still reported, and for Rs 43.91 crore worth of coins to be added, partly to replenish the depleted stocks at offices and partly to provide for additions to these stocks as and when the circulation of small coins increased in accordance with the Bank's projection.

(vi) The Bank's projection should normally provide for 1, 2 and 3-paise coins to be minted in the ratio of 0.5 per cent and 1 per cent of the total circulation of small coins, but lower denomination coins might not be actually needed to this extent. While small-value coins might still be used for balancing the value of transactions or for giving away, the projection could be too high and an ad hoc provision of just 500 million pieces of 1-paisa coins, 1,000 million pieces of 2-paise coins and 500 million pieces of 3-paise coins were seen to be adequate, in which case a total reduction of 3,652 million pieces in all these three denominations could be made, reducing the total number of pieces to be minted to that extent.

(vii) The Bank assumed that the government would accept its proposal to meet the entire increase in the circulation of one-rupee notes every year in the future by minting whole rupee coins that would be put into circulation side by side with one-rupee notes.

The Reserve Bank advised that the total requirement of coins of all descriptions, including small coins, on the basis of the above assumptions, would be about 13,995 million pieces during the six years from 1973–74 to 1978–79, i.e. a yearly average of about 2,332 million pieces, and that a production programme undertaken in the light of this projection could be considered realistic. It added that it was unlikely there would be a glut of small coins in the near future.

Change-over from One-Rupee Notes to One-Rupee Coins

To Mukherjee's query whether the Reserve Bank would succeed in pushing the metallic one rupee into circulation, Seshadri responded that cupro-nickel, being lighter, should be more acceptable than the pure nickel rupee, and that it was not possible to say at that stage how popular the metallic rupee would turn out to be. But the labour, delay and inconvenience involved in examining and disposing of one-rupee notes returning from circulation were so considerable that a serious attempt would have to be made to meet at least a part of the demand for one-rupee notes by metallic coins.

The prevailing shortage of bank note paper was another strong reason cited by the Bank for issue of a lightweight cupro-nickel metallic rupee side by side with the one-rupee note. In view of the increase anticipated in the circulation of notes, the consequent increase in the demand for bank note paper and the recent unsatisfactory experience about the production of paper at Hoshangabad, the Bank was doubtful if its requirements of paper would always be met in full. In fact, currently, the presses were importing paper. In the circumstances, the Bank did not find it worthwhile to draw any plan on the premise that the entire demand for the one-rupee denomination would necessarily be met in the form of notes, and suggested that production programmes at Hoshangabad and Nasik and the three mints would need to be considered together. The inadequate supply of one-rupee notes at any given time was to be supplemented, if necessary, from the Bank's stocks of coins or *vice versa*, depending on whether there was shortage of paper/printing capacity or metals/minting capacity.

The Reserve Bank's perception was that its estimate of 13,995 million pieces till 1978–79 (or 2,332 million pieces per year on average) juxtaposed against the capacity of the mints, which stood at about 2,165 million pieces per year and capable of being raised to about 2,350 million pieces with a second shift introduced at the Hyderabad mint, would be 'more or less adequate'. Moreover, the Bank suggested certain interlinkages in the working of the three mints at Calcutta, Bombay and Hyderabad, if overtime working in the Calcutta mint had to be discontinued for any reason. The exercise showed that the Bank's view of the supply of notes and coins was comprehensive, and was based on technical considerations and other economic criteria.

Proposal for Introduction of a 30-Paise Coin

The Ministry of Finance sought the views of the Reserve Bank in September 1973 on a suggestion made by the Department of Communications, Posts and Telegraphs Board, for introduction of a 30-paise coin for operating coin-collecting boxes at telephone booths. The Bank was averse to the proposal as it created a misfit in the decimal series, and the coin was likely to become redundant if telephone call charges were raised. The Bank stated, in its reply to the Ministry of Finance in November 1973, that, although an exception had been made in introducing a 3-paise coin (which did not fit in the decimal series) with a view to reducing the demand for 2-paise and 1-paisa coins, the current proposal bristled with two incongruities. First, it was a misfit in the decimal series, adding to the multiple denominations already in circulation; second, no other country had till then introduced a coin for such an odd denomination. The Posts and Telegraphs Board wanted one coin in the denomination of 30 paise in place of three 10-paise coins of an aggregate weight of 6.9 grams being used in coin-collecting boxes at telephone booths. The Bank pointed out that the new coin should ideally weigh approximately 6.9 grams (for being accepted by the machines), which was not practicable because the cupro-nickel 25-paise and 50-paise coins weighed only 2.5 grams and 5 grams, respectively. A cupro-nickel 30-paise coin having a weight of approximately 7 grams was also ruled out, as the value of the coin in relation to its weight would be disproportionate to that of the 50-paise coin. If the new coin were to be minted, it would necessarily have to weigh between 2.5 and 5 grams, which would necessitate recalibration of the coin-collecting boxes.

In fact, the government had already been apprised of the need to demonetize the existing cupro-nickel 25 and 50-paise coins, as the prices of copper and nickel (needed for the minting of these coins) were expected to reach a value level at which it would be profitable to have these coins melted, and necessitating their replacement with a cheaper alloy. The Bank also highlighted the fact that, as 10-paise coins were being minted in very large quantities, they were more freely available for meeting the demands of the public, and, therefore, the impression (of the Posts and Telegraphs Board) that 10-paise coins were not being minted in sufficient quantities to meet the demand was not correct.

Change-over from Notes to Coins

As mentioned earlier, the Reserve Bank was concerned about the disruption in manufacturing operations at the Hoshangabad paper mill and the looming shortage of bank note paper and printed notes in 1973. The matter was taken up by Seshadri with the government in January 1973 and again in October 1973, suggesting the replacement of one-rupee notes with a metallic rupee, at least to the extent of the annual increase in the circulation of one-rupee notes. Governor Jagannathan thereafter followed it up with the Finance Minister, Y.B. Chavan, and strongly advocated a change-over from notes to coins, at least in the case of lower denominations. As the availability position did not show any improvement, Seshadri, in a letter dated 19 October 1973 to M.G. Kaul, Finance Secretary, again raised the issue and requested early action.

The main reasons put forward for substitution of smaller denomination notes by coins were: the overall increase in the cost of manufacture of notes on account of the hike in the wages of the staff producing bank note paper; the cost of printing bank notes and the cost involved in examining and disposing of soiled notes; and, finally, the much shorter life-span of notes, which had to be replaced very frequently. Therefore, in spite of the increase in prices of coinage metals, it was still economical to replace notes with coins. The Bank argued that because of the above reasons and the prevailing inflation levels in many countries of the world, it had steadily become less economic to handle paper currency as compared to coins in the case of smaller denominations.

A comparative study of the costs of importing note paper and coinage metals (copper, nickel, etc.) at current prices revealed that the latter was appreciably lower. Furthermore, it was recognized that, in actual practice, the foreign exchange outlay on the import of coinage metals might turn out to be much lower than the theoretical cost worked out. The life of a one-rupee note was assumed to be six months, entailing recurring foreign exchange expenditure in the import of paper. In contrast, the foreign exchange outgo on import of coinage metals—assuming the life of the cupro-nickel rupee to be forty years—could turn out to be much lower than the notional cost adopted for the purpose of calculations, because it was not necessary that all the copper and nickel had to be imported for the mints were recycling the cupro-nickel already available in the current coinage.

The Reserve Bank was of the view that, as and when the 25 and 50-paise cupro-nickel coins were demonetized (before the prices of copper and nickel reached a level at which these coins were likely to be melted), the cupro-nickel alloy available in the demonetized coins could be utilized for producing cupro-nickel whole rupees or other coins in higher denominations. It was expected that, taking into account the metal retrieved by recycling cupro-nickel in the coins withdrawn from circulation, the import bill would not be higher than Rs 1 crore per annum, as against the vast sums being spent on the import of copper, stainless steel, etc., each year for industrial and domestic uses. Second, the mints could benefit from long-term contracts for nickel, if India decided definitely on a programme for minting one-rupee coins and ordered nickel supplies accordingly. Third, as world supplies improved and production picked up in Chile, Zambia and Canada, and internally within India, the prices and availability of copper could become much easier. The Bank was also influenced by the possibility of the metal value of the cupro-nickel whole rupee being contained within its face value for a reasonable period of time—in the US, between 1961 and June 1973 nickel prices had risen by a little less than 100 per cent. In the case of copper, the factors governing future movement of prices indicated that it would be at least ten to fifteen years before copper prices, which were then at an all-time peak, doubled.

The metal value of a cupro-nickel whole rupee weighing 8 grams, assuming that 17 paise was the effective cost to the government in foreign exchange (and about 25 paise at the ruling Indian prices for nickel–copper in the market, after allowing for import duty at 45 per cent), would not go up at least for the next ten to fifteen years to such levels as to make melting of the cupro-nickel whole rupee coin worthwhile. The Reserve Bank presumed that long before melting of the cupro-nickel whole rupee became profitable due to a further increase in copper and nickel prices, it would recall the cupro-nickel rupee and replace it with one made of a cheaper alloy. In its final recommendations, the Bank reiterated that minting of the metallic coin in the quantities estimated should commence without any delay, and that, in view of the increase in metal prices, the weight of the new cupro-nickel rupee could be reduced to 8 grams. The Bank did not anticipate any difficulty in pushing the whole rupee coins into circulation, or in receiving them back from circulation. The net result would be that the coins would continue to circulate, and the burden on both the government and the Bank in servicing a growing volume of note issue would correspondingly reduce.

Interestingly, Deputy Governor Seshadri, in a letter of 19 October 1973 to J.S. Baijal (Joint Secretary), raised the specific issue of switching over to the minting of a cupro-nickel whole rupee and to freeze the circulation of one-rupee notes more or less at the prevailing level. Starting with about 100 million pieces per annum and going up to about 250 million pieces every year thereafter, the strategy was expected to take care of the annual increase in the demand for one-rupee notes. As for the issue of the prices of coinage metals rising all over the world (although the difference between the face value and the metal value of the cupro-nickel whole rupee was still unlikely to be great), it was assumed that this metallic coin, once introduced, would be in circulation at least for ten to fifteen years. The Bank stressed that it would be desirable for the government to prepare 'a long-range plan' for coinage for the next ten or fifteen years, taking into account, among other things, (i) that the Bank's demand projections for notes and coins up to March 1979, and for one-rupee and other notes up to the value of, say, Rs 5 in the five years ending March 1984 were approximately double the requirements for the previous five years; (ii) that the production of bank note paper within the country had to be augmented and supplemented it by imports till the second security paper mill was established and (iii) the expected increase in the prices of coinage metals, particularly nickel and copper. By preparing a perspective plan the government would be better placed to anticipate any increase in the metal value of the cupro-nickel coins after they had been introduced, to withdraw and demonetize these coins with a view to reissuing them in a cheaper alloy, to recycle the cupro-nickel alloys for use in new and higher denomination coins, and to enter into contracts abroad for fairly long periods for the import of nickel and copper whenever the opportunity arose.

Seshadri, in his letter, also outlined a scheme for the minting and issue of the cupro-nickel one rupee to be merged into the long-range plan. He suggested that the Government should ask the mint master, Bombay, to contact all the mints and leading suppliers of nickel, copper and other coinage metals, and some research organizations in India and abroad, in order to obtain the technical information on the basis of which a long-term plan for coinage could be prepared. This plan could be drawn up with particular reference to the coinage metals to be used, the phased withdrawal and demonetization of existing coins as soon as their metal values approached their face values, the introduction of new coins and recycling of metals for purposes of minting the new coins. In Seshadri's words:

> A little time and effort and even some extra money if it is to be spent on preparing this perspective plan will be very much worthwhile. It would enable us to anticipate new developments as and when they occur and to avoid ad hoc decisions which have proved to be unsatisfactory in the past.

Thus, the Reserve Bank tried to envision the shape of things to come and to prepare well ahead to meet the challenge, before the situation went out of control.

DEMONETIZATION OF HIGH DENOMINATION NOTES

Demonetization of high denomination notes is one of the radical measures normally resorted to by governments to counter forgery and illegal printing of notes by unauthorized sources. The Wanchoo Committee on Black Money had recommended demonetization many years ago. This suggestion was not acted upon, partly because the very publicity given to the recommendation resulted in black money operators getting rid of high currency notes. The Committee had observed that black money should be regarded largely as a flow, not as a hoard, and different members of the Committee held different views on how much black money was in circulation. The government resorted to demonetization of Rs 1,000, Rs 5,000 and Rs 10,000 notes on 16 January 1978 under the High Denomination Bank Notes (Demonetization) Ordinance, 1978 (No. 1 of 1978). The Finance Minister, in his budget speech of 28 February 1978, announced that demonetization was part of a series of measures that the government had taken for controlling illegal transactions and against anti-social elements. The purpose of the Demonetization Ordinance was stated in the preamble thus:

> The availability of high denomination bank notes facilitates the illicit transfer of money for financing transactions which are harmful to the national economy or which are for illegal purposes and it is therefore necessary in the public interest to demonetize high denomination notes.

According to the Ordinance, all high denomination bank notes ceased to be legal tender in payment or on account at any place after 16 January 1978. The Ordinance further prohibited the transfer and receipt of these notes between persons after 16 January 1978 so as to make itself operationally meaningful.

The demonetization of 1978 was the second such exercise in India, the first one having been conducted in 1946. Governor I.G. Patel was not in favor of this exercise. According to him, some people in the Janata coalition in the government saw demonetization as a measure specifically targeted against the allegedly 'corrupt' predecessor governments or government leaders. Patel recalled in his book, *Glimpses of Indian Economic Policy: An Insider's View*, that when Finance Minister H.M. Patel informed him about the decision to demonetize high denomination notes, he had pointed out that:

> such an exercise seldom produces striking results. Most people who accept illegal gratification or are otherwise the recipients of black money do not keep their ill-gotten earnings in the form of currency for long. The idea that black money or wealth is held in the form of notes tucked away in suit cases or pillow cases is naïve. And in any case, even those who are caught napping—or waiting—will have the chance to convert the notes through paid agents as some provision has to be made to convert at par notes tendered in small amounts for which explanations cannot be reasonably sought. But the gesture had to be made, and produced much work and little gain. (p. 159)

Demonetization was a sensitive issue and secrecy was imperative. R. Janakiraman, a senior official in the chief accountant's office in the Reserve Bank, was asked by some officers of Government of India over the telephone on 14 January 1978, to go over to Delhi immediately on 'some urgent work'. When he enquired the purpose of the visit so that he could go prepared, the officials stated that matters relating to exchange control would need to be discussed and that he should leave for Delhi on his own. Janakiraman, however, took along with him M. Subramaniam, a senior official of the Exchange Control Department. On reaching Delhi, it was revealed that the government had decided to demonetize high denomination notes and he was required to draft the necessary Ordinance within twenty-four hours. During this period, no communication was allowed with the Bank's central office in Bombay, since such contacts could give rise to speculation. Janakiraman and Subramaniam made a request for the 1946 Ordinance on demonetization to get an idea of how it was drafted, and the request was acceded to by the Finance Ministry. The draft Ordinance was completed on schedule; it was then finalized and sent for the signature of the President of India (N. Sanjiva Reddy) in the early hours of 16 January 1978. The news was to be announced on All India Radio's news bulletin at 9 am the same day; it was given as a flash towards the end of the news bulletin.

The Ordinance provided that all banks and government treasuries would be closed on 17 January 1978 for transaction of 'all business except the preparation and presentation or the receipt of returns' that were needed to be completed in the context of demonetization. For purposes of the Negotiable Instruments Act, 1881, 17 January 1978 was deemed to be a public holiday notified under the Act.

Issuing the Ordinance was one matter. Implementing it and working out the modalities to receive and exchange notes across the length and breadth of the country was another. The Ordinance contained comprehensive provisions for the exchange of notes held by banks and government treasuries as well as by the public; for exchange of notes after the time limit; and provisions related to offences and the power of the central government to make rules giving effect to the provisions of the ordinance.

Banks and government treasuries were required to submit information (in the form of data 'return') to the Reserve Bank of high denomination notes held with them as at the close of business on 16 January 1978. The notes held would be exchanged for an equivalent value by the Bank. The general public[2] was given three days to surrender high denomination notes for conversion. After 16 January, notes could be exchanged on tender of the high denomination notes in person by the individuals themselves or by

[2] The term public included the Hindu undivided family (HUF) where the *karta* was required to tender the notes, companies where directors where required to tender the notes, firms (managing partner), associations (principal officer), etc.

a person competent to act on his/her behalf. They had to tender the notes at the Reserve Bank or at notified banks in the prescribed format with full particulars giving, among other things, the source or sources from which the notes came into his/her possession and the reasons for keeping the amount in cash.

The arrangements for exchange of high denomination notes to be surrendered by the public at the Reserve Bank in Bombay required that the Bank open additional counters and mobilize manpower from other departments to meet the high demand. Long winding queues started forming in front of the Reserve Bank office right from the morning as also at the main office of the State Bank of India, to collect declaration forms. According to press reports on 18 January 1978, the day started with utter confusion over the issue of declaration forms at the Reserve Bank headquarters at Bombay and the working hours stretched to 6.30 pm. Enterprising city printers are said to have made quick money selling forms in sets of three for Rs 3. As expected, there were frayed tempers and a considerable hue and cry from the public as well as foreign tourists, especially those who did not have, or did not care to preserve, documentary proof to support the exchange of notes. Many tourists were reluctant to fill the forms, particularly tourists from the Gulf countries. Generally tourists who had a small number of currency notes of high denomination had their notes exchanged across the counter.

On the day following demonetization, two noted economists, Professor C.N. Vakil and Dr P.R. Brahmananda, expressed the view that the measure would not have any enduring effect on money supply, prices of necessities and problems like low savings, acute poverty, unemployment and industrial relations, as the high denomination currency notes formed only a small proportion of the total money supply. They were the authors of the memorandum titled ‘Semibombla’ submitted to the union government for tackling the inflationary situation in 1974.

10

Managing the Bank

The initial organization and office structure of the Reserve Bank of India was detailed in the first volume of the Bank's history, spanning the period 1935–51. The second volume, relating to the period 1951–67, did not dwell specifically on the subject. In this chapter, an attempt has therefore been made to narrate the major developments in regard to the Bank's in-house management from 1951, with emphasis on the years 1967–81.

With the introduction of development planning and expansion of state-driven economic activities in the early 1950s, the Reserve Bank's role widened to include functions that went beyond the traditional areas. To meet the increasing responsibilities, often in uncharted areas, Government of India expanded the management team of the Bank. The number of Deputy Governors was raised from two to four—one in 1955 and another in 1964. The number of Directors on the Central Board of the Bank was also increased in 1964. Excluding the Governor, Deputy Governors and the government nominee, the Central Board was to have fourteen Directors as against ten in the earlier years. To reduce the work pressure on the Governor and Deputy Governors, the position of Executive Director (ED) was created for the first time in 1950, and the first person to hold it was B. Venkatappaiah, an ICS officer from Bombay. The management of the Bank comprised the Governor and the Deputy Governors assisted by the Executive Director and heads of different departments. As stated in the Reserve Bank of India Act, 1934, in the absence of the Governor, a Deputy Governor nominated by him would have all the powers that the Governor would wield, but, as Section 7(2) of the Act states: 'The general superintendence and direction of the affairs and business of the Bank shall be entrusted to a Central Board of Directors which may exercise all powers and do all acts and things which may be exercised or done by the Bank.'

MANAGEMENT

Governors and Deputy Governors

During 1951–81, there was a large turnover of Governors in the Reserve Bank: as many as eleven Governors in a matter of thirty years. Of these, seven Governors—B. Rama Rau, H.V.R. Iengar, P.C. Bhattacharyya, L.K. Jha, S. Jagannathan, K.R. Puri and I.G. Patel—were appointed on a regular basis but their initial terms of appointment varied from five years (Rama Rau, H.V.R. Iengar, P.C. Bhattacharyya and L.K. Jha) to one year (K.R. Puri). B. Rama Rau had the longest tenure, of about seven-and-a-half years. He was initially given a term of five years, which was extended first by one year and then again by two years. K.R. Puri was first given a term of one year; this was extended by two years but he did not complete the extended term. He had a short tenure of one year and nine months. L.K. Jha was appointed as Governor for a period of five years but he relinquished his office in less than three years to take over as India's Ambassador to the United States at Washington DC. S. Jagannathan and I.G. Patel relinquished their offices a few weeks before the completion of their terms of five years each. The remaining four Governors—K.G. Ambegaonkar, B.N. Adarkar, N.C. Sen Gupta and M. Narasimham—were appointed on the clear understanding that they would occupy the position temporarily till regular appointments were made. Their terms ranged from forty-two days (B.N. Adarkar) to seven months (M. Narasimham). K.G. Ambegaonkar and B.N. Adarkar were Deputy Governors when they were elevated to the post of Governor. N.C. Sen Gupta and M. Narasimham came from the Banking Department, Ministry of Finance, although Narasimham was with the Reserve Bank prior to his secondment to the Ministry of Finance in the early 1970s. Excepting K.R. Puri, all the Governors were directly or indirectly associated with the RBI before they became Governors. Most of them had been on the Bank's Central Board. Prior to their appointment, H.V.R. Iengar and P.C. Bhattacharyya had had exposure also to commercial banking.

The Governor of the Bank is the Chairman of the Central Board of Directors. He enjoys full powers of superintendence and direction of all the affairs and business of the Bank, the details of which are provided in the following sub-section. More importantly, he enjoys a privileged position in the financial system. Although the Governor has not been accorded any place of significance in the official warrant of precedence, he is given a very high place in official functions. The RBI Act does not contain any qualification for the post of Governor.

Most of the Governors, particularly those from the Indian Civil Services, came to head the Bank at the fag end of their careers. In 1968, Madhu Limaye raised the issue in the Parliament about the appointment of civil servants as Governors. Morarji Desai, Deputy Prime Minister and Finance Minister, gave an assurance that in the future civil servants would not be appointed as Governors. The government, however, did not keep this promise and L.K. Jha was succeeded by S. Jagannathan, another civil servant. In 1974, Madhu Limaye stated in Parliament:

> I had suggested several times to Mr Morarji Desai, when he was the Finance Minister, that it was wrong to continue to appoint the ICS officers as Governors of the Reserve Bank. Appoint as Governor only experts who have sound knowledge of fiscal and monetary policies. However, the Government has not so far taken any policy decision in this regard. I would, therefore, request Sushilaji … to clarify on this point … and to state that in future no ICS and IAS but only experts will be appointed as Governors of the Reserve Bank.

Former Governor I.G. Patel expressed a similar view in an interview with a newspaper columnist in 1993 when he said rhetorically: 'Why the Governor of RBI should … nearly always come from the secretaries of the Ministry of Finance? Why not a worthy academician or even a successful businessman who has the understanding? I think we need to bring a new spirit.'[1] An exception, however, was made in the case of K.R. Puri, who was neither Secretary in the Finance Ministry nor an expert in macroeconomic matters. In fact, Puri came from the insurance sector. There was a difference of opinion between Prime Minister Indira Gandhi and Finance Minister C. Subramaniam over his appointment. While the Finance Minister had considered economists and/or economic administrators like I.G. Patel, Narayan Prasad, S.R. Sen and M.G. Kaul as possible names for the post of Governor, the Prime Minister proposed the name of K.R. Puri, chairman, Life Insurance Corporation (LIC) of India for the Governorship. As a compromise, his appointment was deferred by three months, during which period N.C. Sen Gupta held the charge. Sen Gupta took over as Governor a few days before the declaration of the 'Emergency'. Puri's appointment

[1] I.G. Patel's interview to Subir Roy, published in the *Business Standard* on 10 December 1993.

order was issued upon Sen Gupta completing three months as Governor during the 'Emergency', and the Appointment Committee of the Cabinet was informed subsequently.

While RBI Governors generally enjoyed considerable autonomy in their working, on certain occasions, the position of the Governor was undermined. B.K. Nehru, in his book, *Nice Guys Finish Second*, wrote:

> The Governorship of the Reserve Bank was also an office which was going to fall vacant in a few months as Paresh Bhattacharyya's term was about to come to an end. Sachin Chaudhuri had wanted to know whether I would like the job and I had said no. Before him, TTK had done the same and received the same negative answer. And then Morarjibhai, who was already slated to become Finance Minister and Deputy Prime Minister, not only offered the job to me but wanted me to take it. The reason why I had so far refused this was the lack of independence of the Governor. I explained to him that the great battle between TTK and Rama Rau, which the latter lost, had made it clear that the Governor was a subordinate of the Ministry of Finance. Even as Joint Secretary, I used to issue orders to the Reserve Bank. I did not cherish the idea of my juniors ordering me about. Morarjibhai assured me that he would give me as much autonomy as I wanted and that the Governor's position in the warrant of Precedence—which at that time was exceedingly low—would be raised to an appropriate level. While I told him that I did not think he would be able to give me the autonomy I needed, I did certainly toy with the idea of taking that job if the Deputy Chairmanship of the Planning Commission was not available.

The question of the autonomy or independence of the Reserve Bank was raised in the Parliament during the debate on the RBI (Amendment) Act, 1974. Madhu Limaye, MP, in his intervention, stated:

> The second point of deep concern is that this Government has completely usurped the autonomy of the Reserve Bank. I would like to invite your attention to a strange incident that had happened at the Joint Parliamentary Committee of the Financial Institutions. Reserve Bank Governor Shri S. Jagannathan, who is an ICS, had come to give evidence before the Committee. I put a straight question to him as to whether he had submitted

> his views about this Act to the Government and if so, whether he had any objection to the basic principles of this Act. Reserve Bank Governor who had come to give evidence stated that he would reply to my question after consulting the Government and obtaining their permission. Thus, not only did he insult the Joint Parliamentary Committee but it also reflects the psychology of the Reserve Bank's Governor.

This perception about the Governor was the personal view of Madhu Limaye but it was shared by a number of persons who were contacted for oral discussions on an understanding that their names would not be divulged.

While autonomy in decision-making was in principle cherished by all the RBI Governors and also by numerous academics, the Governors in general showed considerable understanding of the limitations of their office and coordinated their efforts with those of the government for promoting public welfare. Some accepted relatively low salaries essentially to keep in line with the salaries paid in the government, and agreed to have minimal facilities.

There were only two Deputy Governors till 1955 as per the legal provisions of the Reserve Bank of India Act. The need for an additional Deputy Governor arose when the *Rural Credit Survey Report* recommended that the Bank should pay attention at the high management level to issues relating to expansion of rural credit. Following this recommendation, Governor Rama Rau took up the matter with the Finance Minister, on 23 May 1955, of amending the Reserve Bank of India Act and of creating an additional post of Deputy Governor. It was agreed between him and the Minister that the third Deputy Governor should be B. Venkataippiah, who was then Exe-cutive Director in the Reserve Bank and concerned with the Rural Credit Survey. The position of a fourth Deputy Governor was created when the Industrial Development Bank of India (IDBI) was established on 1 July 1964, for appointment as vice chairman of IDBI. B.K. Madan, Executive Director in the Bank, became the fourth Deputy Governor from 1 July 1964. He was in charge of IDBI and the Industrial Finance Department (IFD) of the Bank.

As per the Reserve Bank of India Act, Deputy Governors are appointed for a period of five years but they can be given further extension. In some cases, Deputy Governors appointed for a term of five years were given an extension on completion of their tenure, whereas in some other cases, the appointments were for a shorter duration.

Madan relinquished the office of Deputy Governor on 31 January 1967 to become India's Executive Director at the International Monetary Fund (IMF). B.N. Adarkar, a professional economist from the central government, joined the Reserve Bank as Deputy Governor on 16 June 1965, for a term of five years. Adarkar was appointed as Governor when L.K. Jha, who was Governor, left the Reserve Bank to take up an assignment as India's Ambassador to the USA. He was Governor for only a short period—from 4 May 1970 to 15 June 1970. When S. Jagannathan became the Governor, Adarkar retired from the Bank. He was known mainly for his association with the Department of Banking Operations Development (DBOD) and the Exchange Control Department (ECD).

A. Bakshi, from the Ministry of Finance, was appointed as Deputy Governor on 24 January 1967, for a period of five years. He was given lien of service in the government till the completion of qualifying service for entitlement to government pension. Bakshi left the RBI in September 1969 to take over as Secretary in the newly created Banking Department in the Ministry of Finance. He was also vice chairman of IDBI in place of B.K. Madan.

J.J. Anjaria, an economist from the Reserve Bank, was appointed as Deputy Governor from 1 February 1967 for a term of three years; he retired on 28 February 1970. He was in charge of the Economic Department and Statistics Department.

P.N. Damry was appointed as Deputy Governor on 13 February 1967, for a period of five years. After completion of his term he was given an extension of five years. However, he left the Reserve Bank on 15 March 1973 to take up an assignment in the World Bank. Damry was in charge of administration and Agricultural Credit Department (ACD).

R.K. Hazari was appointed as Deputy Governor on 27 November 1969, for a term of five years. His term was later extended by three years, up to 26 November 1977. Hazari was an academic, an economist and a financial journalist. He took a very active interest in the development of banking in the post-nationalization period. He was in charge of ARDC and took keen interest in the expansion of credit to the agricultural sector through formulation of new strategies. He also led the research activities in the Bank.

V.V. Chari joined the Reserve Bank as Deputy Governor on 17 November 1970 and remained in that position up to 30 November 1975. He was vice chairman of IDBI. S.S. Shiralkar, from the Ministry of Finance, was appointed as Deputy Governor on 18 December 1970 and retired on 17 December 1975. Shiralkar was in charge of DNBC.

R.K. Seshadri, from the Ministry of Finance, joined the Reserve Bank as Executive Director and was elevated to the post of Deputy Governor on 26

July 1973, for a term of three years. Seshadri played an active role in public debt and open market operations. He also took an interest in streamlining accounts in the Bank.

K.S. Krishnaswamy, who joined the Reserve Bank as a research officer in 1952, became Deputy Governor on 29 December 1975 for a period of five years. His term was further extended up to 31 March 1981. Krishnaswamy, as the person in charge of the Economic Department, Department of Statistics, Credit Planning Cell and DBOD, played an important role in formulating policies and anti-inflation packages in critical years.

P.R. Nangia, an officer from the Reserve Bank, was made Deputy Governor on 29 December 1975 for a term of five years and continued further up to 15 February 1982. At the time of appointment of P.R. Nangia as Deputy Governor, the name of C.D. Datey, Executive Director of the Bank and in charge of the ACD, had also surfaced. Datey was a well-known expert in agricultural credit and played a vital role in the development of the rural credit structure in the country, particularly cooperative credit institutions.

In 1975, Governor K.R. Puri recommended to the government the names of Krishnaswamy and P.R. Nangia, both Executive Directors, for appointment as Deputy Governors against the vacancies caused by the retirement of V.V. Chari and S.S. Shiralkar. Puri did not recommend Datey, who was senior to P.R. Nangia, on the ground that he was on extension of service beyond 58 years of age. However, Finance Minister C. Subramaniam noted the confidential reports on Datey, which were obtained from the Bank at his instance. He approved the proposal of the Secretary (Banking) to appoint Krishnaswamy and Datey as Deputy Governors—for a full term of five years in the case of Krishnaswamy and a reduced term of three years for Datey. However, when the proposal was put up to the Appointments Committee of the Cabinet (ACC), it approved the names of Krishaswamy and Nangia, Nangia with replacing Datey.

J.C. Luther, who came to the Reserve Bank as an officer on special duty, was promoted as Deputy Governor on 4 January 1977. However, he resigned and went back to his parent department, viz. Revenue Services, on 1 June 1977. M. Ramakrishnayya, from the Indian Administrative Service, was appointed as Deputy Governor from 2 January 1978 for a term of five years.

Central Board of Directors

Under the Reserve Bank of India Act, 1934, the general superintendence and direction of the affairs and business of the Bank was entrusted to the

Central Board of Directors.[2] Under the Act, the Governor was also given powers of general superintendence and direction of the affairs and business of the Bank. After nationalization of the Reserve Bank on 1 January 1949, it was realized that the Governor's powers as envisaged in the Act were not adequate to meet an emergency situation. It was argued, in the Exchange Bank's case, that as per the relevant provisions of the Act that existed prior to 1951, the Governor could only transact the authorized business of the Bank cited in Section 17 of the Act, and Section 7(3) did not authorize the Governor to substitute for the Central Board. The Reserve Bank of India Act was therefore amended to ensure that the acts of the Governor, under relevant provisions of the Act, on behalf of the Bank remained above any question in a court of law. Substitution of the words, 'the Bank' for the words 'Central Board' in Section 18 was found to be logical and necessary to empower the Governor to take appropriate decisions under this Section.

Accordingly, the following amendments were effected in the RBI Act. First, Section 7(3) was amended in 1951. As per the amended provision, the Governor and, in his absence, the Deputy Governor nominated by him on his behalf, shall have 'full powers of general superintendence and direction of the affairs and business of the Bank' and 'exercise all powers and do all acts and things which may be exercised or done by the Bank'. Second, Section 18 was amended to replace the words, 'Central Board' with the words 'the Bank', to enable the Governor to take appropriate decisions independently when warranted. Third, Section 58(2)(h) of the Act, relating to delegation of the power and functions of the Central Board to the Governor, Deputy Governors, Directors or officers of the Bank, was amended in 1953 to delete the word 'Governor' so that the Governor need

[2] Immediately after nationalization of the Reserve Bank of India on 1 January 1949, the Bank's Central Board and local boards became non-functional as the terms of the directors and members of the local boards automatically lapsed. With the announcement of the names of directors and members of the newly constituted Central Board and local boards, respectively, on 15 January 1949, the Central Board and local boards became functional from that date. The first meeting of the Central Board after nationalization was held on 31 January 1949. Between 1 January and 15 January 1949, the powers and functions of the Board were exercised by the Governor/Deputy Governor, in terms of Section (5) of the Reserve Bank of India (Transfer to Public Ownership) Act, 1948, which empowered the Governor or, in his absence, the Deputy Governor, to exercise all powers, pending constitution of the Central Board. With the reconstitution of the Central Board on 15 January 1949, the transitory provision in Section 5 of the Act came to an end.

not seek delegation/authorization from the Central Board on any matter. The Governor could exercise powers to nominate a Deputy Governor to act on his behalf in his absence.

After nationalization of the Bank and the transfer of its entire share capital to the central government, the government assumed the powers to appoint the Governor, Deputy Governors and Directors of the Central Board, and members of local boards. The Governor and Deputy Governor 'shall hold office' for a term 'not exceeding five years', as fixed by the central government. When the RBI was set up in 1935, the RBI Act had provided for ten Directors of the Central Board besides the Governor, two Deputy Governors and a government nominee. When the Bank was nationalized, the number of Directors on the Central Board remained unchanged at ten but, in 1964, it was raised to fourteen.

The RBI Act did not prescribe any criterion or qualification for appointment of Directors on the Central Board. The Central Board was usually broadbased with equitable regional representation and with persons from diverse fields, such as trade, industry, economics, law, the judiciary, science and technology, etc., as Directors. During 1951–81, the Reserve Bank had the privilege of having on its Central Board, eminent persons like B.M. Birla, Professor Bhabatosh Datta, Professor M.L. Dantawala, Professor D.R. Gadgil, Justice P.B. Gajendragadkar, Professor A.M. Khusro, Professor D.C. Kothari, S.L. Kirloskar, Kasturbhai Lalbhai, B.N. Mukherjee, Meherchand Mahajan, V.S. Tyagaraja Mudaliar, N.A. Palkiwala, Professor K.N. Raj, Sir Shri Ram, C.R. Sreenivasan, Dr Triguna Sen, J.R.D. Tata, Sir Purshotamdas Thakurdas, P.L. Tandon and Professor C.N. Vakil, to name a few. As the Central Board could not meet frequently enough to perform its function, a Committee of the Central Board was set up, that met every week. The Board was assisted by two sub-committees, viz. a staff sub-committee that looked into staff requirements, keeping in view the productivity and efficiency of the staff, and a building sub-committee that looked into the acquisition and construction of buildings, repairs, etc.

On some occasions, the central government gave guidance to the Governor on the composition of the Board. S.S. Shiralkar, Additional Secretary, Ministry of Finance, in a letter dated 18 May 1967 to Governor P.C. Bhattacharyya, mentioned that Deputy Prime Minister Morarji Desai had suggested, in filling up future vacancies on the boards of the Reserve Bank and the State Bank of India, that more emphasis be paid to appointing economists, retired bank officials, etc. It would be useful to have a few businessmen on the boards in order to have the benefit of their experience but they should be in a minority. With this in mind, the Minister would like a panel to be made of persons considered suitable for appointment to the boards.

Though there was no provision in the RBI Act for reservation of vacancies in the Central Board/local boards for minority communities/scheduled castes/scheduled tribes, etc., social objectives were not ignored while nominating Directors/members. Governor Iengar, in a letter dated 27 August 1958 to Rangachari, Special Secretary, Ministry of Finance, mentioned that it was desirable to appoint as a member someone from the Muslim community, and recommended the name of Col. B.H. Zaidi, vice chancellor of Aligarh Muslim University, for the position. Government of India appreciated the idea and nominated Col. Zaidi as a Director of the Central Board. On his subsequent resignation from the Board, another Muslim candidate, Professor M. Mujeeb, was nominated against the vacancy. In September 1974, the Ministry of Finance specifically wrote to the RBI Governor asking him to suggest names of suitable persons belonging to scheduled castes/scheduled tribes, for consideration for appointment on the Central Board/local boards.

During the debate on the RBI (Amendment) Bill, 1974, in the Parliament, there was a demand from some members for representation of employees of the Bank on the Board of Directors. In the exchange between Ramavatar Shastri, Member of Parliament, and Sushila Rohatgi, Deputy Minister, Shastri referred to her statement that Board members should know about credit and monetary matters as an insult to the labour community, and asserted that the leaders of the Bank Employees Association understood credit policy better than the Directors. Sushila Rohatgi, in her reply to Shastri's point regarding inclusion of employees on the Board of Directors of the Reserve Bank, clarified that she did not mean to belittle the employees. On the contrary, employees were included on the boards of the nationalized banks and there was an advantage in doing so. However, in so far as the Reserve Bank was concerned, experts in economic estimations and monetary stability should be on the Board of Directors. She pointed out that the earlier Directors of the Reserve Bank of India had mostly been from industry and trade, while presently, they included economists, agriculturists, lawyers and jurists. She also pointed out that when the question of inclusion of workers' representatives in the Central Board of Directors of the Reserve Bank of India came up, the concerned representative had to leave because of opposition from his own party. There was therefore no workers' representation in the Central Board.

Although the Act did not mention Directors' nomination on a territorial basis, by tradition, four Directors were nominated from the Bombay region and two each from the other three regions. A larger number of Directors were nominated from the Bombay region to enable the Bank to hold weekly meetings of the Committee of the Central Board without facing problems of quorum for attendance. Similarly, there was no provision in the Act for the nomination of Directors to represent different areas of activities, except for four Directors nominated to the Central Board from four local boards who were required, as far as possible, to represent economic interests and the interests of cooperative and indigenous banks. As a result, the Directors on the Central Board came from a fairly wide range of activities, like industry, economics, social work, education, law, science and public life.

On many occasions, guidelines were sent from the government to the Bank regarding nomination of Directors. In June 1968, S.S. Shiralkar, Additional Secretary, Ministry of Finance, while approving the names of three Directors on the Central Board, suggested to M. Narasimham, Secretary of the Central Board, that, at the next opportunity, suitable names of agriculturists (or cooperators) and small-scale industrialists may be recommended in order to bring the Central Board in line with the policy underlying social control over banking.

The RBI Act laid down clauses for disqualification of Directors of the Central Board; the same applied also to members of local boards. A salaried government official, or one who had been adjudicated as insolvent or had suspended payment or had compounded with his creditors or had been found lunatic or had become of unsound mind or was an officer or employee of any bank or was a director of a commercial or cooperative bank, was debarred. However, the disqualification relating to a salaried government official and an officer or employee of the Bank or a cooperative bank or a director in a bank would not apply to the Governor or Deputy Governor or the government nominee. At first, only an employee or a director of a commercial bank was not permitted to become a Director on the Board of the Reserve Bank of India. When the Banking Regulation Act was extended to cooperative banks in 1966, directorship of a cooperative bank became a disqualification for appointment as Director on the Central Board or as member of the local boards. Accordingly, the Secretary of the Central Board sent letters to all the Directors and members to ascertain whether they were directors of any cooperative bank.

The rationale behind the provision of not allowing directors of commercial banks or cooperative banks on the RBI Board was that such persons should not influence the policies of the Reserve Bank of India. However, on many occasions, directors/officials of the State Bank of India were appointed as Directors of the RBI Board because SBI was considered as a statutory corporation. After the nationalization of fourteen major Indian banks in July 1969, some directors on the boards of these banks were also appointed to the Central Board of RBI. M.P. Chitale, for instance, was a director on the board of Dena Bank when he was appointed to the Central Board of the Bank. However, it was decided that directors on the boards of the nationalized banks and SBI should resign from those boards before joining the Central Board of RBI. R.K. Seshadri, Executive Director, in a note dated 29 August 1972 to Governor Jagannathan, proposed: 'While it is not necessary to discriminate against the nationalized banks as compared with the State Bank of India, we may as a matter of policy in future ask the directors, both of the State Bank and the nationalized banks, to resign from the Boards of these banks before they join our Board.' Accordingly, Chitale was asked to resign from the board of Dena Bank.

S.M. Joshi, a well-known trade union leader and a member of the Praja Socialist Party, was appointed to the Central Board of the Bank. A member of a political party becoming a Director on the RBI's Central Board was not considered as a disqualification under the RBI Act. However, he resigned from the Central Board on his party's directive. In a letter to the Governor, Joshi wrote:

> I do not know what to do when the national committee of my party asks me to withdraw from the Board. After careful consideration of the issues involved I came to the conclusion that it is in the interest of disciplined political life in our country to resign. So long as I am a member of the party, I might be subjected to their direction. I do not know whether you would agree with me in this regard. I know the loss is mine. I do not know to whom the letter of resignation should be addressed. Therefore, I am sending it to you. Kindly forward it to the appropriate authorities and oblige.

Earlier to this, when Joshi had come to the RBI for attending a Board meeting in Bombay, there was a demonstration by class III and IV employees of the Bank against his accepting Directorship of the Bank because they objected to a socialist sitting with capitalists.

In 1956, as stated earlier, a controversy arose when Governor Rama Rau submitted a memorandum to the Central Board against the hike in stamp duty proposed in the central budget by the Finance Minister, T.T. Krishnamachari, as a fiscal measure with monetary intent, the entire Board, opposing the proposal, passed a resolution against it. The Ministry of

Finance and even the Prime Minister took strong exception to such a resolution, and asked for of the memorandum and of the proceedings. The Governor replied that there was no system of keeping a record of the discussions of meetings of the Central Board. On occasions when the Directors wanted the Governor to communicate the views of the Board to the government, such views were not incorporated in the proceedings but separate notes were sent to the government by the governor.

After taking over as Governor in 1957, Iengar suggested that it was necessary to maintain a brief record of discussions (if, necessary separately) at Board meetings on important subjects like credit policy. He felt that it was, in fact, the most important subject that the Board had discussed, and it was essential that a record of the discussions be kept. In 1967, when M. Narasimham became the Secretary after reorganization of the Secretary's Department and he was required to attend Central Board and committee meetings, he started the practice of recording fairly detailed proceedings of the Board meetings for the benefit of posterity.

While the Central Board was the highest managerial body of the Reserve Bank, most of the agenda items that came up at its meetings were of a routine and administrative nature, and did not provide much scope for contributing to improvements in policy. Some members of the Board, realizing that the memoranda and agenda items were not lively and did not have any policy content, privately aired their views to the Governor from time to time. This was reflected in a note recorded by Governor L.K. Jha on 31 January 1968, where he mentioned that the papers for the Board, although voluminous, contained little of what might be called points meriting consideration. The prime responsibility in regard to policies did not in fact rest with the Board; nevertheless, one would hope to keep the Board members better informed.

On 3 February 1970, P.L. Tandon and Bhaskar Mitter, referring to the discussions at the Board meetings, wondered whether steps could be taken to enable the members to contribute more effectively to the deliberations. The Governor stated that the agenda and papers were prepared after taking into consideration the topics and items in which Directors were interested. He also mentioned that while attempts were being made to prepare a suitable and relevant agenda for every meeting, a summary record of the discussions was also being maintained by the Secretary for the Bank's own purposes, and that the comments and views of the Directors were always taken into consideration before any decision was taken. While the formal agenda items were of an administrative and routine nature, there were many notes relating to monetary and credit policy, foreign exchange, etc., that were placed before the Board/Committee, albeit only for information. Professor K.N. Raj, who was a Director on the Board and who actively participated in the discussions, felt that the Bank was not using its Board. On many economic policies, particularly budget proposals, the Directors made valuable suggestions which were conveyed to the Minister of Finance. N.A. Palkiwala, as Director of the Central Board sent his comments to the Governor (L.K. Jha) on many budget proposals.

Local Boards

When the Reserve Bank of India Act, 1934, was originally framed, for administrative convenience, India (including Burma) was divided into five areas and local boards were constituted at Bombay, Calcutta, Delhi, Madras and Rangoon. With the separation of Burma, the local board for the Rangoon area was abolished. Each local board consisted of five members elected by shareholders on the register for that area, and three members nominated by the Central Board. In exercising its power of nomination, the Central Board aimed at securing representation of territorial and economic interests that were not already present among the elected members on the Central Board, and, in particular, the interests of agricultural and cooperative banks.

At the time of nationalization of the Reserve Bank in 1948, the Finance Minister was in favour of abolishing the local boards. However, Governor C.D. Deshmukh suggested that they should be retained. According to Deshmukh, local boards served a useful purpose in advising the Bank on matters relating to banking. In view of their local knowledge, their services were also useful in matters like acquisition of land and property by the Bank, building of the Bank's premises, etc. Further, the Governor felt that there were very few people who understood the Bank's operations and it would be useful to associate some of the local board members with the work of the Bank. As a result, the local boards continued even after nationalization of the Reserve Bank.

However, with the disappearance of shareholders consequent upon nationalization of the Bank, with effect from 1 January 1949, the local boards were no longer called upon to perform their primary function relating to shares for which they were originally constituted. The other functions performed by the local boards were of an advisory nature. Therefore, Governor Rama Rau again raised the issue of abolition of the local boards. The Committee approved the Governor's suggestion on 9 February 1955, and the Board agreed that the local boards should be abolished on the expiry of their present term on 14 January 1957. The Reserve Bank of India (Amendment) Bill, 1956, was introduced in the Parliament for giving effect to the decision to abolish the local boards. In February 1956, the Bank wrote to the government for effecting suitable amendments to the RBI Act for nominating four Directors (in lieu of members of local boards nominated on the Central Board) on the Central Board to represent, as far as possible, territorial and economic interests and the interests of cooperative and indigenous banks. It suggested that, alternatively, the number of Directors nominated under Section 8(c) be hiked from six to ten.

During discussions on the Bill in the Parliament, there was strong protest against the decision to abolish the local boards. Accordingly, Government of India dropped the clause relating to their abolition. Discussions about divisibility and their areas of activities, however, continued to surface time and again at Central Board meetings and in the Bank's correspondence with the central government.

In 1969, in consultation with various departments , the Bank proposed to delegate some significant functions to the local boards. They were given ample scope to discuss matters and offer their advice to the Central Board. Though it was, *inter alia*, envisaged that local boards would be consulted in the disposal of applications for opening of commercial banks, it was subsequently decided to seek their advice only in cases relating to opening of branches in metropolitan cities and port towns, and opening of offices by foreign banks in India. Similarly, in the case of cooperative banks, it was decided that applications for opening of branches should be disposed of departmentally, and that a quarterly statement showing the particulars of applications received from cooperative banks for permission to open/change locations from existing places of business should be submitted to the local boards. This was considered necessary to ensure speedy disposal of the numerous applications for opening new branches.

In spite of the efforts made by the Bank from time to time to enlarge the scope and content of the functions of local boards, there was a general feeling that they were not being utilized adequately as they served no useful purpose. In fact, in 1970, a member of the northern area local board resigned his membership on this ground. In that context the then Governor, L.K. Jha, observed:

> The point made by the members of the Local Boards that Local Boards do nothing useful is valid and warrants further consideration. Perhaps the best solution would be to abolish them and if Government agrees with this view nothing more

> needs to be done, but, if they are to continue, then we must examine ways and means of the possible use we can put them to.

It was, however, decided not to take any action for the time being as the functions of the local boards had been enlarged only in 1969 and some time was allowed to elapse before a further review.

The question of enlarging their functions was once again considered in 1976. It was then decided that, in addition to various advisory activities, the local boards should be vested with certain powers having a bearing on financial disbursements of certain categories. Accordingly, they were authorized to take financial decisions in regard to purchase of land for office buildings and alterations to existing buildings owned by the Bank at any place within the jurisdiction of the boards, provided that the cost of the project was not in excess of Rs 5 lakh at a time. The boards were also authorized to decide on repairs to the Bank's residential accommodation within the same limits, and subject to the norms and standards prescribed by the Committee of the Central Board. These limits could be increased further but it was decided to defer such increase until some experience was gained by the local boards on disbursals.

The local boards, from time to time, highlighted regional problems, like sick industrial units and the state of small-scale industries in Calcutta, difficulties in procuring raw materials and marketing finished products in Bombay, etc. There was a suggestion from the local board of Calcutta that the Bank may set apart a token sum to be used by the local boards to investigate local economic problems and generate data having a bearing on the work of the Bank. The local boards at Delhi and Bombay felt that they were not very clear about and/or did not fully appreciate the Bank's criteria for deciding the number and location of branches, and stressed the need for laying down more meaningful criteria that could be fine-tuned to the environmental factors in different parts of the country rather than applying broad criteria uniformly in all situations. Some members suggested that local boards should be able to take up with the Bank the problems of customers of commercial banks, on the clear understanding that problems of individuals would not be taken up but only more general ones affecting particular economic sectors, say, of traders and industrialists.

The memorandum submitted by A.K. Banerji, Executive Director, to the Central Board, as an informal item on 11 February 1978 suggested various steps to meet the requirements of local board members. Senior officers of local offices of the Bank could, if needed, attend their meetings to discuss any of the memoranda of the Central Board, and publications of the

Bank could be regularly sent to them. The initiative of bringing the local boards closer to the policies of the Bank and to the developments in different sectors of the economy was welcomed by members.

Some Resignations

On many occasions, Directors of the Central Board of the RBI and members of the local boards resigned, for a variety of reasons. A noteworthy example was the resignation of Sir Purshottamdas Thakurdas (Sir PT, as he was fondly called), who had been a Director of the Central Board since 1935 and also chairman of the western area local board in 1956, when there was a clash between Governor B. Rama Rau and Finance Minister T.T. Krishnamachari. The clash led to the resignation of Governor Rama Rau on 13 January 1957, an issue that was elaborately detailed in Volume 2 of the history of the Reserve Bank of India. The Finance Minister had made a public statement that the Reserve Bank was only a department of the Finance Ministry, to which Governor Rama Rau reacted by resigning. This incident led to the resignation of Sir PT as well. In a letter addressed to the Reserve Bank, Sir PT stated:

> The happenings in the last couple of weeks in the relations between the Board of the Reserve Bank and the Central Finance Ministry are so extraordinary, one-sided and unprovoked that I feel it is not in the interest of the country that any non-official should avoidably keep up his connections with the Reserve Bank. I, therefore, hereby request you to do the needful so that I may not be renominated after what has been happening lately.

In 1964, H.P. Nanda of Escorts Ltd was appointed as a Director of the Central Board. He was later asked to resign because he and his company had committed a technical violation of foreign exchange regulations, which was pointed out by the Finance Minister, T.T. Krishnamachari, himself to the Governor.

The provision for reappointment of Directors often led to differences in perception. As a result, many Directors who joined the Board of the Bank in 1935 continued for a long time; for example, Sir PT remained on the Board till 12 January 1957. Governor Iengar, vide letter No. Sy.59–1401 dated 16 November 1960 to the Finance Minister, suggested: ‘As a general rule, it would seem desirable that persons who have served for two full terms (which means eight years) should be replaced unless there are special considerations which would justify their retention.’

In reply to this letter, L.K. Jha conveyed that the Finance Minister was happy to note the suggestion to limit the tenure of Board members to two full terms. The Governor, while suggesting two terms, also recommended that S.S. Anantharamakrishnan of the southern area local board, who had already completed two terms should be given one more extension. The Finance Minister declined this proposal. In 1961, Governor Iengar wrote to L.K. Jha (letter dated 27 November 1961), suggesting that the term of Professor D.R. Gadgil, who had been on the Board since 1952 and had completed more than two terms, could be considered for another extension. He wanted this as an exception. In support of Professor Gadgil, the Governor wrote:

> Apart from his membership of the Board, where his contribution is quite outstanding, he has been of great value to us in our economic and statistical investigations. As he comes to the Reserve Bank once a week, it has been possible for us to consult him about these investigations and to take full advantage of the knowledge and experience he has gained as the Head of the Gokhale Institute in Poona. It would be more difficult to do so if he did not regularly visit us in the Reserve Bank in his capacity as a Director. I would personally consider that both on account of his outstanding contribution to our discussions as an economic stand, also of his assistance to our Economic and Statistical Departments, an exception may well be made. I will be grateful if you will let me know urgently what the Minister's views are.

The Governor's proposal was turned down by the Finance Minister. Jha, Secretary, Ministry of Finance, in his communication to the Governor, wrote:

> Finance Minister fully appreciates the reasons which you have given regarding the desirability of continuing Professor Gadgil for another term. He feels, however, that it would be extremely awkward to distinguish between director and director when considering the question of extension for a third term. It would imply that Government makes an assessment and comparison of the usefulness of the contribution which individual directors has made on the Board. Finance Minister feels that such an impression should be avoided and we should adhere to the decision that no director shall serve for more than two full terms.

In 1965, Governor P.C. Bhattacharyya recommended to the government that Professor D.R. Gadgil be nominated on the Bank's Board. The Governor mentioned in his letter that whatever be the objection that had prevented the government from granting him a third consecutive term no longer operated, and that it was opportune to reappoint him on the Bank's Board. However, even before a decision was taken by the government, Professor Gadgil on his own declined to accept the offer as he did not desire to sever his connection with Maharashtra State Cooperative Bank, of which he was the chairman.

An office note dated 3 November 1972, recorded by R.K. Seshadri, Executive Director, stated that: 'In accordance with the decision which has already been taken by the Prime Minister (Smt Indira Gandhi) the appointment of a Member of a Local Board or of Director of the Central Board is not to be renewed except in very exceptional circumstances.' It appears that this decision was taken in response to the criticism levelled in the press in November 1971 by S.A. Dange, communist leader, against the continuation of Directors on the Board for long periods of time. Further, in June 1972, during the course of a discussion about granting a second term as Director to Kamaljit Singh, V.M. Bhide, Additional Secretary, Government of India, conveyed to Governor S. Jagannathan that it was of the view that no Director should be appointed in the future for a second term unless there was an exceptional reason for doing so. But the Governor strongly recommended granting an extension to Kamaljit Singh and stated the new policy not to renominate a Director who had already served one term was not absolute, as he understood it, and could be relaxed on merits occasionally. Despite this strong recommendation, the government did not agree to his reappointment. In March 1974, Government of India, on the recommendation of the Bank, reappointed Justice P.B. Gajendragadkar and Professor A.M. Khusro as Directors of the Central Board for a second term. Justice Gajendragadkar, however, resigned from the Board on 17 May 1975 when Governor Jagannathan relinquished his position. In his letter to the Governor, Gajendragadkar said:

> As you know, it was solely out of regard for your request to authorize you to recommend to the Central Government that I should be renominated as Director to the Central Board of the Reserve Bank of India when my first term as Director of the Bank came to end on 27th February 1974. Since you are relinquishing I am sending herewith, for your information, a copy of letter which I have already addressed to the Finance

> Minister (C. Subramaniam) resigning my post as Director of the Board of the Reserve Bank of India.

When Government of India declared a national Emergency on 25 June 1975, Professor M.L. Dantwala, Director of the Bank's Central Board, and member and chairman of the western area local board and director on the board IDBI, resigned from all three posts in protest. In his letter to Finance Minister C. Subramaniam, Dantwala wrote:

> I am profoundly perturbed by the recent political developments in the country commencing with the Declaration of National Emergency and subsequent trends of events. As I am unable to reconcile myself with the measures adopted, I have to request you to permit me to tender my resignation effective from the afternoon of Wednesday, 2nd July 1975, from
> (1) the Central Board of Directors of the Reserve Bank of India
> (2) the Board of Directors of the Industrial Development Bank of India
> (3) Chairmanship and Membership of the Western Area Local Board.

Dantwala, however, became Director of the Bank's Central Board again after the removal of the national Emergency in 1977.

On 30 June 1975, Professor Bhabatosh Datta, another Director of the Bank's Central Board, resigned, citing poor health as the reason. In his letter to the Secretary, Banking Department, Government of India, Professor Datta mentioned:

> I had recently to undergo a major operation, requiring long hospitalization and subsequent rest. I have been asked to reduce my travel commitments to the indispensable minimum. I could not attend the last two meetings of the Reserve Bank Board. I now feel that it will not be proper for me to continue to retain my seat on the Board and thus block a new appointment.

DEPARTMENTS

By the early 1950s, the Reserve Bank of India had a number of departments that reflected the diverse financial and economic functions associated with the process of economic development. From the three departments with which the Bank started functioning in 1935, namely the Banking Department, the Issue Department and the Agricultural Credit Department (ACD), it progressed quickly, in the 1940s and early 1950s, to set up the Exchange Control Department (ECD), the Department of Research and Statistics (DRS), the Inspection Department, the Department of Banking Development (DBD), the Department of Banking Operations (DBO), and the Central Office with the Chief Accountant as head, and legal, premises and secretary's divisions.

In July 1954, a proposal was made to set up an Estate Department headed by an assistant engineer at Bombay and under the general supervision of the Bombay office manager would have the responsibility of overseeing and maintaining all the Bank's properties. As the responsibility had increased enormously with the construction of a large number of staff colonies, the Committee of the Central Board approved the proposal for setting up the Estate Department at its meeting of 28 July 1954.

In August 1955, the Bank decided to reorganize and expand the ACD and DBD in the context of the recommendations of the Committee of Direction of the All India Rural Credit Survey, 1954, and the enactment of the State Bank of India Act, 1955, proposing the setting up of subsidiaries by SBI. The ACD was reorganized in order to strengthen and widen the cooperative credit structure and to train the cooperative sector personnel, with three divisions—planning and reorganization, inspection and general. The existing rural division of the DBD was transferred to the ACD. The DBD, at the same time, was strengthened in terms of staff to take up inspections of state finance corporations, and to deal with issues relating to industrial finance and the developments associated with the expansion of SBI and its subsidiaries.

Reorganization of DBD was undertaken once again in September 1957 when Government of India decided to set up a Refinance Corporation to provide financial assistance to medium-sized industrial units. The DBD was accordingly bifurcated into two departments—the Industrial Finance Department and the Department of Banking Development. Both departments needed additional staff with the increase in work and were headed by chief officers.

In April 1959, the DRS was divided into two departments—the Economic Department and the Department of Statistics—given the growing complexity of economic functions of the government and of credit management, and the need to develop extensive financial statistics on organized lines and to make elaborate empirical analyses of developments in the economy.

By October 1964, the Reserve Bank had a large number of buildings—nine office buildings and thirteen residential colonies—at different cities ('centres' as they are referred to in the internal notes of the Bank, and in this chapter as well). Four new projects were under construction and eleven more were in the pipeline. In view of the growing number of premises, it was proposed that the Estate Department should be headed by a superintending engineer at the Central Office of Bombay, and supported by technical cells headed by executive engineers at the Calcutta, Madras, New Delhi, Nagpur and Bombay offices.

The DBD that came into being in 1950 and which was divested of its industrial finance wing in 1957 diminished in importance in view of the contraction of work with the full-fledged formation of the SBI group. Inspector V. Atma Rao who inspected the DBO in 1963 suggested the merger of DBD with DBO. Acting on his cue, Governor Bhattacharyya proposed the merger in a note dated 31 March 1965, which was approved by the Committee of the Central Board at a meeting held on 7 April 1965. The merged department came to be known as the Department of Banking Operations and Development (DBOD). Bhattacharyya made a proposal to the Committee of the Board at the same time to reorganize the Central Office of the Bank. Till then, the Central Office was headed by the Chief Accountant who was in charge not only of Central Office accounts but also of administration, personnel, expenditure, planning and construction of buildings, and other miscellaneous associate functions. Bhattacharyya felt that the designation of 'Chief Account' was a misnomer in that it did not suggest the responsibilities that were shouldered by the office. He, therefore, suggested that the office be split into three departments on a functional basis—the Department of Administration and Personnel headed by a chief manager, the Department of Accounts and Expenditure headed by chief accountant and the Premises Department headed by a chief officer. The Committee approved the proposal without any reservations.

Bhattacharyya's other important accomplishment was the formation of a separate Department of Non-Banking Companies (DNBC) in March 1966 at Calcutta, carved out of what was hitherto attended to on a temporary basis by the publications and press relations division in the Economic Department. Another area where Governor Bhattacharyya's imprint was visible was in the creation of the Secretary's Department, by upgrading the Secretary's section that dealt with not only the work relating to meetings of the Central Board and its Committees, but also the work associated with the government's public borrowings and the management of public debt. The Governor proposed in June 1967 that while the Secretary's post could be filled by selection from among senior officers belonging to all the departments or, if necessary, by appointment of a suitable person from outside the Bank, his suggestion, without prejudice to this proposal or any other arrangements, was that M. Narasimham, who was then Deputy Economic Adviser in the Bank, should be appointed as Secretary. The Committee of the Central Board approved this at a meeting held on 22 June 1967.

During the tenure of Governor Jha, too, some organizational changes took place. As the volume of work increased and new activities were added, the Bank's staff strength almost doubled between 1960 and 1966, to over 17,000. The establishment costs had gone up as a result, without any evidence of a corresponding increase in the overall efficiency or output of the Bank. To ensure improvements in output/efficiency, traditional methods of work and procedures had to be discarded. Deputy Governor P.N. Damry suggested in August 1967 the setting up of an organization and methods unit in the Bank. The unit would help to codify the basic developmental procedures in the form of manuals, handbooks, etc., and update them continuously with a view to eliminating wasteful procedures and streamlining methods of work. The unit was called the management services section (MSS) and was made a part of the Department of Administration and Personnel. The senior officer in charge of MSS took initial training related to organization and methods at the National Institute for Training in Industrial Engineering (NITIE) at Powai, Bombay, and completed an assignment by January 1968 that led to suggestions for simplification and quality control of work of the DAP and for further delegation of powers. Given the critical importance of the section, the Efficiency and Development Sub-Committee of the Central Board monitored its functioning. The Sub-Committee took the view that the training at NITIE was useful but it was necessary to organize the section on more scientific lines. This led to the hiring of the services of the All India Management Association (AIMA), New Delhi, in a consultative capacity and on a retainer basis, in April 1968. AIMA, in a preliminary paper, suggested that the word 'management' in the title of the unit was likely to produce an adverse psychological reaction among the working staff. On July 1968, in a memorandum to the Efficiency and Development Sub-Committee of the Central Board, K.C. Mittra, chief manager proposed that the unit be renamed as the 'O&M division'. The Committee approved the proposal on 24 July 1968. The division's working was examined in detail subsequently—in 1976, by the Cadre Review Committee, which recommended that the division, instead of restricting itself to designing forms and simplifying procedures, should act as a change agent with due emphasis on human factors. The Cadre Review Committee also suggested that the O&M division should undertake tasks related to (i) manpower planning, (ii) job evaluation, job satisfaction and job enlargement, and (iii) operations research. The Efficiency and Development Sub-Committee, which considered these proposals, suggested that the O&M division should be called the 'Management Services division', in line with its evolving role. The Committee of the Central Board approved the proposal on 14 July 1976. The division became a full-fledged department in 1978–79, and was called the Management Services Department (MSD).

The setting up of the MSD heralded a major shake-up in the organizational structure of the Bank. In July 1979, Governor I.G. Patel constituted an in-house Study Group headed by the director of the MSD, to review the departmental and organizational set-up in the Bank. The Study Group submitted its report in February 1980. At a meeting held on 1 July 1980, the top management approved most of its recommendations and decided that the adviser, MSD, should implement the approved recommendations. Accordingly, an implementation cell was formed. The impact of the recommendations was most felt by the Department of Administration and Personnel (DAP) and the Department of Accounts and Expenditure (DAC). Some departments were expanded and were given new names. Thus the Economic Department became Department of Economic Analysis and Policy (DEAP) with some additional divisions, such as international economic relations and national income, savings and flow of funds. The Department of Statistics became the Department of Statistical Analysis and Computer Services (DESACS) with divisions associated with surveys and computerization. DAP was reorganized on a functional basis into (i) the Department of Administration and (ii) the Personnel Policy Department, after the Committee of the Central Board cleared, on 21 January 1981, a proposal of Deputy Governor P.R. Nangia in favour of the said bifurcation. DAE was also reorganized on functional lines into (i) Department of Currency Management, (ii) Department of Expenditure and Budgetary Control, and (iii) Department of Government and Bank Accounts, again on the basis of a specific proposal made by Deputy Governor M. Ramakrishnayya in a memorandum that was approved by the Committee of the Central Board on 21 January 1981. On the same day, the Committee approved the introduction of a three-tier system of inspection and audit, namely, financial audit, systems and staffing audit, and performance audit.

The Bank prepared itself for the imminent changes in the departmental structure concerning rural and cooperative credit in light of the recommendation that the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD) made in its final report (submitted on 5 March 1981) to set up an apex bank for agriculture and rural development, the details of which are given later in this study. The apex bank, viz. NABARD, which came into being on 12 July 1982, heralded the dissolution of one of the first departments of the RBI, the Agricultural Credit Department, and the coming into existence of two new departments, the Rural Planning and Credit Department (RPCD) and Urban Banks Department (UBD).

SPREAD OF BANK OFFICES

The first volume of the history of the Reserve Bank of India (1935–51) had referred to the original proposal to have RBI offices in Calcutta, Madras, Delhi, Rangoon and London. In the early 1950s, the Bank owned office buildings in Bombay and Calcutta. The Rangoon office was closed when Burma became independent in 1948. At the remaining two major centres, viz. New Delhi and Madras, the process of acquisition of land for the Bank's offices was in progress around that time. For New Delhi, the Committee of the Central Board, at its meeting held on 25 May 1949, confirmed acceptance of land allotted by the government to the Bank, measuring about 4 acres on Parliament Street; it also sanctioned payment to the government of a sum of over Rs 12 lakh towards the premium for the plot. There were some accompanying conditions, too, pertaining to the annual ground rent payable and the share in the unearned increase in the value of land at the time of transfer.

The acquisition of a plot for the Madras office encountered certain initial hiccups. In August 1950, the Committee of the Central Board authorized the purchase of a site known as Stanley Club at Vepery, Madras, from Government of India. Even though it was the government of Madras that suggested the site, Madras Corporation opposed the move and almost unanimously passed a resolution objecting strongly to the construction of any building on that site, on the ground that such construction would mar the natural and aesthetic beauty of the Island Grounds and deprive the city of valuable open area. Even the local press came out against the allotment of the site to the Bank. In view of the public opposition, the Bank considered an alternative site on North Beach Road near Fort Glacis, in the Fort St. George area, as suggested by the Corporation Commissioner, and found it to be suitable. The site, measuring 3.96 acres, belonged to the central government, which agreed to transfer the same to the Bank for a sum of about Rs 5 lakh. The proposal to acquire the plot was approved by the Committee of the Central Board in January 1951.

The first organized initiative that the Bank undertook for setting up branches at the headquarters of each major state was in September 1950, when the issue was discussed at a Central Board meeting, in the wake of the examination of the *Report* of the Rural Banking Enquiry Committee. The Central Board generally agreed with the proposals made by Governor Rama Rau, which in turn were in line with the recommendations made by the Rural Banking Enquiry Committee.

In pursuance of this policy, the Bank opened a branch at Bangalore on 1 July 1953, and took steps to acquire plots or to initiate construction at centres like Nagpur (Madhya Pradesh), Bhubaneswar (Orissa), Chandigarh (Punjab), Gauhati (Assam), Patna (Bihar), Hyderabad (Hyderabad) and Lucknow (Uttar Pradesh). The Rural Banking Enquiry Committee recommended branch expansion of the Reserve Bank from several points of view: extension of currency chests; improvement of remittance facilities; taking over the cash work of governments at state headquarters; and expansion of banking facilities for commercial and cooperative banks, governments and the public. As an additional justification, the Committee pointed out that, in this process, closer contacts would be established between the Reserve Bank, on the one hand, and the state governments and banks, on the other.

While reviewing the position in this regard in August 1955, the Central Board made a marked shift in policy. It decided that, in the context of the establishment of the State Bank of India (SBI), all future branch expansion at state headquarters should be that of SBI and not of the Reserve Bank. It also decided that the question of establishment of new offices or sub-offices of the Reserve Bank should be considered thereafter with specific reference to the needs of (i) the Issue Department, (ii) the Department of Banking Operations and (iii) the Agricultural Credit Department (whose functions could not be met by SBI). This had the effect of putting on hold, at least for the time being, many expansion programmes of the Bank. It gave up the idea of establishing offices in Chandigarh (Punjab) and Bhubaneswar (Orissa) and the state governments were accordingly requested not to proceed with the acquisition of sites for the RBI at these centres, for which negotiations were then in progress. The idea of an office in Patna (Bihar), where the Bank had acquired about 3 acres of land, and of acquiring a site for permanent location of a sub-office at Gauhati (Assam) was also not pursued further.

By the early 1960s, the Reserve Bank had full-fledged offices at Bombay, Calcutta, New Delhi, Madras, Kanpur, Bangalore and Nagpur. In addition, it had sub-offices of the Issue Department at Gauhati (established in 1949) and Hyderabad (established in 1956), and note cancellation sections at Lucknow (established in 1946), Ludhiana (established in 1950) and Jaipur (established in 1954). A review of the position of other offices in 1960 showed haphazard of expansion. In 1954, a branch of the Public Debt Office was established at Lucknow to manage the zamindari bonds issued by the Uttar Pradesh government, on abolition of the zamindari system in that state. In 1956, with a view to facilitating the taking over and management of the public debt of the former Hyderabad state, a branch of the Public Debt Office was established at Hyderabad. And in early 1960, a branch of the Public Debt Office was opened at Patna to manage the zamindari abolition bonds of the government of Bihar.

To enable the Bank to discharge its growing responsibilities in yet another field, an office of the Department Banking Operations was established at Trivandrum in 1954, in addition to other regional offices of the department at centres where the Bank already had regular offices of its Issue and Banking Departments.

Regional expansion of the offices of the Agricultural Credit Department was comparatively well organized. With the acceptance, in 1955, of the recommendations of the Committee of Direction of the All-India Rural Credit Survey, the Reserve Bank assumed crucial responsibilities as the largest ultimate source of cooperative agricultural credit, as well as the coordinating agency for planned development of the cooperative credit structure. This called for a more intensive pattern of inspections of cooperative banks, with a consequential increase in inspecting staff and establishment of more regional offices to ensure adequate coverage. A decision taken by the Central Board of RBI in July 1958, to open offices of ACD in various states in three phases. The existing offices at Bombay, Delhi, Calcutta and Madras constituted the first phase. In the second phase it was proposed to open new offices at Indore (for Madhya Pradesh), Bangalore (for Andhra Pradesh and Mysore), Lucknow (for Uttar Pradesh) and Patna (for Bihar and Orissa). In August 1958, however, the Committee of the Central Board decided not to pursue the idea of opening an office at Lucknow and retained the Bank's office at Kanpur. The expansion proposed in the third phase included offices at Ahmedabad, Bhubaneswar, Gauhati, Jaipur and Hyderabad, and two sub-offices at Trivandrum and Srinagar, as decided at a meeting of the Committee of the Central Board in June 1960.

An overall review of the expansion of the Bank's offices took place in 1960. The memorandum submitted by Governor Iengar to the Central Board meeting in December 1960 stated:

> The time has arrived to take a long-term view of our requirements and plan the expansion of our offices in an orderly and integrated manner. Under the successive Five Year Plans the Bank's work is bound to increase not only in the traditional lines, viz. the management of note issue, conduct of Government business and management of Public Debt, but also in the field of banking operations and control, and supply of rural and industrial credit.

Iengar went on to suggest the establishment of integrated offices at the headquarters (or other principal towns) of the principal states and construction of the Bank's own buildings at these places as soon as possible. The advantages of setting up integrated offices included the ability to take up additional workload, decentralization of work leading to all-round efficiency, abolition of the various note cancellation sections, reduction in the number of large cross-country remittances, etc. The widening responsibilities of the Reserve Bank connected with, or arising from, the increase in note circulation, the management of public debt, regulation and control of banking and credit, administration of exchange control, and the development of financial institutions to cater to the needs of agriculture and industry, could not be fulfilled by expansion of the State Bank of India, which could deal only with purely banking and remittance aspects. The memorandum visualized the setting up of integrated offices with wings of the Issue and Banking Departments, Public Debt Office, Exchange Control Department (where necessary), Department of Banking Operations and Agricultural Credit Department in all the states to which the Reserve Bank was the banker. A beginning was to be made by upgrading the sub-offices or sectional offices of the Bank at Gauhati, Hyderabad, Patna and Ahmedabad into regular offices. The Central Board meeting approved the proposal to have an integrated office of the Reserve Bank in each state.

The Bank then initiated action to secure suitable sites for construction of office buildings (as well as staff quarters) in different states. Out of eight state capitals where the Bank had full-fledged offices, viz. Chandigarh, Bhubaneswar, Hyderabad, Trivandrum, Bhopal, Gauhati, Jaipur and Ahmedabad, it was able to secure land for offices at the first five centres by 1965. The plot for the office building at Gauhati was purchased from the state government in 1966 and that at Jaipur was purchased in early 1967 from the Jaipur Improvement Trust. In Gujarat, the Bank's effort to acquire a plot at Ahmedabad near Gandhi Bridge, initiated in 1965, was inordinately delayed on account of protracted litigation proceedings with the owners; the plot could be finally acquired only in December 1970. As regards the states of Jammu and Kashmir and Nagaland, the Bank did not plan to establish full-fledged offices there during this phase of expansion.

A significant development of the 1960s was the closure of the London office of the Reserve Bank. By an amendment Act of 1955, Section 6 of the Reserve Bank of India Act was amended so as to remove the obligation on the Bank to maintain a branch in London. The need for this amendment was explained to the Central Board of the Bank in notes attached to the Governor's memorandum in February 1955.

> The Reserve Bank of India Act at present makes it obligatory for the Bank to maintain a branch in London. This provision was made in response to demands made in Parliament under conditions which are no longer applicable. The maintaining of a branch in London is unnecessary expense for the Bank and does not serve much useful purpose. After the establishment of the State Bank, which will have a branch in London, whatever justification there might have been in the past for the Reserve Bank maintaining such a branch would disappear. Few Central Banks of the world have foreign branches, and doubts have been expressed in Parliament as regards the propriety of the Reserve Bank continuing to maintain a branch in London after India became independent. It is, therefore, proposed to remove the present obligatory provision in the Act. As soon as circumstances permit, arrangements will be made to transfer the present functions of the Reserve Bank's London Office which are of a non-essential character to the office of the State Bank in London.

Arrangements were made, in consultation with the State Bank of India and Government of India, to close the London office of RBI on 30 September 1963 and to let the functions of that office be performed by SBI. The terms of the arrangement, *inter alia*, included taking over of the Reserve Bank's staff (excluding the manager, who was to be repatriated to India) by SBI, and the lease agreements of the Bank's office premises and the manager's residential flat being assigned in favour of SBI. Governor Bhattacharyya's proposal in this regard was approved by the Central Board in a meeting held on 18 September 1963.

In May 1967, the note cancellation and verification sections at Ludhiana, which had been functioning since February 1948, were closed down, and the staff and work of the sections were transferred to the New Delhi office. Towards the end of the 1960s, the Bank's offices at Patna and Kanpur started functioning from the Bank's own premises. The next centre where construction of the Bank's office building was completed was Bangalore, and the departments that were till then housed in leased buildings were shifted to the new premises in June 1973.

Construction of the Bank's office premises elsewhere was adversely affected on account of the ban imposed by the government in 1973 on construction of non-functional buildings, and because of the restriction on the use of cement under the Cement (Conservation and Regulation of Use) Order, 1974. Both were withdrawn in January 1976 and thereafter the building projects of the Bank gained momentum. The Hyderabad office was completed and occupied in June 1978.

Certain other developments also came in the way of project execution at some of the centres. At the time of excavation for laying foundations of buildings at the plots acquired by the Bank on Gopinath Bardoloi Road, Gauhati, some archaeological finds were discovered, following which the then state government declared the site as protected under the Assam Ancient Monuments and Records Act, 1959, and asked the Bank to surrender the plots. The construction work was stopped and the Bank approached the state government for allotment of an alternative plot. The government's proposal to refund to the Bank the cost of the old plots, which were on 'residential land', and to allocate an alternative plot on Station Road, Pan Bazar, which was on 'first class commercial land', was accepted by the Bank. The difference in the assessed value of these plots was paid to the government for acquiring the new plot.

In Ahmedabad, when taking possession of the plot in December 1970 after prolonged litigation, the question of locating the main office of the Bank at the new capital of Gujarat, viz. Gandhinagar, came up for consideration. However, it was finally decided to locate it at Ahmedabad in view of the city's industrial and financial importance. In Trivandrum, a slightly different issue was raised regarding relocation of the office building. Several representations were received by the Bank from various commercial bodies in Kerala indicating that Ernakulam would be a better place for locating the office, since it was the main centre of industry and trade in Kerala. However, the government of Kerala, whose views were sought on the subject, considered Trivandrum, the state capital, as the appropriate centre for locating the Bank's full-fledged office, but conceded that from the point of view of international trade it might be advantageous to have a unit of the Exchange Control Department of the Bank at Ernakulam/Cochin. The state government's view was accepted by the Bank and action initiated accordingly.

Towards the end of the reference period of this volume, the office buildings at Gauhati and Trivandrum were completed and occupied. These were followed by completion of the projects at Ahmedabad and Bhubaneswar in early 1982. The construction of office buildings at the remaining centres, viz. Jaipur, Chandigarh and Bhopal, in that order, were completed much later.

The largest, perhaps the most grandiose ever, construction that the Bank undertook during the period of the present volume was the central office building in the Mint Compound, Bombay. The acquisition of the plot, and planning and execution of this project had to go through several stages of revision and refinement. The proposal to construct a central office building to meet the growing needs of the various departments of the Bank was first mooted in 1962. Government of India, which was approached in this regard, agreed to lease to the Bank a portion of the Mint Compound, measuring about 2,590 square yards, at a nominal rent of Rs 1 per annum, provided the Bank made available to the government, free of charge or rental, the ground floor of the proposed building, for use by the mint. Taking into account the FSI requirements, it would be possible to construct a building on this site consisting of a ground and six floors, and having a total area of 73,800 square feet. The plans for the proposed building were prepared by the architects, M/s Parelkar-Ovalekar-Parpia, and were approved by the building sub-committee in April 1965. But given the possible growth of the various departments of the Bank, the space that would eventually be available in the building was considered inadequate, and, in October 1965, it was decided to take on lease from the government of Maharashtra four plots of land, measuring about 7,525 square metres, in Backbay Reclamation area, for construction of a multistoreyed office building comprising twenty-four floors. It was therefore decided to defer the construction of the office building in the Mint Compound. Although the plans prepared by the architects, M/s Pheroze Kudianavala and Associates, for the multistoreyed office building at Backbay Reclamation were approved by the Municipal Corporation in September 1965, the project was abandoned in March 1969, as it was felt that it would be inappropriate to incur such a large expenditure. Instead, it was decided that the Bank would go ahead with the plan of an office building in the Mint Compound after utilizing the FSI to the maximum extent possible. The Bank approached the Bombay Municipal Corporation and the latter agreed to relax certain municipal requirements, which, in effect, meant that the FSI of the entire mint property could be made use of by the Bank, provided the mint agreed not to exceed the same at a later date. The mint authorities agreed to abide by these conditions but with a proviso: that they would be given, free of cost, three floors instead of one as agreed to earlier, and that the lawn adjoining the building would be restored to them.

With the increase in the area of the plot from 2,590 to 5,850 square yards, the architects, M/s Pheroze Kudianavala and Associates, were able to design a building with two large basements and a tower block comprising a ground, a mezzanine and twenty-seven upper floors with total built-up area of about 3.80 lakh square feet. The plans prepared by them were approved by the efficiency and development sub-committee at a meeting held on 5 January 1972. Stage-by-stage construction of the multistoreyed building—the diaphragm wall, the foundation and the superstructure—commenced from 1972. Despite the restrictions on the use of cement in the middle of the 1970s and the large size of the project, the fast progress made in the completion of the work was noteworthy. Proposals for housing the various departments and the pattern of utilization of space, excluding the area allocated to the mint, were submitted to the Committee of the Central Board on 4 January 1978 by Deputy Governor P.R. Nangia. The new central office building was completed and formally inaugurated by the Union Finance Minister, R. Venkataraman, on 7 November 1981.

Even after occupation of the new building, it was estimated that there would be a continuing demand for more office space of about 30,000 square feet every year, to meet the expansion requirements of departments in Bombay. With a view to the long-term requirements of office space in Bombay and the state government's policy of decongesting south Bombay to the extent possible, the RBI entered into correspondence with the Bombay Metropolitan Regional Development Authority (BMRDA) and the City Industrial Development Corporation of Maharashtra Ltd (CIDCO), for allocation of suitable plots for construction of office buildings in the Bandra–Kurla scheme. These efforts attained fruition only after the period of this study.

INDUSTRIAL RELATIONS

During the entire period of this study, with the exception of the Emergency years, industrial relations in the Reserve Bank were at a low ebb. On many occasions, aggressive and militant agitations of the staff paralysed the working of the Bank, with the result that it could not provide services to the public, banks and government in full measure or efficiently. In 1979, persistent staff agitations (the word agitation/agitations is used in the remaining part of this chapter to mean aggressive and militant attitudes and actions, since that word has been frequently used in the internal notes of the Bank) led to the Bank becoming non-compliant in respect of finalization of its financial accounts on time. The annual accounts and the report of the Central Board of Directors were submitted after a delay of six weeks. Even this would not have been possible had the central government not promulgated the Reserve Bank of India (Maintenance of Service) Ordinance, on 4 July 1979, declaring the Reserve Bank's services to be a part of essential services. The 'Maintenance of Essential Services Act' had been in fact passed in 1968, and it covered the banking industry including the Reserve Bank. But the Act was allowed to lapse in 1971. The Reserve Bank's services were again declared as essential in 1976, at the height of the Emergency, under the Defence of India Rules, to contain disruptive staff agitations.

All the three categories of staff in the Reserve Bank (class I staff consisting of officers, class III consisting of workmen, and class IV consisting of subordinate staff) have well-organized unions/associations with a considerable following. Although the Bank and unions/associations had mechanisms to resolve industrial disputes through bipartite settlements, they were unable to resolve their differences on many occasions and were compelled to resort to arbitration. The issues that created industrial unrest in the Bank were several: some were purely 'political' in nature, some were on flimsy personal grounds, some were 'local' in character, and most were concerned with matters like, pay revision, determination of dearness allowance, promotion policy for existing staff in the context of fresh recruitment from the market, automation and computerization.

These issues apart, the fact that a majority of the class III staff was employed in the Bank's Issue Department, particularly in the handling of soiled currency notes, gave an unequal advantage to the unions in their bargaining power. This, in turn, lent a structural rigidity to the mechanism of settling disputes through negotiations. The management often took recourse to asking officers to discharge the tasks of class III staff, utilizing the regulations relating to officers' duties. Such an approach led to disharmony among the classes of staff, with striking/agitating staff adopting militant postures towards those who were not willing to strike work. In addition, the unions took advantage of the prevailing political situation in the country to pressurize the management to achieve their demand. The management had limited expert human resources to handle the sensitive area of industrial relations, the personnel officers being either untrained or inexperienced in the art of negotiation. The effort of Governor Jha to appoint an expert in industrial relations in 1968 was a lone one, and was not pursued further. While there were instances of success, from the management point of view, in negotiations with the unions when senior officers known for their tact were utilized, these were few and far between.[3]

In the absence of data on man-hours lost in different offices of the Bank (including the Central Office), it is difficult to ascertain the impact of the various methods of agitation—'gheraos' (encirclement), demonstrations, rallies, 'pen down' strikes, wearing of black badges, 'go slow', 'work to rule' and, finally, strikes—on the productivity of the Bank. Again, there is hardly any record of the relationship between the offices and the Central Office during agitations, and of the rationale behind the strategies recommended by the Central Office management to the offices.

AGITATIONS

Class III Agitations, 1967–68

In 1967, most of the violent agitations by class III staff of the RBI took place in the Bank's Calcutta office. These agitations received the support of the Communist Party of India (Marxist). The genesis of the agitations was political: the dismissal of the United Front government headed by Ajay Mukherjee on 22 November 1967 and the installation of a government headed by an old Congressman, P.C. Ghosh led to demonstrations and rallies by the staff. The Employees' Association gave a call for observing 16 December 1967 as protest day. The Association also held lunch-time demonstrations for withdrawal of Section 144 imposed in some areas of Calcutta and for the release of political prisoners.

In early 1968, the Bank took the decision to instal a computer in the Central Office. The Employees' Association opposed the installation, and gave a call to its members to abstain from work on 3 January 1968 and 1 February 1968 from 1 pm to 1.45 pm. During the week of 5–10 February 1968, the Association organized mass hunger strikes in batches against the automation, which resulted in daily absence of a large number of employees.

The Association also began to agitate against the proposed Banking Laws

[3] In 1972, Governor S. Jagannathan and Deputy Governor P.N. Damry asked Executive Director V.G. Pendharkar to negotiate with the Employees' Association (class III staff) on certain ticklish issues, and Pendharkar managed to get the negotiations concluded to the satisfaction of both the management and the staff. In 1981–82, C.V. Nair, as manager of the Calcutta office and one-time head of the Officers' Association, helped to resolve many issues raised by class III and class IV employees of the Bank through negotiations and confidence-building measures, and without any show of high-handedness.

Exhibit Major Agitations by the Staff of the Reserve Bank

No.	The starting time of the agitation	Source of agitation	The stated cause(s)
1	2	3	4
1.	December 1967	The Employees' Association, Calcutta (spread to all offices when anti-computerization and anti-social control were launched)	Demand against dismissal of UF Government in West Bengal; subsequently mixed with agitation against computerization and social control.
2.	April 1969	The Employees' Association, Calcutta	Against the extension of the Aiyar Award.
3.	September 1970	The Employees' Association, Calcutta	Arrests of some staff members suspected of being naxalites.
4.	Mar/April 1972	Class III staff at Hyderabad. Class IV staff also joined	Against the posting of three economic assistants to Hyderabad office from Madras and Trivandrum offices.
5	June 1972	Class III staff at Byculla office, Bombay	Refusal to accompany remittances to Madras for destruction of soiled notes
6.	June 1972	Class III staff at Kanpur	Against emergency procedures relating to disposal of soiled notes.
7.	February 1975	Officers at all offices.	For eliminating anomalies in pay.
8.	February 1975	Class IV flash strike at Bombay; subsequently joined by Class III.	Local issues (including cleaning of tables and chairs).
9.	Dec. 1979	Officers – Mass Casual Leave – all India	Demand for pay revision.
10.	Apr/M '77	Class IV Staff	Livery clothes
11.	April 1977	Class IV staff	Livery clothes
12.	September 1977 December 1997 29 April 1979	Class III - all India (violent protest at Jaipur office).	Against many issues including computerization.
13.	May 1981	Class IV staff	For filling of vacancies by their children.

Amendment Bill that aimed to introduce social control over banks. It gave a call for participation in a strike on an all-India scale on 28 February 1968. To ensure the success of the strike, activists of the Association at Calcutta, mostly from the Issue Department, went around to all the departments threatening employees who were neutral or unwilling to join, and officers with dire consequences for their non-cooperation. The activists (in particular Ashis Sen and Naresh Das) called on the Manager on 27 February 1968 and asked him not to seek police help since such an action would be considered as an act of provocation. On the day of the strike, 28 February 1968, the agitationists resorted to intimidation and physical assault of the staff who did not join (the 'loyal' staff, according to the management) and of officers to prevent their entry into the Bank's premises. Some of the officers and supervisory staff managed to enter with police escort. More than twenty-five officers were assaulted and beaten; one of them, S.K. Das Gupta, banking officer, who was severely beaten by the strikers at Writers Building, was rescued by the joint secretary of the Judicial Department of Government of West Bengal and taken to hospital in an ambulance. Three lady telephone operators who attended the office in the morning were intimidated, threatened and verbally abused.

The next day, there was a lightning strike in protest against the police arrangements made by the Bank to protect the loyal staff on the previous day. The Bank, on the other hand, declared the strike on 28 February as illegal since it was without due notice. The Bank manager, therefore, instituted disciplinary action against the agitationists. Before doing so, he made sure that he had the support of the Central Office of the Bank. Deputy Governor P.N. Damry gave an assurance to the effect that the Bank would stand by what the manager would do in all cases that merited stringent disciplinary action.

The Association regarded the disciplinary action as 'victimization' and began to hold *en masse* demonstrations daily at lunch-time. Some members of the staff were asked by the Association to go to their respective heads of departments, and to the manager, demanding immediate withdrawal of all disciplinary action, and threatening to stop all work in the Bank if the management did not comply with their demand. An atmosphere of fear was created among officers and the staff and the manager had to summon police help whenever threats or physical assaults on officers were apprehended.

When, eventually, it was found impossible to conduct the Bank's functions in a peaceful and normal way, the management at the Calcutta office approached the Calcutta High Court for an injunction, restraining 1,746 members of the staff from threatening or intimidating any office or other loyal staff within the Bank's premises or within a reasonable distance of the premises. The Bank got the injunction from the High Court on 14 June 1968, and the hearing of the case was fixed for 1 July 1968. Upon the Bank getting the Court's injunction, members of the Association began to take casual leave *en masse* department-wise, thereby paralyzing the work in almost all the departments. There were also pen down strikes on 15 June and again on 28 June. Junior officers were not allowed to do clerical work, as the clerks did not vacate their seats. Employees in different departments took mass casual leave again on 19, 21, 24, 25 and 26 June, without prior permission. This led to the High Court passing an interim order on the 1,746 employees, restraining them from taking mass casual leave until final disposal of the application made by the Bank. On 1 July 1968, all the defendants went to the High Court in a procession to appear before the judge. Ashis Sen, the first defendant in the list, submitted to the Court in his counter-affidavit that, out of the 1,746 names mentioned in the list, some had died before December 1967, some were on long leave and some were out of station. This created an embarrassment to the management. The Central Office felt that while the manager at Calcutta was a well-intentioned disciplinarian, he did not have the skills to avoid confrontation with the staff. It decided to withdraw the disciplinary action against the staff, thereby compromising the position of the manager who eventually resigned from the Bank.

Agitation Against Extension of Aiyar Award, 1969

The 1969 agitation against extension of the award given by T.L. Venkatarama Aiyar, retired judge of the Supreme Court of India, was a classic case where the management of the Reserve Bank responded to the demands of the Employees' Association by neutralizing the losses sustained by a section of the employees through grant of what was termed 'personal pay'. The adjudication by Aiyar was a result of an agreement between the Bank and the All India Reserve Bank Employees' Association on 24 January 1967, to refer certain issues relating to pay and allowances and other conditions of service of class III workmen employees. The arbitrator gave his award on 12 February 1968. In the terms of the award, the revised scales of pay and allowances were given with retrospective effect from 1 January 1966, and in all other respects the provisions of the award came into force from 5 April 1968. On expiry of the award on 4 April 1969, Government of India exercised its statutory powers (conferred by the second proviso to sub-section (iii) of Section 19 of the Industrial Disputes Act, 1949), to extend it.

The All India Reserve Bank Employees' Association impressed upon the Ministry of Labour, Government of India, that it did not favour extension of the award and that it should be terminated as on schedule (on 4 April 1969). But the extension took place, and the Association organized demonstrations and other forms of agitation at all the offices of the Bank including a one-day token strike on 30 April 1969. The Association also issued a press statement on 30 April 1969, published by *Statesman*, a reputed Calcutta newspaper. The press statement stated that while the wage level in the Reserve Bank was claimed by the management to be better than in other parts of the banking industry, employees of the Bank were worse off as compared to those in State Bank of India and Bank of India, even after excluding the bonus that the employees of commercial banks received. It also pointed out that 'by implementing the Aiyar Award, amounts ranging up to Rs 1,000 have been recovered from many employees, those employees who have suffered wage cut having been made to refund even interim relief of Rs 300 prior to the announcement of the Award.' The statement also referred to the effect of the application of the middle class consumer price index and mentioned that the dearness allowance paid in July–September 1968 was partially recovered from the employees in three months of that year at the rate of Rs 10–25 per month.

The Reserve Bank issued a statement in response, citing the inconvenience caused to the public, banks and government departments on account of the strike. The Bank also mentioned that during the last one year there had been stoppages of work that affected the working of the Bank for a part or whole of the working day. The Bank added that stoppages of work and strikes were against the ethics and code of discipline of the industry. According to the Bank, of 12,000 employees, all excepting 54 got a raise in the total emoluments through the Aiyar award, and in the case of the 54 employees, the Bank had neutralized the loss by granting them personal pay.

After the token strike on 30 April 1969, the Employees' Association approached the Bank's management to arrive at a negotiated settlement; the Bank responded positively by agreeing to consider providing some benefits to the employees affected by the Aiyar award, and promotion opportunities for coin/note examiners within the framework of the award.

Staff Agitation at Calcutta, September 1970

In September 1970, class III employees of the Calcutta office of the Reserve Bank launched an agitation mainly for political reasons—against the arrest by the state government of some employees of the bank who were thought to be associated with the Naxalite movement. The agitation started on 12 September 1970 (Saturday) over the reported arrest of Ranjit Kumar Dey, temporary clerk gr. II attached to the Public Accounts Department (PAD). On the same day, members of the Representative Council of the Employees' Association numbering about 100, met P.R. Nangia, manager of the Calcutta office, urging his immediate intervention for the release of Dey. Nangia told the representatives that he was very concerned over the arrest of the Bank's employee and expressed his sympathies for him; however, there was very little that he could do as the employee had been arrested outside Calcutta and, also, it was not known for what offence he had been arrested. The Association's representatives were agitated and not willing to listen to any reasoning. Nangia therefore assured them that he would make enquiries with the police and apprise them of the situation. Nangia contacted the Inspector General of Police (IGP) over the telephone to ascertain the full details. The IGP informed him that the employee was a Naxalite and had been arrested for serious offences under Sections 303 and 304 of the Indian Penal Code.

Meanwhile, members of the Association stopped attending to their normal duties in the Bank's departments, and employees attached to the clearing house did not complete their writing of the books. As such, the clearing house could not be balanced. The agitation continued on 14 September 1970 (Monday). The Association wanted the manager to impress upon the state government the need for immediate release of the concerned employee as, otherwise, it would become difficult for them to advise their members to call off their agitation. The agitating staff came in mass deputation to the manager again, shouting slogans against the state government, and demanding the release of their colleague and a halt to the indiscriminate arrests of people by the police. As part of the agitation, the staff refused to work overtime. They also started a 'go slow' agitation.

The agitation continued for more than ten days. The Association threatened that if the Bank was unable to secure the release it would intensify its agitation and the work situation would further deteriorate. The situation was further complicated by the fact that authorities of the General Post Office of Calcutta (which is located next to the Reserve Bank), through the good offices of the Post Master General of India, were able to arrange for the release of one of their employees who had been charged by the police for throwing bombs. The employees of the Bank felt that it should be equally possible for the Reserve Bank to obtain the release of the RBI staff member on bail. Meanwhile, the manager, Nangia, in a letter to the Central Office, suggested that as the normal flow of work in the Bank had been seriously affected due to the agitation and go slow tactics of the staff, the Bank might issue a notice in the local papers to the effect that: 'In the circumstances, the members of the public are informed that transactions are likely to be considerably delayed and it might not be possible to make payments of Government cheques on 29^{th} of this month and 1^{st} October 1970.'

Ranjit Kumar Dey was released on bail on 23 September 1970. The Employees' Association informed the manager that the Bank should take the wise step of not taking any action against Dey.

On 25 September 1970, a Bank employee, Ajay Sanyal, clerk gr. II (T) working in the Issue Department (General), was killed in police firing in the city in the early hours of the morning. The local employees of the Association gave a call for a 'pen down' strike for one hour, from 11 am to 12 noon, to mourn the death of their colleague and thereafter they observed a two-minute silence. The employees also refused to work overtime and left the office after office hours to participate in the agitation.

On 18 January 1971, Tapan Kumar Datta, coin/note examiner grade II, was arrested in connection with a reported dacoity in SBI's Chittaranjan branch. According to the Employees' Association, Datta was falsely implicated as he was present in the RBI office on that date, and it demanded immediate intervention of the Bank for his release from police custody. The police authorities informed the manager that the concerned RBI employee was not arrested in connection with the bank dacoity, that he was a Naxalite and had been arrested for some serious offence. The Association asked that the Bank should put pressure on the police authorities to secure Datta's release, failing which the employees would be compelled to resort to agitation. Tapan Kumar Datta was released on 18 January 1971.

On 25 July 1971, an RBI staff member, Harendra Bhattacharjee, residing at the Bank's staff quarters at Singhi Park colony, was arrested by the police in the early morning hours—along with another person who was stated to have been sheltered by him that night. Residents started an agitation over the entry of the police into the staff quarters, and asked the manager to approach the police for securing the release of Bhattacharjee. The entire class III staff left the seats to join the demonstration that was held at the Bank's office entrance. Representatives of the Association informed the manager that there had been a number of such cases of police harassment of its members, and, unless these arrests were stopped, they would have to intensify their agitation, culminating in complete stoppage of work. As part of the agitation they stopped overtime work and continued to hold regular demonstrations at the Bank's entrance. They also threatened that, if necessary, they would advise members to abstain from work on the government's pay day, to bring pressure upon the state government.

On 3 August 1971, the secretary of the Employees' Association addressed a letter to the Governor of West Bengal, routed through the manager, Reserve Bank of India, Calcutta, which said that a 'state of complete disaster and lawlessness has been prevailing in West Bengal since the imposition of the President's Rule in March 1970', and that there had been disruption of work in several walks of life and life had become insecure. It alleged that leaders and workers of trade unions and democratic movements were being murdered or frightened by the police, the CRPF, the military and gangsters organized by the ruling class, and urged that the reign of terror, lawlessness and anarchy come to an end. It threatened that workers of the Association would be forced to launch much higher forms of united action if necessary.

On 24 August 1971, another employee, Sudharshan Choudhry, coin/note examiner grade II, was arrested at his house. The staff again went on deputation to the manager for his release and held a massive demonstration near the entrance of the Bank.

Apart from the arrest of RBI staff members, the arrest of other government employees by the police also became a reason for agitations by the Association. As a result of such frequent agitations by the class III staff for reasons that were not connected with the functioning of the Bank, the Bank was not able to extend normal services to the central and state governments and to the public. In fact, the administrative machinery in the Calcutta office was preoccupied with staff agitations and the manager (Nangia) was busy writing daily letters to the Central Office apprising it of developments relating to the agitations of class III staff. Deputy Governor Damry, in a note to the RBI Governor, mentioned that the Bank was unable to appreciate why this sort of disruption should take place on account of matters totally unconnected with the Bank's working, namely, the arrest of an employee by the police acting on their own accord; he urged the Association to call upon its constituent units to restrain from such interference in the normal working of the Bank. The Deputy Governor suggested that if the Association did not cooperate in the matter, the Bank should put up the matter before Government of India without loss of time. This was the reasoning behind asking the government to declare the Reserve Bank's services as 'essential' under a statutory framework.

Agitation at Hyderabad, March 1972

The Hyderabad office of the Reserve Bank witnessed a violent and vociferous agitation by class III staff from 15 March right through up to 8 April 1972. The agitation was launched by the Employees Association, Hyderabad unit, against the posting of three economic assistants (from the Madras and Trivandrum offices) as staff officer grade II in the Agricultural Credit Department (ACD).

Prior to December 1967, the seniority of staff officers grade II in the ACD was maintained on an all-India basis. On a review of the position in December 1967, it was found that maintenance of the all-India seniority list was not conducive to the smooth working of the department. It was, therefore, decided that the all-India list should be split up into zonal seniority lists. For this purpose, the regional offices of the ACD were grouped into four zones, the southern zone consisting of Madras, Hyderabad, Trivandrum and Bangalore. After the splitting of the all-India seniority list, it became necessary to allot long-term vacancies of staff officers grade II in each zone to the seniormost eligible economic assistant in that zone. Under the scheme, it was decided that the posts of all the officiating staff officers grade II should be reviewed every quarter, and, if it was found that any junior employee was working against a long-term vacancy of staff officer grade II, the position should be rectified by transfer of the seniormost employee from another centre to that centre within the same zone.

Accordingly, three seniormost economic assistants (two from Madras and one from Trivandrum) were transferred to the ACD, Hyderabad, where three long-term vacancies of staff officer grade II existed. The Employees' Association opposed the transfer of these staff members to the Hyderabad office and urged the Central Office to cancel these postings. The Hyderabad unit of the Association informed the Central Office, through a telex on 8 March 1972, that any effort on the part of the management to make them report for duty at Hyderabad would be met with resistance, and the responsibility for the consequent industrial unrest in the office would rest solely with the management. On the same day, the Hyderabad unit sent another telex to the Central Office to the effect that, upon failure to cancel the transfers, the Association would immediately launch serious agitations including stoppage of work. On 11 March, in yet another telex message by the Hyderabad unit of the Association to the Central Office, it was stated that the vacancies of staff officer grade II in Hyderabad should be filled immediately without considering staff transferred from other centres. On 12 March 1972 (a Sunday), the assistant secretary of the Hyderabad unit of the Association delivered a letter dated 11 March to the manager at his residence, giving fourteen days' notice for a strike. A copy of the strike notice was also given to the Regional Labour Commissioner, Hyderabad.

The Assistant Labour Commissioner (Central) Hyderabad commenced conciliation proceedings on 14 March 1972, but the meeting had to be adjourned as Dr Raj Bahadur Gaur, president of the Employees' Association, was not available on that day. On 15 March 1972, Ramamurthy, the seniormost economic assistant from the Madras office, reported for duty at Hyderabad. The employees of the Hyderabad office went on an illegal strike from the afternoon of 15 March 1972. The following day, i.e. 16 March, was a holiday at Hyderabad and Bombay. The strike continued on 17 March.

The Central Office rushed two senior officers to Hyderabad in the morning of 18 March 1972 to hold discussions with the Association's representatives and to try to persuade them to call off the strike. They, however, failed to convince the local leaders of the Association. The agitation was further intensified. Thereafter, the management invited two representatives from Hyderabad to Bombay for discussions with officials at the Central Office, at the Bank's cost. Initially, the leaders of the Association accepted the offer but then they changed their minds and continued their agitation. On 25 March, two representatives of the Hyderabad Association came to Bombay on their own and had prolonged discussions with Central Office officials at a meeting where the general secretary of the all-India Association was also present. The discussions, however, proved futile. The Association leaders from Hyderabad insisted that they were not prepared to accept the three transferees from the Madras and Trivandrum offices and that would therefore continue their agitation, in different ways—by squatting on the floor in the manager's room, by shouting and singing 'bhajans' (prayer songs), and by preventing other employees, including officers, from working in the building.

On 29 March, the class IV union whose president was also the president of the class III Association, went on a strike in support of the agitation launched by the class III Association. The premises and furniture of the Bank were deliberately dirtied during the nights, with the result the manager could not use his own room. Agitating employees visited the Andhra Bank building, where some of the departments of the Reserve Bank were located, and broke some furniture. They entered the cabin of the deputy chief officer, shouted slogans, placed rubbish on his table, cut his telephone wire, and smashed his briefcase and threw it out of the widow. The agitating employees even tried to enter the room of the general manager, Andhra Bank, but were prevented by the police force.

On 30 March, when remittances of treasury worth Rs 19 crore, in 180 boxes, arrived from Nasik, the striking employees did not allow the boxes to be kept in the building's vaults. The manager called the secretary of the Association and explained to him that the treasury could not be left outside and that they should not obstruct the Bank from putting the treasury inside the vaults. Initially, the secretary said they would not object if the labour provided by the Bank's contractor was used for the purpose. However, when the contractor brought his labour force, the striking employees started threatening them with dire consequences if they handled the treasury boxes; they were therefore reluctant to help the manager in transporting the boxes into the building. As a last resort, the Manager arranged for some police force and, with the help of casual labourers, he was able to put the boxes inside the vaults.

Meanwhile, on 31 March, the Regional Labour Commissioner had sent a failure report to the government. The Bank continued its dialogue with the secretary of the all-India Reserve Bank Employees' Association and representatives of the Hyderabad office to resolve the issue. At last, on 8 April 1972, an agreement was signed between the management and the Employees Association, Hyderabad unit, and the strike was called off. The management agreed that the transfer and posting of staff officers grade II under the zonal seniority scheme in the ACD, Hyderabad, and at other centres, effected from 1 February 1972, would be regulated by the decision relating to the combined seniority list, etc. It would also ensure that the interests of the staff in the Hyderabad office were safeguarded, keeping in view their grievances. During the agitation, the working of the Bank had come to a standstill and services to the government and to banks had completely stopped. The work of the clearing house, that had already been paralysed from 3 March 1972, when employees of SBI and Andhra Bank went on agitation, stopped altogether with the Reserve Bank employees striking from 15 March 1972.

Staff Agitation, June 1972

In June 1972, class III employees went on an agitation against the emergency procedure for destruction of soiled notes. Though the system was introduced in 1964, the sudden provocation was the suspension of an employee in the Byculla office at Bombay, when he refused to accompany the remittances to Madras for destruction of soiled notes. The Employees' Association demanded that the Bank authorities should discontinue the dangerous procedure of destroying torn and soiled currency notes without prior scrutiny under what was termed as 'emergency special procedures'. The Association feared that this procedure might result in malpractices as well as reduction in the employment opportunities in the Bank.

The Bank's spokesperson clarified that the modified procedure had been adopted as early as 1964, 'keeping in mind fully the requirements of security'. He noted that there had been a large and almost unmanageable accumulation of soiled notes in the Bank's vault which could not be reissued. As for employment opportunities, he noted that over the last ten years, there had been a 100 per cent increase in the Bank's strength of coin and note examiners. The management also pointed out that this issue had not been raised at the negotiations held in 1970 and in May 1972.

Irrespective of this reasoning, the strike, first in the form of a 'sit-in' strike, began on 16 June 1972. On 19 June 1972, Madhu Dandavate, Member of Parliament and general secretary of the Socialist Party, wrote a letter to the Union Finance Minister to intervene and settle the dispute. On 17 June, N.D. Deshpande, president of the Indian Workers' Organization (the union representing class III employees, with significant support at Bombay), was suspended. Thereafter the employees started a 'pen down' strike. On 24 June, the Union Labour Minister, R.K. Khadilkar, called upon the class III employees to resume duty forthwith and to create an atmosphere congenial to holding bilateral talks.

During the agitation the Bank employees had the apprehension that the Bank would transfer currency from its vaults to the State Bank of India, located very close to the Bank's headquarters, to enable it to make payment of cheques drawn on the Reserve Bank of India. According to the Association spokesperson they came to know that the Bank had requisitioned private vehicles to transfer the cash some time during the night. On 28 June, more than a hundred RBI employees kept a watch at the headquarters of the Bank throughout the night, in a bid to stop dispatch of cash to the State Bank of India's vaults. On the same day, the Reserve Bank Employees' Association in Bombay called upon all its unions in the country to go on a 'stay in' strike on 29 June 1972. The press, meanwhile, took a critical view of the agitation. In a hard-hitting editorial, the *Times of India* of 27 June 1972 termed the agitation as 'strong-arm tactics' and the pen down strike as cynical. The editorial argued that the employees had no evidence to prove their charges since the modified procedure had been adopted by the authorities more than seven years ago, and that they had put the national interest in jeopardy. It said that the employees had deliberately resorted to false propaganda and strikes to cover up their real intention, which was to ensure that the authorities paid them substantial amounts of money every month by way of overtime. The editorial also called upon the Union Finance Minister to make efforts to suspend the agitation forthwith, failing which the Governor should be allowed to invoke emergency powers and declare the strike illegal.

The Bank management and the Employees' Association held several negotiations to resolve the strike. At midnight on 30 June 1972 they reached an agreement by which the suspension orders against the Bank employees who had refused to accompany the consignment of soiled notes to Madras would be withdrawn. The concerned employees would also not be charge-sheeted. The wages for the strike period except for two Sundays would be recovered on an instalment basis, and the emergency and special procedures for destruction of soiled notes would be referred to a committee of the All-India Reserve Bank Employees' Association and the management. The strike was called off thereafter.

Kanpur Office, June 1972

In sympathy with their colleagues in Bombay, the class III employees of the Kanpur office of the Reserve Bank organized a demonstration that turned out to be violent. The manager (K.C. Banerjee) was gheraoed for many hours in his chamber. The manager recounted to the Central Office, in a letter dated 30 June 1972, the details of the incident. P. Dey, secretary of the Association, stood on a table (kept near the entrance to the manager's room) and spoke at length to his colleagues condemning the Bank's resort to the emergency/special procedures, and the unwarranted suspension of two employees of the Byculla office. The manager was asked to give his views on the procedures being adopted for the disposal of soiled notes. The manager spoke briefly, reiterating the management's views on the subject. An hour or so later, about thirty-five class III employees barged into the manager's room and informed him that they would come in batches throughout the day to voice their resentment. With more employees gathering, the manager was surrounded on all sides. They attempted to intimidate him into admitting that he was in complete agreement with the views expressed by them. One of the employees then asked the manager whether the Central Office had consulted him before resorting to the emergency/special procedures; the manager answered in the negative. The employee then shouted that the manager may as well vacate his chair and let a peon occupy it. The manager was not allowed to have lunch or do any work, including the approval of a press advertisement about the flotation of central government loans, which was to appear on 30 June 1972 in the newspapers. The employees occupied the room till about 5 pm, all the while shouting slogans and hurling insults. The manager showed enormous equanimity and did not seek police assistance.

The Central Office took strong exception to the behaviour of the Association and the employees, and it was decided to issue show cause notices to twenty-one employees. This affected industrial relations in the Kanpur office for almost two to three years, till it was decided to withdraw the show cause notice on the tendering of apologies by the concerned employees.

Officers' Agitation, 1975 and 1979

In the case of officers working in RBI, dearness allowance (DA) was not linked to the cost of living index, unlike in the case of class III and class IV employees. As a result, over 95 per cent of the officers, according to the Officers' Association, drew nearly Rs 400 less than employees in the lower cadre who were at the maximum of their pay scales. To resolve the anomally and neutralize the impact of inflationary pressures in the economy, officers of the Bank demanded higher DA based on the cost of living index for industrial workers. To pressurize the Bank management to concede to their demands, officers at different offices resorted to an agitation in February 1975 that lasted for two weeks.

About 1,000 officers of the Bank waited in deputation before a meeting of the Bank's Central Board of Directors in Bombay on 6 February 1975, seeking settlement of their demand for enhanced DA. The RBI Officers' Association and the RBI Staff Officers' Association announced that they would resort to work-to-rule all over the country from Monday, 10 February 1975. Governor S. Jagannathan told the deputation of officers that the Bank's Board had recorded that 'enhancement of the officers' dearness allowance was necessary and justified'. The Governor also mentioned that his proposals in this regard were awaiting the approval of the Union Cabinet.

The work-to-rule procedures adopted by the officers affected the cash and clearing transactions of the Bank. The working conditions in the Bank received a further jolt when class IV employees went on a flash strike in Bombay on some local issues, on 18 February 1975. Due to the strike of the class IV employees, dusting and cleaning work in the Bank came to a halt; as a result, class III employees whose tables and chairs were not dusted decided that they too would not work. Some commercial banks found it difficult to meet the demand for cash because they were not able to withdraw cash from the Reserve Bank. Hence many banks started placing restrictions on the withdrawal amounts of their clients. The general public was also inconvenienced, especially as they could not pay income tax. People going abroad and seeking foreign exchange release or any other authorization were also adversely affected.

The officers suspended their twelve-day work-to-rule agitation on 21

February, when the Governor informed them of the government's decision to grant an ad hoc increase in their DA, ranging between Rs 150 to Rs 240 per month, from January 1975. The Governor also announced ad hoc lump sum payments of Rs 1,050 and Rs 1,675 to officers in the pay range of Rs 851 to Rs 1,000. K.P. Augustine, convener of the Officers' Coordination Committee, said that the increase in DA was unsatisfactory, particularly at the higher and lower levels, and would not eliminate the anomalies. The Committee appealed to class IV employees to end their five-day-old agitation. The class IV employees responded positively to the appeal and called off their agitation on 22 February 1975. The press was critical of the agitation by officers of the Bank. The *Times of India*, in its editorial dated 24 February 1975, called the agitation irresponsible. On 4 March 1975, the Union Finance Minister (C. Subramaniam) admitted in the Parliament that there were anomalies in the pay scales of officers of the Reserve Bank, and that the government would soon take a decision in regard to the wage policy including the demand for dearness allowance.

RBI officers resorted to agitation again in December 1979 to demand pay revision. Over 6,000 officers in twenty-two offices all over the country went on mass casual leave on 21 December 1979, bringing work in the Bank to a near-standstill. The officers also announced a work-to-rule agitation the following day. Clearing houses announced that their operations would be restricted to one clearing on working days instead of the normal two or three in Bombay and other major centres; clearing houses in principal centres managed by the Reserve Bank did not function. Governor I.G. Patel appealed to the officers to withdraw their agitation in the interest of the society at large. On 24 December, after obtaining assurances of support from the Governor, the officers gave up their work-to-rule agitation.

Kanpur and Patna, 1977

On a local issue relating to the quality of cloth provided for liveries of class 'D' staff at Kanpur, the working of the Kanpur office of RBI was paralysed for twenty-one days. The prescribed material for summer liveries for this class of staff was drill cloth at all the offices but due to some misunderstanding, superior-quality cloth was used in 1970. Although this irregularity was noticed subsequently, the superior cloth continued to be in use due to pressure from the local unions. This matter was taken up with the All-India Workers' Federation in 1975 and it was decided that only drill cloth would be used in the future at all the offices. Accordingly, the uniforms in 1976 were made of drill cloth. Because of the Emergency, the unions did not raise any objection. After the Emergency was revoked in March 1977, the unions in Kanpur and Patna resorted to coercive methods demanding better-quality cloth—Binny Gaberdine No. 251 in particular—for their uniforms.

On 12 April 1977, Vindyachal Singh, an ex-class IV employee at Kanpur, whose services had been terminated by the Bank in 1975, along with about 50 class IV employees, barged into the manager's room. They shouted slogans, and demanded uniforms in the said quality, withdrawal of disciplinary proceedings against class IV employees and opening of the union's office in respect of which court cases were pending. They threatened the manager with assault if their demands were not met.

Meanwhile, the Bank referred the matter of liveries to the Assistant Labour Commissioner at Kanpur for reconciliation. The agitation intensified to such an extent that the manager's office was picketed and the manager was encircled. On 12 May 1977, the entire class D staff in Kanpur went on mass casual leave. On 2 June, the Union Federation declared total strike till the acceptance of their demands. The strike continued till 23 June (twenty-one days). The District Magistrate of Kanpur arranged a meeting between the management and office-bearers of the class 'D' union and got an agreement to end the strike. After a week, the Regional Labour Commissioner intervened and called two representatives of the Central Office and two representatives of the All-India Reserve Bank Workers' Federation to a meeting to work out the type of cloth to be supplied for uniforms. The request was for supply of cotton jeans; the Bank went further and supplied terrycot cloth for the uniforms in order to normalize the situation.

At Patna, class IV employees started an agitation from 15 April 1977 on the issue of liveries. They conducted mass deputations/demonstrations during office hours on a regular basis, outside and sometimes inside the manager's room. The manager was also encircled (gheraoed) in his office by some 50 to 60 class IV employees for about three-and-a-half hours on 23 April 1977. The gherao was ultimately lifted when the manager threatened to call in the police.

Staff Agitation for Pay Revision and against Computerization, Jaipur

There were numerous demands for pay revision raised by class III employees during the 1970s, with the exception of the years of the national Emergency. The Employees' Association submitted a charter of demands for wage revision in July 1974 for the Reserve Bank's consideration; to press their demands, they observed a one-hour strike on 10 June 1975. Soon thereafter the Emergency was imposed and the agitation was suspended. After the revocation of the Emergency in March 1977, the employees again started demanding consideration of their charter. The class III staff went on strike on 27 September 1977 and again on 30 December 1977. On 22 April 1979, the Bank installed a new computer in the Department of Statistics late at night. This led to a 'dharna' by the class III staff. The staff again observed a strike for one-and-a-half hours on 29 April 1979.

On 6 May 1978, the Bank entered into a bipartite agreement with the Association and agreed to concede to its first charter of demands. This, however, did not hinder consideration of a dispute regarding the payment of DA to the staff. Under the Bank's decision, only 90 per cent DA was to be added to the basic pay, while the Association desired to have 100 per cent DA added. The Bank also suggested a ceiling and tapering off of DA, a proposal that was rejected by the Association. As a protest against the Bank's approach to DA and as the negotiations on wage negotiations broke down, the class III staff observed a strike on 3 April 1979 and launched agitations in the form of 'go slow', mass deputations, demonstrations, work-to-rule, 'dharna', and 'no overtime', at all the centres of the Bank. The agitation intensified when it was decided to refer the demands to a tribunal. In some centres, particularly Jaipur, the agitation took a very violent form, forcing the government to issue a Presidential Ordinance on 4 July 1979, by which stoppage of work or instigation to stop work in the Reserve Bank became an offence for which the offender could be arrested on the basis of an FIR filed by the Bank authorities.

The agitation in the Jaipur office was aimed at what the staff called '*shanti bhang*' (destruction of peace). On 2 July 1979, the Jaipur unit of the Employees' Association issued a circular that instructions had been received from Bombay by the manager to suspend three employees at Jaipur. The manager did in fact issue the suspension orders on that day, at around 4.30 pm. Thereupon, about 70 class III employees, led by S.D. Khaspuria, secretary of the Association at Jaipur, and other activists, entered the manager's room, encircled him, turned off the lights, fenced the air conditioner, removed the receivers of both telephones, broke his portfolio, removed his chair and made him stand in a suffocating atmosphere and in sultry heat. They intimidated the manager and jeered at him in an insulting way; they asked him to withdraw the suspension orders on the three employees. This continued for over two hours. Finally, a police team came into the manager's room and escorted him out of the building into his car. About 70 class III employees, again led by Khaspuria, reached his residence and started shouting abuses.

Notwithstanding the Presidential Ordinance, the violent agitation of class III employees continued on 6 July 1979. On the advice of the Central Office, the manager (R.C. Mody) suspended the services of Khaspuria. Arrests were to be made in terms of the Presidential Ordinance but the leaders of the Association continued to shout slogans against the manager as well as the political leaders of the country. This was a time when political uncertainties were so sharp that the police officers were reluctant to arrest the agitating employees. On 13 July, the class III staff again had a massive demonstration. When the manager contacted the state government for help, he was informed that no concrete action could be taken due to political developments at the centre. Meanwhile, the leader of the class III Association at the all-India level, Ashis Sen, held negotiations with Deputy Governor Nangia on 19 July. The Bank showed willingness to revoke the suspensions and to treat the Jaipur incident, including the behaviour of Khaspuria, as a stray one. Ashis Sen thereafter visited the Jaipur office (on July 30) and held discussions with the manager. The talks failed as the manager took the stand that there would be no withdrawal of the cases and that Khaspuria should give him a private apology in writing. Ashish Sen had suggested a verbal apology.

The situation changed very quickly. The chief manager (K.C. Banerjee) of the Reserve Bank at Bombay informed the manager of the Jaipur office on 4 August that an agreement had been signed with the All-India Employees Association on resumption of talks without preconditions. It was also decided to withdraw the reference to the tribunal of wage revision, and to withdraw all FIR-based cases and cases of contempt. The suspension orders were also to be withdrawn, though gradually. There was no mention of any apology by Khaspuria. The manager's position was compromised but he seems to have taken the matter in his stride. The Presidential Ordinance was allowed to lapse.

Staff Agitation, 1981

The year 1981 witnessed violent agitations of class IV employees in the Reserve Bank, which paralysed normal functioning of the Bank in many centres, in particular Calcutta and Bombay. The seeds of these agitations were sown first in the Calcutta office in May 1978 by the Workers' Union, who demanded that the Bank should employ children of class IV staff against 42 vacancies that had been notified. This demand was unacceptable to the Bank, since the national policy was not to show any preference in the matter of recruitment. The agitation took the form of 'go slow', 'no overtime' and not allowing the staff to close their papers, thereby paralysing the work of sections where members of the class IV staff were absent. When C.V. Nair took over as manager, Calcutta, on 11 April 1981, he found that in almost all the departments, one or two sections were not functioning because of the absence of peons. In his letter to the Governor, Nair cited such instances in the Public Debt Office, Public Accounts Department, Issue Department and the Records Section. Besides, a number of highly restrictive practices and self-imposed norms of work were in vogue and were officially accepted by the management. There were, as a result, enormous arrears of work in all the departments.

The Workers' Union was active in creating obstacles to recruitment against the notified vacancies. As a result, the Bank had to approach the court to restrain the union. Despite the court orders, some activists continued to create obstacles and a case of contempt of court was filed against them. Meanwhile, the state government provided the necessary support for recruitment of staff against the notified vacancies. The government provided elaborate police arrangements on all the eleven days during which interviews and medical examinations were held in and around the area adjoining Maulana Azad College. Nair, in the meantime, discussed with various sections of the Workers' Union and convinced them that their demand was not justified, particularly since the state had large numbers of unemployed youth. As a result of his efforts, the call given by the union for a two-hour strike on the day of the start of the interviews failed to succeed.

The situation in Bombay turned out to be different. Agitation by the Workers' Federation became intense from 1 June 1981. On the fourth day of the agitation, the management served show cause notices to thirteen class IV employees and dismissal notice to Suryakant Mahadik, secretary of the federation. Mahadik took the stand that the agitation was not only for reservation of certain posts for their children, but also for liberal housing loans, promotions policy and switch-over of employees from one functional area to another in the same category. The agitating employees demonstrated and shouted slogans inside the premises of the Bank, and resorted to gherao of officials of the Public Accounts Department and Deposit Accounts Department, as well as the administrative section of the main office, disrupting normal work. As this was in violation of the Bombay High Court's order, contempt of court proceedings were instituted. The Bank advised the employees that they should strictly follow the staff regulations since there are well-defined policies of recruitment and promotion of class IV staff with matriculation as the qualification for the clerical cadre, and housing loans were given liberally and at concessional rates.

On 6 June, the Reserve Bank dismissed eleven of its class IV employees in Bombay on charges of misconduct and of adopting obstructive tactics to prevent other employees from doing their duties. Twenty-one employees were served with show cause notices as to why they should not be dismissed from the Bank's service. The RBI Employees' Association dissociated itself from the agitation of the class IV employees under the Workers' Union leadership, and called the demands of the union wrong, sectional and motivated.

On 12 July 1981, Governor I.G. Patel appealed to the agitating employees to call off their agitation but he was not heeded. On 15 July, the agitating employees abstained from work after signing the attendance register and staged an illegal sit-in strike without giving any notice. Some of them obstructed the work of the clearing house. Four class IV employees were arrested for criminal trespass and for intimidating certain officers from carrying on their duties. The Union Government took a serious view of the recalcitrant attitude of the agitating employees and supported the Bank management's recruitment policy. The agitation ultimately collapsed.

The above narrative of some major agitations is only illustrative. The fact was that whenever a demonstration or agitation by any class of employees took place in any office, employees of the same class in all the other offices responded positively by adopting an attitude of non-cooperation. There were also cases of sympathetic response from other staff members. There was all-round absence of discipline in the offices. In general, the class III and class IV staff associations/unions adopted a belligerent attitude towards officers who did not take adequate disciplinary action, probably, out of fear of repercussions, or because of uncertainty of support from the top management. Industrial relations could have been much better had the Bank taken strong disciplinary action within the law.

RESEARCH INPUTS

In this section, an attempt is made to present the Reserve Bank's endeavours towards collection of data, publication and analysis. The rationale for these arises in the context of the need to process massive data/information relating to exchange control and various economic and financial sectors, such as balance of payments, monetary and banking magnitudes, financial savings of the household sector, financial flows, company finances, etc. These are but a few of the areas in which the Reserve Bank of India, by virtue of the nature of its responsibility and independent decision-making role affecting the whole economy, plays the role of a primary data source. Economic Department and Department of Statistics played the crucial role, in coordination with other departments of the Bank, Governments and other institutions.

Collection and Dissemination of Information

The volume of data to be collected and processed on different financial and macroeconomic variables increased substantially over time, particularly during the period of this study. To give a brief historical background, the Reserve Bank collected data on a number of variables—foreign exchange rates, foreign exchange reserves, government securities (including treasury bills) transactions, bullion and commodity markets, call money, industrial security prices, balance of trade and balance of payments, bank deposits and advances, cash on hand with banks, balances with RBI, bills discounted, RBI's balance-sheet items and corporate finances—in a systematic fashion from the late 1930s.

The first issue of the *Report on Currency and Finance*, pertaining to the financial year 1938–39, contained a vast array of data and analyses based on the data. In July 1941, the Bank took over the compilation and publication of *Statistical Tables Relating to Banks in India* from Government of India. With the first issue being for the years 1939 and 1940, this publication was released thereafter by the Bank every year. In 1942, the RBI took over from Government of India the publication of *Statistical Statements Relating to Cooperative Movement in India*, and brought out the issue for 1940–41 for the first time. This publication was also thereafter released every year. The Bank also started to issue the monthly *Bulletin* in 1947, with a weekly supplement of statistical data. In July 1949, the first official estimates of India's balance of payments for the years 1946–48 were provided in the monthly *Bulletin*. In 1948–49, the Bank undertook, in preparation for the data requirements of the International Monetary Fund (IMF), a census of India's foreign liabilities and assets as of 30 June 1948, aimed at obtaining India's international investment position. In the same year, construction of the index of industrial security prices was also taken up by the Division of Statistics in the Department of Research and Statistics (DRS).

DRS undertook a number of surveys towards the end of the 1940s, most notably the ones on ownership of bank deposits and investments of banks, and on advances of banks. In 1949–50, the Division of Statistics brought out, in booklet form, the *Weekly Index Numbers of Security Prices (General Purpose Series)* for the period January 1946 to October 1949. From January 1950, the Division began to release the index number of security prices every week through the press. In the same year, the Division analysed the available balance sheets for the year 1947 of Indian joint stock companies other than financial concerns. Right from 1954 analyses of the finances of the corporate sector were made on a regular basis by the Division of Statistics (renamed Department of Statistics from August 1959) and these were published periodically in the monthly *Bulletin* of the Bank.

The Economic Department brought out a *Foreign Collaboration Survey* for the period 1960–61 to 1963–64 for the first time in 1968. Subsequently, this survey was undertaken every five years. The Economic Department was also involved in drafting the *Annual Report* of the Central Board of Directors and the *Report on Currency and Finance* (*RCF*), every year. These reports contained a considerable amount of macroeconomic information and analyses of developments in the Indian economy. The *RCF* was widely used by the academic community and the media for purposes of research, reactions to policy and collection of information on a time series basis. The Department of Statistics provided the data for the statistical part of *RCF*. The Economic Department was also involved in drafting the report on the *Trend and Progress of Banking in India*; this report gained critical importance after 1969.

In 1966–67, the Department of Non-Banking Companies conducted a survey of deposits as of 31 March, for the period 1962–65. This survey was subsequently conducted every year. The results of the surveys were periodically published in the monthly *Bulletin*.

The Reserve Bank also brought out a number of reports and seminar volumes on different subjects, helping the Bank's policy-making and working. Articles on themes relating to money, banking, finance and the external sector started appearing in the RBI *Bulletins* and the Bank's research journal from the mid-1970s.

Basic Statistical Returns, Some Research Works

The major developments of the period under study in this volume were in banking and finance. In 1968, in the context of the setting up of the National Credit Council (NCC), the Reserve Bank evolved the uniform balance book (UBB) system of reporting for commercial banks. It was designed mainly to provide a detailed and up-to-date picture of the flow of bank credit according to purpose, security and the interest rate. It had the twin objectives of ensuring a steady flow of information and minimizing the reporting load on branches. Information for the UBB proforma was required to be submitted by every bank office every month to the Division of Banking of the Economic Department. The proforma also provided for detailed reporting of account-wise information in regard to credit limits sanctioned and advances outstanding, according to the type of account, type of borrower, occupation, purpose, security and rate of interest charged. This was considered sufficiently comprehensive for policy purposes and was to eventually replace the purpose-wise survey of bank advances, fortnightly survey of advances and half-yearly survey of interest rates on advances. However, after a few rounds of the survey, it was noticed that the response from branches was poor and that the quality of reporting data was not up to expectations. Beset with these difficulties, the UBB had not gone beyond what could effectively be called the experimental stage.

Meanwhile, the nationalization of fourteen major Indian commercial banks required that more definitive shape be given to the collection of data on the pattern of credit. There were a large number of requests for giving particulars of loans and advances granted to specific industries or categories of borrowers in different states and districts. The Reserve Bank, therefore, constituted a Committee on Banking Statistics in April 1972 under the chairmanship of A. Raman, director, Credit Planning Cell, and with members from various departments of the RBI and commercial banks, to look into various aspects of statistical reporting by banks and to suggest appropriate measures to acquire the required data.

The Committee submitted its report in August 1972. The overall pattern of the statistical reporting system envisaged by the committee was designated as basic statistical returns (BSR). It was meant to obtain a steady flow of the required data from banks, and constituted the following returns.

1. *BSR 1*
   - Return on advances
   - Half-yearly
   - As on the last Friday of June and December
   - From all branches
   - In two parts
   - Part A for accounts with limits over Rs 10,000
   - Part B for accounts with limits of Rs 10,000 and less
2. *BSR 2*
   - Return on deposits
   - Half-yearly
   - As on the last Friday of June and December
   - From all branches

3. *BSR 3*
   - Return on advances against the security of selected sensitive commodities
   - Monthly
   - As on the last Friday of each month
   - From head offices
4. *BSR 4*
   - Return on ownership of bank deposits
   - Once in two years
   - As on the last Friday of March
   - From all branches (replacing annual survey from head offices)
5. *BSR 5*
   - Return on bank investments
   - Annual
   - As on the last Friday of March
   - From head offices (on the lines of survey of bank investments)
6. *BSR 7*
   - Returns on branch-wise deposits and gross bank credit
   - Monthly, changed to quarterly returns from August 1974

In addition to these, it was recommended that the survey of debit to deposits (Form T-1) be done once in three years instead of every year. This survey was subsequently renamed as BSR–6.

The Reserve Bank agreed with the recommendations of the Committee and took action to implement them. The Department of Statistics was charged with the responsibility of bringing out the BSR data. The dissemination of information of BSR returns was done through various publications brought out by the Bank. In the context of BSR 1 and 2, the publications are various volumes of *Banking Statistics: Basic Statistical Returns*, while the results of the BSR 7 quarterly return are brought out as a separate publication, *Banking Statistics: Quarterly Handout.* In the case of the other BSR returns, the results are published in the form of articles in various issues of RBI *Bulletin.*

The early studies of corporate finance covered only non-government non-financial public limited companies. Later studies covered private limited companies, as well as financial and investment companies. Banking, insurance and other financial companies, as also companies limited by guarantee and associations and organizations functioning on a no-profit basis, were outside the purview of these studies. Initially, the focus of the studies was on capital formation and industrial profits; in due course, other financial magnitudes, rates and ratios were developed so as to provide a better understanding of the economic strength of the corporate sector. Further, studies on government companies were also prepared from 1959–60 to 1978–79, and separate studies were published in respect of the finances of branches of foreign companies and foreign-controlled rupee companies.

The Reserve Bank also conducted, through its Department of Statistics, large-scale sample surveys on an all-India basis, adopting scientific sample designs. These included: (i) Debt and Investment Survey; (ii) Small-Scale Industrial Units Survey; (iii) Survey of Traders and Transport Operators; (iv) Survey of Small Borrowal Accounts. One of the major surveys undertaken by the Bank was the All India Debt and Investment Survey. This was conducted decennially with the main objective of building dependable estimates of assets and liabilities, borrowings, capital formation, etc., of rural and urban households, at all-India and state levels. The first two of these surveys, viz. the All-India Rural Credit Survey (AIRCS) 1951–52 and the All-India Rural Debt and Investment Survey (AIRDIS) 1961–62, conducted by the Department of Statistics, covered only the rural areas of the country. These were followed by various annual follow-up surveys on different aspects of rural credit. Their scope was enhanced to include both rural and urban households from the third decennial survey, from 1971–72 onwards. The reports of the surveys were prepared jointly by officers of the Department of Statistics and the Economic Department. The fourth survey, viz. All-India Debt and Investment Survey 1981–82, formed a part of the NSSO's 37th Round. The sampling design for the debt and investment surveys was a two-stage, stratified one, with census villages (in the rural sector) and urban blocks (in the urban sector) as the first-stage units, and households as the second-stage units—except for the 1951–52 survey, in which districts were the first-stage units, villages the second-stage units and households the third-stage units. For the purpose of selecting households, the selected villages/urban blocks were divided into sub-strata based on the criteria of landholdings (in the case of the rural sector) or monthly per capita consumer expenditure (in the case of the urban sector).

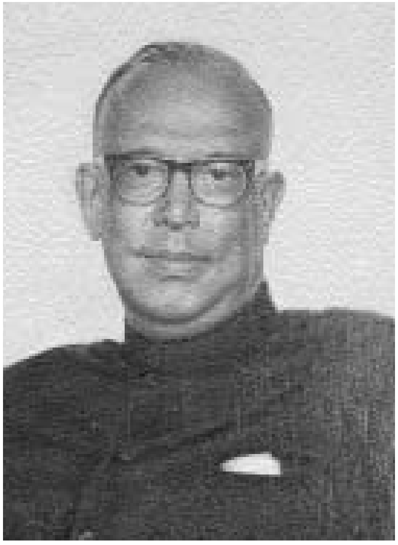
In 1977, the Reserve Bank conducted a Survey of Small Scale Industrial Units since small-scale industries (SSIs) were considered as part of the 'priority sector' for purposes of bank finance. The survey collected both quantitative and qualitative information, with different aspects of management and performance of bank-financed units as also the customer service rendered by financing banks being covered under the qualitative aspect. The survey thus covered all SSI units assisted by commercial banks and under the Credit Guarantee Scheme. April 1976–March 1977 was taken as the reference year and fieldwork for the survey was carried out by the staff of the financing banks. The sampling design was a two-stage, stratified one, with bank branches forming the first-stage units and assisted SSI units of the branch being the second-stage units. The survey data were collected through a set of three schedules relating to (i) assets, liabilities and other economic parameters of the selected unit, (ii) the financing bank's appraisal of the selected unit, and (iii) the customer service provided by the banks. The results were published in two volumes of statistical reports, and the analysis of the results appeared in the form of an article in the RBI *Bulletin*.

In 1979–80, the Reserve Bank's Department of Statistics conducted a Survey of Traders and Transport Operators, to collect information on the organizational, financial and operational aspects of different segments of priority sectors, and with a view to assisting formulation of appropriate credit policies. The objective of the survey was to yield estimates of important economic characteristics in respect of three populations, viz. retail traders, wholesale traders and transport operators, besides qualitative data on management and performance of the assisted units and the customer service rendered by banks. The end of the accounting year in the one-year period preceding the month of investigation formed the reference period of the survey. The samples of traders/transport operators were selected through a two-stage, stratified random sampling procedure. The financing bank branches formed the first-stage units, while separate samples for each of the three occupations (retail trade, wholesale trade and transport operators) constituted the second or ultimate-stage units. The results of the survey were released in the form of statistical reports and articles in the RBI *Bulletin*.

In the system of basic statistical returns, introduced in 1972, data on bank credit were collected through the BSR 1 return consisting of two parts. Part A called for account-wise detailed data in respect of accounts having a credit limit above a predetermined cut-off limit. While branch-level and occupation-wise consolidated data for other accounts (referred to as small borrowal accounts) were small in total bank credit, the small borrowal accounts were significant in terms of credit to the priority sectors.

The Survey of Small Borrowal Accounts was conducted with the objective of obtaining a profile of small borrowal accounts and the structural pattern of these accounts according to important characteristics such as size of credit, occupation, loan scheme, gender, etc. The first survey was conducted by the Department of Statistics with the last Friday of September 1979 as the reference date. The sample design of the survey was a two-stage, stratified sample, with bank branches as first-stage units and borrowal

GOVERNORS OF THE RESERVE BANK OF INDIA, 1967–1981



1 P.C. Bhattacharyya
(March 1962 to June 1967)

2 L.K. Jha
(July 1967 to May 1970)

3 B.N. Adarkar
(May 1970 to June 1970)

4 S. Jagannathan
(June 1970 to May 1975)

GOVERNORS OF THE RESERVE BANK OF INDIA, 1967–1981

5 N.C. Sen Gupta
(May 1975 to August 1975)

6 K.R. Puri
(August 1975 to May 1977)

7 M. Narasimham
(May 1977 to November 1977)

8 I.G. Patel
(December 1977 to September 1982)

9 Courtesy *Times of India*, July/August 1973

10 Courtesy *Times of India*, 19 January 1977

11 Board meeting in progress

12 Board meeting in progress

13 S.B. Chavan (*left*) with K.R. Puri (*right*)

14 Governor Narasimham (*left*) with foreign dignitary (*right*)

15 Dr K.S. Krishnaswamy

16 R.N. Malhotra, Secretary, Ministry of Finance (*left*) and I.G. Patel, RBI Governor (*right*) in conversation

17 Bimal Jalan, Economic Advisor, Government of India (*left*) and I.G. Patel, RBI Governor (*right*) in conversation

18 Conference of In-charges of the Department of Banking Operations and Development at various centres, 25 May 1976
Left to right: P.R. Nangia (Deputy Governor), K.R. Puri (Governor), K.S. Krishnaswamy (Deputy Governor), J.C. Luther (Executive Director), C.L. Thareja (Chief Manager)

19 Conference of In-charges of the Department of Banking Operations and Development from various centres, 1 March 1978.
Front row, left to right: A.N. Bhattacharya (Joint Chief Officer), N. Vagul (Director, NIBM), A.K. Bhuchar (Additional Chief Officer), S.R. Avadhani (Additional Chief Officer). *Back row, left to right*: K.B. Chore (Joint Chief Officer), A. Ramanathan (Deputy Chief Officer), S. K. Kapur (Deputy Chief Officer), M.C. Chetty (Deputy Chief Officer)

You said it

What's the idea? Are you trying to humiliate me by asking all sorts of personal questions about my assets, securities, liabilities, etc?

20 Courtesy *Times of India*, May/June 1978

21 In-house conference, 6 August 1979
Left to right: K.R. Subrahmanyan (Additional Chief Officer), K.B. Chore (Chief Officer), I.G. Patel (Governor), K.S. Krishnaswmay (Deputy Chief Officer)

22 V.B. Kadam , Adviser, Economic Department (*left*); H.B. Shivamaggi, Adviser-in-Charge, RPCD (*middle*); W.S. Tambe, Executive Director (*right*)

23 K.C. Banerjee (*left*) and M.V. Hate (*right*)

24 I.G. Patel, Governor (*left*); N. Ramakrishnayya, Deputy Governor (*middle*); P.R. Nangia, Deputy Governor (*right*)

25 Courtesy *Times of India*, December 1978

26 *Left to right*: Finance Minister, RBI Governor, Minister of State for Finance

27 Conference of In-charges of the Department of Banking Operations and Development from various centres, 19 February 1981
Left to right: I.G. Patel (Governor), W.S. Tambe (Executive Director), D.C. Rao (Special Adviser), K.C. Banerjee (Executive Director), M.V. Hate (Executive Director), V.B. Kadam (Adviser, Economic Department)

28 Governor S. Jagannathan with staff of the Regional Office at Srinagar

29 Members of the Committee of Parliament on Official Language entering Bankers Training College, Bombay, 8 January 1979

30 Courtesy *Times of India*, 16 April 1980

31 Finance Minister R. Venkataraman inaugurating the new Central Office Building, Bombay

accounts as second-stage units. The results of the survey were released in the form of articles in the RBI *Bulletin*.

A study by V.V. Divatia and Ravi Varma of the Department of Statistics presented estimates of the utilization of available productive capacity in select manufacturing industries in India. This was the first study on the subject. It appeared in 1968 in the RBI *Bulletin*, and pertained to the years 1965, 1966 and 1967, using conventional installed capacity figures obtained under the licensing regime. In 1970, the Department published estimates of 'potential utilization rate' for manufacturing industries in India for the years 1960 to 1968. Potential production was considered to be a result of several factors, such as installed capacity, the extent of availability of inputs, the availability of skilled labour and the demand situation.

Monthly data of the financial time series reflected the combined influences of secular trends, cycles, seasonal variations and irregular fluctuations. For better appreciation of the trend-cycle movements underlying the time series, it became necessary to adjust the data for intra-year movements, i.e. seasonal variations. For this purpose, seasonal factors were derived and the adjusted series for seasonal variations were worked out based on the X–11 variant method developed by the US Bureau of Census. The seasonal pattern in the selected financial time series for the period April 1950 to March 1956 was first published in the December 1956 issue of the RBI *Bulletin*. Subsequently, the exercise was extended to the period 1951–52 to 1963–64. A separate series for wholesale price indices was brought out in the June 1965 issue of the RBI *Bulletin* for the period 1951–52 to 1964–65. Similar data were regularly published for the subsequent years.

Prior to 1970–71, the State Bank of India (SBI) acted as the RBI's sole agent for the conduct of government business, under Section 45 of the RBI Act. The rates of commission were to be reviewed every five years on the basis of actual costs of conducting government business, in accordance with the formula drawn up by Sir James Taylor, the then Governor of RBI. The scheme of computing costs and reviewing commissions continued till 1969–70 under the Taylor formula through bilateral negotiations. However, both RBI and SBI felt that the formula did not take into account several items of expenditure for the purpose of computing the costs of conducting government business, and did not reflect the true costs of conducting government business in view of SBI's activities and wide range of functions. Accordingly, the RBI appointed a Committee in December 1973 under the chairmanship of Rameshwar Thakur, a chartered accountant of repute, to investigate the costs of conducting government work by the SBI and to recommend rates of commission for the period 1970–71 to 1978–79. Two senior officers, one each from the RBI and SBI, were appointed as members of the Committee. After detailed examination of the matter, including the data submitted to it, the Committee submitted its report in August 1975. It recommended commission at the basic rate of 9.25 paise per Rs 100; accordingly, this commission was paid to SBI up to 1978. Also, as recommended by the Committee, a similar study to compute the costs of conducting government business by associate banks of the SBI was undertaken by the Reserve Bank's Department of Statistics, and the basic rates of commission payable to them for the period ended 1978 were thus determined. The rate of commission applicable to SBI was also made applicable to the fourteen scheduled commercial banks that were nationalized in 1969, and which were entrusted with government work subsequently.

After successful completion of the first Census of India's Foreign Liabilities and Assets as on 30 June 1948, the Reserve Bank conducted three more surveys, in 1953, 1955 and 1961, which were published as ad hoc reports in 1955, 1957 and 1964, respectively. Owing to the magnitude of efforts required to conduct comprehensive census/surveys, annual assessment in a summarized form with a link to the results derived from the detailed benchmark surveys were undertaken thereafter, and published in the monthly *Bulletin*. The annual assessments reviewed both the flow of foreign investment during the year and the volume of foreign investment outstanding at the end of the year.

The depth of research work undertaken by the Reserve Bank, particularly its research and data-related departments, may be gauged by the quality of the *Annual Report* and other publications of the Bank. These included the *Reserve Bank of India Occasional Papers* series, whose objective was to publish high-quality research papers by Bank officials based on empirical work on various economic issues, which might be useful to interested policymakers and researchers. The *Occasional Papers* were well received both internally and externally. The papers selected for publication were subjected to an extensive review process using internal experienced and knowledgeable referees. The views presented in the published papers, however, did not necessarily reflect the position of the RBI, although they did not criticize the Bank's and government's policy. Many of the findings in the papers were used for future policy discussions. The *Reserve Bank of India Occasional Papers*, issued twice a year, did not also cover external and internal comments/criticism on the works published.

Reserve Bank of India: Functions and Working entered its third edition in 1970, having been first published in 1941 and had a second edition in 1958. The volume presented a concise and updated narration of the responsibilities and functions of the RBI in the areas of central banking, banking and financial regulation, international finance and other related areas. The volume was found very useful by students, the teaching fraternity and professionals.

The Reserve Bank took the initiative to broadbase training in various aspects of banking and finance by setting up the Cooperative Bankers Training College in Pune in 1969, in order to make officials of cooperative banks better professionals. Other training colleges of the Bank were strengthened to conduct effective programmes on banking operations and related issues. The Bank's initiatives towards encouraging a proper mindset for modern banking were really commendable and pro-active.

Officials particularly from Economic Department and Department of Statistics were effectively involved with the deepening of empirical macroeconomic research of the economy. The Bank played a very useful role to encourage economic research as well as data mining of the country through financial as well as intellectual supports. Besides, the Bank gradually progressed to be a significant employer of economists and allied professionals. Governors, Deputy Governors and senior officials of the Bank regularly took part in various public deliberations on various issues, mainly concerning the central banking. Many new central banks as well as institutions used the Bank's knowledge and experience over the years.

FINANCIAL ACCOUNTS OF THE BANK

The Reserve Bank has been bringing out the main items of its liabilities and assets every week, for submission to the Committee of the Central Board of Directors and to the government, ever since it was nationalized. It has also been giving details of its liabilities and assets as well as its profit and loss accounts every year to the Central Board of Directors, in the month of August, and sending them to Government of India along with the *Annual Report*. The Bank's accounting year has been July–June. Its liabilities and assets are given separately for the Issue Department and for the Banking Department—a distinction modelled on the Bank of England pattern. The issue of notes was to be conducted by the Bank in its Issue Department, which was to be separated and kept distinct from its Banking Department.

The Bank's income emanates from (i) interest earned on rupee and foreign securities; (ii) interest earned on loans and advances to banks, state governments, etc.; (iii) discount earned on rupee and foreign treasury bills, and internal bills; (iv) receipt on account of exchange from purchase and sale of foreign currencies, transfer of foreign currencies on government account, and issue of drafts, telegraphic transfers under the Remittance Facilities Scheme; and (v) commission earned on account of management of public debt of both the central and state governments, and purchase and sale of securities on account of governments and others. The income has always been expressed in net terms after making the statutory provisions.[4] On the expenditure side, the major items are establishment charges, agency charges and security printing. The table on the next page provides a view of the acc-ounts between 1966 and 1982.

Establishment expenditures, followed by agency charges and security printing (of cheques and notes), formed, in the initial years of this study, around one-fourth of the total net income (or expenditure, including surplus paid to the government); this went up to above 45 per cent by the end of the period of the study. Establishment expenditures rose from Rs 8.9 crore at end-June 1966 to Rs 76.2 crore at end–June 1982, i.e. at an annual compound rate of 14.4 per cent. This reflected the sharp growth in staff strength as well as revisions in pay and allowances. Agency charges increased from about Rs 3 crore in 1966 to Rs 70 crore in 1982, i.e. at an annual compound rate of 22.9 per cent. This increase reflected the growing dependence of the Bank on commercial banks as its agent, for performing different functions relating to currency distribution, remittances and other banking requirements. The increase in security printing during the period reflected the sharp rise in the volume of transactions and the growing use of banking facilities. The surpluses paid to Government of India increased by four times, from Rs 50 crore in 1966 to Rs 210 crore in 1982.

The net income growth of the Bank during the period of study, from Rs 67.5 crore at end-June 1966 to Rs 411.8 crore at end-June 1982, was impressive. The annual compound growth in income was about 12 per cent. This was largely facilitated by the fact that interest income on Government of India rupee securities and discounts on treasury bills increased sharply owing to the government resorting to credit from the Bank. Since the boost to income was mainly on account of the government, it was obvious that the surpluses payable to the government would increase, assuming that there were adequate expenditure control mechanisms within the Bank, and the provisions on account of the national agricultural and industrial credit funds were reasonable. Such provisions led to an increase in the total

[4] The provisions include (i) interest paid to scheduled banks on the additional average daily balances maintained by them with the Reserve Bank; and (ii) transfers to NAC (LTO) Fund, NAC (Stab) Fund and NIC (LTO) Fund.

Table 1 RBI Accounts, 1966–82

(Rs crore, rounded off)

End-June	Income (excl. provision)	Surplus paid to govt.	Establishment expenses	Agency charges	Security printing	Other expenses (derived)*
1966	67.5	50	8.9	2.6	3.9	2.1
1967	85.1	60	10.2	7.8	4.7	2.4
1968	92.9	65	11.2	8.7	5.0	2.5
1969	99.4	70	14.3	6.7	5.1	3.3
1970	105.5	75	14.8	7.0	4.7	4.0
1971	136.5	100	20.6	7.2	4.9	3.8
1972	157.2	120	20.9	7.3	4.8	4.2
1973	171.3	130	22.9	8.3	5.0	5.1
1974	195.5	145	28.5	11.2	5.2	5.6
1975	228.0	150	34.7	31.3	5.8	6.3
1976	295.0	190	35.5	43.0	14.4	12.1
1977	297.3	200	35.5	35.5	19.4	6.9
1978	316.8	200	39.6	42.0	21.6	13.6
1979	320.3	200	44.7	46.0	24.3	5.2
1980	347.4	210	55.8	52.2	20.2	9.2
1981	373.9	210	71.8	56.1	23.2	12.8
1982	411.8	210	76.2	70.2	41.6	13.8

Note: *Other expenses include: Directors' and local board members' fees and expenses; auditors' fees; rent, taxes, insurance, lighting, etc.; law charges; postal and telegraph charges; remittance of treasure; stationery, etc.; depreciation and repairs to Bank property; contributions to staff and superannuation funds; and miscellaneous expenditures.

outstanding funds from Rs 151 crore at end-June 1966 to Rs 3,560 crore at end-June 1982, i.e. an increase of Rs 3,409 crore over the sixteen-year period, for facilitating long-term industrial growth and short and long-term growth of agriculture. The provisions for funds increased continuously but more significantly from 1974 onwards.

The Bank's functioning was, as expected, factored by developments in the domestic sector as well as the external sector. The Bank's core policy i.e., monetary policy (mainly in practice, credit policy), worked in tandem with the thrust of the overall economic policy which was deeply socially oriented. However, some important developments in the external economy had some notable bearing on the Bank's perception as well as functioning and thus, in the remaining chapters attempts were made to capture those developments.

11

Exchange Rate Conundrums

The 1970s ushered in a period of great uncertainty for the global economy. The breakdown of the Bretton Woods system of stable exchange rates and the emergence of floating regimes presented serious problems for exchange rate management, and created balance of payments difficulties for many countries. The oil shock of 1973–74 amplified these trends. The speed and magnitude of all these developments resulted in destabilizing the global monetary system, leaving the authorities generally unprepared to cope with the evolving pressures within the system. Established mechanisms of liquidity creation were unequal to the task of absorbing the massive capital flows and propelled the need for reform of the monetary system. The backlash of these developments had to be borne by the developing countries, too, although they were on the periphery of the debate.

This chapter seeks to evaluate the response of the Reserve Bank and the Indian government to the global events and to the efforts at attaining exchange rate stability. It highlights the Bank's thinking on the initiatives launched for future reform of the monetary system.

A word of caution might be in order here. The documentation and official records available for a comprehensive evaluation of India's exchange rate management policy are woefully inadequate, and the methods of storage and retrieval of archival material rather poor. What is more, the Indian bureaucracy, as a rule, does not maintain diaries and personal jottings. The Reserve Bank's records of this period show little evidence of commitment to paper of sensitive policy issues. Perhaps the rigid laws regarding disclosure of classified material prevented senior officials from baring their thoughts on paper. Despite this infirmity, the chapter attempts to narrate the happenings of the tumultuous decade of the 1970s and the response and reactions of the Bank and the government in the formulation of major policy decisions.

The narrative begins with the rupee devaluation of 1966. The historic alteration in the exchange rate through the devaluation of the rupee in June 1966 was a greatly controversial event in the monetary history of India's economy, and it sparked interest for years afterwards. The vigorous, even acrimonious debates that preceded the devaluation—whether or not it was needed, and whether or not would be effective in reducing the large and rising trade deficits—gave high motivation to the central Bank and the Ministry of Finance officials, as well as the academic community, to analyse and measure its effectiveness and repercussions in the second half of the sixties.

Although the devaluation itself was covered in Volume 2 of the history of the Reserve Bank of India in great detail, its effectiveness and repercussions need to be restated here in order to better appreciate the developments that influenced the value of the rupee in the 1970s. The early plan periods, beginning with the Second Plan, were marked by a very difficult balance of payments situation brought on by the policy of heavy industrialization and reliance on import substitution, and the tragic failure to recognize the potential of foreign trade as an engine of growth for the economy. Not only was the option of export earnings ignored but, while eschewing commercial borrowing, heavy reliance was placed on foreign external assistance to finance current account deficits. No doubt, adverse external factors, like the three wars (in 1962 with China, and in 1965 and 1971 with Pakistan) interspersed with droughts compounded the problem. However, in retrospect, it is abundantly clear that policy-makers underestimated not only the export potential but, more importantly, the import intensity of the import substitution process. Austerity was enjoined on a population that was gradually being strangulated by permits, physical rationing, and currency restrictions on foreign travel and foreign investment. Short supply and import licensing marched hand in hand with the shortage of foreign exchange reserves. In 1956–62, intense use was made of QRs to control the unsustainable deficit; in the years 1962–66 use was made of the price mechanism by tampering with export tariffs and surcharges, and export subsidies and tax rebate; 1966–68 was a period in which exchange rate change was effected to improve the external payments position and, although reliance on QRs continued, export subsidies and tax rebates were withdrawn. From the point of view of allocative efficiency and its impact on growth, trade policies were not complementary to the exchange rate policy being pursued. In the long run, the commitment to a strategy of import substitution proved to be high-cost one as inefficiencies crept into the system and problems stemming from the overvalued exchange rate became more apparent.

It is pertinent to note that the Reserve Bank, although historically the administrator of monetary and exchange rate policy, was able, in the mid-sixties, to exert little direct and effective resistance to influence the course of exchange rate policy. But it would be wrong to infer, on that account, that the RBI had no role to play. Although in guarded terms, the senior hierarchy of the Bank, ever since 1963, had favoured a move towards a more realistic exchange rate policy. Several staff notes and memoranda prepared in 1965 and 1966 bear evidence of the need felt for a greater emphasis on export promotion policies and appropriate exchange rate adjustment. Governor Bhattacharyya, while giving a patient hearing, failed to share his views or information candidly with his deputies although he himself was privy to Delhi's views and agreed with the group that favoured devaluation. This was because he knew that there were hard opponents like T.T. Krishnamachari, who believed that multilateral agencies were forcing the country on to the suicidal path of devaluation. But, following the devaluation in June 1966, the Governor was the chief spokesperson of the view that devaluation by itself was not a solution. In one of his addresses he said that 'it was a challenge to stand on our feet' and went on to state: 'The success with which we are able to contain inflation, increase exports and reduce dependence on others for imports will determine how soon we could make a turnaround in our balance of payments.' These thoughts were indicative of the fact that the Governor was aware of the conditions in which the country could hope to maintain the devalued rupee rate. Inflation had to be kept firmly in check if the maintenance of any export advantage derived from devaluation had to be translated into a gain in reserves.

So, in crafting a package of supportive measures, Governor Bhattacharyya took extra special care to see that there was no general relaxation of the credit policy; in fact, there was overall tightening of credit expansion in the interest of monetary stability, even while ensuring its flow to various sectors according to their priorities. Exports were accorded high priority in the credit policy, and tools like moral suasion and concessional unlimited refinancing through the Reserve Bank for short-term finance, at pre and post-shipment stages, as well as by the Industrial Development Bank of India (IDBI) for longer-term finance, were employed to render exports profitable. The policy was kept under constant review and fine-tuned to meet emerging developments. Bhattacharyya went so far as to give an assurance to the export community that adequate refinance would be available at the Bank rate to all categories of export bills purchased by the banking system. Likewise, in framing the structure of rates at which commercial banks bought sterling export bills and in fixing the rates at which the

Reserve Bank bought sterling from banks, the interests of the export community were safeguarded.

Devaluation was accompanied by some changes in import policy as well. Imports were liberalized and tariffs reduced. Devaluation had also narrowed the disparity between the rupee prices of indigenous products and imported products. Apprehending freer availability of imported products, the RBI Governor urged the business community to encourage the use of local products and not to make a beeline for imports except where essential, warning of the dangers of unemployment and consequent recession. In the closely related field of foreign collaboration, Bhattacharyya cautioned against the reckless entry of foreign collaboration arrangements, which, according to him, would be a burden on the balance of payments and a set-back to the development of Indian industry. In short, the challenge of devaluation was the ability of the nation to stand on its feet by containing inflation, increasing exports and reducing dependence on imports.

Introduction of the devaluation package represented a major policy reversal entailing exchange rate adjustment, import liberalization, elimination of export subsidies and greater fiscal discipline. The earlier inward-looking policy of industrialization coupled with export pessimism was the root cause of the deterioration in the terms of trade and the external payments position. Devaluation, however, failed to correct the external payments situation immediately: the financial year 1966–67 witnessed a draft on reserves excluding International Monetary Fund (IMF) transactions of $170.5 million. The main factors responsible for the deterioration in reserves were the sharp drought-induced decline in exports, and an increase in debt service payments accompanied by a sharp reduction in external aid inflows. The exceedingly difficult foreign exchange situation was relieved in 1967–68 as a result of debt relief, larger utilization of foreign aid, improved exports and reduced foodgrains imports following better availability of domestic supplies. The unsettled export conditions following devaluation of the rupee continued for the greater part of 1967–68 with the reserves recording a further loss of $61 million and coming down to $577 million. Despite this loss of reserves, the external accounts in 1967–68 were, surprisingly, in better shape. The pick-up in reserves from December 1967 to March 1968 was due in part to CFF drawing and the sharp improvement in exports.

By December 1967, there were distinct signs that post-devaluation clouds were lifting. The clearest indication was a revival in the growth of exports. A major international development occurred at around the same time, viz. the devaluation of the pound sterling. The 1960s were a period of growing shortage of international liquidity in relation to the volume of world trade, with both the United States and the United Kingdom experiencing chronic balance of payments problems and both reserve currencies—the pound sterling and the US dollar—under heavy selling pressure. Payments crises of varying degrees of intensity had plagued the British economy at two-year intervals. In mid-1967 there was once again a sharp deterioration in the British current account and, despite a rise in Britain's Bank rate to a high of 6 per cent and the announcement of a new line of IMF credit, confidence evaporated; Britain was forced to act in the face of a heavy speculative outgo of sterling. On 18 November 1967, the pound sterling was devalued by 14.5 per cent, from $2.80 to $2.40.

India, in unison with the major world currencies, retained its existing gold parity. Having devalued the rupee just eighteen months back by 37.5 per cent, and bearing in mind the political fall-out and criticism which accompanied that move, Indian authorities, on the basis of the central Bank's advice, decided that since the measure of devaluation of the sterling was not all that large, the correct course of action would be to refrain from making an immediate adjustment, even though several countries like Ceylon, Hongkong, New Zealand, Spain, and Israel had done so. Pakistan, too, had revised its bonus voucher scheme. In a memorandum submitted to the Reserve Bank's Central Board on 8 December 1967, it was explained that the decision was based on the reasoning that there was no need for yet another change. It was pointed out that Indian exports in terms of sterling would be costlier in the British market but, as Indian exports like tea and tobacco did not compete with UK manufactures in the domestic market, the danger of earnings from these exports declining was minimal. What, however, was of significance was the impact on Indian exports—such as jute goods and tea—in the British and other markets, of Ceylon's devaluation and Pakistan's adjustment in its multiple exchange rate system; these would adversely affect the competitiveness of India's exports of jute manufactures and tea. While proferring advice that the trend of sterling would have to be watched, the Bank cautioned the government against rushing in to adjust the level of export duties; it said that corrective measures of this type should not worsen the terms of trade for the exporting country to the benefit only of the importing country. On the import front, discounting any price rise in the UK on account of the devaluation of that currency, imports would be cheaper in rupees. Admitting that India had suffered a loss in its sterling holdings as a result of the UK devaluation, it stood to gain, in rupee terms, so far as repayments were concerned. In retrospect, it would appear that the decision was a wise one.

There was, however, a change in the actual maximum and minimum rates at which the Reserve Bank would buy and sell sterling from authorized dealers—the Bank's buying rate was adjusted from \$4.7619 to \$5.5556 per Rs 100, and its selling rate for ready delivery from \$4.7467 to \$5.5360 per Rs 100. It may be recalled that forward sales by the Bank were discontinued following its bad experience during the devaluation of the rupee in June 1966, when some authorized dealers in foreign exchange took advantage of the facility to make speculative gains by effecting purchases of foreign currencies that were not backed by genuine trade transactions.

Indicating the impact of the devaluation of the sterling on the Reserve Bank's balance sheet, the Governor placed the total loss at around Rs 10 crore, amounting to 4 per cent of the total assets excluding gold. In his view, this was not large for a country which was an important member of the sterling area. The loss, to some extent, was minimized as a result of the timely diversification of holdings of foreign assets undertaken by the Bank a few months earlier. The increase in the UK Bank rate, too, was expected to improve the investment income on India's sterling holdings. To the extent that British prices moved up—in the Bank of England's reckoning a 4 per cent price rise was anticipated as a result of the devaluation—some real loss was inevitable.

The Governor, in discussions with financial interests abroad, sought their views on ensuring the safety of India's international reserves. His impression was that both the UK and the US authorities were determined to avoid a devaluation of their currencies; moreover, the existence of mutual support operations amongst central banks suggested that runs on reserve currencies would be adequately met. Besides, the UK no longer objected to 'outer sterling area' countries keeping their reserves in currencies other than sterling. The likelihood of the UK providing any guarantee at that point of time against any change in the par value of the reserve currencies appeared remote.

But, within a year, the UK was pressed by several of the sterling area countries into offering specific proposals for guaranteeing their official sterling holdings. When the details were received officially from the Chancellor early in July 1968, the Indian reaction was one of surprise. Each of the thirty-eight members of the overseas sterling area was urged to maintain an agreed percentage of its reserves in sterling for seven years. The agreed percentage was expected to be 'not lower than the present level'. In turn, the British government offered to provide a guarantee in terms of dollars for all the sterling holdings of sterling area countries if these holdings exceeded 20 per cent of their total gold and foreign exchange reserves. The offer of a guarantee, for which a small charge was proposed, was a measure of the extent to which the sterling had fallen from grace and an indication of the UK government's desire to retain a key role for the sterling in the international payments system. As a result of negotiations, these proposals were amended and the final form in which the agreement took shape was as follows. All sterling holdings in excess of 10 per cent of India's gold and foreign exchange reserve would qualify for the guarantee. Deputy Governor Anjaria, when apprising the Board of the amended proposal, pointed out that India's sterling holding formed 13 per cent of its total reserve holdings, and the intention of the authorities was to raise this proportion to 15 per cent as it was to India's advantage to earn the higher rate of interest that could be obtained on investments in sterling. The proposal for levying a charge was also dropped. Regarding the period of guarantee, the UK authorities were persuaded to make the agreement effective for three years instead of seven years, as the Indian authorities considered seven years too long a period. As part of the operations to provide stand-by credit to the sterling, the BIS was anxious to increase its own resources. India accepted that there was some value in the arrangement and for the purpose of assisting stability in the international system, it transferred 5 million to a dollar account with BIS and a further DM mark 140 million to two deutsche mark accounts with it. These balances with BIS were denominated in their original currencies. The DM balances with the BIS earned a higher rate of interest compared with what was obtained from the Deutsche Bundesbank; however, the BIS was hesistant to undertake a further switch from dollars to DM as it could involve a substantial loss of income on the investment. In arriving at decisions regarding the future disposition of foreign exchange balances, officials like Seshadri, who were responsible for taking the decisions, were wary of pursuing this path in haste.

Overall, the negotiations on the guarantee arrangements that were concluded on 21 September 1968 were cordial and smooth, and it was conceded that there was a benefit in the guarantee despite the weakness of the dollar. Wisely, the authorities recognized that if India was to continue to play a responsible role, it had no option other than to negotiate within the ambit of the draft Basle agreement.

Liquidity management and inflation control were the centrepiece of Bhattacharyya's governorship of RBI in the post-devaluation period. Inflationary trends were discernible in 1966–67 and 1967–68. The wholesale price index rose by 13.9 per cent in the former year and by another 11.6 per cent in 1967–68. It was difficult to insulate the economy from the drought-induced inflationary pressures caused by the large fall in foodgrains production necessitating heavy reliance on foodgrains imports. The key to controlling inflation lay in improving the supply position of foodgrains and raw materials production, for it was the serious imbalance in the demand/supply situation and not devaluation per se that was the root cause of the inflation. On the import side, though devaluation was accompanied by liberalization measures, imports failed to pick up because of higher prices; in fact, the capital goods industry tail-spinned into a recession because of the subdued public investment demand, which the Reserve Bank attributed to the substitution of cheaper, domestically produced substitutes.

In the difficult post-devaluation transition phase (1966 to 1968), for those in charge of macroeconomic policy at the central Bank, there was always a dilemma of not allowing inflation and inflationary expectations to get out of hand while, at the same time, not aggravating recession by adopting an overly restrictive credit policy stance. Management of credit in those difficult years called for a delicate balance between demand/supply forces. With deft strokes the Reserve Bank's management struggled to create that balance by placing an accent on credit liberalization measures, but on a very selective basis, for productive sectors like agriculture, exports and small-scale industry, while keeping the rest of the economy on a short leash so far as cost and availability of credit were concerned.

By the second half of 1968–69, overall industrial recovery was in evidence with a rise in exports and a steady strengthening of agricultural production through the application of new technology. The economy appeared on surer grounds for the resumption of growth. It was steered away from the path of drought-induced recession on to a path of stability. But, to sustain the latter, as rightly underlined in the Bank's *Annual Report* for 1968–69, further success in the growth of exports depended crucially on the maintenance of competitiveness of comparative costs, for any resurgence of inflationary pressures could not but affect adversely the 7 per cent export growth target envisaged in the Fourth Plan.

While some change in attitude towards exports became evident with the Export Policy Resolution of 30 July 1970, which contained measures aimed at identifying thrust areas with long-term export potential and the setting up, soon thereafter, of the Trade Development Authority to build up exports through a package of personalized services in the field of trade, information, research and analyses, import substitution over a wide area continued to remain the basic premise of the development strategy.

At this point, we need to retrace our steps to discuss external monetary developments and the sterling area arrangements. Since India was a member of the sterling area, the bulk of her reserves were held in sterling. In

1966 India was required to devalue for domestic considerations. Till then, the exchange rate was not an issue. Occasionally there was some discussion in the Reserve Bank whether it was worthwhile to remain in the sterling area or to diversify from the sterling into dollar and deutsche mark. But these were modest initiatives and at the beginning of the 1970s, the sterling still represented a sizeable proportion of India's foreign exchange reserves. In the two decades after World War II, being a member of the sterling area meant there was no practical alternative to holding the bulk of external reserves in the traditional form of sterling balances, as an overwhelming proportion of Indian exports were invoiced in sterling. True, the 1966 devaluation of the rupee was guided wholly by domestic considerations but, nonetheless, with an eye on the sterling and closely aligning with whatever moves the UK made in its exchange control system. As the seventies approached and the international monetary system came under growing pressure from 1967 onwards, there were a series of currency crises that culminated in the May 1971 upheaval, in which the par values of the deutsche mark and Dutch guilder were suspended, and those of the Austrian schilling and Swiss franc raised, and Belgium transferred all capital transactions to the free market. Though these changes in the parity of the deutsche mark/ French franc came on top of the 1969 changes in their parities, they were unable to meet the needs of the situation, and the entire Bretton Woods system was thrown into disarray with the suspension of convertibility of the US dollar on 15 August 1971.

Following the 1971 annual IMF-World Bank meeting, an air of uncertainty gripped the global exchange rate scenario. The mild euphoria exhibited earlier evaporated, for it was felt that it was without justification. The battles within the G-10 seemed as insoluble as ever, and moods and attitudes were, if anything, becoming more firmly entrenched. The fact of the matter was, the Americans did not want to be seen retreating and they allowed the situation to run into October and November hoping for an early solution to the whole crisis.

In mid-November, Prasad, the then Executive Director at the IMF, wrote to I.G. Patel and narrated the frank exchange of ideas that the developing country directors had had with the Assistant Secretary of the US Treasury, Volcker. It was apparent to Prasad that Volcker, who always spoke with self-assurance, was doubtful about the ability of the US to push through its own formula at the forthcoming G-10 meeting. Things were certainly not going according to the US book—in fact, answering a question from Prasad whether the European countries, having embraced floating exchange rates, were adopting a leisurely approach to the solution of these problems, Volcker confirmed that he shared Prasad's apprehension; he added that there seemed to be an increasing tendency in Europe of working towards regional monetary integration. With the major European industrial countries having picked up another US$1.2 billion in reserves, Prasad's reading was that it would cut into the US leverage to bargain with the European Economic Community (EEC). As spokesperson for the developing countries, Prasad then queried Volcker on the universal European demand for a gesture on the gold price issue and devaluation of the dollar in terms of gold, and whether the US would concede to the European demand. In categorical terms the US Treasury Secretary thundered: 'No—the US was not willing to make any compromise, no matter what pressures the Europeans may bring and how long it may take to stave off agreements on other issues.' Reacting to Volcker's response and realizing that there was no easy road to salvation, Prasad merely added that the third world countries were not exercised by the 'gold price of the dollar' and were unlikely to pressure the US on this issue. However, he took the opportunity to tell the US authorities to come up with positive suggestions, to either accept a formula of fixing currency values in terms of a 'numeraire' of a selected group of currencies, or quickly work out an agreement to set up the SDR of a stated value as a symbol for the measurement of currency values. While stating that the US had no objection to devaluation, Volcker admitted he had no real suggestion to offer to get round the impasse.

The upshot of the uncertainty about the value of the dollar was that several countries, large and small, were reluctant to put through their transactions with the IMF and were holding back, in the hope that they would get a better package and that the Fund management was undoubtedly concerned about the flagging of its operational status.

SEARCH FOR STABILITY

The year 1971 stands out for special attention in the annals of the history of international finance, for it saw the breakdown of the par value system, so carefully crafted in 1944. The system crumbled because of the unprecedented growth of the global economy in the 1960s, the inadequate supply of gold and massive US current account deficits, indicative of the overvaluation of the US dollar in terms of leading world currencies. Accentuating the weakness of the dollar were massive short-term capital outflows to the rich industrialized nations, which facilitated the build-up of huge dollar holdings outside the USA. The underlying problem was a large and growing external payments deficit by the US, which touched a high of US$30 billion per month in 1971, amidst widespread speculation that a currency realignment was inevitable. The outflow of funds from the US was a response to the widening interest differentials in favour of Europe, following the tight monetary conditions prevalent in Europe. Added to this was the speculative element, as portfolios were adjusted to take advantage of the appreciation of currencies against the US dollar. Borrowers sought to increase their exposure to the US dollar, while holders of assets increased their holdings of instruments denominated in the deutsche mark, Swiss franc and other stronger currencies. Touched off initially by interest rate considerations, the short-term capital movements fed on speculation regarding parity changes. Their volume and frequency were aided by the return to convertibility of major currencies, the emergence of important currencies of equal strength for the first time since 1944, and the existence of the largely restriction-free Euro-dollar market.

By 1970, the view was steadily gaining ground that the international monetary boat had been rocked by massive short-term capital flows that had culminated in a series of costly crises in the international monetary sphere, and that there was need for orienting the par value system in the direction of greater flexibility.

The Indian approach towards the new flexibility was not one of enthusiasm but of open-minded willingness to consider suggestions that might improve the working of the monetary system in the direction of more orderly and effective adjustment without changing the essential features, for too wide a margin in their perception could tantamount to abandonment of the par value.

The flotation of the mark and the Dutch guilder in May 1971, and the readjustment of several European exchange rates offered a brief respite. But the continuing large deterioration in the US payments position undermined fundamentally the viability of the US dollar at the parity established since December 1946, and threatened the Bretton Woods system which the dollar parity and gold convertibility of the US dollar had underpinned. Substantial leads and lags developed in US external transactions despite the strong reflationary stance of the US monetary and fiscal policy, and further eroded the confidence of the US dollar. Speculative pressures on the US dollar were also provided by the continued refusal of Japan to consider revaluation of the yen.

The figure, for the first half of 1971, of US balance of payments deficit on official settlements basis, was US$2 billion; it moved up to US$2.5 billion for July alone, and bounded up to $7 billion for the first fortnight of August—a number that removed the last vestige of confidence in the stability of the US dollar. Although swap credit lines were hurriedly put together, the US was forced to introduce a major economic package on 15 August 1971, which, among other measures, included the slapping of a 10 per cent import surcharge and suspension of convertibility into gold and other reserve assets of dollars held by foreign treasuries and central banks. US President Nixon also called for international consultations to secure a viable realignment of exchange parities of the US dollar in relation to world currencies, and for negotiations by the G-10 industrial nations leading to a reform of the monetary system.

Following the US announcement, the UK declared that the parity of the sterling would remain unchanged at US$2.40 a pound but dealings would not be confined within the existing limits; when the rate tended to rise above US$2.42 to the pound, the US dollar would be allowed to float upwards without a ceiling at $2.40 to $2.42 per pound. The developing countries were not quite in on these decisions. So, when the US decided to suspend the gold convertibility of the US dollar, understandably, the significance of the departure from Bretton Woods was difficult to comprehend. It became apparent that with the breakdown of the Bretton Woods system, an interim floating arrangement had emerged for the major currencies. In view of this, the Finance Ministry, in consultation with the Reserve Bank of India, announced on 22 August 1971 that while there would be no change in the gold parity and consequently the rupee–dollar parity of Rs 7.50 to the dollar, the Reserve Bank would buy and sell pound sterling for ready delivery at rates that would be determined daily, and with regard to the par value of the sterling.[1] In order to take advantage of the depreciating dollar, the rupee peg was shifted from pound sterling to the dollar. A wait and watch approach to the breakdown of the Bretton Woods system, in the circumstances, was perhaps the most pragmatic way of addressing the problem.

Reporting to the weekly Committee of the Central Board of the Reserve Bank on President Nixon's shock measures of 15 August 1971, Executive Director Pendharkar explained that the external aspect of the measures was to reduce speculative pressures against the dollar through the suspension

[1] Between August and December 1971, while the gold parity as well as the US dollar parity of the rupee as fixed in June 1966 remained unchanged, the rupee–sterling rate was allowed to fluctuate with reference to the par value of the rupee in terms of US dollars and the exchange value of pound sterling daily in the London foreign exchange market, where it was allowed to float freely upward against the dollar. The margin retained by the Reserve Bank over the London cross rates for arriving at its rates for buying and selling spot sterling, which was fixed at £0.0175 from 23 August 1971, was reduced to £0.125 with effect from 8 September 1971, on representations that the earlier margin was too steep.

of dollar convertibility into gold and the imposition of an import surcharge. Internally, the measures were intended to lift stagflation in the economy through cuts in government expenditure on foreign aid and a wage price freeze. The Reserve Bank's initial assessment was: if Japan and Germany revalued their currencies by 10 per cent or thereabouts, India's exports to these countries would not be affected as they were not that large, but imports from these countries would become costlier and India's foreign assets, which were in dollars and sterling, would be reduced. However, in the judgement of the Bank, the likelihood of revaluation of the yen and deutsche mark was remote, particularly in the case of the former as Japanese exports to the US were sizeable. On the other hand, the impact of the US measures on Indian exports to the US would be contained in view of Secretary Conally's assurance that the surcharge would not affect developing countries. The proposed measures on foreign aid would impact on the quantum of aid, particularly as the International Development Agency (IDA) replenishment would suffer. The August measures were described by Pendharkar as preparation for a dollar devaluation; if that happened, Indian jute and tea exports would be affected.

Adding to the comments, Governor Jagannathan stated that India had an obvious stake in a healthy US economy which would signify orderly trade and aid prospects. Mafatlal, a member of the Committee, raised the issue of how the Bank would react if both the US dollar and the British pound were devalued. The Governor responded, if that happened, India would have to seriously rethink its position, but added, it would depend on the extent of the devaluation. Mafatlal was also curious to know the implications of pegging the rupee parity to the dollar while allowing the rupee–sterling rate to float, and how the Bank proposed to deal in other currencies such as the mark and the yen. The Governor clarified that India obviously had to peg the rupee to some currency. Having decided that the rupee's parity with gold would not be disturbed, this meant keeping the parity with the dollar unchanged. It could not therefore be construed that if the value of the dollar in relation to gold were changed, it would *ipso facto* follow that the Indian rupee's value to gold would also change. The Governor emphasized that the Indian decision was clear—not to change the par value in terms of gold. In the case of the sterling, he explained that the Reserve Bank was obliged to sell sterling and the rate at which the deals in sterling would be concluded would depend upon the sterling/dollar rate. As for the other currencies, the rate would depend on the float rate.

These events were of momentous significance, for they marked the demise of the fixed exchange rate system established under the Bretton

Woods arrangements. The inflexibility of the gold exchange standard had revealed the difficulty of making appropriate and timely exchange rate adjustments, but, despite that, it had imposed a certain measure of discipline on countries that were members of the system, except for the US. The drawback of the fixed exchange rate system stemmed from the way in which reserves were created, for it relied heavily on the US balance of payments deficits to provide the needed global liquidity. The upshot of this was that the US was the only member to escape discipline, as it was the country issuing the reserve currency; and, as the world economy expanded, demand for international liquidity greatly exceeded the supply of monetary gold and this gap was filled by the issue of central bank liabilities of the reserve currency. This was generally perceived to be unsatisfactory.

In the debates that ensued to rehabilitate the international monetary situation on an enduring basis, the developing countries, initially on the periphery of this debate, strongly opposed the system of floating rates. The Reserve Bank of India's official view, as elaborated by Executive Director Pendharkar in a memorandum to the Central Board, was to develop a neutral reserve asset, which would not be subject, as would any national currency, to the changing fortunes of an individual economy or, as gold was, to the natural and other irrational and unique limitations to its production and use. Such a neutral asset would enable countries to hold their reserves profitably and only by reference to such an asset could international reserves, assistance and obligations be determined, without making the monetary system overly dependent on the predilections or policies of individual reserve currency economies. The move to a high level of flexibility in the exchange system removed most of the discipline and blunted the adjustment process. A widening of the margins, Pendharkar argued, would necessarily require general resort to forward cover in all external payments transactions and the costs of forward cover would rise with the width of the margins within which the currencies were allowed to fluctuate. This would prove a serious handicap for the exports of many developing countries, particularly for their new exports, while their imports would be generally more expensive due to the resultant adverse impact on their terms of trade. All in all, the new arrangement was viewed with considerable suspicion. Economists like Madan, Pendharkar and Bhatt within the RBI maintained that an alternative to devaluing the US dollar would be to retain the dollar price of gold, and to raise the gold value of SDRs and express all currency parities in SDRs. This, in their view, would mark signal progress in gold demonetization and in the development of a neutral reserve standard. However, easing out the dollar and making the SDR the centrepiece of the international monetary system was nowhere on the agenda of the reform exercise.

The foregoing makes it clear that a lasting solution to the problems confronting the international community after the 15 August 1971 package of measures announced by the US, called for a fundamental reform of the monetary system. From the viewpoint of the Reserve Bank, the elements of such a reform were a resolution of issues relating to the choice of a stable and appropriate reserve asset or a mix of assets with a diminishing role for gold and national currencies; provision for adequate addition to liquidity for the orderly growth of trade and economic development; establishment of acceptable criteria for exchange rate adjustment; control of short-term capital flows; and an overhaul of the structure of the IMF to correct the lopsided weight that the rich industrialized countries enjoyed in the decision-making process on the basis of the then existing quotas. It was, however, realized that, with major currencies floating, reform of the monetary system could not be considered till after a realistic realignment of currencies.

After four months of intense negotiations, the Finance Ministers and Central Bank Governors of the Group of Ten (G-10) met in an executive session under the chairmanship of Mr Connally at the Smithsonian Institute in Washington on 18 December 1971, and hammered out an agreement on a new pattern of exchange rates.[2] The crux of the realignment was a proposed devaluation of the US dollar against gold of 7.89 per cent, fixing the new parity at US$38. Simultaneously, the US removed the 10 per cent surcharge imposed earlier. But the suspension of gold convertibility of the dollar was not revoked. It was understood that, pending legislative approval of the 7.89 per cent devaluation of the dollar against gold, formal action establishing a new par value of the US dollar would take some time.

Meanwhile, the agreed changes in the exchange rates of other currencies were given effect to by the adoption of appropriate central rates. The adoption of central rates with wider median entailed a medium appreciation of major currencies against the US dollar of about 11 per cent. The Canadian dollar continued to float. While adopting the central rates, most countries indicated that they would avail the margin of 2.25 per cent permitted by the IMF. The significance of the Smithsonian agreement was that, after months of disagreement, there was agreement on a realignment of major currencies, the first such multilateral determination of exchange rates in history.[3]

[2] Schweitzer, Managing Director of the IMF, took part in the meeting and reported on the views of the Executive Directors of non-G-10 developing countries.

[3] *IMF History: 1972–78*, Vol. I, p. 263.

The Smithsonian agreement partially shored up the par value system but failed to provide a lasting solution. It called for some major decisions by India. Averse to floating the rupee and wedded to the fixed exchange rate system, India was required to decide on the choice of the reserve currency on which it would peg the rupee and on the exchange rate for the Indian rupee. The devaluation of the dollar by 7.9 per cent had changed the dollar–sterling parity from \$2.40 to \$2.60. The choice of reserve currency was not all that difficult as the pound sterling continued to have its adherents within the Reserve Bank who held the view of steady depreciation of the rupee. There was every indication that the centre of financial gravity had moved towards the dollar and a substantial part of the speculative funds that had resulted in massive outflows prior to the realignment were expected to return across the Atlantic, firming the US dollar on the exchanges. In this situation, the desirability of discontinuing with the dollar peg became evident; so, the Indian government decided to delink from the dollar and establish a central rate in terms of sterling, equivalent to the average of the buying and selling rate of sterling, based on the London quotations for dollars on 17 December 1971, before the realignment. Recognizing that establishing an appropriate exchange rate was a vexatious issue, highly sensitive politically, Government of India decided to keep unchanged the rupee–sterling rate prevailing at the end of the preceding week and resumed forward purchases of sterling which had been temporarily suspended. The new rupee–sterling rate was fixed at Rs 18.9677 as against the old rate of Rs 18, entailing a devaluation of the rupee against pound sterling by 5.38 per cent. Further, the rupee–dollar rate was also altered from Rs 7.50 to the dollar to Rs 7.27—a modest revaluation of the rupee of 2.95 per cent against the dollar. Through Prasad, the Indian Executive Director, the IMF was accordingly informed of the change and the Fund took note of the Indian proposal without expressing any difficulty.

Like many other countries, India also took advantage of the wider band of 2.25 per cent on either side of the central rate. The main consideration influencing the Indian decision appears to have been the anxiety of not wanting to hurt exports and invisible earnings. Overall, it was a modest adjustment; the weighted depreciation of the rupee vis-à-vis the new rouble parities and agreed central rates, according to the Reserve Bank's calculations, was around 4.5 per cent against the major currencies in relation to the April 1971 parities.

As part of the Smithsonian accord, it was agreed that negotiations would be promptly undertaken for a fundamental reform of the international monetary system. Not to be left out of the discussions and following the mandate given by the Group of 77 at Lima on 7 November 1971, a twenty-four-member Inter-Governmental Group on International Monetary Reform (G-24) was set up to ensure full participation of the developing countries in the reform exercise and to safeguard their interests. At its inaugural Ministerial Meeting in Caracas on 6–7 April 1972, G-24 decided to support the creation of a Committee of the Board of Governors of the IMF (C-20) on issues related to the reform. The United Nations Conference on Trade and Development (UNCTAD), at its third Santiago session in April 1972, supported the effective participation of developing countries in the decision-making process, and endorsed the view that the nine developing countries should be represented on the Board of Governors Committee.

In the months that followed world exchange markets were relatively calm, but, in the third week of June, a sudden burst of speculation against the pound sterling disturbed the calm. In the preceding two months there had been growing uneasiness about the prospects of the UK balance of payments in the context of industrial unrest, and continuing inflation set off rumours of a possible devaluation of the sterling. This triggered concerted intervention by the Bank of England and the Central Banks of European countries in the exchange markets in London. Despite the efforts to save the sterling, 22 June witnessed the biggest outflow of short-term capital in a single day, forcing the UK authorities to take an expeditious unilateral decision to let the pound sterling float and impose exchange control measures as a precaution against speculative outflow through sterling area currencies. These measures effectively circumscribed the sterling area to the UK, Ireland and Gibraltar. India was also subject to controls but nevertheless it allowed the rupee to float with the sterling.

The pound sterling slumped from the Smithsonian rate of $2.6057 to $2.4430. With considerable uncertainty prevailing in the market and difficulties in predetermining the 'correct rate', Indian authorities decided to make no change in the exchange rate system, except for a small upward adjustment in the Reserve Bank's rates for spot purchases and sales of sterling from authorized dealers. The adjustment was effected in two stages—a minor one on 26 June, followed by a slightly larger one on 4 July, involving an appreciation of 0.87 per cent in the sterling value of the rupee over the position obtaining before the sterling float. This was all done in the hope and expectation that the float would be temporary. Although a number of countries, including Pakistan, had chosen the US dollar, Reserve Bank officials debated the policy alternatives and decided against establishing a formal link with the dollar; they concluded that in the long run a hard currency would not be suitable from the Indian standpoint.

The difficulties of the sterling could not but cast a shadow on the viability of the Smithsonian realignment. Following the sterling float, speculative attention turned to the US dollar and massive intervention by European Central Banks was required to hold up the dollar to its support point. It was only after the US intervened and displayed its readiness to do so, that the suspended swap network was restored and the US dollar strengthened above its support point.

These developments provoked the IMF's Board to study the UK experience and see what lessons could be drawn from it for a reformed monetary system. It was evident that a reformed system should be able to reduce the disturbing effects on exchange rates of short-term capital flows. Another lesson, to which Prasad, a former Economic Adviser of the Reserve Bank and a second-time nominee of Government of India on the Executive Board of the IMF, drew attention, was the disadvantages for the developing countries of a monetary system that relied primarily on national currencies for reserves. He graphically pointed out that on twelve of the fourteen occasions on which India had changed its exchange rate since 1918, India, as a member of the sterling area, had responded to changes in the rate for the pound sterling, rather than to its own needs and requirements. This, he said, pointed to the limitations of a monetary system based on reserve currencies; no matter how small the change, it introduced complicating factors in the trade and payments arrangements of these countries. Prasad advocated the need for a uniform international standard, like the SDR, to which world currencies could be linked to obviate the problem.

Reporting the debate in the IMF, Prasad, in a secret letter to I.G. Patel, hinted at the possibility of avoiding disturbance of the rupee by continuing to maintain quotations for the rupee in terms of all currencies other than the pound sterling within the 2.25 per cent margins, but allowing the sterling rate to go past 2.25 per cent. This would tantamount to transgression of the wider margin decision but it could be defended on the ground that it helped reduce disturbance to trade and payments. But the Reserve Bank would need to examine if, in practice, there would be operational problems.

These developments on the international monetary front had led to the setting up of the Committee of the Board of Governors on 'Reform of the International Monetary System'—the C-20. Unrest and upheavals in the foreign exchange markets, punctuated by closures, had highlighted the urgency for restructuring the framework of international monetary arrangements. And this was of particular importance to the less developed countries because the environment of greater exchange rate flexibility that had emerged from recurring currency crises posed for them the problem of greater uncertainties to cope with, for which they had no institutional arrangements. At the C-20 deliberations, the Indian delegate advocated adoption of a more efficient and equitable adjustment mechanism with stability of exchange rates, international creation of and control over liquidity with the SDR as the principal reserve asset, and establishment of a link between international creation of liquidity and development finance as an instrument for the transfer of real resources.

While the deliberations on the Reform of the Monetary System were underway, the position regarding the dollar turned adverse, so much so that it was worse than that of the pound sterling. The weakness of the dollar stemmed from the continued growth in the US trade deficit and misgivings about the US administration's ability to deal with the situation; this forced the dollar to devalue despite the massive support to it by the major Central Banks. Against this background, Volcker, the US Treasury Secretary, rushed to meet the financial heads of Europe; these consultations paved the way for further devaluation of the dollar. On 13 February 1973, the US administration proposed to the Congress a reduction in the par value of the dollar of 10 per cent in terms of the SDR, setting the new rate at SDR 0.828948 = $1. With the currencies of six countries—Germany, France, Denmark, Belgium, Luxembourg and the Netherlands—agreeing, on 12 March, to make no change and to float jointly, and the rest of the currencies including the yen floating independently, a new structure of exchange rates came into being: the invincible dollar was devalued for a second time in fourteen months. The new realignment of currencies was seen as a 'solution' that had been reached with remarkable speed. The Governor of the Bank of England, in a message to RBI Governor Jagannathan, described the move as 'bold and constructive'; he reassured him that the sterling agreements would remain in force and that consultations about the implementation of the guarantee would continue in the period in which sterling continued to float. But the new floating arrangements had unhinged the par value system and, despite the efforts of the IMF and the developing countries to prevent it, a new era of widespread floating had dawned.

In view of the uncertain conditions prevailing in the international foreign exchange markets, on the advice of the Reserve Bank, no change was made in the existing parity of the rupee, which was maintained at Rs 18.9677 per pound sterling, and foreign balances continued to be held at the existing central rates. As a precautionary measure, the Bank thought it fit to stop purchases of both spot and forward dollars as also purchases of forward sterling, while continuing to abide by the statutory obligation under the Reserve Bank of India Act of purchase and sale of spot sterling. The press and some political critics, racked by doubts, purported that the authorities were unaware and caught by surprise. Justifying the Bank's stand, Governor Jagannathan explained to representatives of the press that the sterling had not been officially devalued and that sterling had not depreciated either in terms of the dollar or in terms of the rupee; but, because of its float, it had depreciated vis-à-vis strong currencies like the yen and western European currencies. India, like many others, was not master of the situation; in fact, no country was. The Reserve Bank had rearranged its dollar portfolio by reducing the holdings of dollars to a comparatively small amount, but the high degree of loyalty to the sterling because of the sterling area arrangements, coupled with the high rate of interest earned on sterling holdings (around 9 per cent, as against barely half that amount on the deutsche mark and yen), had prevented diversification out of sterling. Hence the Bank's preference for holding money in sterling in the UK.

Floating rates, however, failed to dampen speculative flows of funds from one currency to another, and the exchanges lacked an undertone of stability. It is pertinent to note that the Federal Reserve Bank of New York, in September 1973, expressed strong reservations about 'an international monetary system based on freely floating exchange rates … as having failed to meet its real life test'. Even after the June 1973 revaluation, the currencies of the EEC joint float appreciated noticeably against the US dollar. With the deteriorating trade position of the UK, pound sterling continued its downward float despite the raising of the minimum lending rate, necessitating reactivation of the swap arrangements. The approach of the expiry date of 24 September 1973, of the UK Sterling Guarantee Agreements, was an additional factor undermining the sterling on the exchanges. Not to worsen an already volatile situation, the UK government unilaterally extended the guarantee arrangements by a further period of six months and offered to protect the value of sterling reserves in terms of the US dollar at a guarantee point of $2.4213, provided the holders maintained the stipulated minimum proportion throughout the six-month period. For India this was 11 per cent of the total reserves including gold. This decision, along with the Bank of England's intervention in the exchange markets, eased the pressure on the sterling but put exactly the opposite type of pressure on currencies like the Australian dollar, the New Zealand dollar and the Netherlands guilder, threatening the joint float arrangement, which moved to the top of the snake by mid-August and pierced the ceiling by the middle of September.

Meanwhile, the Committee on the Reform of the International Monetary System and Related Issues (C-20) was vigorously debating the central issues of adjustment and convertibility but conflicting views strongly held by the major countries posed great difficulty in arriving at a common position. Nor were the issues relating to gold or the valuation of SDR anywhere near resolution. As for the link between SDR creation and development finance, its consideration was seen to be receding. Lack of political will in the exercise of reform of the monetary system was seen by the developing countries as an effort on the part of the developed countries to drag on the current floating arrangement, in the hope that it would stabilize and weaken support for a return to a fixed exchange rate regime. The developing countries feared the emergence of a polycentric world monetary system and creation of ad hoc currency areas in which the IMF would play the more distant role of arbitrator between them. Restating the views India held on basic aspects of the reform, at the annual meeting in Nairobi, the Finance Minister expressed India's dismay at the tardy progress, and the absence of political will and vision it implied, emphasized the lack of attention being paid to provide a link between international creation of liquidity and development finance, and warned the international community that any agenda that failed to transfer real resources to the less developed countries would not be acceptable to them.

INDIAN RESPONSE TO WIDESPREAD FLOATING

Reverting to the Indian scene, the parity of the Indian rupee was taken up at the Cabinet level. In preparation for a full-scale discussion in the Cabinet, Governor Jagannathan wrote a lengthy letter to P.N. Dhar that provided cogent answers to aspects of the Reserve Bank's policy that were a cause of concern to the government—viz. the disposition of India's monetary reserves, why the Indian rupee had to be linked to the sterling and not the US dollar, and were the authorities caught by surprise. On diversification, it explained that the Reserve Bank had pursued a policy of a blend of tradition and a cautious stance towards diversification. It had reduced to the lowest its official holdings of dollars (4.8 per cent) and acquired German and Japanese currencies at the cost of depleting sterling and dollar holdings. This was no accident. Sensing revaluation of the yen and the deutsche mark, a conscious decision was made to acquire these currencies, but there was no escape from holding dollars and sterling as these were reserve currencies used as intervention currencies even by powerful and rich nations like Germany and Japan. This, then, was the constricting factor in the diversification of the currency portfolio. The interest factor too had played a role in the Reserve Bank's decision to acquire hard currency; it meant lower earnings on the investment in these currencies for it entailed complex guesswork to know how far appreciation would compensate for the loss of interest. Despite this, the RBI had taken the risk and had profited. The Governor wrote:

> The rupee was not linked to sterling, in the sense that we were not bound to move the same way as sterling. We had the freedom to choose, but for good reason we had chosen sterling as it was the intervention currency and designated our central rate in terms of sterling.

Refuting that the Bank was caught unawares, the Governor asserted that in a complex situation India had not taken longer time than reasonable nor longer than other countries similarly affected.

Based on the material provided by the Reserve Bank, the Finance Minister, in a statement in the Rajya Sabha, defended the government stand. He stated that the course of action taken was the best in the interest of the country. Maintaining continuity with the past and without a detrimental effect on trade, the rupee–sterling rate remained unchanged; the extent of the fluctuation in the exchange value of the rupee vis-à-vis other currencies was not large and the effects on exports, imports, budgetary receipts and service payments were likely to be of a marginal nature. The Finance Minister assured the House that in the ongoing discussions on international monetary reform, every endeavour would be made to secure arrangements that reflected the needs of the developing countries for adequate liquidity, and stability of trade and exchange rates.

In the aftermath of the dollar devaluation, the Exchange Control Department was flooded with queries from the East European countries on the official parity of the rupee. The Reserve Bank confirmed that the gold clause was still applicable to the agreements as there was no change in the gold parity of the Indian rupee.

Volatility in foreign exchange markets also posed accounting issues, which were examined by the Chief Accountant's office. Based on the guidelines suggested by the Department, Executive Director Seshadri ruled that so long as the sterling and other currencies floated, revaluation of holdings should be carried out each calendar quarter with reference to market rates and not to central rates, as was earlier the case, and revaluation gains transferred to the Exchange Fluctuation Account. But, on reconsidering the issue, Governor Jagannathan felt that revaluation gains may best be booked as unrealized appreciation in the Issue Department for the time being, in effect treating the gain as a sort of secret reserve. The Governor's preference to understate the rupee value of the reserves was to avoid creating a perception that reserves had increased, which could lead to increase in demand by spending ministries for larger allocations of foreign exchange. But, unclear about the advantages of revaluation gains being treated as hidden reserves, the Finance Ministry pointed to the discrepancies such a procedure would give rise to, between the published reserves and the reserve figures as reflected in the Bank's balance sheet. The Reserve Bank, realizing the practical limitations of indefinitely deferring the gains by transferring them to a secret reserve, later rescinded the instructions and ruled that the entire revaluation gain of Rs 26.4 crore should be transferred to the Exchange Fluctuation Reserves, which would be included in the published figures of other liabilities, while, on the asset side, the value of the assets would be written up. The Central Board of the Bank was informally apprised of the change.[4]

Meanwhile, anticipating a steady rise in the deutsche mark in terms of sterling and a further weakening of the dollar accompanied by a sympathetic weakening of the sterling, the Reserve Bank, for the first time, moved to acquire deutsche mark and French franc deposits with the BIS and diverted their holdings away from investment with central banks. Adopting a policy of turning over, at short intervals, deposits with leading commercial banks in Europe and with the BIS to gain the benefit of rising interest was seen as a remunerative strategy for diversifying the disposition of the country's reserves. For the first time, the RBI's foreign exchange reserves outside sterling and dollars were in excess of its reserves in sterling and dollars. Having made an appreciation of Rs 43.4 crore, the Bank realized the limits of any further diversification and adopted a cautious stance as it realized that there was no lender of last resort in the Euro-currency market. The first foray into the Euro-market was successful; however, a judicious management policy of reserves demanded slow travel on this route.

The government was appreciative of the manner in which the Reserve Bank had managed its foreign exchange portfolio. However, in view of the very large liabilities in US dollars, the Economic Secretary, M.G. Kaul, advised the RBI Governor not to diversify out of dollars—a suggestion that was not well received by the Governor who remained of the view that switching from other currencies to the US dollar would have to be done cautiously. It must be conceded that, despite the limitations of the difficulty in

[4] Minutes of the meeting of 7 July 1973.

anticipating exactly the prevailing trend and when it was likely to be reversed, operating from Bombay with no direct or intimate links with the leading global foreign exchange markets, and having no advance information about the operations of multinationals and interventions by central banks, the Reserve Bank management, maximized the income on the country's foreign exchange assets. The switches it had made were at fairly good rates and had yielded overall profits.

Between June and September 1973, despite the clarifications provided by the Bank's representatives to the Joint Select Committee on the Foreign Exchange Regulation Bill, a tirade of criticism was levelled against the Bank by Jyotirmoy Bosu, that the RBI and the government had devalued the rupee thrice without saying so. The Bank management reiterated that technically there had been no change in the par value of the rupee in terms of gold, and that operationally too, the central rate of the rupee had continued to be £1=Rs 18.7677 since end-1971. The Bank had, within the permissible margin of 2.25 per cent of this rate, varied its spot buying and selling rates for the sterling. This, in effect, meant that the rupee's cross rates had varied in accordance with the market value of the sterling for all those currencies that were not specifically linked to the pound sterling.

The complexity of policy-making was highlighted by the perverse movement of exchange rates in a period of major currency readjustments. Following the dollar devaluation of February 1973, the dollar remained generally weak; between April and July, it fell, in part because of the Watergate scandal. But after November 1973 there was a distinct hardening of the dollar. Linkage of the rupee to the sterling had resulted in the appreciation of the rupee to Rs 8.20 to the dollar, while the sterling had dipped below $2.29—an all-time low, and a development whose ramifications Economic Secretary M.G. Kaul urged the Reserve Bank to consider, in view of its low holdings of dollars. The Bank forthwith made a detailed currency-wise presentation in which, while accepting that the dollar had hardened and all other currencies were much weaker, it attributed the hardening to the oil crisis. But it sought to correct New Delhi's perception that the Bank's holdings were abnormally low and needed replenishment: in the latter half of 1973, as the dollar strengthened, the process of converting sterling into dollars had been resumed and to avoid losses resulting from adverse rates for conversions, dollar purchases had been made directly from the market.

TOWARDS AN OUTLINE OF REFORM

Following the quadrupling of oil prices in January 1974 and the submission by the Committee of the Board of Governors (C-20) of the outline of Monetary Reform, discussions were stepped up in the Interim Committee—successor to the C-20. Substantial agreement emerged regarding improvements in the characteristics of the SDR and amendments of the Articles of Agreement of the IMF, but differing views continued to be held on vital issues regarding gold and exchange rates. There was general agreement on abolishing the official price of gold between member countries and the IMF. In principle, support was also forthcoming for the use of profits from the sale of part of the Fund's gold holdings for the benefit of the developing countries, although agreement on specific arrangements remained to be evolved. Some headway was discernible on the arrangements between Central Banks on the use of gold reserves but uncertainty continued to dog the gold market. The emerging strength of the US dollar and the Rambouillet agreement between the French and the US Presidents to allow Central Banks and the monetary authorities to revalue their gold holdings at market-related prices, coupled with South Africa's decision not to sell on the market its entire gold output, prevented gold prices from escalating further. No consensus, however, could be reached on exchange rate arrangements or their stabilization.

India's reaction to these developments was one of great disappointment, for the continued floating of major currencies with exchange rates moving both ways by fairly large margins, left the developing countries open to the vagaries of the key currencies. Clearly, the size of the reserves of developing countries was inadequate to bear this type of buffeting. Although the majority of the Fund's membership had favoured a return to a system of par values with provisions for the establishment of central rates, this remained a distant pipe-dream. The pound sterling remained the weakest of the major currencies and, by July 1974, the trade-weighted depreciation of the pound sterling amounted to 17 per cent from its Smithsonian parity. In anticipation of possible further weakness of the sterling, the Reserve Bank of India set about examining the various options and implications of the steady depreciation of the pound and the rupee along with it, but came up with no conclusive solution. Hopeful of a return, sooner rather than later, of the par value system, its early judgement was that India might be worse off experimenting with a new exchange rate than under the existing sterling exchange system.

A major breakthrough came at the Kingston Jamaica meeting on 6 January 1976, when the Interim Committee settled arrangements relating to gold and exchange rates by endorsing the Sixth Quota increase by 32.5 per cent to SDR 39 billion—allowing a doubling of the present share of the oil-exporting developing countries as a group without a change in the collective share of the other developing countries—and adopted the amendments to the Fund's Articles. Legalizing floating exchange rates, whether they floated independently or collectively, the Jamaica agreement conferred the seal of approval by the international community on a system of floating rates, putting to rest the hybrid system in existence since the breakdown of the Bretton Woods par value system. Introduction of stable but adjustable par values was contemplated, but at a future date, when underlying stability of the world economy was in evidence. The Jamaica accord reiterated the right of members to have exchange arrangements of their choice but emphasized collaboration with the Fund to ensure orderly exchange arrangements for fostering growth with stability, and avoiding manipulation of exchange rates and the international monetary system to gain unfair competitive advantage. To assist the balance of payments adjustment process, the Fund's armoury for providing assistance for balance of payments deficits and covering members' reserve needs was enhanced through an increase in quotas; each drawing tranche was temporarily increased from between 25 per cent to 36.25 per cent of the existing quotas. Disposal of 50 million of the gold held by the Fund—25 million ounces by restitution and 25 million by sale at market-related prices—constituted another element of the Jamaica package to help tide over the adverse impact of the oil price increase on the adjustment process. Profits from the gold sale were earmarked for the creation of the Trust Fund for extending concessionary assistance to low per capita income countries. The Jamaica agreement thus brought down the curtain on the reform exercise that was embarked upon after the breakdown of the Bretton Woods system.

The Reserve Bank's evaluation of the Jamaica agreement was negative. Its principal objections, as stated in a Board memorandum of 2 February 1976, were the abandonment of stable but adjustable par values and the enshrining of the right of members to have exchange rate arrangements of their own choice. In the view of the Bank, by legitimizing floating, the system had been made flexible but unpredictable. A disappointing feature of the new arrangement was that it had enhanced the reserve role of key currencies, detracting from the international control of liquidity through SDR creation. Arrangements in regard to gold were seen as seriously undermining the monetary role of gold; in fact, the clock had been set back for an SDR-controlled system. The decisions pertaining to gold would help mobilize the immobilized official gold, resulting in uneven additions to international liquidity and postponement of possible SDR allocations. The objective of promoting a real transfer of resources to developing countries through a link between the creation of SDR and development finance had received scant attention—in fact, the link debate was shoved on to the back-burner of the reform agenda. In short, all that the Jamaica agreement had achieved was to make the international monetary system more US dollar-centred than the gold-based Bretton Woods system.

THE BANK'S EXAMINATION OF THE RUPEE–STERLING LINK

Although the Reserve Bank provided the argumentation for discussions on the international monetary reform debate to the government and the Indian Executive Director at the IMF, it was not involved in the various rounds of the discussions. However in 1975, the Bank's Executive Director, Seshadri, along with Janakiraman, in light of the international developments, assumed greater responsibility for examining the implications of the steady depreciation of the pound sterling and, along with it, that of the rupee.

Among the major European currencies, the pound sterling remained the weakest. With the UK economy slipping into severe recession, OPEC investment tapering off, and the rate of inflation and current account balance of payments deficits assuming unmanageable proportions, the pound sterling faced its most strenuous period through the greater part of 1975 and the first half of 1976. The market remained bearish, notwithstanding the government's anti-inflationary programme and the hike in the interest rate structure. By end-December, the sterling's trade-weighted depreciation from its Smithsonian parity widened to about 30 per cent. The turbulence in the European exchanges in early 1976, following the selling run on the lira and strong pressure on the French franc, depressed the sterling further. Despite massive intervention by the Bank of England, foreign exchange reserves declined by nearly $3 billion in March and April of 1976, and the trade-weighted depreciation remained at a high of 38.8 per cent at end-June 1976.

Against the backdrop of these developments, Seshadri, in a note, examined the pros and cons of the Indian rupee's link with the sterling. He showed that a conjuncture of powerful forces had dramatically altered the official financial environment between 1968 and 1976. The end of the Bretton Woods system of stable but adjustable par values and the decline in the status of the sterling as a reserve currency had resulted, over the nine-year period since 1966, in a substantial and cumulative depreciation of the rupee. The note seriously questioned the view that the sterling link had been convenient and beneficial to India's exports, in light of the developments in the exchange markets in the early and mid-seventies. It argued that continuance of the link was justified so long as the sterling was relatively stable, but the rate of inflation in the UK, the liquidity crises, the secondary banking crisis and the diversification out of sterling by oil-producing countries precluded even official intervention to support the sterling. The oil shock of 1973–74 had greatly amplified these trends. To avoid a vicarious and unintended depreciation of the rupee, in the future, Seshadri made a strong plea for fixing the value of the rupee independently. 'The logic for severing the ties with sterling', he said, 'was compelling.' First, there was a decline in the status of the sterling as a reserve currency. Second, the proportion of trade invoiced in sterling had declined considerably. Third, a number of sterling area countries had switched to the US dollar or other currencies or adopted a currency basket, and only six countries, besides India, were floating with the sterling. On the other hand, exporters' rupee export earnings were protected through a massive forward exchange cover, the implications of which for the government's budget and for the Indian importer and industry could not be overlooked. In short, importing British inflation via the link with the sterling was no longer justified.

Seshadri's note sparked off further examination by the Reserve Bank, of the mechanics for determining the value of the rupee. It had been urged by some quarters that the Indian rupee should be allowed to float independently. The Bank categorically advised against floating, stating that Indian conditions ruled out this option. First, the inter-bank market was not broadbased, and the Reserve Bank was statutorily required to buy and sell foreign exchange within limits specified by the central government. Second, the value of the rupee was not market-determined, and tight exchange controls and the inability of commercial banks to keep open positions in foreign currencies militated against the creation of a broadbased inter-bank market in India. Although a number of countries, including Pakistan, had chosen to follow the dollar, a formal link with the dollar from the Indian viewpoint was considered unsuitable. Bank officials eagerly looked at other options and studied the experience of other countries, in order to introduce a measure of relative stability into the Indian exchange rate regime. Ruling out independent floating, currency cocktails and trade-weighted index, the Bank suggested linking the rupee to the SDR as the most advantageous and operationally least difficult option. Operationally, it would mean declaring a base rate for the rupee, in terms of the SDR determined via sterling, at the notional rupee–sterling parity of Rs 18.80 to the £, with the policy objective of ensuring that the actual rate for the rupee in terms of the SDR did not deviate beyond 2.25 per cent of the base on either side. If a variation of more than 2.25 per cent continued beyond five working days, a correction would be made for the rupee prospectively. However, as a ground rule, whenever a rate adjustment went beyond 2.25 per cent, every effort would be made to bring the rate back to the base rate to ensure stability in the value of the rupee. The Bank sought authority from the government to determine the exchange rate on the basis of this formula without any interference or prior consultation with the government, but this was not conceded.

While the Finance Ministry mulled over the policy alternatives and the mechanics of the change, the pound sterling steadily lost ground on the exchange markets. The US dollar/pound sterling declined from $2.4430 in June 1972 to around $2.20 in September 1975. Consequently, the rupee depreciated vis-à-vis the US dollar to the same extent. From June 1971 through June 1975, the rupee depreciated against the French franc by 53 per cent and against the Japanese yen by 35 per cent. The effective depreciation of the Indian rupee during this period amounted to 23 per cent. The vulnerable international exchange rate scenario ultimately forced the Finance Ministry to take a historic decision on 24 September 1975. The rupee's peg to the pound sterling since 1931, except for a brief interlude of three months in September 1971, was abandoned, and the rupee was pegged to a basket of currencies. The rupee was delinked from the sterling and a new arrangement was adopted under which the exchange value of the rupee was determined with reference to the daily movements of a selected number of currencies of countries which were major trading partners. Initially, it was a five-currency basket, of which one currency was variable and that depended on the pattern of payments falling due. In designing the basket and working out the modalities for its operation, Oxford-returned Dr Vijay Joshi, who was appointed special adviser in the Ministry of Finance, assisted the government. Taking a leaf out of the Australian experience, the currencies included in the basket and the weights assigned to them were not disclosed but left to the discretion of the authorities operating the basket. It was a tightly guarded secret. The available Bank records throw no light on how the multi-currency basket adopted for determining the value of the rupee was settled, nor are there any records or documents that reveal the composition of the basket. Presumably, the basket included the US dollar, the pound sterling, the deutsche mark, the French franc and the Japanese yen, and the weights assigned to these were on the basis of these countries' shares in India's trade. Although the peg was shifted to a secret multi-currency basket, the pound sterling continued to remain as the intervention currency, which meant that the Bank was required to buy and sell spot sterling in order to keep the exchange rate vis-à-vis that currency stable. The RBI's rates for spot sterling were revised so as to yield a middle rate of Rs 18.3084 per pound. Thus the central rate of Rs 100 = £5.2721 was no longer valid.

The government issued a press release to describe the contours of the multi-currency peg and the delinking from the sterling. It emphasized that the new arrangement was designed to meet a transitional situation, and that the IMF was engaged in devising a durable system of exchange rate relations. Defending the government's move before the Consultative Committee of Parliament, C. Subramaniam, Finance Minister, said 'the new link to a basket of currencies should provide greater stability and less uncertainty in the minds of businessmen'. He went on to note that the decision to switch to the new arrangement was prompted by the need to insulate the imports of food and oil, which were becoming expensive in the face of the decline of the sterling. With political support coming from members of all the leading political parties, the Finance Minister assured that the government would remain 'wide awake' to safeguard the country's interests in the matter of the rupee's exchange rate, while hinting that the rupee must become stronger at home to be strong abroad.

The secrecy surrounding the decision was patently clear. Using the sterling as the intervention currency would have presented no problem had the pound been steady in international markets. That not being so, moving to a basket system of valuation on grounds of stability, between June 1975 and June 1976, resulted in the Bank being required to revalue the rupee with reference to the pound six times, to the extent of 12.6 per cent in the aggregate. These revaluations were carried out to keep the value of the rupee stable vis-à-vis other currencies. The dollar rate throughout was kept more or less stable at Rs 9. Although the official announcement was that the rupee was linked to a currency basket, the IMF, in its classification of exchange rate arrangements of member countries, categorized the Indian exchange rate arrangement as under 'managed float'. This meant, in practice, that the authorities had the flexibility to operate a multi-currency peg in a discretionary manner and not be guided or driven by mechanical parity adjustments of the rate for the rupee against its intervention currency, viz. the pound sterling.

In operating the basket, the Reserve Bank was initially faced with the problem of announcing the rates on time. The perception of the government was that the Bank would not be in a position to manage and operate the mechanism without technical expertise. The government was therefore reluctant to give unrestricted freedom to the Bank to set the daily rupee rate without prior clearance from it, even when the change in the rate was within the band of 2.25 per cent. Logistically, such consultations entailed delays, sometimes of a couple of days, by which time events had overtaken the new rate. On one occasion (some months after the introduction of the basket), in view of the urgency involved, Janakiraman, a senior Bank official in charge of DEIO, was forced to take a late-night flight to Delhi to meet the economic adviser, Manmohan Singh, to obtain the Finance Ministry's clearance. To expedite matters, both of them then rushed to the Finance Minister, H.M. Patel. On learning that the existing procedure of seeking prior clearance from the Finance Minister before announcing the exchange rate change precluded the Reserve Bank from making timely adjustments in the rate, Patel ruled that the Bank be authorized to effect the change provided the adjustment was within the permitted band, and to notify the government daily regarding the change. This decision provided the needed flexibility to the Bank to operate the new exchange rate mechanism more effectively.

As mentioned, the sterling continued to remain the intervention currency but its continuous weakening between September 1975 and July 1976 compelled the Reserve Bank to revalue the rupee six times, to the extent of 12.6 per cent, in a brief span of nine months. This made the Bank re-examine the justification for continuing with the pound as the intervention currency, and whether to change over to the use of the dollar. Two officials, Janakiraman and Seshadri, who shared similar approaches and worked well together, examined the issue. In a cogent, well-argued note, later forwarded to the government, the Bank reasoned that it would not be advantageous to change over to the use of the dollar as the intervention unit. After all, purchases of both the sterling and the US dollar by the Bank had to continue and only one of the rates could be kept constant, and it was not material which of the two was chosen to be kept constant. The Bank's preference clearly was for the sterling, mainly on the ground that the London and European markets were broadbased, and offered finer rates and better facilities for trading and investment. Similar facilities could not be accessed from the New York market.

There were other constraints, too, in using dollar as the intervention currency. The Reserve Bank bought forward currencies through six of its offices, whereas the Federal Reserve Bank of New York insisted that it would act only on instructions from the Central Office. The matter was discussed at great length and after the visit of Paul Volcker, the Fed agreed to deal with branches of the RBI as well. The Bank started buying dollars directly from authorized dealers from October 1972. Purchases of deutsche marks and Japanese yen were started from May 1974. However, the Bank sold only pound sterling. The Bank of England offered facilities for investment of surplus funds, and the costs of conversion from sterling into dollars was negligible. At that point in time, therefore, the Bank saw no particular financial advantage in changing over to the US dollar as the intervention currency, but hedged its conclusion with a caveat that should the pound's international value turn erratic, necessitating frequent alterations in the rupee–sterling rate, use of dollar could then be considered.

As it turned out, continuous fluctuations in the exchange rates of the currencies called for several revisions in the pound–rupee rate. It was found difficult to maintain the rupee value of the basket of currencies within a band of 2.25 per cent on either side of the base value of Rs 18.3084 that was adopted when the basket was introduced. So, effective 30 January 1979, it was decided that the exchange rate would be maintained within a wider band of 5 per cent on either side, providing the authorities manoeuverability to fix a more appropriate rate for the rupee.

At this point, a word about the behaviour of the inter-bank market might be in order. The Reserve Bank had laid down the maximum margin that commercial banks could load on their spot and forward buying rates and spot selling rate for currencies while quoting rates to their customers. Since the Bank did not sell these currencies for forward deliveries, the authorized dealers (ADs) were free to quote forward selling rates for them. With a strengthening of the sterling against the US dollar in the third week of July 1979 in London, the inter-bank exchange market in India suddenly became disorderly. The Bank's senior management in charge of foreign exchange management responded with alacrity. They examined the circumstances in which this had happened, the need for avoiding a recurrence and the remedial steps that could be taken. The Bank attributed the inter-bank market turning erratic to the sudden absence of confidence in the US dollar rate against the sterling in London, as a consequence of which there was widespread expectation that the rupee would be devalued against the sterling. Exporters decided to keep off the market whereas importers scrambled to cover their foreign exchange requirements, giving rise to a lead and lag phenomenon, and banks falling short of foreign exchange. To add to the shortage of availability of funds, overseas banks were seen to be withholding funding remittances to India and maintaining minimum balances to meet immediate needs. The drying up of this source of liquidity resulted in the sterling rate touching rock-bottom level (400 points below the floor). Interestingly, a number of banks made enquiries whether the Reserve Bank would allow 'ready' against 'spot' swaps with overseas banks against the rupee. The Bank firmly replied in the negative, as it saw that the intention of the banks was to postpone funding remittances to India in the hope of securing a better rate later.

The sudden and abrupt drop in the rate below the RBI floor destabilized the market and created a deep depreciation psychosis. In fixing the two upper and lower limits, the Bank's intention was to ensure that the rupee, internally as well as externally, did not move beyond these limits. Clearly, the situation warranted swift action on the part of the Bank to arrest the unhealthy competition in foreign currencies that had developed, whereby the inter-bank market had turned lopsided with demand exceeding supply, driving down the rate for the Indian rupee to levels unwarranted by its external value. Moreover, the offer of the banks to sell rupees against foreign currencies had resulted in depreciating the rupee in foreign markets to an undesirable extent. The inter-bank rate for the pound sterling was driven down below the rate at which the RBI was prepared to sell sterling.

Through an AD circular on inter-bank dealings, the Bank sought to stem the speculative tendencies. The circular framed fairly stringent regulations governing inter-bank dealings with a view to ensure that the facilities provided by the Bank were availed of for legitimate transactions, and warned that a serious view would be taken if ADs were found flouting the regulations. This entailed micro-monitoring through snap checks of ADs' foreign exchange transactions. ADs were required to be vigilant to see that rupee funds acquired by overseas banks were not utilized in swap operations by their overseas units, as these were perceived to be of a speculative nature. Furthermore, ADs were called upon to keep a watchful eye on the relaxation afforded in the limit for overdrafts in the rupee accounts of overseas banks, to ensure that the relaxation was not abused to postpone funding in anticipation of rate changes or to convert rupees into foreign currency.

The circular was an interim response to regulate the market, pending a view being taken on the broader issues of narrowing the rate spread and, eventually, active intervention in the market. The logical course would have been for the Reserve Bank to actively intervene in the market. But active intervention presupposed adequate communication links, trained dealers, delegation of powers from the government to the Bank to take spot decisions to intervene or abstain from the market, internal control on the functioning of ADs on a continuous basis, and assessing the profit or loss arising from day-to-day intervention. Realizing the inadequacy of infrastructure and the need to build capacity for taking on such a task, there was a tendency on the Bank's part towards crises management through circulars. Administration by rule, a powerful tendency of the Bank, had not yet given way to direct intervention even when events foreshadowed the need for quick consideration of substantive issues.

By mid-1979, the managers of the Indian exchange rate system started feeling that the stability in the exchange value of the rupee sought to be achieved through adoption of the basket peg was eluding them. The new dynamic flexible floating rates perplexed the monetary authorities and they found that it had given speculative advantage to larger commercial and overseas banks for funding the latter's rupee accounts in India. In order to reduce the speculative advantage, as a first step, procedural and regulatory tightening measures were instituted. With effect from 28 March 1980, sale of Japanese yen to the RBI for funding the rupee accounts of overseas banks was prohibited,[5] and, with effect from 2 June 1980, a revised procedure of working out the dollar, deutsche mark and yen rates was adopted. Although hailed by the market as a step in the right direction, as it considerably helped to reduce the speculative advantage overseas banks enjoyed in a regime of floating rates, the Bank realized that these measures required to be supplemented through further policy initiatives. The situation called for a shift from the current policy of keeping the rate structure static to one of realignment of the rates.

The policy of keeping the exchange rate structure static had given speculative advantage to the larger commercial and overseas banks. There were some in the senior policy-makers' group, like the Controller of Exchange and Janakiraman, who saw that scope for such advantage could be reduced by 'moving with the market' rather than remaining static in the formulation of the structure of exchange rates of currencies that the Bank dealt in. They admitted that in a regime of floating rates, it was well-nigh impossible to eliminate speculative tendencies, and that it was just not possible for the Bank to be 'right' all the time. The aim of the authorities was to reduce speculative advantages: for this reason, the weights and currency composition of the basket were kept secret. Even when the IMF desired to know the weights accorded to the foreign currencies in the basket, the Bank did not disclose the details. In course of time, the market and the IMF succeeded in making a fairly accurate guess of the components of the bas-

[5] Purchase of yen—both spot and forward—in cover of actual merchant transactions entered into by Indian exporters was continued.

ket and the weightage given to the currency. The Reserve Bank responded by revising the rate not to the previous base rate but by refixing another base rate within the band, thus precluding the possibility of applying statistical tools to unravel the composition of the basket. The basket itself was reconstituted more than once to reflect the changes in trade flows.

In July 1980, at Deputy Governor Krishnaswami's prodding, A.P. Aiyer undertook an in-depth examination of the issues relating to the structure of exchange rates. The suggestion was made that the spread between the spot buying and selling rates for the intervention currency be narrowed or widened as the situation demanded, to reduce the scope for speculative operations. Advantages were also cited for reviewing the forward margins on sterling periodically. The market's belief that forward margins on sterling would be kept unchanged had facilitated speculation. Spot and forward rates for other currencies, like the dollar, yen and deutsche mark, could be loaded on to Reuter rates structure and varied daily in such a manner that the rates structure which evolved would serve as a base for the market, even as it kept the market guessing and prevented speculation.

The practice of giving extension of forward contracts in sterling at a uniform rate, just for the asking, should also be discontinued. And, finally, the oft-debated policy issue of change in the intervention currency from the sterling to the dollar was taken up. The experience of the last couple of years had revealed that sterling as the intervention currency had not only favoured speculative forces but, with the bulk of the country's external transactions now being conducted in dollars, distortions in the sterling–dollar rate and weakening of the dollar had encouraged heavy sales of sterling and their conversion into dollars. As the US dollar was the transaction currency of the future and given India's heavy import bill for oil, the note indicated that the country's requirement of dollars was likely to grow. It pressed for a decision to switch over to the US dollar as the intervention currency, or to adopt both the US dollar and the sterling as intervention currencies, through an amendment of Section 40 of the RBI Act.

The second part of the examination was devoted to restructuring the administrative set-up, creating the infrastructure of a proper dealing room, improving communication links, and building a proper information and database to regulate the market which, currently, was being regulated on hunches. The changes suggested to streamline the foreign exchange market were indeed radical, and received the Joint Chief Accountant's and Accountant's informal blessings, but Deputy Governor Krishnaswamy was sufficiently cautious. Keeping aside policy matters for a while, he ruled that the Bank must get on with the job of equipping itself with the facilities for active dealing. He ordered the Foreign Section to prepare a plan outlining the timeframe within which the arrangements for communications, staff and information could be put in place, to coincide with the proposal to move into the new Central Office buildings. Although regulatory philosophy held sway, the suggestions were indicative that the Bank's thinking was to create an environment in which authorized dealers would be seen more as market participants and less as clients of the Bank.

By 1981, there was general agreement on the need to switch to the dollar as the intervention currency, but political considerations came in the way of its adoption. Apprehending criticism of toeing the American line, the government shied away from taking the plunge. The upshot was between January 1981 and March 1982, as a matter of policy, the Bank allowed the US dollar to appreciate from Rs 7.90 for 1 US dollar to Rs 9.30 for 1 US dollar. This necessitated changing the pound–rupee middle rate 94 times during the fifteen-month period. An internal note of the Bank showed that the same objective could have been achieved, at best with five changes, if the intervention currency had been the dollar. In other words, the same basket with the same weights would have worked with the dollar as the intervention currency.

Despite the Reserve Bank buying large quantities of dollars to accommodate the preference of exporters to invoice their bills in dollars, it continued to maintain the sterling as the intervention currency for a very long time. In the process, it had to unnecessarily convert dollars into sterling. On behalf of the Reserve Bank, SBI was asked to buy dollars from the market, which was kept a well-guarded secret until SBI began to purchase even odd lots. Moreover, the market became suspicious when SBI, which was a regular supplier of dollars to the foreign exchange market, turned into a voracious buyer. An unguarded slip on the part of a Deputy Governor that the Reserve Bank had asked the SBI to buy the dollars resulted in termination of this arrangement.

The Reserve Bank then officially started buying and selling dollars from and to authorized dealers at rates determined by it, which practically amounted to giving the dollar the *de facto* status of an intervention currency. The Bank fixed the rate for dollars in the morning and bought dollars in the evening when the rates changed. This encouraged a reputed AD to take undue advantage of the Bank's intervention in the foreign exchange market, by buying dollars from RBI's Bombay office at about 2 o'clock at rates fixed in the morning, and, whenever the sterling weakened against the dollar, selling the dollars and buying sterling. Prompt punitive action against the authorized dealer for indulging in such speculative activities nipped such transactions in the bud.

There is no easy explanation for why the Reserve Bank persisted with using the sterling as the intervention currency although alternative possibilities were actively explored in the late 1970s and early 1980s, but political considerations appear to have precluded decisive action till 1992. This serves as a reminder that the philosophical shift to market-based decision-making was still heavily circumscribed. In retrospect, it can be said that, in the unsettled and disturbed market environment of the seventies, the basic exchange rate regime adopted by India, an adjustable nominal exchange rate (NER) peg, a managed float arrangement, was highly desirable, and some depreciation was also appropriate to eliminate the overvaluation. However, it leaves open the question of how well the authorities operated the framework. Two distinct phases were discernable. The 1971–75 phase which called for adjustment to the first oil shock required a depreciation of the real exchange rate (RER). This was skilfully achieved through nominal depreciation by maintaining the sterling peg, which provided the cover for depreciation. Similarly, the period 1975–76 to 1978–79, when the RER depreciated 20 per cent, also witnessed strong export volume growth and low inflation—in fact, those few years were described as the 'golden years' of India's balance of payments. The move to a fixed NER was made only after the inflation monster had been tamed. For a year or so, low inflation brought about depreciation of the RER.

The exchange rate scenario changed following the second oil shock. Inflation reared its head again and the decision to keep the RER fixed resulted in its appreciation. The years 1979–83 witnessed erosion of the competitive advantage for exports and export volume growth was stagnant; at the same time, foreign debt grew rapidly resulting in widening of the current account deficit. Clearly, the macroeconomic fundamentals were not strong enough to withstand the appreciation of the RER after the second oil shock. Depreciation was necessary to restore parity with the key currency—the dollar. In retrospect, again, the inactive exchange rate policy of the late 1970s and early 1980s raises the question whether the valuable instrument of balance of payments adjustment had been sacrificed on the altar of stability. The reluctance to vary the nominal exchange rate actively in the first instance and, thereafter, to devalue insufficiently, led to stagnation of exports. With no tightening of imports, this resulted in recurring deficits that had to be financed through commercial and concessional borrowings, which sowed the seeds of later trouble. Clearly, the phase of appreciation of

NER was 'undesirable' and the decision to keep it fixed was a grave mistake. To what extent the Bank played a major part in the decision is difficult to say, in view of the absence of commitment on paper of the vital decisions pertaining to exchange rate management.

ATTEMPTS AT DIVERSIFICATION OF RESERVES

The breakdown of the Bretton Woods system in 1971 set in train disintegration of the exchange system based on fixed gold parities. At that time there was little official support to jettison a system that had served well. The emphasis, therefore, was on technical improvements within the existing structure (wider margins around official parities). The creation of the SDR in 1970 as an additional form of international liquidity was expected to introduce an element of stability into the exchange markets. But the uncertainty surrounding the key currencies—the dollar and the pound—failed to reassure markets about the stability of the reserve currencies.

From 1971, the Reserve Bank started gradually and cautiously rearranging its portfolio. Following the termination of the Indo–UK sterling agreement in December 1974, under which India received compensation on two occasions, the process of diversification of foreign exchange reserves was speeded up. In the early 1970s the Bank was empowered to purchase securities issued by foreign governments to be payable in foreign currencies, and to deposit balances in accounts opened with foreign central banks or any international bank (supranational institutions). Subsequently, with the growth in reserves triggered by the second oil shock and drawals from the IMF, in July 1978, the statutory provisions were amended and enlarged to cover investment in Eurobonds and commercial bank deposits, as well as open gold accounts abroad with central banks. The main advantage of the diversification was that the Bank could utilize and invest more effectively the foreign exchange reserves that had been rising continuously since 1975.

In 1979 and after, the Reserve Bank was seen placing a number of special deposits through the Indian commercial banks. However, the level of reserves held in different currencies was a very sensitive issue and switches from one currency to another was a tightly guarded secret. Earlier, because of the lack of infrastructure, such conversions were blindly effected through the Bank of England or the Federal Reserve of New York or the Bank of International Settlements (BIS) but, in the late 1970s, it was the Joint Foreign Exchange Committee of the government and the RBI who laid down the broad guidelines for the deployment of foreign balances. On one occasion, the government indicated to the Bank that its deposit exposure with the BIS and its deposits with commercial banks were on the high side in the context of safety of funds. However, with the fall in the level of foreign balances in 1981, the level of BIS deposits to the total level of reserves came down appreciably.

With the advantage of hindsight it can now be said that the sterling guarantee agreement delayed the diversification of official reserves but it did provide some protection of their value at a time of high risk in holding any other currency. For the global system as a whole, sterling agreements facilitated an orderly retreat from the sterling without aggravating the disruption in global currency markets, and ensured the smooth disintegration of the sterling area.

12

Debating International Liquidity

This chapter deals with the Reserve Bank of India's involvement in broader issues that dominated the agenda of the International Monetary Fund (IMF) in the second half of the 1960s: international liquidity and the creation of special drawing rights (SDRs). Those were the burning topics of that time, when the world's monetary authorities were preoccupied in finding a new instrument that would enhance world liquidity. Their search lasted for almost a decade, during which plans and counter-plans were proposed. There were clashes of opinions and doctrines, as enquiry gave way to negotiation. The account that follows does not cover every facet of the debate but describes the process that culminated in the advent of SDRs and India's reactions.

The Reserve Bank was not directly involved in conceiving any of the liquidity proposals, though it remained on the periphery of this vital debate, for the Group of Ten (G-10) industrial countries arrogated to themselves the responsibility for provision and distribution of any additional liquidity, arguing that the responsibility should be 'borne by those countries who were best able to shoulder the resulting burden'. As India was one of the more than 90 countries that were not members of G-10, the government looked to the Reserve Bank for guidance on these technical issues. The Bank, through Anjaria and Madan, who were Executive Directors on the Executive Board of the IMF, kept a close and careful watch to see that the developing countries were not confronted with a *fait accompli* in which their legitimate interests were disregarded. In fact, India, being one of the major developing countries, was required to take up the cudgels on behalf of the developing world, and the historical record is replete with evidence to show that India remained a vigilant participant in this debate.

INTERNATIONAL LIQUIDITY: CONCEPT AND FORM

International liquidity has been formally defined as all the resources that are available to the monetary authorities for the purpose of meeting balance of payments deficits, and covers the whole spectrum of financial assets including borrowing facilities. Reserves constitute the most definite and easily measurable form of liquidity; they include official holdings of gold, foreign exchange and the gold tranche position in the IMF.

A question that comes to mind is: why were the developed countries so adamant on restricting the debate to a limited group? A few key statistics on international reserves provide the clue. Over the sixteen-year period 1950–66, international reserves of the United States recorded a sharp decline and those of the United Kingdom showed a modest drop, while the reserves of European countries registered a spectacular rise and those of the developing countries displayed little material change. The entire increase in global reserves over the period was attributable to the European countries. Another troublesome feature was that by end-1966, the monetary reserves of the rest of the world in the form of US dollars exceeded the US reserves. In other words, the monetary liabilities of the US exceeded its monetary assets and herein lay 'the ultimate paradox' to which Triffin (in *Gold and the Dollar Crises*) had drawn attention in the early sixties.

Not all monetary authorities were enthusiastic about continued addition of dollars to their reserves without some form of exchange guarantee. The prolonged deficit in the balance of payments of the United States provided the monetary authorities of other countries with reserves, but the deficit that produced this result also instilled uneasiness about the size of this currency in the reserves.[1] In addition, there was concern that the ability of reserve currency countries to settle international obligations with their own liabilities removed the discipline, imposed on the rest of the world by asset settlement, of maintaining domestic policies inconsistent with balance of payments adjustment. This lack of discipline of reserve currency countries could bring about a collapse of the system.

[1] The supply of national currencies in world reserves was dependent on the deficits of countries of issue and this built into the system a latent instability, for, sheer accumulation, over time, of other countries' sterling and dollar claims in relation to the gold held by the reserve currency centres was likely, at some point, to cause misgivings—and any tendency to liquidate such claims could create serious strains. See Address by Pierre Paul Schweitzer, Managing Director, IMF, to the New York Financial Writers' Association, 17 June 1968.

Origins of the Problem and Early Response

The period 1958–60 witnessed a massive build-up in the external liabilities of the US and the earlier dollar shortage gave way to a dollar glut. Although the British and the EEC countries were aware that continuation of large European surpluses would pose considerable problems for the rest of the world, there was no political will on either side of the Atlantic to come to grips with the liquidity crisis. In fact, the US informed a high-level British mission in mid-1958 that the 'so-called crisis was yet to materialize'. The IMF's studies, too, confirmed the view that there was no lack of liquidity. The same refrain marked the 1961 *Annual Report* of the IMF, although the Managing Director made a proposal to study arrangements for the Fund to borrow the needed currencies and to review the use of the Fund's resources. This, however, did not mean that no thought was given to the problem; the subject featured actively in other fora and studies were afoot in other quarters.[2]

At that point of time, there was no desire to involve the developing countries in this debate. Even so, Indian representatives never missed an opportunity at international gatherings, to bring to the fore the viewpoint of the developing world. At the 1959 annual Fund–Bank meeting, the Governor for India, Morarji Desai, pointed out that industrial countries had greatly added to their reserves in the recent past, whereas the less developed countries, including India, had depleted their reserves. Investment in large reserves of their own necessarily imposed a greater sacrifice on poorer countries than on others, with the result that the secondary line of reserves provided by the Fund assumed much greater importance.

First Phase of the Liquidity Debate

By the spring of 1963, there was a discernible change in the liquidity situation. Final figures of 1962 world reserves revealed that the aggregate of countries' reserves had fallen, in contrast to the increases witnessed over the last

[2] (i) The Maxwell Plan combined the needs of the industrial countries for additional liquidity with the needs of the developing countries for more capital.
(ii) Robert Triffin, Yale University, proposed that an enlarged and amended Fund should provide a new kind of international reserve, and that all reserves except gold should be centralized in the Fund.
(iii) E. Bernstein and the US Treasury Secretary suggested that the gold standard be broadened by a system of multiple reserve currencies. On the other hand, Jacques Rueff of France advocated increasing the price of gold.
(iv) Maulding proposed a mutual currency account.

three years. This signalled the need for the IMF to commence a study of the liquidity issue. Its 1963 *Annual Report* carried a chapter on 'International Reserves and Liquidity', which emphasized that if the problem of expansion of liquidity was approached through the Fund, lack of liquidity was unlikely, in the future, to present a bar to the adoption of desirable policies.

The IMF Managing Director, Schweitzer, who had assumed charge barely eighteen days earlier on the sudden demise of Jaccobson, and who was privy to the idea of the G-10 organizing a discussion of their own on the subject, in an unprecedented move, briefed the Board about the substance of his opening remarks at the forthcoming annual meeting. The message he sought to convey was that the Fund should be the instrument through which the bulk of any required expansion in liquidity is suitably undertaken. But this was not taken seriously by the G-10 representatives. The US Governor, who made a statement on behalf of the G-10 at the 1963 annual meeting, noted that the current national reserves of member countries, supplemented by the resources of the IMF and the network of bilateral facilities, seemed adequate. He went on to add, however, that it would be useful to undertake a thorough review of the future liquidity needs of the international monetary system, and instructed the G-10 Deputies to do so, in collaboration with the IMF. This meant that G-10's involvement remained central to the liquidity debate.

As leader of the Indian delegation, RBI Governor Bhattacharyya sought to confine the debate within the Fund through his intervention, by forcefully reiterating that the Fund was the appropriate focal point for action to safeguard and strengthen the international payments system. Stressing that increase in world liquidity was a problem that concerned all countries, including the less developed, he urged consideration of another general quota increase and the need for mitigation provisions relating to gold subscriptions.

Following on from the 1963 Annual Meeting, the staff of the IMF became actively engaged in examining the liquidity problem from all angles including the analytical and operational aspects of liquidity.[3] But, endorsing the Schweitzer line implied that the members did foresee a shortage of liquidity in the long run. In their perception, liquidity was adequate. What was needed was strengthening the international payments system in

[3] These studies included (i) Marcus Fleming's paper entitled 'Role of the IMF in the Provision of Liquidity' and (ii) the staff paper on the 'Role of Gold in the Fund'. This paper suggested some mitigation in gold payments in connection with quota increases, as well as finding a way of selling the gold held by the IMF in return for currency.

such a way as to avoid situations where they would have to hold unwanted dollars. For them, the urgent problem was to rectify the US payments deficit and not to reinforce liquidity. Despite the cleavage of views, however, the IMF was set on the road towards liquidity studies.

This did not mean that parallel inquiries by the G-10 had receded into the background.[4] The period 1963–64 was marked by hectic intellectual exchanges between the G-10, on the one-hand, and the Managing Director and staff of the IMF, on the other. To cap it all, in the summer of 1964, the G-10 Deputies set up a committee under the chairmanship of Rinaldo Ossola of Italy, to examine various alternative proposals for the creation of additional liquidity. The report submitted by the committee (the Ossola Report or Report of the Study Group on the Creation of Reserve Assets) marked an important step in the evolution of the scheme of SDRs. A little later the G-10 appointed their Deputies to examine the technical aspects involved in the creation of a new reserve asset. Outside the Fund and the G-10, the UNCTAD also published a report in 1965, which outlined various ways of increasing world liquidity.

Confabulations among a limited group naturally upset the non-G-10 countries. What bothered them was that negotiations on a matter as important as international liquidity were proceeding without any participation of 90-odd members of the IMF. The Fund management, aware of their uneasiness, scheduled an internal seminar discussion on a staff paper entitled 'Creation of International Liquidity in the Fund: An Appraisal of Alternative Techniques', on 9 May 1965. The paper suggested two techniques: (i) extension of quasi-automatic drawing rights in the Fund, and (ii) initiation of an investment policy by the Fund on the basis of additional deposits.

The outcome of the seminar was disappointing; there was no consensus on whether to create additional liquidity and through whom. The prospect of any scheme involving special deposits that the Fund could use for investments in less developed countries through the IBRD was dubbed as a mixture of monetary and aid techniques, and hence, unsuitable. The idea of liberalizing tranche policies was attacked. The only technique that gained some support was automatic drawing rights for the industrialized countries in the Fund, on the basis of an understanding that they would give increased deposits to the Fund as and when called upon to do so—a kind of

[4] Edward Bernstein, US, proposed that G-10 countries plus Switzerland should establish a composite reserve unit (CRU) equivalent to gold consisting of a stated proportion of their currencies.

systematization of the GAB-type arrangement directly under the Fund, with a clear differentiation between the rights and privileges of the industrialized countries and the rights and privileges of the rest. The Indian Director saw in this move a concerted effort to create a Group of Ten within the Fund and vehemently opposed the same, stating that he could not subscribe to any scheme that, in terms of eligibility criteria, would create different types of membership.

Discussions on the draft 1965 *Annual Report* proved equally troublesome. The Europeans put up a stiff and concerted fight, arguing that there was no shortage of international liquidity and none was likely in the foreseeable future, and that the function of the Fund was to accelerate adjustment. Moreover, it was dangerous to float the idea of creating additional liquidity via Fund investments in countries other than those that would take on additional responsibilities. The attempt was to delete the portions relating to the techniques of additional reserve creation through the Fund or to hive off the issues to a separate part of the *Report*. The Indian Executive Director, Madan, objected to this. He was supported by all the developing country Directors and even the Managing Director felt it was not right. The end-result was a compromise—an abridged version revealing the bare bones of how reserves could be created.

At the brainstorming sessions on the technical aspects, the Indian Director continued to champion the cause of the 'lowest and the lost'. On distribution of deliberately created reserves, Madan questioned the distinction between the need for reserves to hold and the need for reserves to spend, and underlined that the problem could not be resolved by creating additional liquidity for a small group; a satisfactory scheme had necessarily to encompass *all* the members of the Fund. On distribution, the Indian Director rejected the criteria relating the share in the new assets to existing gold holdings of members or to their total reserve level or contribution to foreign aid, and opted for Fund quotas as the most rational distribution key.

Unmindful of non-G-10 reservations, the G-10, at their Paris meeting of 31 January to 2 February 1966, agreed on some common points.[5] Clearly,

[5] These were: (i) the reserve asset would be created by and under the responsibility of a limited group of countries; (ii) the group would not be a closed one but entry would be subject to qualifying conditions; (iii) initial distribution of the newly created assets was to be based on Fund quotas and GAB commitment formula; and (iv) to take care of countries outside the group, there would be a dual approach in terms of concessional access to Fund resources.

the Paris proposals held no interest for the developing countries. An interesting development at that meeting was the statement made by the Fund representative on behalf of the Managing Director. It stressed admirably the interest of the developing countries in any scheme of international liquidity. A few significant sentences will demonstrate that the Fund was pulling in the right direction.

> We believe … and I want to be blunt about this, that it would be most unfortunate if the proposals as developed here (meaning Paris) did not meet the realities of the wider group…. These realities require a scheme that starts from the recognition of the legitimate reserve needs of the world and not from the needs of the Group of Ten combined with some ex-gratia payments to the rest of the world…. Just as an acceptable programme must start out from the recognition that liquidity is a world-wide problem, so the decision-making process in our opinion should be one that properly reflects these world-wide interests.

Ignoring the global approach, the G-10 came to the decision that three-fourths of the newly created reserves should be distributed among the G-10 and the remaining one-fourth among all members of the Fund. The Germans were the driving force behind this proposal. The Fund management viewed this as a dangerous portent for future monetary cooperation and the Managing Director publicly denounced the proposal. To prevent crystallization of the proposal by the G-10 Finance Ministers, diplomatic pressure was applied by the developing countries at the United Nations, where the UNCTAD was trying to rally support for a global approach. An Expert Group on International Monetary Issues[6] was set up by the UNCTAD, which prepared a report entitled 'International Monetary Issues and Developing Countries'. The main conclusions of this report were: (i) the establishment of a link between the creation of international liquidity and the provision of development finance was both feasible and desirable, and would be detrimental to neither; (ii) the reform of the international system should be truly international; and (iii) developing countries should be represented in the discussions leading to monetary reform and in the operation of the new arrangements.

Meanwhile, the Fund came up with its own scheme for additional

[6] I.G. Patel, Chief Economic Adviser, Ministry of Finance, represented India on this Group and, in his absence, K.N. Raj, Professor of Economics, Delhi School of Economics, was appointed as an additional member.

liquidity creation through the IMF ('Creation of Additional Reserves through International Monetary Fund', Staff Paper SM66/30). One option envisaged the creation of reserves in the form of quasi-automatic drawing rights, and the other involved the creation of a new reserve unit transferable between countries and operated by an affiliate of the Fund. Both schemes were open to participation by all members. The paper unequivocally enunciated the principle that 'reserve creation was the concern of all member countries and all should participate, with due safeguards and in due degree, both in the distribution of the newly created reserves and in the decisions which led to their creation'. The developing countries, having openly denounced the establishment of a group of 'second-class participants', supported the Fund's scheme but the industrialized countries remained non-committed.

Meanwhile, the Managing Director, Schweitzer, persisted in his public utterances on the inappropriateness of the dual approach. Arguing in support of a universal plan, the MD stressed that he could not accept the view ' that all but a few members had little or no need of reserves and were not capable of keeping any that they may receive, nor could he see a way to divide the member countries of the Fund in an objective and non-discriminatory manner into the reliable few and the less irresponsible many. This led to some rethinking and some among the G-10 Deputies became more receptive to a universal approach.

The discussions entered a second phase with the Americans mooting the suggestion to constitute a Committee of Twenty members. The move was resisted, as it was seen as a denial of the functions and privileges assigned to the Executive Directors. Schweitzer's variant of fusing the Deputies and the Fund Board into a single Advisory Committee to the Governors was also dubbed as impracticable by the G-10 Deputies (Communique of the Ministerial Meeting of G-10 in the Hague, 25 July 1966, para 6b). In the circumstances, the only course open was for the Deputies of the G-10 and the Executive Directors to continue their parallel work, with a proviso of holding three to four joint meetings to arrive at a consensus. The Hague communique, while recognizing the interest of the world community in liquidity creation, emphasized that the requisite majorities and voting power were a necessary condition for any decision on reserves creation. This implied a veto power being vested in the G-10 in connection with any decision on reserve creation, which this was totally unacceptable to the Directors of the developing countries.

Anjaria, the Indian Executive Director, was quick to perceive that the move was a determined effort to transfer the decision-making process from the Fund to the G-10. This, as Anjaria reported to the RBI Governor, was the rationale of the parallel forum with a different balance of power, the end-result of which could well be the Fund abdicating some of its functions voluntarily, through these joint meetings, to a rich men's club functioning somewhere in Europe. What the less developed countries were getting out of the 'global approach' of the G-10 was a promised share of the new liquidity to be created. On the vital issue of who takes the decisions, who runs the scheme, the dice were all loaded in favour of an outside mechanism. The less developed countries, Anjaria reported, were forced to take solace from the Managing Director's remark at the ministerial meeting of the G-10 on 25 September 1966, where he said that 'they (implying the non-Ten) were not willing that they be assigned a subordinate role in negotiations affecting the world's monetary system'.

Wiser counsel prevailed, however: starting from November 1966, parallel discussions gave way to direct exchange of views between the Executive Directors and the Deputies through joint meetings, under the joint chairmanship of Schweitzer and Emmingar, chairman of the Deputies of G-10. The first joint meeting[7] revealed not only wide differences but, more importantly, as Anjaria reported to his authorities, that the G-10 countries were not by any means a solid phalanx. On the need to create reserves in unconditional form, there was little disagreement among them, but on its nature and form there were wide divergences. Some favoured reserve units for all countries, others indicated reserve units for the developed countries and drawing rights for the developing countries, and yet others were in favour of drawing rights for all. Opposing the latter, the Indian Director insisted that the solution envisaged should be the same for all, whatever form the reserves creation might take.

The claim of special responsibilities and therefore of special privileges for industrial countries was rebutted by the Directors of the developing countries who argued that no one was really required to finance this initially, as it would be a fiduciary issue, at the time of liquidation, and that the Fund could take care of it.

Through 'harmonization of reserve ratios', the attempt was to bestow gold-like characteristics on the reserve asset whereby the possibility of some

[7] The first joint meeting was held in Washington on 28 through 30 November 1966. The agenda was: (i) aims and objectives of reserve creation and its relationship to adjustment policies and supply of conditional liquidity; (ii) nature and form of deliberately created reserves; (iii) distribution and utilization of new reserve assets including conditions for transfer of and for assuring acceptance of the assets; and (iv) conditions and circumstances for the activation of a contingency plan.

participants unloading their new reserves in order to switch to traditional reserve forms at the expense of others could be avoided. The Indian argument was that the unit could not be made gold-like by tying its use to gold, particularly as so many countries had so little by way of gold reserves; a proper agreement on acceptability was the answer. At the ECOSOC meeting of 19 January 1967, the Indian Ambassador, G. Parthasarthi, also warned: 'We need to beware of any tendency there might be to enthrone old ideas or idols—and to accept a scheme of reserve creation that can only sap the vitality of the system.'

The second joint meeting held in London from 25 to 27 January 1967, discussed the most vital issue of decision-making. Little headway was made as the Europeans hinted that a stronger safeguard was necessary for activation of the new scheme—namely, an 85–90 per cent majority vote, which would give the veto virtually to the ECM. In addition, participants that had accumulated reserve assets would have more voice than others in the decision-making process. Ancillary questions surfaced. Should the distribution of votes be based on Fund quotas or should GAB commitments also be included? Should there be split voting? A meeting of minds on the critical issue of voting was undoubtedly difficult. The developing country Directors *en masse* opposed any scheme that would have the effect of endowing any group of countries with the right to veto any decision. The result was that no broad support for any scheme or any specific decision-making process was forthcoming.

It was the third joint meeting that came to grips with some of the tougher issues, such as rules that would govern the use and transfer of reserves, financial resources that would back the scheme, the kind of reconstitution that ought to be instituted and the decision-making process to be adopted. The European angle on most of these issues was to give a restrictive bias to the scheme. On the other hand, the aim of the developing countries was to have as progressive a scheme of reserves creation as feasible, one that would conform to the requirements of universality and non-discrimination, and one that avoided an adverse impact on the structure and machinery of Bretton Woods.

Between 1965 and 1968, while protracted discussions were on to formulate a scheme, the Economic Department of the Reserve Bank of India carefully studied the various twists and turns in the debate. It advised the government to indicate its preference for a reserve type of scheme, and to also show preference for the organization of a new department with separate accounts and resources and with a separate entity such as an affiliate of the Fund.

By September 1967, agreement was reached by Ministers and Governors on the outline of contingency plan for the creation of special drawing rights in the IMF. The role of the Fund in any new arrangement no longer remained in doubt, for the idea of integrating the new facility had gained acceptance. The need for a supplement to reserves of an unconditional type was also generally accepted and the principle of universality acknowledged. A disheartening development was that the EEC Ministers endorsed the suggestion to create reserves in the form of drawing rights and not as reserve units, for, in their perception, any scheme of international liquidity had essentially to be limited to a willingness to expand international credit and not to print new money. The French, particularly, were averse to the creation of new money, which would compete with or supplant gold. They fought for complete freedom of a member to opt out of any allocation. On the voting issue, the high majority requirement (85 per cent) was made a condition of acceptance for any move forward by members of the EEC—their endeavour was to gain a veto over new liquidity creation.

The fourth joint meeting was held in Paris from 19 to 21 June 1967, to grapple with two contentious points, viz. decision making and reconstitution. It was agreed that special drawing rights were to be distributed at specified intervals over basic periods of normally five years, in proportion to quotas in the Fund. The Managing Director was to formulate the proposal, which had to be approved by a high qualified majority, although, at that point of time, the high qualified majority remained an open issue. Again, use of drawing rights would not be unlimited; there would have to be a provision for reconstitution of assets at appropriate intervals. The debate on this was long and fierce, though the principle of reconstitution was agreed upon. On the voting issue, India, on the advice of its authorities, opposed the Monetary Committee's recommendation to introduce, in addition to an 85 per cent majority, a second-unit vote that included at least half the major creditor countries. India also remained cool to the American band proposal which had a range of voting majority between 75 and 90 per cent, and comprised a double vote. On split voting, Anjaria, the Indian Executive Director, said it would be a retrograde step as the split vote procedure would be divisive and 'would atomize the personality of the executive director who would produce, each time, a new symphony according to the mix of their masters' voices'. Because of the vigorous opposition of the developing countries to bestowing larger votes on the creditors, there remained a strong possibility of this being dropped in the final debate.

The reconstitution provision also continued to balk agreement. The tussle was between the French, supported by other Europeans, who dug their heels in against any use of the new facility in excess of 50 per cent, and others within the G-10, principally the US, who were fighting for non-reconstitution of 75 per cent of the facility.

In retrospect, what were the achievements of the joint meetings so far as the developing countries were concerned? Had their participation made a difference to the outcome of the liquidity debate? The objective of the joint meetings was primarily to ascertain the views and reactions of the non-G-10. The role of the Indian Executive Director, Madan, was to ensure that the basic interests of the non-G-10 were safeguarded. Later, reporting the debate to the Governor, Madan said:

> There were quite a few ghosts of a complex and technical nature that were let loose from various quarters—by the US (the band proposal), the UK (free and unguided transfers) and toughest of them[8] all, by the EEC countries, who sought at various points, to create the Fund into a creditors' club and undermine the new facility completely, through a highly restrictive mechanical formula for reconstitution.

In the assessment of Madan, the contribution of these meetings was 'it laid several of these ghosts to rest'. For instance, on the basis of allocation of the new reserves, at the Paris meeting, in the face of resolute advocacy by Van Lennep of a different basis than Fund quotas, Madan urged not to add this to the pile of outstanding issues and thereby open the biggest of all Pandora's boxes. His able advocacy, along with that of the Fund staff, resulted in the acceptance of quotas as the yardstick for allocation.

On the technical provisions of the extent to which the Fund should 'guide' transfers, the Indian Director sought to steer the discussion on the lines that it was a right to be used in terms of balance of payments need. Here, he ran up against the British, Italian and Nordic countries who pressed for a minimum of guidance and rules of transfer, on the plea of improving the reserve nature of the new assets. But Madan saw in such a provision the possibility of stronger countries using the facility for harmonization or reduction of their new drawing, thereby limiting the utility of the new facility to countries in balance of payments need. Eventually, however, it was decided to adhere to transfer practices the Fund had built up over the years for its regular drawings. Thus, the importance of conformity to principles applicable to all was conceded.

[8] See the Fund staff study entitled 'Outline of a Facility Based on Special Drawing Rights', for five alternative formulations on reconstitution.

The reconstitution provision, too, threw up a large number of alternative solutions. Here also, the Indian Executive Director's intervention dealt a fatal blow to the Ossola formula. The Ossola concept of harmonization was based on proportionality of use of new assets in relation to other reserves by transferor countries, as against proportionality of the holdings of new assets, both of which were possible ways of harmonizing reserves. Because the use of traditional reserves was sometimes subject to statutory requirements, Madan emphasized that there was an important difference between the two techniques, and that any reconstitution provision should take into account the diversity of balance of payments situation that countries may encounter. The result was that the Ossola formula was out and the resultant toned-down version read: 'Participants will be expected not to use their special drawing rights to a disproportionate extent in comparison with the use of their reserves.' But, despite intensive efforts to resolve the reconstitution conflict before the Rio meeting, it remained unresolved, except that the five alternatives narrowed down to two.

DRAFT SDR SCHEME AND RESOLUTION

Following the fourth joint meeting, in mid-1967, the Executive Directors of the Fund were entrusted through a resolution at the Rio meeting, with the responsibility to draw up a scheme for the establishment of SDRs and for improvements in the Rules and Regulations of the Fund. They were also required to submit draft amendments to the Articles of Agreement and Bye Laws for these purposes. The deadline for submission of these reports was set at 31 March 1968 but, in the event, they were delayed by three weeks and were published on 22 April 1968.

In preparing the draft of a final outline as a working document, considerable effort was expended by the Fund staff in search of finding a 'less energetic terminology' that would be acceptable to the majority.[9] The essential point of the Rio resolution was that it made the reform of the Fund a parallel exercise to new liquidity creation. The bracketing of Fund reform with liquidity creation meant further delay in setting up the new facility.

[9] Professor Fritz Machlup described the effort thus: 'The words credit, credit facility, loans, repayment, borrowed reserves—all of them were with great circumspection avoided in the outline drafted. Words not burdened with a history of controversy, not associated with recognizable ideologies and not widely used in monetary theories, words therefore with still neutral and not always fixed connotations, were put in place of the old, battle-scarred and now banished words.' Fritz Machlup, 'Remaking the International Monetary System: The Rio Agreement and Beyond', p. 9.

Eventually, agreement was reached on a brief document entitled 'Outline of a Facility Based on Special Drawing Rights in the Fund'. Thus, after years of patient negotiations was born the basic ingredients of a contingency plan for reserves creation. The plan was only an outline—the task of fleshing out the new facility and incorporating it into the Articles of Agreement remained. The Indian Governor of the Fund, addressing the 1967 annual Fund–Bank meeting, expressed the hope that the liquidity exercise will not remain suspended in 'mid-air', and that the time between the adoption of the contingency plan and the activation of the scheme will be as short as possible.

Amending the Articles

Following the approval of the outline by the Board of Governors, the Fund staff and the IMF Board addressed themselves to the tortuous task of carrying out the first amendment to the Articles of the IMF. The marathon exercise, which lasted from 1 December 1967 to 22 April 1968, entailed 74 sessions covering 170 hours; the Indian Executive Director along with his alternate assisted in hammering out successive drafts of a satisfactory and technically tenable scheme.

What the amendments eventually achieved was to establish the special drawing account within the Fund but not as a separate legal institution. Members of the Fund were entitled but not compelled to participate in the account but participants alone were allocated SDRs. Decisions to allocate SDRs would be taken by the Board of Governors on a proposal formulated by the Managing Director. The hotly contested issue of majority was settled by accepting a majority of 85 per cent of the total voting power for a decision to allocate special drawing rights.[10]

After considerable discussion there was agreement that the reserve assets should be unconditional, and that there should be a more expeditious machinery to activate the use of these reserve assets when conditions demanded it. However, the French were persistent in their objections to unconditional liquidity; they fought for (and won) the use of these drawing rights not being unlimited and for reconstitution of assets at intervals. The debate on this was long and fierce. Again, as a compromise, it was accepted that reconstitution of assets should be to the extent of not less

[10] An 85 per cent majority, in effect, placed a veto in the hands of the common market countries. This demand of the common market countries was to counteract the voting power that was heavily weighted in favour of the US and the UK whose currencies functioned as reserve and trading currencies.

than 30 per cent of the total allocations. In practice, this meant that only up to 70 per cent of the SDRs would have a money-like quality; the rest would represent conditional liquidity with a five-year term for reconstitution.

A number of safeguards and limitations were provided so that confidence in the new assets was not undermined. For instance, a participant could transfer special drawing rights to a participant designated by the Fund only for balance of payments need and not for the sole purpose of changing the composition of its reserves. Economic criteria were established by which the Fund decided which participants would be included in the designation plan. Rules for designation were framed to promote, over time, equality in the ratios of participants' holdings of special drawing rights in excess of net cumulative allocation of their official holdings of other reserves. SDRs were not convertible into gold and would thus function as a final reserve asset along with gold. Reform of the gold tranche was also settled. The amendment recognized the automaticity of the gold tranche drawings by making them no longer subject to challenge or to the need to obtain a waiver, and available to meet large or sustained deficits.

To avoid the risk of prolonged imbalances, reconstitution rules were written into the Articles which required that a participant's net use of special drawing rights must be such that the average of its daily holdings of them, over any five-year period, will not be less than 30 per cent of the average of its net cumulative allocations over the same period. The Articles also sought to improve the asset-like qualities of special drawing rights by allowing transfer of SDRs to other participants without fulfilling the exception of need.

A major point of concern to the developing countries was the simultaneous enforcement of Fund reform with activation of the SDR scheme. On the eve of the G-10 meeting in Stockholm, Madan, as spokesperson for the developing countries, made an impassioned plea not to link the two. This was because the developing countries felt that the acceptance of changes imparting a restrictive bias to the Fund's existing rules and regulations should follow an activated SDR scheme and not precede it. In terms of a compromise, an understanding was reached that the changes would be applied in a spirit of cooperation and that members of the Fund would avoid their application in any unduly restrictive manner.

On 16 April 1968, the Executive Board of the Fund gave final approval to its report to the Board of Governors, giving a full account of the proposed amendments to the IMF Articles and the way the SDR scheme would work. Following the approval of the report by the Governors, the members were notified and asked to 'accept' the amendments. Each member then initiated the legislative steps necessary to do this. The special drawing account, however, would become effective only after members with 75 per cent of the total quotas indicated that they wished to become participants. In the assessment of the Bank of England, the ratification by members' legislatures of the SDR scheme would be a 'significant milestone' in the progress towards a more rational system of expanding international liquidity. So far as changes in rules and practices were concerned, it would not add very much to the effectiveness of the institution; on the other hand, it would not reduce the Fund's ability to assist those of its members that were in temporary balance of payments difficulties.[11]

In retrospect, how far were the basic elements of the scheme, as they emerged out of the amendment exercise, in keeping with the aspirations of the developing countries? Did the qualities and characteristics of the new asset reflect the views of the developing world or was it a industrial product bearing the exclusive hall-mark of the G-10 group? Historical facts confirm that the basic aspects of the scheme did accord in several areas with the views expressed by the Directors of the developing world. Many of them suggested that any new asset should be allocated on a non-discriminatory basis, that it should be distributed universally, that it should be automatically available to any member who wished to participate in the scheme and that the distribution key for drawing rights should be the quotas. The Fund would administer the scheme through a special drawing account, and all decisions and questions on proper use of the asset would be centred in the Fund. In this way the oft-repeated idea of the creation of a reserve asset by a limited group of countries was given a decent burial, and the status of the Fund was preserved and its responsibility enhanced. However, the developing countries regretted that the liquidity proposals were not specifically directed towards meeting development needs. In their reading, with the slowing down of aid flows, the creation of special drawing rights in unconditional form would add to their reserves, which, in turn, would aid their growth and development. Subsequent narration will bring out the fragility of that hope!

Following the approval in principle given by the Board of Governors of the IMF for the introduction of the SDR scheme, Finance Ministry, Law Ministry and Reserve Bank officials were preoccupied in examining the legislative action needed for India to participate in the SDR facility. The Bank's advice was an important element in the amendment of the IMF and

[11] Copy of Leslie Obrien's confidential letter of 19 April 1968 to RBI Governor L.K. Jha, giving the gist of developments in the area of international liquidity.

Bank Act. The amendments authorized the Reserve Bank to receive, acquire, hold, transact and operate SDRs, and to perform all acts incidental thereto, on behalf of Government of India. The procedure to be adopted for recording the transactions relating to SDRs in the Reserve Bank books resulted in considerable interaction between the Finance Ministry, the Bank and the Executive Director.

The Fund's Articles of Agreement did not prescribe any particular domestic treatment for SDRs. In fact, according to the Fund, 'participants were to be guided by their own legislation, policies and practices in regard to (domestic) treatment of Special Drawing Rights'. The one guiding proviso given by the Fund was that the procedures adopted by participants for the use of SDRs should be so devised that the allocation of SDRs to the Central Bank of the country should not lead to an expansionary or contractionary impact on the domestic money supply—in other words, the procedures would have to ensure that SDRs would have a neutral effect on domestic monetary expansion. Use of the new instrument as a method of budgetary assistance was to be eschewed. However, no special procedures were called for in the case of SDRs *acquired* from other participants through balance of payments surplus.

Intensive exchanges followed between the Reserve Bank and the Finance Ministry, to evolve an accounting procedure that would have a neutral impact. The matter was examined threadbare by Seshadri and Anjaria at the Reserve Bank end, and by Ramakrishnayya at the Finance Ministry end, with the Executive Director, Madan, providing guidance on the basis of decisions taken in this regard by some members like the US and the UK. The main difficulty arose out of the Finance Ministry's perception that the government was the recipient of SDRs allocated to a member country, and, so long as SDRs remained as a drawing power, they need not be taken into account either by the government or the Reserve Bank. The Bank considered the approach inappropriate. On the basis of a detailed examination by Seshadri, Deputy Governor Anjaria explained in a telex message to I.G. Patel that a mechanism would have to be devised that will achieve the objective of bringing SDRs even as a drawing power into the Reserve Bank's books and then neutralize the immediate effect of this accrual on government's cash balances. But to do this, it was for the government to transfer SDRs to the Reserve Bank, who would hold it as an asset against a blocked balance in favour of the central government.

The Ministry of Finance had some concerns regarding the procedure suggested by the Bank, resulting mostly from a territorial claim. Treasury officials were unduly sensitive to the idea that SDRs would be treated, even if notionally, as an asset, and exhibited as such in the Bank's balance sheet. Setting aside the procedure suggested by the Bank, C.S. Swaminathan informed the Fund that the government had proceeded on the basis that the SDRs will not be reflected as stock in the balance sheet of the Bank but as flow, i.e. they would be reflected in the books of the Reserve Bank at the point when they are actually utilized. This view, that holdings of SDRs would not be reflected as assets in the RBI's balance sheet, was endorsed by the Central Board of the Bank at its meeting in Patna.

Thus, by legislation, Government of India conferred powers on the Bank to act on its behalf for using, receiving, acquiring, holding, transferring or operating SDRs. However, as it was the practice of the Bank not to show the IMF gold tranche position or a stand-by position as assets in its books, the same treatment would be afforded to the initial allocation of SDRs.[12] The Fund officials were not too sanguine about the allocation procedure outlined by the government, which would not provide direct budgetary support to the government but, nonetheless gave their tacit approval.

Seshadri remained uneasy. Some ancillary issues surfaced, too, such as the inclusion of SDRs in the country's foreign reserves, and the treatment of SDRs in the balance of payments compilation and in relation to the sterling guarantee agreement with the UK. Although status quo was maintained with respect to the procedure adopted for accounting of SDRs, there was great uncertainty within the Bank, whose officials continued to examine various facets of the issue. Ironically, when the Fund requested for factual information on the accounting procedures followed by India, the government, as was customary, passed the buck to the Reserve Bank to answer the Fund's questionnaire, which was duly taken care of by the Economic Department of the Bank. The government, which was keen on taking the initial decision on the SDR issue, was not as keen on replying to the Fund on the accounting issue.

Activating the SDR Facility

As the Fund approached the requirement that members having 75 per cent of the total quotas were ready to deposit instruments of participation in the SDR account, the Managing Director mooted the proposal of a five-year basic period in which annual allocations in the range of \$2.5 to \$4 billion a year could be considered. To compensate for the slow growth of global

[12] The initial allocation would, under government procedure, be reflected in a proforma account, and this account would reflect all transactions involving SDRs for the internal records of the government.

reserves and the decline in official gold holdings, he further suggested 'some front loading' in the initial years. The general tenor of the Board was supportive of the Managing Director's proposal; however, several Directors urged that the magnitudes of the quota increase and the allocation of SDRs should be considered in tandem. Madan, the Indian Executive Director, was quick to perceive the danger of such a course. Presenting the developing countries' viewpoint, he said: 'Like the industrial countries, the developing countries too had been adversely affected by the steady erosion in the supply of liquidity, as evidenced by the shrinking proportion of reserves to imports and international trade and capital movements.' Emphasizing that the developing countries were keenly interested in the activation of the SDR facility and bearing in mind the hints earlier given by some industrial countries for large special increases in quotas, Madan made no bones about opposing large special increases in the structure of Fund quotas. He was supported by the developing countries' members who wanted an assurance that activation of the SDR facility would not shortchange the outcome of the quota review.

From the above, it is clear that the special drawing rights scheme was a product of protracted debates, negotiations and compromises within and outside the IMF, spread over a period of nearly five years. The final decision to make the scheme operative came with formal approval by the Board of Governors at the Fund's annual meeting at Washington, on 29 September–3 October 1969. In accordance with this approval, the IMF was to allocate SDRs to the tune of \$3.5 billion in the first year and \$3 billion each on 1 January 1971 and 1972. A three-year interval rather than a five-year one was chosen for the first basic period because of the difficulty of estimation of reserve needs over a longer period.

In retrospect, how far were the basic elements of the scheme, as they emerged from the amendment exercise, conducive to the aspirations of the developing countries? The basic aspects of the scheme did accord in several areas with the views expressed by the Directors from the developing world. In a memorandum to the Central Board of the Bank, 'the development was described as a new era in international monetary management'. Deliberate creation of international liquidity on the basis of assured needs and under the auspices of an international agency of high competence and rich experience, in the assessment of the Reserve Bank, was 'unquestionably a momentous step forward'. The main regret of the developing countries was that the liquidity proposals were not specifically directed towards development needs. In the Bank's thinking, an automatic link of this 'fiduciary' money with aid for economic development would have been helpful, but it remained optimistic that the idea recommended strongly by a number of distinguished experts[13] would find acceptance later. Also, the high qualified majority and right of veto given to some groups of countries disturbed the Bank.

Overall, however, the Reserve Bank was receptive to the proposals, for in its reading, with the slowing down of aid flows, the creation of special drawing rights would add to reserves, which, in turn, would aid growth and development. As for the government, I.G. Patel, then Special Secretary in the Ministry of Finance, advised Madan in a letter dated 26 August 1969, that the Indian government, in the interests of the SDR scheme, would go along with the consensus; however, the scheme overlooked the needs of reserve facilities needed by the developing countries—who were 'holding just one-third of the voting power—and the share in SDRs'. Linking the distribution of SDRs with quotas and changing the latter in a way that might further reduce the weightage of the developing countries would be a retrograde act, not conducive to creating a proper climate for international cooperation. India was accepting the proposals on the assumption that the proposed quota revisions would not aggravate the present situation and some rectification by way of a link between SDR creation and assistance for development would be considered.

Between September and December 1969, the requisite decisions concerning convertible currencies, rules for designation and acceptance of SDRs for charges and repurchases, and a few other technical points were ironed out. On 1 January 1970, the first allocation planned at SDR 3.5 billion was made. India was a recipient of SDR 126 million at the beginning of 1970, SDR 100.6 million in 1971 and SDR 99.6 million in 1972. The allocations came at a time when India's reserves position was relatively strong. As a consequence, India found itself included in the designation plan among twenty-five countries selected by the IMF to accept SDR 14 million and to provide convertible currency to other participants. The new obligation was accepted with some satisfaction as it was a reflection of the significant improvement in India's balance of payments position. From now on, the responsibility of maintaining the books reflecting SDR transactions and making arrangements with the Bank of England to provide convertible currency devolved on the Reserve Bank. It was a new experience and responsibility that was discharged ably and efficiently by the Bank.

[13] UNCTAD Expert Group on International Monetary Issues had recommended the establishment of a link between SDRs and additional development assistance.

But the travails of SDR were not over. Although the second activation came through in 1979, in a speech at Brookings Institution, Ossola indicated that 'second activation appears difficult if Europe is still then awash with dollars'. Despite these ripples of doubt, however, within less than two years, SDRs became an accepted reserve asset. Almost all members of the IMF became participants in the scheme, and the usage and conversion procedures agreed upon between the Fund and issuers of currencies functioned well. As confidence in the US dollar as a reserve currency retreated, there were suggestions to make the SDR the numeraire of the monetary system.

Controversy over SDR–Development Finance Link

But the SDR link (specifically, the link between reserve creation and development funding) issue remained unresolved. As part of their preparations for the annual meeting in Copenhagen, on 21–25 September 1970, the Group of 77 developing countries considered this issue afresh, and, at the Commonwealth Finance Ministers' Meeting in Cyprus, they urged reconsideration of the link. At the annual IMF meeting, several Governors representing the developing countries pressed for a reconsideration of a link between SDR and development finance. The Managing Director, in his concluding remarks, assured them that this subject would figure in the future work programme of the Fund. A UN document outlining 'An International Development Strategy for the Second United Nations Development Decade' also sought to nudge the conscience of the developed world to seriously reconsider the possibility of establishing a link between the allocation of new SDRs and provision of additional finance for economic development. But the wall of resistance raised by the developed nations to the very idea of such a link made further progress difficult.

Early in 1971, the Fund staff came up with a paper containing a lucid explanation of the case for the link by the Secretary General of UNCTAD, and called upon the Board to identify the main lines of enquiry that should be pursued. Preliminary discussion revealed agreement on the point that the impact of the link on the volume, regularity and quality of aid would have to be carefully analysed. Directors from the developed countries expressed reservations regarding the advisability of such a study but were prepared to examine the implications of an inorganic link rather than an organic one. The need for two specific studies was agreed upon, viz. (i) a comparison of the main types of link proposals and their implications for aid and for SDR allocations, and (ii) an analysis of the different link schemes from the viewpoint of the monetary character of SDRs and the longer-run developments envisaged for the SDR facility.

It is worthwhile to mention that the Directors of the less developed countries met regularly as a group in this period to discuss the organizational and substantive aspects of the monetary system. The Indian Executive Director's office at times served as the secretariat and accepted the responsibility of preparing background papers, as was the case for the Caracas meeting of the G-24. The Fund management had initially expressed considerable unhappiness at the birth of the G-24 but then appeared reconciled to the idea of living with the less developed countries' group, especially after Prasad, the Indian Executive Director, assured Schweitzer that the group was not aimed at or against the Fund as such but was merely an answer by the developing countries to the other pressure group set up by the G-10. The aim of the G-24 was to coordinate the activities of the Directors of less developed countries and to ensure a certain measure of political support for coordination from a wider political group. It may be recalled that, despite the Indian delegation's attempt, at the time of framing the original Articles of Agreement, to include development as a purpose of the Fund in the preamble, the Indian initiative had met with stiff resistance. Except for the creation of compensatory and, later, buffer stock facilities in the 1960s, there was little evidence to indicate that the policies were intended to benefit the developing countries.

The inability of the developing countries to get agreement on a link between allocation of SDRs and the provision of financing for economic development convinced them that the existing monetary system and the manner in which it operated would not safeguard their interests. However, Prasad, the Indian Executive Director at the Fund, lost no opportunity to ram home the point that any report on monetary reform must contain proposals on arrangements for linking SDRs with development finance. In this context, he reserved his views on proposals for consolidating the then overhang of dollars and the asset settlement scheme outlined in the draft report on monetary reform. He saw in the scheme for asset settlement, an attempt to settle the large liabilities of main reserve centres and to make the poor countries even more dependent on the reserve centres. Prasad cautioned the management that creating SDRs on a scale needed for this purpose would 'seriously cripple the confidence in the new instrument' as a reserve asset. Truly progressive reform required the monetary system to become a handmaiden of development and trade, and to ensure the related aspect of a link between money and development finance. As there were reservations of a fundamental nature in regard to the approach outlined in the draft report, defending the link became the primary objective of representatives from the developing countries. And so, grudgingly, the link issue was brought back on the agenda for monetary reform.

In September 1972, the IMF staff prepared a paper in which it described five types of schemes[14] by which a link could be established between SDRs and development finance. The paper went so far as to say that 'direct repercussions of any of the schemes on aggregate world demand and hence on inflation were not likely to be sizeable'. Discussions on the link towards the end of 1972 and early 1973 revealed that most of the industrialized countries, including the US, were against using SDRs to increase assistance to the developing countries. However, with the threat of the coming into being of the G-24, there was a distinct thawing of attitudes of developed countries, to permit a discussion of the idea in the context of monetary reform. The debate was indicative of the fact that the industrial countries were not in a mood to forge an explicit link between SDR allocation and development finance. The nine Executive Directors elected exclusively by the developing countries' members, all spoke out resolutely in favour of a link of some kind.

India, being a keen proponent of the idea, battled hard for its recognition. The thrust of Prasad's intervention was that SDR-based development finance was not a risky idea fraught with disaster, as many seemed to think, and that it had potentialities that needed to be explored. After all, the ultimate stability of the international system was related to growth and trade, and some kind of a link between the monetary system and development finance was inevitable. Emphasizing that the Fund's purposes were broad, aiming at full use of world resources to achieve full employment and higher living standards was not such a bad idea. Prasad cautioned the Board not to be obsessed with balance of payments equilibrium as the sole objective to be obtained at all costs, and accused the Fund of losing sight of its basic principles. He was vigorously supported by his G-9 colleagues. Some came up with even newer arguments for the link, the burden of their song being

[14] Type A scheme, in which the Fund would directly allocate SDRs to international institutions. Type B scheme, in which developing countries would be given a larger share of SDR allocations than corresponding to their share in Fund quotas. Type C scheme, in which the share of developing members' initial quotas and hence in SDR allocations would be raised. Type D scheme, in which national governments receiving SDR allocations contributed a predetermined proportion of their SDR allocations to development finance institutions. Type E scheme, which depended on the creation of a substitution account and amounts of interest received by the Fund from operations with the account would be contributed to development finance institutions.

that the gap between the needs of the less favoured Fund members and the amount of resources available needed to be filled either through the link or through alteration of the Fund's policies pertaining to the use of regular resources.

The several hours of discussion left no one in doubt that the task of hammering out a new monetary system would indeed be a difficult one, entailing hard bargaining. These were preliminary skirmishes and many more battles would have to be fought before one could get down to the brass tacks of devising a new system. But the one fall-out of the link discussions was that the Managing Director and staff of the IMF became seriously interested in finding some way of channelling a larger quantum of financial resources to the developing countries. The upshot of this change of heart on the part of the staff was the idea of instituting a new facility that would provide larger resources for longer periods to developing countries for undertaking structural adjustment of their economies; a 'link within the Fund', so to say, meaning that assistance to developing countries would come directly from the Fund. The suggestion roused the interest of the developed and developing country members and, within a year, after careful study, the Extended Fund Facility was instituted in 1974.

This, however, did not mean that the demand for the SDR link faded away. At the May 1973 meeting of Deputies of the C-20, the G-24 presented the consensus of officials of developing countries in a report[15] on the link. The report emphasized that transfer of real resources to developing countries ought to be an integral part of reform of the system. At the meeting, the developing countries stated their commitment to the link and indicated their preference for the type B scheme. Rehearsing familiar arguments against the link, the developed countries warned that the Fund should be cautious in entering the field of development finance, that a link would reduce confidence in the SDR, and that balance of payments adjustment would be adversely affected.

While the idea of linking SDRs to development finance was eminently attractive to the developing country members, the developed country members refused to see the logical connection between SDR creation and development finance. The key industrialized countries were adamant that development aid should not be linked with the global need for SDR creation; if the decision was dictated by that need, the outcome could well be that liquidity creation would be excessive, uneashing inflationary tendencies that

[15] Lal Jayawardena of Sri Lanka was the chairman of the Working Party on the Link.

would shake the confidence of the SDR. This attitude of the industrial countries provoked the Indian Executive Director Prasad to remark: 'Acceptance of a reformed system that included the link might be politically difficult to some developed members; acceptance of a reformed system which did not include the link would equally be politically difficult for many developing countries.'

The outcome of the May 1973 deliberations was that the link issue could not be usefully pursued by the C-20. However, to keep the issue alive, a Technical Group on 'SDR–Aid Link and Related Proposals' was set up in May 1973, to examine in depth the modality through which the link could be instituted, and to examine other technical aspects such as the amount, timing and distribution key for SDR allocations. Despite the negative approach of the industrial countries, the developing country members continued to vigorously argue in favour of the link. The Technical Group had representatives from Central Banks and Ministries of Finance of developing countries, who were aided by their Executive Directors. India was represented on the Technical Group by I.G. Patel from the Finance Ministry and Kadam from the Reserve Bank. The Group met twice and gave its report to the Deputies. Suffice it to say, there was no shift in the entrenched national positions but the lobby of representatives from developing countries remained firm on their preference for a type B scheme. They viewed the proposed extended facility, the easing of conditionalities and enlarged drawings under the compensatory financing facility, and the buffer stock facilities, not as substitutes for a 'link' but as 'welcome supplements'. But it was pretty obvious that the European countries were resisting, in every way possible, attempts at diverting the new reserve medium for aid. Articles that appeared in a German daily displayed the mood and thinking of the Europeans on this issue.[16]

[16] *Neue Zuercher Zeitung* stated that the less developed countries had acquired newfound energy after the activation of SDRs, an activation that completely ignored statutory preconditions and which was anything but restrictive in measuring out the amounts involved. The developing countries for some time had been urging pressingly for a larger share of new SDR allocations, demanding vehemently an institutionalized link between SDR creation and development aid, and would like a special SDR allocation to compensate their losses from last year's realignment of industrial countries' exchange rates. The article went on to say that expansion of the former G-10 into a G-20 to include developing countries was a significant sign of lowered resistance from some industrialized nations. It disputed that the developing countries were under-represented in the Fund, adding that the third world receives proportionately more SDRs from the IMF than it would if total reserves were used as the basis for allocation. The above observations were indicative of the uphill task that the developing countries would have to face in the G-20 discussions on the subject.

July and August 1973 saw frenzied activity in the Committee of Twenty (C-20) to reach agreement on the outline of reform before the annual meeting in Nairobi. Entrenched positions, however, came in the way of an agreement as models for adjustment and for convertibility were discussed. Neither was agreement forthcoming on the valuation of gold. As for the SDR link, the developing countries were eager to establish a reformed international monetary system that would 'promote an increasing net flow of real resources to developing countries'. The possibility of establishing a link between development finance and SDR allocation in the context of the reform was closely examined but no agreement was reached.

Nevertheless, the demand for a link between SDR and development finance was forcefully reiterated by several of the Governors of developing countries at the 1973 annual Fund–Bank meeting in Nairobi. India's Finance Minister, Y.B. Chavan, who attended the meeting said 'the link could be established through regular transfer of a certain proportion of newly created SDRs, which would provide an additional flow of resources needed for economic development and thus would help to fulfil a function that is essential over the longer run for the adjustment process to function efficiently.' He warned that 'it would be incorrect to distribute new reserve assets entirely as some sort of unearned dividend on the basis of Fund quotas'. The outline of reform declared firmly that 'if a link were to be established, the amount of SDR allocations and the principal characteristics of SDRs should continue to be determined solely on the basis of global monetary requirements'.

The only outcome of these deliberations was the establishment of yet another Technical Group on the Transfer of Real Resources. This Group met four times between November 1973 and April 1974. While the developing countries wanted the Technical Group to go into the full range of topics, from trade and investment to development aid, participants representing the developed group of countries were only prepared to confer a narrower mandate on the Group; they wanted it to confine its examination to a much shorter list of questions pertaining to resource transfers, and specifically related to the features expected in a reformed international monetary system. In view of the differences that surfaced over the very terms of reference of the Technical Group and since the C-20 was to wind up its work, it was decided to limit the work of the Group to issues concerned with arrangements for the international monetary system, leaving aside the wider issues of transfer of real resources to be considered later by some other committee.

The sum and substance of the Technical Group's conclusions were that an improved, smoothly working adjustment process would be beneficial to the developing country members, and that developed country members should undertake corrective measures so as not to disrupt the development programmes of developing country members. Issues such as exchange rate mechanism and the effect on borrowing by developing country members, consolidation of currency reserves and financing of the enlarged deficits resulting from the increase in oil prices of non-oil developing countries, were also covered by the report of the Group. Finally, the Group recommended the establishment of new institutional arrangements for study of the broad questions involved in the transfer of real resources to developing countries. Thus the seed was sown for the setting up of a joint Fund–World Bank Ministerial Group to consider issues pertaining to transfer of real resources to developing country members. The subsequent creation of the Development Committee was an outcome of this recommendation.

By the beginning of 1974, it was evident that the C-20 was about to abandon its efforts to reform the international monetary system. India had the rare distinction, along with two other countries, of having Y.B. Chavan as the ministerial representative at six C-20 meetings; in the case of most of the others, there was a change of faces but little change in positions. Representatives of Belgium, France, Italy and the UK supported type A or B schemes; Japan, Australia and the Netherlands were supportive of a link but preferred type D schemes. But Germany and the USA continued to oppose the idea; Shultz of the USA went as far as to declare, that the United States had grave reservations about the link. Burns, in support of Shultz, said that 'the link would undermine confidence in the SDR and would provide a good excuse to the US Congress not to vote for the aid appropriations'. Hope was expressed that constructive compromises would enable the C-20 to put together an Outline of Reform of the International Monetary System. But long standing patterns of behaviour of the key countries made such constructive compromises extremely difficult. Meanwhile, the international payments scenario was overtaken by a sharp increase in the price of crude oil.

Disappointed with the turn of developments and realizing that the C-20 was likely to give up its efforts to reform the international monetary system, as a last-ditch effort, the G-24 met in Rome on 16 January 1974. They pressed home the point that they wanted early agreement on all outstanding issues, including an improved trading system and an improved system of transferring real resources from developed to developing countries. Since the prospects appeared dim, the G-24 officials stated their positions on various aspects of the reform. Briefly put, their demand was that arrangements should be made to facilitate use of the SDR in official settlements; and that there should be changes in the structure of members' quotas in the Fund and in their voting power so as to give developing country members a larger share in decision-making; that a permanent Council of Governors could be created to help run the Fund and developing country members should be given adequate representation on that Council; and that some kind of link arrangement should be established without further delay.

All that came out of the pressurizing by developing country members was that the outline contained a separate section on the link and on credit facilities in favour of the developing countries; the substantive decision to establish a link between SDR allocation and development finance was shelved. It was a sad commentary that after years of intense negotiation at various levels, financial officials were unable to come to an agreement on creating a reformed monetary system. Morse, chairman of the C-20, attributed the failure of the Committee to lack of political will. But the work of the Committee was significant in facilitating agreement, later, on aspects of the evolving architecture of the monetary system, such as guidelines for floating and valuation of the SDR. Agreement on a number of points were later incorporated into the second amendment of the Articles of Agreement.

By early 1974, an atmosphere of crisis had gripped the international monetary system. There were wide swings in the exchange rates for the main currencies but there were no international rules for exchange. Commodity prices were zooming and speculative stockpiling was in evidence. Some of the industrial countries were experiencing inflation rates of 10 per cent. The inflationary flame was further ignited by an unprecedented rise in crude oil prices; this development gave the C-20 a readymade alibi to state that it was 'overtaken by events'. The fact, however, was that the political will for creating a reformed system just did not exist.

The years from 1974 onwards saw a non-system in place that led to increased volatility in exchange rates and capital flows, and a slowdown in the growth of world trade and output. The IMF attempted to adjust the nature of its facilities, added new ones like the Oil Facility and the Extended Fund Facility, and displayed a little more flexibility in its approach to conditionality, in order to improve its effectiveness as a lender to developing countries. In preparation for an evolving system, a special consultation procedure was inaugurated, the central rate decision was revised, and discussions were initiated to determine the value of the SDR and its rate of interest, which, in turn, led to a discussion on related changes in the rate of remuneration and charges. Tackling this heavy agenda meant many more Board meetings and intensive study of the issues, requiring the Indian Executive Directors, Prasad, S. Jagannathan and S.D. Deshmukh (who succeeded Jagannathan in 1977), to remain ever-viligant to safeguard the interests of the constituency they represented.

It may be recalled that in the absence of a proposal by the Managing Director, the second basic period—1 January 1973 to 31 December 1977—began as an empty period. When it came to considering an allocation for the second basic period, there was a good measure of support, particularly from developing country Directors, for further allocation over a short basic period. Admittedly, there was a very large increase in reserves, but they pointed to the uneven distribution of the reserves. The Directors regarded it important to continue allocation, even if on a smaller scale, as failure to do so would lead to adverse political reactions among the less developed countries.

The Indian Executive Director, Prasad, ably argued the case for an allocation. He tellingly brought out the inequity of the international financial system by stating that although the Articles of Agreement do speak of 'reserve needs reckoned on a global basis', the Fund should develop a more sophisticated concept of assessing reserve needs, according to different regions and different types of countries; that reserve excess in some areas and reserve stringency in others might coexist, and, unless varying situations are duly taken into account, developing countries would be faced with hardships simply because a few of the developed countries had managed to pile up reserves. This argument received considerable support from developing country Directors but a group of developed country Directors refused to be swayed in their interpretation of 'global need', and literally clung to their own concept of need. Throughout the second half of 1972, the Managing Director continued his consultations. But, as there was no broad support for an allocation proposal, he ceased his consultations following the very large increase in foreign exchange reserves (about US$ 20 billion) that took place in the first quarter of 1973. Hence the second basic period began as an empty period on 1 January 1973.

It was not till early 1977, then, that the Interim Committee requested the Board to consider whether a further allocation of special drawing rights was warranted. A staff paper had made a convincing case in support of further allocation of SDRs in the range of 5 to 8 billion per annum. Developing countries supported the staff analysis and pointed out that continued laxity in SDR allocation would have a detrimental effect on the viability of the SDR. Some developing country Directors went as far as to say that they would find it difficult to support proposals to make SDR a more attractive asset unless the Board adopted a more positive stance on the allocation issue. Deshmukh, the Indian Executive Director, stressed the importance of a fresh dispensation as a crucial and essential step in the march towards making the SDR the principal reserve asset of the system, and urged that since the possibility of making a supplementary financing facility appeared remote and quota negotiations were time-consuming, positive action was needed on the allocation front. Supporting the staff's conclusion that the expansionary effect of an SDR allocation would be very small, Deshmukh said that an allocation would help in broader distribution of reserves and reduce reliance on commercial banks for countries facing debt servicing problems.

But most of the arguments, no matter how convincing, failed to wash with the hardliners—Japan, Germany and the USA. Japan's concern was the impact of a sizeable allocation of SDRs on the size of the seventh quota increase and its adverse effects on Japan's chances of getting a special increase. Germany and the USA continued to express the view that there was no general shortage of liquidity and that the issue should be addressed after a lapse of two to three years. Despite the staff pointing out that there would be need for annual allocation of SDRs to satisfy the members' need for a secular growth in their reserves due to expanding world trade, the developed countries stonewalled the proposal with the intention of extracting concessions from the developing countries that they would support proposals for improvement in yield on SDR and also cover issues regarding the size and distribution of the seventh quota increase. In light of the above, the Managing Director concluded that he could not make any proposal for an allocation at that point of time. He said that the Board should consider all aspects of the SDR question and when these issues were resolved, he would submit a proposal for an SDR allocation. Thus the first year of the third basic period began as an empty year with no fresh allocation.

It was not till mid-1978 that the Managing Director, in an Aide Memoir, suggested an allocation of SDR 4 to 6 billion a year for a period of three years, 1979 to 1981, and utilization of part of the allocation towards payment of 25 per cent of the quota increase. When the proposal was forwarded to the Reserve Bank for comment, Governor I.G. Patel was of the view that we should not readily support the proposal and that our support could be used for bargaining to have SDRs created at a satisfactory rate. The Aide Memoir came up for discussion, but there was little evidence of a consensus and hope of reaching an agreed position appeared dim. On the quantum of allocation, the numbers varied from SDR 6 billion supported by the G-9 directors, to SDR 4–5 billion favoured by Italy, to a token allocation supported by the USA and Canada, with Germany, as usual, urging the Managing Director not to make any proposal for an allocation. Such divergent views made reconciliation of positions difficult. On the Managing Director's proposal of 25 per cent increase in quotas in SDRs, while many developed countries were inclined to extend support, Germany and Italy did not show any special interest. Deshmukh, the Indian Executive Director, based on instructions received from his authorities,[17] proposed an allocation of SDR 6 billion a year without the conditionality of part payment of the quota, and showed willingness to go along with SDR 6 billion with link but at a lower rate than the proposed 25 per cent of quota increase payment in SDRs. On the other elements of the package, viz. increase in charges, rate of remuneration and relaxation of the reconstitution provision, although differences did surface, they appeared to be manageable. The Indian Executive Director's evaluation was that consensus could emerge on SDR allocation of SDR 3–4 billion a year, 80/90 combination rates for charges, remuneration, and reduction in the reconstitution provision to 20 per cent.

The Interim Committee meeting of 24 September 1978, which stated that, 'in the Committee's view, the Fund should make allocations of 4 billion SDRs in each of the next three years 1979 to 1981', gave the Managing Director the necessary mandate to establish that 'a long-term global need existed … to supplement existing reserve assets'. Accordingly, on 19 October 1978, a redraft of his proposal for allocation of special drawing rights during the third basic period, from 1 January 1979 to 31 December 1981, was brought before the IMF Board. Based on consensus in the Board, the Governors approved the resolution on 11 December 1978. While advising the Indian government to cast an affirmative vote on the package, the Reserve Bank, in a cable to Manmohan Singh, said that 'the consensus evolved on which the vote is being taken is the best that we could secure in the present circumstances'. In a brief message, the immediate implications of the approval for India were spelt out. India was to receive an allocation of SDR 119 million, Bangladesh SDR 15.8 million and Sri Lanka SDR 12.4

[17] Governor I.G. Patel's view was that an allocation of SDR 6 billion, with part payment in respect of increase in quota to take place thereafter in the form of SDRs, may be preferred to a lower allocation of SDR 4 billion per year, and if that was not possible, to bargain for an unconditional allocation of SDR 5 billion. The RBI brief rightly pointed out that if 25 per cent of the increase in quotas is payable in SDRs and the seventh quota review is to raise the size of the Fund by 50 per cent, i.e. by SDR 19.5 billion, there would, in effect, be no SDR allocation in the year in which the quota increase became effective.

million, which amounted to 10.4 per cent of their quota as on 11 December 1978. The rate of interest on SDRs would form 80 per cent of the combined rate, whereas the remuneration rate would be 90 per cent of the SDR rate and the reconstitution provision 15 per cent.

Apart from this exercise of advocacy in favour of a large SDR allocation, the Reserve Bank assisted the government in responding to the Fund's questionnaire to members on the accounting aspects of SDR allocations and holdings. Information was also sought by the IMF on the manner in which members finance and account for subscription payments and other operations with the Fund. The questionnaire contained thirteen questions. The Bank's Economic Department, in collaboration with the Chief Accountant's office, prepared comprehensive replies, setting out the procedure and accounting aspects of the questionnaire, and underlining the fact that until such time as the SDRs were actually utilized, it was not the practice of Government of India to treat mere drawing power as cash and to account for it as a receipt.

On 1 January 1980, under the decision covering the third basic period, the IMF allocated SDR 4.033 billion to 139 members. The allocation for the members of the Indian constituency was the same as in the previous year. The last allocation under the third basic period was scheduled for 1 January 1981 and this, as previously intimated by Deshmukh to I.G. Patel, was affected by changes in quota shares following the coming into effect of the seventh quota increase. Moreover, under the amended Articles, 25 per cent of the quota increase had to be effected in SDRs. With the last SDR allocation of the third basic period likely to be completed on 1 January 1981, the cumulative allocation of SDRs after 1969 came to SDR 21.4 billion.

Meanwhile, against the backdrop of a sharp deterioration of the world economic scenario in the early 1980s, marked by lower industrial growth, much higher levels of inflation, slowdown in the volume of world trade and a dramatic increase in payments imbalances among major country groups, questions arose regarding changing the rate of SDR allocation for the remainder of the third basic period and of the appropriate rate of allocation for the fourth basic period. These issues were raised in the outline for a 'Programme of Action on Monetary Reform' of the G-24 in Hamburg in April 1980, and in the Brandt Commission Report.

In response to the demands contained in the G-24 Action Programme, the Managing Director of the IMF, on 8 August 1980, as required under Article XVIII, circulated a staff paper entitled 'Considerations Relating to the Size of SDR Allocations'. The two aspects addressed in this paper related to: (i) whether a supplemental allocation of SDRs because of unexpected major developments was desirable in the third basic period, and (ii) the size of SDR allocation during the fourth basic period. Through circulation of the paper, the Managing Director sought to ascertain whether there was support for his initiative.

As was customary, the paper was forwarded to the Reserve Bank for comments. The Bank's conclusion was that there were strong elements in the world's economic situation—inflation, stagnation, unemployment and large payments imbalances—that justified prompt reconsideration of SDR allocations in the third basic period. The value of world trade in 1981 could be at least 30 per cent higher than the value projected for that year in 1978, which formed the basis for determining the size of allocation for the third basic period. As Finance Minister R. Venkataraman pointed out in his 1981 annual meeting address, 'the problems were deep-seated and no country had escaped unscathed'. The Reserve Bank of India brief further stressed that the large imbalances of major country groups following a marked shift in the terms of trade was another factor that needed serious consideration. As far as the low-income countries were concerned, their terms of trade had deteriorated sharply at a time when their export markets were stagnant and protectionism had increased. Their combined current account deficit had risen from $37 billion in 1978 to $84 in 1980, a factor not taken into account when the decision on allocation for the third basic period was taken. The substantially larger level of trade transactions than anticipated earlier, it was argued, would call for a much higher level of global reserves. There was absolutely no doubt in the minds of Reserve Bank officials, that the level and distribution of reserves among the country groups had altered significantly enough between 1978 and 1981 to warrant a further allocation. A larger allocation of SDRs would also facilitate the recycling of resources, which had assumed great importance in a period of vastly increased imbalances. Emphasizing strongly that 'unexpected major developments' justified an increase in the rate of allocations in the third basic period, the Bank indicated SDR 6 billion as the size of the supplemental allocation.

On the size of the allocation for the fourth basic period, the Reserve Bank's thinking was that even the outside limit of SDR 10 billion per annum suggested by the IMF staff was on the conservative side. With the slippage in the proportion of SDRs in non-gold reserves, the official Indian view was that permitting the trend to continue would mean moving away from the objective of the Articles of Agreement of the Fund to make the SDR the principal reserve asset of the system. The fact that the proportion of SDRs had declined even below the level at the end of 1978 was a pointer that the international community was moving away from the goal. Noting the decision to raise the SDR rate to 100 per cent of the combined market rate and other measures taken towards making the SDR the principal reserve asset of the system, it was felt there was enough justification to significantly speed up the allocation of SDRs in the fourth basic period.

But, despite the strong and irrefutable arguments for a sizeable SDR allocation put forward by the developing countries, the Board discussion revealed a divergence of views, ranging from a large allocation to a modest one and even no allocation, leading the Managing Director to conclude that many had emphasized that 'it would be important to present a very clear case for an allocation that was fully compatible with the Articles'. The thrust of the developed countries' argument was that reserve creation through the capital markets was adequate; given the strong inflationary tendency, since it was the primary responsibility of the Fund to check inflation, it had to be cautious in allocating SDRs. This line of reasoning was stoutly rebutted by Executive Directors from the developing world who urged that a cooperative institution like the Fund could not ignore the distributional aspect of SDRs, and that allocation of SDRs should deal with this aspect, for there were many members that were experiencing difficulties in gaining access to the capital market. The industrial country Directors, while harping on qualitative improvement in SDRs, held fast to the view that quantitative increases would affect the quality and credibility of the SDR. Other approaches for enhancing the role of the SDR, such as the Fund borrowing in terms of SDRs, were not considered as appropriate substitutes for SDR allocations.

In an effort to enable the Managing Director to make a proposal for SDR allocation in the fourth basic period before the Gabon Interim Committee meeting, a paper entitled 'Further Considerations Relating to the Size of SDR allocations in the Fourth Basic Period' was brought up for discussion in mid-April 1981. The paper sought to answer some of the concerns voiced by the Executive Directors. The material provided in it strengthened the argument for a fairly sizeable allocation based on the long-term global need for reserves to grow, and indicated that annual allocations in the region of SDR 11 to 14 billion would be justified. It may be recalled that India had favoured a sizeable allocation of SDR 19 billion, which the developed countries had resisted.

In consultation with Narasimham, the then Executive Director at the Fund, and based on a brief provided by the government, the Alternate Director Kannangara further reinforced the argument for a sizeable allocation by pointing out that even with an annual allocation of SDR 12–13 billion, the non-oil developing countries would receive unconditional liquidity in the form of SDRs of only 3 billion, whereas their borrowings from the Fund representing conditional liquidity would be SDR 9–11 billion. The external debt of these countries, besides, would rise at an annual rate of SDR 32–42 billion. Urging that the grim debt prospects, lack of access to capital markets and the need for a proper balance between conditional and unconditional liquidity be taken into account, the Indian demand was for an allocation larger than SDR 3 billion to non-oil developing countries. Alternately, if the level of SDR 12–13 billion suggested by the staff was agreed to, then India wanted a change in the basis of distribution of SDRs from the existing one related to quotas to one of voluntary renunciation by industrial and oil exporting countries in favour of non-oil developing countries.

Despite the positive tenor of the IMF staff paper, the developed countries continued to pick holes in its analysis. The Americans, Japanese and French said they were studying the issue and had not made up their minds. The British argued that it was important for the Fund to adopt a cautious stance—'the Fund cannot be seen by the outside world as being ambivalent to inflation'. The upshot was that the debate was again inconclusive. True, the matter was complex and not one of mathematical evidence alone, but the Managing Director urged the Board to reflect on the issue and come up with numbers at Libreville. Reminding the Board that the Fund was a cooperative institution that had to take into account the needs of *all* members, he urged it to adopt a cooperative stance. He summed up the discussion by stating that the 'Board was not in a position to take a final view'.

To sum up, on 3 October 1969, with the approval of the first allocation of SDRs, the SDR was established as a reserve asset. Developments in the 1980s indicated the fragility of the hope that the SDR would become the centrepiece of the monetary system. At the time of the first allocation itself, L.K. Jha (Governor for India) urged that the whole question of a formal link between the creation of liquidity and development aid, which had been shelved, should be considered afresh. Thirteen years later, at the annual IMF meeting in 1983, Manmohan Singh reminded the gathering of the urgent need for a fresh allocation of the SDR. Singh pointed out that even though steps had been taken to improve the characteristics of the SDR and it had been brought as close as possible in alignment with currency assets, a disappointing feature was that the proportion of SDRs in non-gold reserves had slipped further. In effect, he said, 'we had moved a step away from the objective of the Articles of Agreement of the Fund to make the SDR the principal reserve asset'. He strongly advocated a reasonable allocation of

SDRs, which would help to activate the unutilized capacities around the world, and rebutted the argument that it would rekindle inflation.

It is indeed a sad commentary that, more than thirty years down the line, the high qualified majority has worked to prevent the growth of the SDR. The developed countries tightly controlled its creation with only four allocations over a span of thirty years totalling SDR 21.4 billion and forming a very small proportion of total reserves, barely 4 per cent, for there were several empty periods in which no allocations were effected. The expectation of the developing countries that, sooner or later, the opportunity would be used to establish a 'link' between the SDR and additional development assistance, remained a fond hope. For over thirty years the developing countries have clamoured for the link, but the prospects have not only receded but the very idea has been buffeted and obliterated from the international agenda by the winds of the liquidity debate. In September 1997, through a proposed fourth amendment to the Articles of Agreement, a move made for a special one-time allocation of SDR 21.4 billion, which would raise all participants' ratios of cumulative SDR allocation to quota under the ninth general review to a common benchmark ratio of 29.32 per cent. To date, the proposed amendment has not been ratified.

13

Adjustment in Uncertain Times

The period 1967–68 to 1980–81 was one of the most unstable and unpredictable ones in the economic history of India. Both on the national and international planes, India was called upon to grapple with events and developments such as the Bangladesh war, breakdown of the Bretton Woods system, the dawn of the regime of floating rates, two oil shocks, the Emergency and the imperatives of development of the domestic economy. This chapter seeks to bring out the conscious application and evolution of policy measures by the Reserve Bank and the government to restore balance and adjustment in the external sector, and the relationship between the Bank and the Finance Ministry in addressing these issues.

POST-RUPEE DEVALUATION ADJUSTMENT PANGS

It may be recalled that while the Third Plan was in progress, certain events imposed unforeseen pressures and burden on the Indian economy. The sharp increase in defence expenditures consequent upon the armed conflict with China in 1962, and with Pakistan in 1965 and again in 1971, and the levelling off of foreign aid, placed the economy in a serious bind. Two consecutive droughts in 1965–66 and 1966–67 aggravated the situation further to reach crisis proportions. In both these years, the GDP fell in absolute terms. Despite tight controls on imports (through quantitative restrictions) and severely restrictive foreign exchange regulations, the current account deficit was 1.8 per cent of GDP. Foreign exchange reserves were low, at Rs 47.4 crore, less than necessary to cover three months' imports. An overwhelming proportion of the current account deficit was financed through inflows of concessional external assistance.

The impact of these adverse circumstances brought into full view the weaknesses of the economic strategy that had been followed in the preceding years. One of these was the intersectoral imbalance between agriculture and industry, and the other, ignoring the option of foreign trade as a stimulant to economic growth, which stemmed from the highly pessimistic view taken by India's policy-makers on the potential of export earnings, despite Dr Manmohan Singh's seminal research that strikingly refuted the export pessimism.[1] As C. Rangarajan, an economist himself, who later became Governor of the Reserve Bank, rightly stressed, 'policy-makers underestimated not only the export possibility but also the import intensity of the substitution process itself'.

The relative neglect of agriculture was, among others, a result of the availability of large quantities of foodgrains in the late 1950s and early 1960s under the PL480 programme. This was, however, corrected later through the adoption of high-yielding crop technology and breakthroughs in research in plant genetics, combined with increased investment in irrigation and an incentive-based farm support pricing policy. This was a major policy shift that helped to reduce the foreign exchange outgo on foodgrain imports.

Another development with serious consequences for the economy was the abrupt reduction of external assistance. The main casualty in the adjustment to reduced levels of foreign assistance was growth, as economizing on essential imports necessarily entailed reduction in aggregate and sectoral growth targets. Other discernible shifts in policy related to a greater effort at export promotion, a greater role for price incentives and a shift to quick high-yielding projects with shorter gestation periods.

The fall-out of the uncertain external aid scenario put on hold the longer-term planning exercise. But the general direction of policy was towards strengthening the process of liberalization. The June 1966 decision to devalue the rupee was not only to correct the overvaluation of the rupee but to move towards a more liberalized trade regime. Around this decision was also woven the aid package that was expected to underwrite the aid programme. As mentioned earlier, the devaluation of the rupee in 1966 had a remarkably unfavourable political reception. The government failed to elicit significant support. The behaviour of key indicators was not supportive of the policy change either, for, devaluation failed to push up export earnings or enhance the level of foreign aid as expected. The export earnings the year following devaluation (1967) declined by 8 per cent. Nor did the aid package materialize. S. Boothalingam, Secretary in the Ministry of

[1] Manmohan Singh, *India's Export Trends*, Clarendon Press, Oxford, 1964. Singh, much later, in the 1990s became India's Finance Minister and prime architect of the successful reform programme.

Finance at the time when the decision was taken, later concluded that devaluation 'was not allowed to work'. It failed to stimulate a major shift into export production as it coincided with two successive serious droughts which necessitated massive food imports and induced a sharp recession.

The policy issue that came to the fore was: could the decision to devalue have been avoided? A Finance Ministry note to Members of Parliament explained why the decision had to be taken. The note clearly stated:

> The action could not be postponed as all further aid negotiations hinged on it. It is extremely doubtful whether, without demonstrable evidence of our determination to push up our exports and improve the internal viability of our economy, we shall continue to get external credits, particularly, as we are already at the stage when we have to incur fresh debts in order to pay off old ones. Without reasonable prospects of aid forthcoming on the scale contemplated by us, the finalization of the Fourth Plan will be still further postponed.

Evidently, the mood of the donors had changed. It was no longer that of the early 1960s, when they had endorsed the general framework of the Third Plan and made a declaration of intent to provide assistance on soft terms.

In the months following the devaluation, RBI Governor Bhattacharyya paid attention to the debate while closely monitoring the evolving foreign exchange situation. On 9 February 1967, in a top-secret note, the governor alerted the Finance Minister that even with the resumption of normal consortium aid, the country would run into balance of payments difficulties as a result of the previous year's drought and the growing burden of debt repayments. Based on the revised estimates prepared by the Reserve Bank's balance of payments division, which indicated a level of foreign exchange reserves of Rs 282.1 crore ($376 million) as on 27 January 1967, Bhattacharya clearly warned that if timely corrective action was not taken, the reserves would breach the legal minimum even before the new government assumed office. The disconcerting fact was that, despite a drawing of $187.5 million from the International Monetary Fund (IMF) and a substantially higher level of non-project aid, the foreign exchange situation had shown no tangible signs of improvement. The Governor attributed this to a variety of reasons: aid was not available for a large part of the requirements such as oil and defence; India had to import from non-aid-giving countries while aid-giving countries insisted that aid should result in higher purchases and not in substitution of purchases normally made with free foreign exchange.

Recognizing that the response on the rephasing of debt had been extremely poor and the World Bank initiative had met with little success, the RBI Governor lamented that this, together with the fall in export earnings, would place additional strain on the reserves. Drought for a second year in succession would further compound the problem by adversely affecting the exports of agricultural commodities and pushing up import payments on food. Superimposed on the enlarged trade deficit were the sizeable payments on external debt. In this bleak scenario, a further drawal on reserves was inevitable. The Reserve Bank's estimate was February to July 1967 would see the reserves drop at a monthly rate of Rs 36 crore or $48 million, reducing them to a rock-bottom level of Rs 80 crore or $106 million by end-July 1967. Predicting a critical external payments situation very soon after the new government took office, Bhattacharyya underlined the need for remedial measures if the government was not to be caught off-guard. It was a question of timing and, here, the two most important considerations were to act early and to act when 'things have been worse and look like getting better'.

The remedial measures suggested were as follows. Commitments for imports against free foreign exchange should be kept to the absolute minimum and, if possible, avoided, till the new government had had the time to examine the foreign exchange situation in detail. All further imports must be covered by the aid available and the announcement of the new import policy for the period April–September 1967 should be deferred till the new government had had the time to assess the position. A comprehensive review of export promotion measures was recommended, including an examination of the programme of subsidies to see if changes were warranted. As an addendum, two other options were indicated, viz. approaching the IMF and the consortium for a standstill arrangement on debt obligations. However, with indebtedness to the IMF at $425 million, the Governor cautioned the Finance Minister that the Fund management may find it difficult to support another large drawing in April 1967 without specific undertakings, not only to impose fiscal and monetary discipline, but also to continue liberalization of imports and avoid intricate and extensive systems of export incentives. In the Governor's reckoning, the need for a Fund drawing was 'urgent' and 'inescapable'. Knowing that it would be politically difficult for any new government to give undertakings that entailed tightrope walking, the Governor's idea was to activate thinking among senior treasury officials on the options available to contain a prospective deterioration in the external payments situation, including vigorous pursuit of the standstill agreement on debt repayments.

The above recommendations constituted good practical advice. But what if approaches to the IMF and the World Bank failed to materialize? Fearing the possibility of such an outcome, a fall-back option was mooted. In a supplement attached to the main note, the Governor prefaced his opening remarks in brackets to read:

> It is suggested FM may not touch on this point tomorrow unless it comes up. Our idea is that we shall separately prepare a note on this with necessary legislative change to be approved after the elections, but by early March. FM, however, should indicate whether we should go ahead on this basis at this stage.

Knowing that for a variety of reasons, particularly relating to the convenience of the new government, it might be thought desirable to postpone a formal approach to the IMF till June or July, and if the standstill arrangement on debt payments too was not forthcoming, the RBI Governor saw real danger of the reserves piercing the legal minimum requirement by the end of May. A tactical way of buying time was to change the legal requirement, which at that time was Rs 200 crore, of which Rs 115 crore had to be in the form of gold valued at the old parity for the Indian rupee. Amendment to the RBI Act would entail stating that the gold parity for this purpose would be the parity after devaluation, which would automatically increase the value of gold holdings from the then existing level of Rs 116 crore to approximately Rs 181 crore, releasing Rs 65 crore more of foreign exchange reserves and thus preventing a fall in reserves below the legal minimum of Rs 200 crore. As an astute banker, Governor Bhattacharyya was aware that such an amendment could weaken public confidence but he was prepared to counteract such sentiments by stating that it was anomalous that the Bank should continue to value its gold holdings at the pre-devaluation rate. He advised the government that if such a change was contemplated, it should be undertaken as soon as possible and preferably before the coming session of Parliament, for a change of this nature had to be made from a position of strength and not when the reserve level was precariously close to the minimum.

On receipt of the governor's secret communication and realizing that a critical foreign exchange situation was likely to develop in the coming months, the Finance Minister immediately convened a meeting of Economic Ministers, which was presided over by the Prime Minister. A wide-ranging discussion ensued based on the issues raised in the RBI Governor's note and the additional note on the foreign exchange situation prepared by the Finance Ministry. It was decided to authorize B.K. Nehru, then India's Ambassador to the US, to informally sound out the Managing Director of the IMF, Schweitzer, on a possible drawing by India, based on a brief the Finance Minister instructed I.G. Patel to prepare in consultation with Bhattacharyya and Jagannathan. Nehru was also to call on Woods, President of the World Bank, to discuss the question of debt relief. In Delhi's perception, wrapping up the debt relief issue was more urgent than a Fund drawing. Keen that the approach to the Fund should in no way jeopardize the standstill arrangement on debt payments that India was seeking from the World Bank, Jagannathan, in his communication to Ambassador Nehru, stressed that Delhi regarded the standstill on debt as the 'real answer' to India's problems. The government's anxiety was that discussions with the IMF should not lead the World Bank to minimize the urgency of the debt relief operation. Knowing that IMF and World Bank matters were seldom kept in separate compartments, after alerting Nehru on the sensitivities of the Bretton Woods twins, the matter was tactfully left in his able hands to handle in the best way possible.

The purpose of deputing Nehru as an emissary of the government to Schweitzer was to prepare the ground to soften the attitude of the IMF towards a drawing by India. Nehru, in his inimitable way, gently reminded Schweitzer of his earlier assurance that once the decision on a realistic exchange rate was adopted and liberalization of imports undertaken, additional assistance from the IMF would be forthcoming. That postdated cheque was now coming up for encashment. With clarity and intellectual coherence, Nehru emphasized that in the current recessionary scenario and drought-induced upward pressure on the prices of basic consumer goods, excessive regard for financial discipline could become an enemy of the industrial revival that was so necessary if the success of liberalization was to be demonstrated. He hinted that if the new government could not agree on terms with the IMF, the liberalization policies, in which the Fund had a wider stake, would be jeopardized. In short, he urged the Fund to desist from enforcing further conditionalities, thereby avoiding a 'sterile impasse'.

At the World Bank end, Woods was pushing the Bank's Board to participate in a debt relief exercise. Recognizing that India was not in danger of defaulting on its debt but the debt service absorbed nearly 14 per cent of the country's export earnings, and that the critical need was for free foreign exchange to maintain the development momentum, Woods plugged hard for arrangements that would ease the debt service burden. While discussions with the members of the India consortium proceeded, Woods thought of an innovative initiative to induce India's official creditors to grant debt relief. He decided that the World Bank, as one of India's major creditors, should set an example by placing up to $50 million from India's debt servicing payments for 1967–68 on deposit with the Reserve Bank of India. Subsequently, the World Bank participated in the debt relief agreement negotiated with the consortium members for the four-year period starting 1 April 1967 to an amount of $15 million per year. Although the amount involved was small, its significance was that it was the only case where the World Bank participated with other official creditors in general debt relief. Both these initiatives proved controversial and a number of Executive Directors questioned the legality of the deposit scheme, as also the wisdom of being involved in debt relief.[2]

From India's viewpoint, the response from the consortium was not such as would obviate the need for a drawing from the IMF in 1967–68. Although Woods persisted, visible progress was not evident on debt financing. There were, however, indications of a marked improvement in export earnings during February and March 1967, due largely to temporary factors such as speeding up of export receipts and inflow of banking funds. Although non-project assistance of $900 million had been agreed to in principle, there was considerable delay in translating this assistance into loan agreements. Unwillingness to supply commodities like sulphur or aircraft spares, needed against aid, refusal to pick up payments against past orders, and the need to import goods that were either not eligible for aid finance or had to be obtained from non-aid sources of supply, all resulted in a larger than anticipated outgo of free foreign exchange. The result was, while aid-financed imports were lower, imports on government account financed out of free foreign exchange resources were higher.

With aid disbursements remaining sluggish and the drought contributing to a worsening of the trade position, it was no surprise that Indian officials apprehended a serious external crisis. There were some in the official hierarchy who pushed for tightening import controls and halting the liberalization process. In February 1967, India's reserves suffered an appreciable drop in dollar terms. A rapid worsening of the external accounts position was anticipated after April, when the lean export season would begin and heavy debt repayments become due on the substantial IMF maturities. A provisional moratorium on debt repayments from Woods and softer conditionality prescriptions from Schweitzer were seen as the only way to ride out of the crisis.

The months from March to December 1967 saw intense and continuous consultations with the Bretton Woods twins. There were four full-

[2] Statement by Woods on India's debt servicing problem at the meeting of Executive Directors, 11 and 20 July 1967.

fledged IMF missions between December 1966 and November 1967, including a special mission on behalf of the management and the compensatory financing team. Indian officials, too, had talks with the management on a number of occasions. In February 1967, B.K. Madan, then Deputy Governor of the Reserve Bank and Vice Chairman of the Industrial Development Bank of India (IDBI), succeeded Anjaria as India's Executive Director at the IMF. During his tenure there, he skilfully orchestrated the request for compensatory finance drawing (CFF) of US$90 million, which came before the Board for approval on 22 December 1967, and postponement of the repurchase of US$387.5 million. The request for postponement of the repurchase obligation, scheduled on the same day's agenda, however, had to be deferred to 29 December 1967, as several Directors needed time to consider some aspects of it.

Leafing through the Board minutes of the meeting of 22 December 1967, it is evident that India's first drawing on the special facility, intended to compensate for the shortfall in exports resulting from the drought, evoked a positive response. The debate, though friendly, was not free of critical overtones, however. The unprecedented duration, range and intensity of the drought and its all-pervasive and far-reaching effects on every sector of the economy, so vividly portrayed by Madan in his opening statement, was followed by expressions of deep concern by the Board. The emphasis on agriculture and the package approach adopted by the Indian government were seen as a step in the right direction; likewise, the disaggregation of financial planning and greater flexibility in targeting in the new Plan strategy were viewed as correct policy responses deserving unqualified support. But the need for stricter control of money supply was emphasized and caution was urged in pursuing selective credit relaxation.

The main issue at stake was adequate flow of foreign aid, on which rested the post-devaluation liberalization policy. It was a hard-fought issue. Madan, in his opening remarks, made the compelling observation:

> There is no tenable approach consistent with a satisfactory rate of growth which, at the present stage of the country's development, can do without significant external infusion or supplementation of resources in a reasonably freely disposable form. A decisive improvement in the aid outlook thus remains a major desideratum in the international outlook for growth.

The draft decision on the India–Article XIV Consultation report, too, had underscored the need for adequate flow of foreign assistance and the need to remove the 'haziness' surrounding the expected size of aid.

Although recognized by all, the aid issue continued to elude the donor group, particularly the USA.[3] As for India's request for a drawing of US$90 million under the decision on compensatory financing of export fluctuations, since it met the requirements, it received the seal of approval from the Fund's Board.

The rescheduling of the repurchase obligation of $387.5 million came up for consideration by the Board on 29 December 1967. There was considerable uneasiness and behind-the-scene discussions with regard to the blurring of the distinction between the repurchase under the stand-by of March 1965 and repurchase of the special drought drawing of April 1966, and the implications of such a procedure on Fund policy. While there was no difficulty in supporting the former, stiff opposition was encountered from Directors representing some European Economic Community (EEC) countries to the latter. The failure of the IMF management to anticipate any objection to the routine treatment of a special drawing and the absence of any special explanation in the staff papers for amalgamating the repurchase for the two different drawings of 1965 and 1966 were regarded as a serious procedural lapse on the part of the management by the EEC Directors. In their understanding, the short maturity of the 1966 drawing reflected the special circumstances associated with a drought, which they had believed, was temporary. Their concern centred on the insufficient conditionality governing the use of Fund resources and apprehension that postponement would convert the special drawing into an ordinary one. Moreover, in their perception, the Indian stabilization effort lacked teeth; they pressed that the request for repurchase should be contingent upon an appropriate framework of policies.

Despite the opposition within the Board, the management stood steadfastly behind the proposal and saw it through by affirming the exceptional nature of the April 1966 drought-related transaction, and by reiterating its intention to take full advantage of the offer of continuous contact and consultation with India. The unswerving support of the management was enough to convince the remaining members of the Board on the genuineness of the need to support the request. They recognized that it would be

[3] The US Director took shelter behind the explanation that 'it had not yet been feasible for the US to make a full pledge in the current fiscal year, largely because of the long delay and deep cuts in the Aid bill'; and added that because of the deep cut in appropriation it appeared likely that the US pledge would be in the neighbourhood of only two-thirds or three-fourths the size of the previous year's pledge, which, in turn, had been somewhat looser than the standard pledge that had been made in the early 1960s.

inconsistent to reject the proposed decision, particularly since the Board felt that the policies were generally in the right direction as per the earlier week's discussion. They emphasized that the past record of cooperation and responsible policies merited unqualified support. The management's intervention helped eight Directors in a row to lend support to the request, buttressed by the political argument of India's world stature and image, the moral argument of everyone being a shareholder in the fate of India, and the procedural and practical argument that India had programmes that were, in fact, approved by the IMF as it had complied with all the Fund's stipulations. In the circumstances, the Directors who had procedural qualms were willing to overlook them and give India the benefit of doubt by accepting the proposed decision without dissent. The extra week, in the event, proved useful.

In retrospect, what emerges from the India–IMF dialogue of the late 1960s is that the Fund, while supportive of India's funding needs, also made serious efforts to gain a toe-hold of influence on the performance of the Indian economy. The aspects of performance at issue were balance of payments policies, controls over imports, monetary policy, particularly interest rates, and the relative emphasis on agricultural output. Poor performance in these areas, it was felt, not only handicapped growth but seriously endangered creditworthiness for future borrowing.

In the meanwhile, realizing that the balance of payments position displayed no clear signs of improvement in exports, the new RBI Governor, L.K. Jha, who had taken over the reigns from Bhattacharyya, in his first credit policy announcement, sought to selectively liberalize credit facilities for exports. Apprising the Reserve Bank's Central Board of Directors of the background to the selective liberalization, the Governor stated that it was confined to exports of the domestic engineering and small industry sectors, and clarified that the new policy was primarily aimed at lowering the rate of refinance in respect of certain sectors. He assured the Board that the RBI would take a view on modifying the system pertaining to liquidity ratios after a clearer picture emerged of the crop out-turn, credit demand and the Bank's resources position in the coming busy season.

Welcoming the selective liberalization, the Central Board wanted to know whether the scope of the 4.5 per cent rate could not be extended to cover all post-shipment bills, and also whether traditional exports should not get the same facility. The Governor explained that if the 4.5 per cent preferential rate was to be extended to all export bills, it would have the effect of delaying the repatriation of export receipts. Likewise, an extension to cover preshipment finance in connection with traditional exports might entail very large sums, as also pose problems of distinguishing between exports of preshipment finance and domestic credit needs. This meant that, under the Bank's package of new measures, the preferential rate of 4.5 per cent would be available for packing credit advances to exporters of only engineering and metallurgical products. For all other packing credit and post-shipment export bills in all currencies, refinance would be charged at the Bank rate. Simultaneously, ceilings of 6 per cent in respect of exporters of engineering and metallurgical products, and 8 per cent in the case of other packing and post-shipment advances were prescribed as rates to be charged by banks to the ultimate borrower.

Jha also took the Central Board into confidence on the prospective reduction of external aid. He said that it was not a dramatic new development but something that had been building up over a number of months. The underlying presumption of the Woods–Mehta accord of 1966 was phased decontrol of imports, supported by continued long-term support for the liberalization programme. Woods himself had corroborated the Indian stand by emphasizing that the steps India was contemplating required substantial additional non-project commitments in an immediately usable form, with an assurance of such assistance in subsequent years. In fact, Woods volunteered to approach the consortium members to explain India's funding for the liberalization programme. In the follow-on talks that ensued between Woods and UK officials, he not only referred to funding for one year, but also pointed out that the same problem would arise in the second and third years also.

The significant development was that the liberal environment for foreign assistance of the 1950s and early 1960s had been vitiated. The consensus that had brought together those motivated by security concerns and those motivated by humanitarianism and a belief in the United States' interest in a rapidly expanding world economy, had disappeared.[4] It was this consensus and support that was eroded in the mid-sixties. Thus the proposal for replenishment of IDA ran into difficulties in the US Congress.

Following the annual IMF-World Bank meeting in October 1967, some broad indications became available on India's debt relief rescheduling problem. Reporting the trend of the discussions, Jha apprised the Central Board that the US response to the IBRD president's plea was good, the UK's slightly less so and the European attitude was lukewarm. This last attitude was

[4] Robert J. Berg and David F. Gordon, 'Cooperation for International Development: The United States and the Third World in the 1990s'.

related to Europe's, particularly France's, interest in Africa, whereas, as was well known, IDA's activities were heavily slanted towards South Asia—with India as the largest beneficiary. Governor Jha also indicated that the World Bank had come to the conclusion that its terms of lending were too onerous for a country like India and hence all lending to India should come from the Bank's soft loan window—IDA. But India was already the recipient of a fairly large share of IDA money. This created a lobby in America pressurizing for a slowdown of the share going to India at a time when IDA itself was running out of funds and failing to obtain adequate replenishment of resources. The failure to obtain adequate funding was linked to a host of internal political factors in the US, viz. its commitment to reduce the outflow of dollars, resisting inflation and maintaining the integrity of the US, dollar by preventing a dollar devaluation. In mid-1967, it was highly uncertain whether IDA could get adequate funds and, if so, when?

With the replenishment of IDA running into difficulties in the US Congress, the connection between aid and liberalization placed India in a peculiar quandary—its import liberalization was based on IDA bank-rolling, which did not materialize. In the Indian authorities' thinking, one way of overcoming the impasse was to activate the promised contribution from countries other than the US. The other solution was for the World Bank itself to take a second look at its lending policy and consider providing loans on soft terms. During his several trips abroad, Jha made it a point to meet officials of several European countries to discuss the issue and pave the way for a more dependable flow of aid.

On 1 April 1968, Robert McNamara succeeded Woods as President of the World Bank. Considered a champion of the developing world, McNamara, on assuming office, made it known that India would continue to obtain the largest slice of assistance from the World Bank group. He was convinced that the developing countries needed more assistance and he made it his mission to find ways to provide it. In order to be able to offer insights and solutions, McNamara travelled extensively; within six months of assuming office he scheduled a visit to India for an on-the-spot assessment. It is reported that L.K. Jha and I.G. Patel were two bureaucrats whose advice he sought freely.

India's import policy was predicated on continued external assistance. The Reserve Bank judged that the reduced foreign assistance would impact on both the reserves and the budget. True, exports had performed better in the slack season of 1968–69 but the Governor felt it was not practical to expect the improvement in exports to be of such an order as to meet the heavy debt service liabilities. Anticipating that the budget, too, would be affected by the sizeable shortfall that then appeared likely in PL480 assistance, the Governor forewarned the Central Board and the government that the Fourth Plan (1969–74) would in all probability have to start on a low base.

The immediate economic consequence of reduced aid was the long shadow it cast on economic planning in the country. Longer-term planning was suspended, and three Annual Plans were executed with a view to consolidating short-run gains before the next phase of growth was initiated. Here, a passing reference to Jha's perceptive advice to the Deputy Chairman of the Planning Commission, Professor D.R. Gadgil, on the approach to the Plan is worth recapitulating. In a personal communication, Jha warned that a rigid Plan targeting high growth rates could lead to frustration because 'what gets highlighted is not what is achieved but the shortfalls'. From a technical and psychological point of view, it was better to have a Plan whose targets could be overfulfilled—a Plan that promised certain minimum results and may go beyond it. Another pragmatic suggestion was: 'Our aid requirements should not be seen as an index of our dependence but as a measure of what we can achieve, if the nature and quantum of external support was adequate.' Stressing that aid-giving countries find it far more difficult, economically and politically, to refinance past loans than to sanction new ones, Jha suggested that reliance on foreign capital—official and private—should be reduced to the minimum, and a limited amount of foreign investment should be accepted only for projects deemed as important.

The RBI Governor also briefed the Bank's Board on the impressions he had formed during a visit to Japan. He attributed the Japanese misgivings about India's ability to service her external debt to their leanings in other directions, particularly towards promoting development in Burma, Indonesia and the Philippines. The Japanese interest in India, he said, was confined to proposals that were commercially advantageous to the Japanese economy, like iron ore, for Japan was hoping to become the world's second largest producer or exporter of fertilizer and fertilizer plants on credit terms. Japan and Germany were countries not enamoured by the US and British philosophy of aid, but with the Americans becoming aid-weary, their leverage in pressing Germany and Japan to increase their share in the aid cake was reduced.

On Eastern Europe's role as an aid giver, the Governor informed the Board that the Soviet Union was no longer insistent on turnkey projects. With the new political set-up, accompanied by tighter discipline, his reading was that resort to switch trading and other 'smart merchandising practices' would be contained. The Bank Board's reaction to the Governor's remarks was that it provided an excellent opportunity for Indian business and industry to expand production and fill the breach. Palkhiwala, eminent lawyer and Board member, added that native ingenuity should be given a chance by adopting greater flexibility in administration.

At the Committee meeting held on 13 November 1968, the RBI Governor made a reference to McNamara's impending visit to India. He indicated that McNamara would not be discussing the financing of specific projects but was interested in getting a first-hand picture of India's socio-economy. It was recognized that India needed funds on a soft-term basis and that the appropriate agency for that was IDA; however, the availability of funds hinged on IDA replenishment. Earlier, IDA had financed a wide spectrum of loans including for local currency expenditure and for financing raw material imports. The stoppage of IDA meant availing own reserves for financing the imports of raw materials. So far the reserves had held well, but with the impending debt service payments, anxiety grew that the pressure on reserves could become unsustainable.

A related policy issue that bothered the Indian authorities was the World Bank's attitude towards local versus global tenders. Its insistence on global tenders, it was felt, adversely affected local industry, which was in a position to fabricate plant and machinery. The World Bank appreciated the Indian viewpoint and conceded that price preference in favour of Indian suppliers would be limited to 27 per cent, as this represented the average rate of import duty on (imported) machinery. Some movement towards softening the terms of World Bank lending was in evidence but favourable consideration of the various suggestions depended not only on McNamara, but also on the views of countries providing the major share of funding to the World Bank. Here, the troubled IDA negotiations were a stumbling block, for it entailed the use of tax dollars.

McNamara's visit to Delhi gave little insight on the World Bank's prospective assistance to India. Contrary to press reports, there was no specific discussion except that contributions from other countries should be energized to replenish IDA resources. His discussions were centred on rural savings, rural unemployment and exports. Aware that the Vietnam war had shattered the foreign aid constituency in the US and unhitched virtually all the familiar geopolitical moorings of US foreign policy, McNamara was in no position to make a commitment. He listened and expressed curiosity and interest but remained noncommittal. A friend of India, his six months' military stint earlier in Calcutta, to plan the flow of supplies across the Himalayas into China, had given him a first-hand insight into the aftermath of the Bengal famine, and the great extremes of poverty, hunger and deprivation. And so, the determining consideration for him was the needs of the developing world. But he also recognized that the World Bank could not handle the job by itself. 'I do not believe', he told the World Bank's Governors while addressing them at the annual meeting of 30 September 1968,

> that the Bank can go it alone and do the job of development that needs to be done around the world by itself; but I do believe that it can provide the leadership in that effort, and can show that it is not resources which are lacking—for the richer countries amongst them have resources in plenty—but what is lacking is the will to employ those resources on the development of nations.

Through utterances such as these, he sought to prod the conscience of the richer nations.

At that point in time, the World Bank had a large share of official debt disbursed and outstanding in India. India depended almost entirely on the World Bank and IDA for its multilateral borrowing. The reduction in IDA lending meant a significant loss of concessionality in India's overall borrowing programme.

Reverting to the debt relief request that the authorities were vigorously pushing for—the granting of relief of $100 million for each of the three years 1968–69 to 1970–71—enabled India to postpone payment of roughly one-fifth of the scheduled debt. However, debt relief was counted as part of the total external assistance provided under the framework of the consortium. Postponement of debt service released free foreign exchange. This was the first occasion when debt relief was viewed in a long-term development context. But the volume of net transfer diminished sharply during the three years in which debt relief was provided. The implications of the US aid fatigue was the constraint it placed on the development journey India had embarked upon. Long-haul cases were given a short shrift. The World Bank group was not willing to get involved in governments' anti-poverty programmes such as those for drought-prone area development or employment generation schemes for rural unskilled labour. The assault on poverty remained an unfulfilled dream.

There were many on the Reserve Bank's Board, like Saraiya and Kamaljit Singh, who felt that the answer to reduced foreign aid was to adopt more aggressive export policies. Seized of the need to promote exports, in June 1968, the Governor requested Bank of Japan to depute an expert to study export credit problems and suggest improvements in the system. The terms of reference given to the Japanese consultant, Yoshiaki Toda,[5] were explicit: (i) the problems arising in assisting exporters of new products and exporters with a relatively small turnover, (ii) the present costs of export credit, and (iii) the mechanisms of Reserve Bank refinance from the point of the adequacy of incentives provided in it to banks for expanding export credit. Toda had wide-ranging discussions with officials of the Reserve Bank, Export Credit and Guarantee Corporation (ECGC), Ministry of Finance, the IDBI, leading bankers, and a wide cross-section of exporters. Several gaps and weaknesses in the system were identified but Toda's final evaluation was that 'the Indian export credit system was one of the best conceived by central banks in the world'.

His key findings were that the cost of credit was somewhat on the high side and that, in order to give better incentive to commercial banks to sanction a larger quantum of credit, the Reserve Bank would do well to reduce its concessional rate of refinance for export credit, and also delink the rate from the Bank rate and fix it in the vicinity of the call money rate (viz. 3.5 per cent).[6] Finding that bankers were not happy with the working of the interest subsidy scheme, which they regarded as cumbersome, Toda's preference was for a lower rate of refinance and scrapping of the interest subsidy scheme. He also saw the need for abolition of the minimum rate or at least for maintaining a sizeable spread between the minimum and maximum rates, and giving the banks freedom to charge varying rates within the ceiling. To safeguard exporters from risks taken against foreign currency depreciation, the suggestion was made that the Reserve Bank should consider providing satisfactory forward cover for long-term contracts. The existing regulations on the availability and maturity of packing credit limited packing credit advances to 90 days. Bearing in mind that the future composition of the export basket would be slanted in the direction of the manufacturer exporter, a general extension of the maturity period to 180 days was suggested, through an amendment of the Reserve Bank of India Act. To enable exporters to meet international competition a more positive approach on the part of ECGC and deferred payment terms of three to five years (even up to 8 years) were suggested.

[5] Yoshiaki Toda was administrative assistant to the chief, Coordination Department, Bank of Japan.

[6] Under the inter-bank agreement then in force, the minimum rate of interest on export lending was fixed at the same level as the ceiling rate fixed by the Reserve Bank, i.e. 6 per cent.

Several suggestions for streamlining and simplifying the export credit system were also mooted. But on the core suggestion to delink the Reserve Bank export refinancing rate from the Bank rate, and to fix it at a low enough rate, as well as to scrap the interest rate subsidy scheme, the RBI was not ready to take the plunge. In the Bank's thinking, it was a substantive change that raised a number of issues of a monetary and budgetary character, which required careful study and coordination with the Ministry of Finance. On several of the procedural and constricting policy aspects, however, the Bank initiated immediate action. The amendment of Section 17 (3A) the Reserve Bank Act, which made it possible to provide refinance to banks for a period of 180 days, initiating studies on each exportable commodity, etc. Meanwhile, wide publicity was given to the report and a summarized version of the findings and suggestions for improvement of the export credit system was presented in the shape of a memorandum to the Board. The Board accorded its broad approval to the recommendations. The full text of the report appeared in the February 1969 issue of the Bank's *Bulletin*.

Aware that provision of finance for the promotion of exports was a complex issue, at one of the Central Board's meetings, Jha sought the Board's views on some aspects of the Toda report. Looking at export financing procedures, the expert from the Bank of Japan had pointed out that concessional rates ceased to be effective if banks were not indebted to the Reserve Bank. To get this benefit, banks had to borrow all the year round and unless the cost of borrowing from the Reserve Bank for this purpose was less than the cost to a bank of raising money from the public, there would be no incentive for banks to borrow from the Reserve Bank. On the other hand, bankers pointed out to the Governor that the existence of ceiling on interest rates to the priority sectors acted as a disincentive to banks in expanding credit to other sectors. The dilemmas and discontent that surrounded the export credit policy prompted the Governor to seek the views of the Bank's Board.

Reacting to the Governor's remarks, I.G. Patel, the government's nominee on the Bank's Board said: 'Our objectives have to be clear—whether Bank lending to exports should be more or export finance be made cheaper.' If the emphasis was on the first objective, the earning margin to banks should be higher; if it was the second, then there was need to ensure that lower rates were passed on to borrowers. Further, the policies followed would have to tie in with the objectives of overall monetary policies. He also made the point that in providing money to commercial banks, the Central Bank should not cheapen it to a point whereby the banks' incentive to mobilize deposits was blunted. Deputy Governor B.N. Adarkar cited the Japanese experience: the Bank of Japan provided export refinance at 3.6 per cent, which was cheaper than the cost to banks of raising funds through deposits at 5 per cent. If similar concessionality of refinance for exports was provided to Indian exporters throughout the year, there was every likelihood that they would borrow from the Reserve Bank for exports and deploy their own funds elsewhere.

The Reserve Bank was beginning to move ahead of the Ministry of Finance in its thinking on these issues but was not sufficiently confident to develop a clear alternative to Delhi's entrenched position. The Bank and the treasury were still dominated in their approach by the public utility model of banking, in which heavy regulation was a substitute for competitive processes.

At this point, a brief look at the emerging contours of the country's external payments position might be in order. As noted, the 1966 devaluation failed to bring about the needed improvement in the trade deficit owing to extraneous circumstances such as drought and reduction of external assistance. The first visible signs of improvement became evident towards the close of 1967–68, when the reserves benefited from a net borrowing of $33 million from the IMF, a debt relief of $46 million extended by the World Bank and RBI's net purchase of $201 million from authorized dealers. The combined impact of these transactions was an increase in the net foreign exchange reserves of $80 million during 1967–68. The improvement continued into 1968–69. However, between November 1968 and end, March 1969, there was no net accretion to the foreign exchange reserves owing to repayment of $78 million to the IMF and a refund of $8 million to the IBRD of special deposits. For the year 1968–69 as a whole, the official reserves recorded a rise of $51 million and stood at $769 million at the close of March 1969. If these special transactions were excluded, the increase in reserves would have amounted to $144 million—the highest annual increase in reserves. A surplus of export earnings and invisible receipts over payments for imports and invisibles aided the recovery. The external balance was restored rapidly and somewhat unexpectedly as a result of a severe cut in imports, particularly of foodgrains, and an increase in exports of items like engineering and metallurgical products. In the Reserve Bank's assessment, the decline in imports was due not only to the impact of the recession in industry but possibly represented progress towards import substitution.

There were, however, some who doubted whether the improvement in the export performance could be sustained. Board member Biren Mukherjee, in the course of a Board discussion on the external sector, pointed out that the export performance was impaired as industry was often exporting at a loss. His anxiety was how long could this continue. There were others like Mafatlal who felt there was considerable scope for cost reduction and improvement in productivity. It was evident the major concern of the Board was the uncertainty regarding availability of raw materials for industry, and the need for orientation of the government's policy towards making available raw materials at stable prices to enable industry to maintain the growth in exports. All that the Reserve Bank's memorandum on the current economic situation sought to bring out was that the initial uncertainty with regard to exports following the devaluation of the rupee had been overcome, that there was a better awareness of the need for exports, and that industries were building up the requisite organization and capacity.

Returning to the global scenario, 1967–68 was a historic year, in the sense that there were distinct signs that the post-war economic order was undergoing a fundamental change. The clearest indication was the growing shortage of international liquidity in relation to the volume of world trade under the conditions of exchange rate stability imposed by the Bretton Woods system. Throughout most of the 1960s, both the US and the UK had experienced chronic balance of payments problems and both the reserve currencies—the pound sterling and the US dollar—were under intense pressure. Eventually, the UK was forced to devalue on 18 November 1967, triggering a chain reaction that culminated in the abandonment of the Bretton Woods system some four years on.

As noted elsewhere, India retained its gold parity and the impact of the sterling devaluation on the country was limited. The RBI Governor apprised the Bank's Board that the total loss of the Bank's and government's holdings of sterling assets was a little more than Rs 10 crore, amounting to about 4 per cent of total assets excluding gold. This by no means could be considered large for a country like India which was an important member of the sterling area. He added that that policy of diversification adopted a few months earlier had helped to contain the loss. The increase in the UK Bank rate was also likely to impact favourably on investment income earnings of India's holdings of sterling assets. The Governor's assessment was that some real loss arising from the 4 per cent expected increase in UK prices would have to be reckoned with, assuming that the UK would secure a 10 per cent competitive advantage from the devaluation.

This, however, did not mean that the RBI Governor was complacent about the future of sterling. During his visit to London in mid-1968, Jha had talks with Haslam in the Bank of England, Douglas Allen in the

Treasury and Wilson in the Overseas Development Ministry. The purpose of the talks was to explore current thinking on the future of the sterling area. It was a known fact that some sterling area countries had been trying to get assurances from the UK in regard to their sterling balances, to protect themselves against the risk of further devaluation of the sterling. But at that point the British maintained that they had given no assurance to any independent country and all had agreed to continue as members of the sterling area in view of the advantages the arrangement brought to them. The talks also confirmed that the general behaviour of the sterling area had shown no discernible change in the pattern of holdings, except for the Middle East countries who now held less of their reserves in sterling as the UK was paying for its oil in sterling IOUs. There was, however, a school of thought within the British Treasury, no doubt among the younger breed, that the sterling area under prevailing conditions was an anachronism and more a liability than an asset to Britain. But this was discounted by the older generation of bureaucrats.

One of the consequences of the rupee and sterling devaluations was growth of awareness in the business community regarding the need for covering forward exchange risks. Although this consciousness was universal, the demand for forward exchange from importers was less than the offerings from exporters, leaving commercial banks with a large amount of surplus dollars and not enough demand in the local inter-bank market to dispose them. The only available option was to sell the surplus sterling proceeds so acquired to the Reserve Bank, which, under its statutory obligation, stood ready to purchase all the sterling offered to it at parity. Such accumulation of sterling was, however, considered undesirable in the circumstances of considerable uncertainty regarding the future of the sterling. As the underlying rationale was that acceptance of this risk was in the public interest, the Reserve Bank, in July 1966, decided as an experimental measure to mop up the dollar offerings, using the agency of the State Bank of India to purchase, on the RBI's behalf, spot and forward dollars up to six months delivery. An interesting, perhaps unintended fall-out of the arrangement was the emergence of the US dollar as a component of India's foreign exchange reserves.

The Basle facility removed the selling pressure to a large extent from the sterling and for the next three years or so, the currency entered a period of stability. In this period the focus of attention shifted to the US dollar. The period immediately following the sterling devaluation saw a surge in demand for gold. The US lost about 20 per cent of its holdings and was forced to back out of supporting the gold pool, which had been designed to maintain the price of gold at US$35 per fine ounce. At the same time-agreement was reached on establishing a two-tier gold price under which official monetary transactions would be effected at the official gold price of $35 per fine ounce. The US trade position slipped further in 1968–69, paving the way for a full-blown crisis in the early 1970s. Thus, while the Basle facility played an important part in propping up the sterling, this had to be seen in the context of growing uncertainty about the future value of the world's leading reserve currency, the US dollar, which ultimately triggered the demise of the par value system.

TURBULENCE AND UNCERTAINTY IN INDIA'S BALANCE OF PAYMENTS POSITION

So far as India was concerned, the period 1968–69 to 1970–71 was a period of consolidation with the reserves showing consistent improvement of more than 40 per cent. But the period of consolidation was shortlived, for 1971–72 witnessed far-reaching changes both in the Indian subcontinent and outside. Events moved fast and drastically that year, culminating in the emergence of Bangladesh as an independent country. This imposed a heavy strain on the Indian economy, first in the form of an inflow of refugees, who at one stage numbered 10 million; second, through the rapid escalation of defence expenditure; and third, in terms of disruption of aid and trade relationships. Government of India faced a daunting dilemma: whether it could absorb the 10 million refugees or more without seriously disrupting the economy of India, more notably that of West Bengal, and would it invite the wrath of the superpower who was constantly warning India against intervention in Pakistan.

Added to this, major world powers were at work. The most significant of these power realignments was the détente between the US and China, resulting in the entry of the latter into the United Nations fold. The Moscow agreement between the US and the USSR further changed the political equations in Europe and Asia. Equally devastating were the developments on the monetary front. Convertibility of the US dollar was suspended in August 1971 and its value was allowed to depreciate until its formal devaluation under the Smithsonian agreement of 18 December 1971. As a consequence of the devaluation of the dollar, there followed a spate of devaluations of other currencies, which included, among others, Pakistan, Nepal and Sri Lanka—India's neighbours and close trading partners. In late 1972, the pound sterling was allowed to float and exchange controls were imposed by the UK, which struck a fatal blow to the sterling area. India, however, retained its link and allowed its currency to float with the pound. The position of the US dollar turned out to be even worse than that of the pound sterling. Continuous growth in the US trade deficit and misgivings about the US administration's ability to deal with the situation forced the dollar to devalue for a second time within a period of fourteen months. With sharp fluctuations in currency values and South Africa's policy of withholding gold supplies, the international prices of gold reached phenomenal heights.

These radical developments totally altered the circumstances in which developing countries like India had to function and progress. In the face of the unfavourable international developments, Indian representatives—Jha, I.G. Patel and Narasimham—valiantly carried forward the debate on readjustment of policies to benefit trade and development in foras like the UNCTAD and the IMF. I.G. Patel attended a conference in New York on International Monetary Reform, organized by Sidney Dell of UNCTAD, at which he presented his ideas on the feasibility and desirability of creating an international reserve that needed no backing except the will of the international community.

Throughout 1971 the Reserve Bank kept abreast of the developments in the international markets and the consequential action taken by the Indian government.[7] Based on the findings of a study presented by the RBI's Economic Department on 'The Dollar Crisis and India's position', the Bank's Board discussed the impact of the US surcharge on India's exports and concluded that the bulk of Indian exports, except engineering goods, would not be affected by the surcharge. Since only 15 per cent of India's trade, at best, would be affected, tactically it was felt that there was no strong ground for seeking its withdrawal; instead, seeking bilateral negotiations on specific commodities was recommended. Alternative possibilities of devaluing or floating the rupee were also discussed but, for a variety of reasons, were regarded as not appropriate under the circumstances, and the wait-and-watch approach was endorsed.

On the domestic front, initially, at least till December 1971, the events of 1971–72 showed no significant evidence of the strains caused by the refugee influx, the natural calamities that affected several parts of the country and the war with Pakistan. The economy displayed considerable resilience in meeting the challenges. Current spending in the economy was more or less matched by the large stocks of agricultural commodities inherited from the unusually good crop of 1970 and intensive utilization of available aid

[7] For details, see the chapter on Exchange Rate Conundrums.

funds. As industrial capacity was available, the special needs of defence were taken care of through additional production. Skilful monetary and fiscal management helped to contain speculative activity and promoted relative price stability. In the event, between end-June 1971 and end-December 1971, the general price index showed a nominal rise of 1 per cent, despite an increase of Rs 320 crore in the net indebtedness of the government in the banking sector and Rs 726 crore in aggregate monetary resources. Foreign exchange reserves, too, showed some improvement following the disruption of jute exports from East Pakistan. The country appeared to have taken in its stride the new challenges posed by declining net foreign aid, the increased requirements for defence, and the assumed responsibility for aiding the reconstruction and rehabilitation of the new state of Bangladesh. While there was evidence of proper economic management at a time of immense strain, the events probably affected the development programme as a result of the diversion of steel, transport facilities and chemicals for defence purposes. As it turned out, there was no great pressure on the rupee during 1971–72 despite the larger import surplus, the bulk of which was financed by aid funds rather than any drawal of reserves. With repurchases of $65 million in March 1971, India eliminated all outstanding debts to the IMF. India's reserves in 1971–72 were aided by the second allocation of SDR 101 million and by the revaluation of gold in December 1971, which resulted in an increase in the dollar value of India's gold and SDR holdings, and its Fund gold tranche position.

On the foreign investment front, with amendment of the Foreign Exchange Regulation Act (FERA), 1947, some changes were made in the measures affecting private foreign investments. These were chiefly aimed at Indianization of foreign-controlled companies. The staff of the Exchange Control Department were required to grapple with drafts and re-drafts of the amendments, taking into account the comments of industry, trade and fourteen ministries.

With the economy in external balance and remaining close to internal balance, one would have thought that the task of monetary policy would have been to facilitate a non-inflationary rate of growth. But the Reserve Bank's Board was clearly uncomfortable with the thought because the economy was already highly liquid and tending to be even more so, on account of deficit financing, on the one hand, and uncertainty about agricultural supplies, on the other. It feared there would continue to be serious pressure on prices, and suggested that the Bank should caution the government of the likely dangers on the price front and urge it to carefully estimate its requirements. Initially the budget provided Rs 60 crore for expenditure in connection with the refugees. But, as it turned out, the inflow of refugees was much larger than anticipated; to meet the expenditure on refugee relief, supplementary demands for grants were presented in August and December 1971, totalling Rs 200 crore.

Since April 1971, the Reserve Bank had been keeping a watchful eye on the happenings in East Bengal and its impact on the Indian economy, and it was mentally prepared for additional draft on account of rehabilitation and assistance to refugees coming from East Bengal. In September, during a Board discussion on the price situation, Executive Director Pendharkar, while explaining how the monetary situation would affect prices, asserted that expenditure on Bangladesh refugees had not contributed to any rise in prices so far, as the government itself was procuring and supplying food to the refugees.

In January 1972, introducing a note prepared by the Economic Department of the Bank on 'Bangladesh: Economic Problems and Prospects', the RBI Governor pointed out to the Board that Bangladesh needed both material and technical resources but that the government had decided it would wait till the Bangladesh authorities formulated their requirements. The Bank's study indicated a deficit of Rs 125 crore in Indo–Bangladesh trade; a Board member queried if this meant that India should provide that much capital to Bangladesh and, if that was so, whether India would either have to produce more or divert its exports from other countries to Bangladesh. It was clarified that in certain commodities like coal and cement, it would be possible to export to Bangladesh without slashing Indian exports to other countries. The immediate, short-term requirements of Bangladesh were for drugs, pharmaceuticals, engineering goods and cloth. Also, tremendous advantages would flow from economies in transport costs following the reopening of inland waterways in Bangladesh. After all, India had considerable scope for enlarging the number of commodities that could be mutually exchanged.

Seshadri pointed out that the currency problems of Bangladesh would need to be resolved, for Bangladesh Bank would have to take over the note issue liability and would need the backing of some foreign assets. The immediate problem, however, was both an accounting and a substantive one. The Reserve Bank recognized that it was an abnormal situation, for it was not an orderly partition of assets and liabilities between the governments or between the Central Banks, but recognized that solutions would have to be evolved to meet the specific circumstances. Against the backdrop of these developments, the slant of the 1971–72 busy season credit policy was towards enabling the banks to meet, on a priority basis, the additional credit needs of industry to manufacture and supply goods for defence purposes, and to ensure smooth distribution of goods in the border areas. Through the grant of defence packing-cum-supply credit limits against confirmed orders or acceptance of tenders, the Bank effected limited relaxations in its credit policy, and sought to accommodate the financial requirements of the industrial units in the eastern sector. At the same time, the Bank was wary that a steep rise in credit levels had the potential to create a climate unfavourable to price inflation.

This growing concern about domestic prices was not misplaced, for 1972–73 witnessed a spiralling rise in the price level. As the year progressed, it became evident to the authorities that this was not a transient or seasonal phenomenon, and that physical and monetary factors were operating together to undermine price stability. Discussion of the deteriorating price situation dominated all else at the weekly meetings of the RBI's Central Board. The tendency was to overlook the favourable developments that had occurred in fiscal 1972–73. Despite the disturbed international monetary conditions, India's exports had recorded sizeable gains and, despite the sharp rise in imports, its level of foreign exchange reserves had remained virtually intact. In the Reserve Bank's assessment, the positive and negative developments had to be jointly evaluated; with the advantage of hindsight, it is evident that what emerged was an amalgam of natural, structural and institutional causes that widened the gap between the current flows of supply and demand in the economy.

In the sphere of external transactions, the improvement recorded in 1971–72 could not be maintained in 1972–73. Whereas, in 1971–72, the major factors facilitating an increase in reserves were the sharp reduction in the trade account deficit and the allocation of SDRs, in 1972–73, the balance of payments moved into deficit, even though there was a surplus in the balance of trade. The main reasons for this latter deterioration were a further decline in net foreign aid and the fact that a substantial part of the increase in exports related to shipments of food and other necessities to Bangladesh on a grant basis. Another point that deserves to be mentioned in connection with the movement in reserves is the increase in the rupee value of reserves by Rs 38 crore, consequent upon the floatation of world currencies. In both 1971–72 and 1972–73, there was a decline in foodgrain output, which led to a surge in prices and resumption of imports in 1973. In both these years, economic growth was barely 2 per cent.

Looking to the performance of exports over the decade of the 1960s, the Reserve Bank was distinctly pessimistic about the dramatic increase estimated in the rate of export growth. Aware that the rate of growth of Indian exports was less than the rate of growth of world exports and even less than the growth rate of exports of less developed countries, the Bank's management gave the Bank's research work a sharper edge, by commissioning analytical studies on exports—commodity-wise and country-wise—to locate the demand and supply constraints facing Indian exports. The studies attributed constraints to problems inherent in the commodity composition of Indian exports, that is, a heavy dependence on exports for which income elasticity of world demand was comparatively low (tea) or which were subject to severe competition from substitutes (jute manufacturers). In order to remedy the unfavourable position, Deputy Governor Krishnaswamy, during the Article XIV consultations, assured the IMF team that Indian efforts were increasingly directed towards changing the commodity composition of its exports.

In 1972–73, for the first time in many years, a trade surplus was recorded, resulting from a 7 per cent expansion in exports and a 12 per cent contraction in imports. Special circumstances aided the export performance, such as the world boom in commodity prices. Currency realignments rendered Indian commodity prices competitive in world markets and increased commercial exports to Bangladesh. On the other hand, there was a distinct slackening in the rate of non-traditional exports during 1972–73; exports of engineering goods had suffered from the shortage of steel and inadequate availability of credit. Changes in forward exchange cover arrangements, the feasibility of which the Reserve Bank had been considering for some time, could no longer be postponed, it was realized, particularly if Indian exports of engineering goods had to compete effectively in international markets.

For some time now, there had been a demand from exporters for a scheme of forward exchange cover extending over the entire period of the contract. The RBI was convinced of the justification of the demand. The then existing arrangement allowed exporters to take a short-term cover for six to nine months and seek extension at best for twelve months, and to roll it over on maturity. Such roll-over, the Bank recognized, was not only expensive but failed to protect the exporters against changes in exchange rates over the entire period of the contract. As early as 1971, as an important measure of export promotion, the Bank designed a scheme to provide forward cover to exporters making exports on deferred payment terms, and forwarded the same to the Ministry of Finance for its consideration in February 1971. However, the turmoil in currency markets around the world and the considerable uncertainty about realignment of exchange rates following the 15 August 1971 announcement and closure of currency markets, forced the Finance Ministry to temporarily shelve consideration of the scheme.

In January 1972, the Ministry of Finance set up a Working Group comprising officials from the Ministry of Finance, the Ministry of Trade, the ECGC and the Reserve Bank, to examine the need for such a facility and to make detailed recommendations for introduction of a suitable scheme. The Working Group endorsed the views of the Reserve Bank that there was need for such a scheme, that the scheme should cover all goods shipped on deferred payment terms, and that the scheme should be operated by the Bank. On rates to be charged, the guideline given was, they should neither be so low as to cast a heavy burden on the Bank nor so high as to rob the facility of its utility; a maximum margin of 2.5 per cent over the Bank's spot buying rate for pound sterling was suggested. The Bank had proposed a scale of rates with a maximum margin of 4 per cent over the Bank's spot buying rate for a deferment of ten years. To ease the burden on the Bank of operating the scheme, the Working Group suggested that the difference between the rates proposed by it and those suggested by the Bank should be made good to the RBI by the government out of the Market Development Fund.

The Finance Ministry was supportive of the recommendations of the Working Group and informed the Reserve Bank that it was keen to have the scheme brought into operation at an early date. However, due to continued crises in foreign exchange markets abroad, some hesitancy was evident on the part of the Bank to do so. It was only in mid-1974 that the RBI commenced providing long-term forward exchange cover in respect of exports of goods on deferred payment terms, the proceeds of which were denominated in pound sterling, US dollar, deutsche mark and Japanese yen. The need to introduce a scheme to extend a forward cover facility to exporters participating in international tenders also engaged the attention of the Bank. Hitherto, authorized dealers could provide forward cover to exporters only against firm orders. Realizing the limitation of such a scheme, the Bank remodelled it so that it would facilitate the exporter bidding for the contract.

Towards the middle of 1973, the government was distinctly uneasy about the prospects of the external payments position in the coming years. With rising inflation, depleting levels of foodgrain stocks,[8] sharp hike in prices and increased debt servicing, the prevailing view in the government and

[8] Government stocks of foodgrains reduced from 9 million tons in July 1972 to less than 3 million in March 1973.

the Reserve Bank was that fundamental instability and disequilibrium would again emerge in India's external accounts. They also believed that some of the instability could be removed by sensible use of macroeconomic tools including reinforcing reserves through IMF borrowing and resumption of imports of foodgrains. Having decided to terminate the imports of foodgrains under PL480 in end-1971, the rapid decline in foodgrain stocks compelled the government to purchase, on a crash basis, 2 million tons of wheat from the USSR in the early part of 1973.

In June 1973, Manu Shroff, officer on special duty in the Ministry of Finance, shot off an urgent message to the Indian Executive Director, Prasad, at the Fund, to immediately arrange for a drawing in the region of SDR 100 million from the IMF to pay for the foodgrain imports. Prasad, after consultations with the staff and head of the Asia division, informed Shroff that if the government so wished, India could avail of a drawing under the compensatory financing facility (CFF) and that the IMF would be ready to consider such a request. Elaborating that the assistance was additional and meant to be used by members experiencing balance of payments deficits arising from a shortfall in their export earnings, Prasad invited the attention of the government to the fact that drawings under the facility would not affect the amounts a member could draw under its gold or credit tranches. Conditionality associated with CFF drawings, too, was mild. The main requirement was that the drawings should help finance shortfalls from a medium-term trend in export earnings. On a rough-and-ready basis, the IMF staff made some calculations and confirmed that India could qualify for a CFF drawing.

The response from the government was negative. It was not interested in considering a CFF drawing, which, in its view, would not be sizeable. It therefore saw no reason to go through the drill of providing commodity-wise forecasts for the two post-shortfall years. Further, there was a political aspect to be taken care of, for, in discussions on the external payments position in the Lok Sabha, the Finance Ministry had consistently held out that exports were increasing. Now, if the government were to avail of the CFF drawing, explanations would have to be provided on how and why there was a shortfall, when the government was all along projecting an underlying growth trend in exports. It was to avoid this embarrassment that Finance Ministry officials were reluctant to consider the CFF option.

But, convinced that India's balance of payments need in the coming period would exceed gold and first credit tranche drawings, Prasad continued his efforts to convince M.G. Kaul, Secretary, Economic Affairs, and RBI Governor Jagannathan on the CFF option. After several exchanges between the Executive Director's office and the Finance Secretary (Kaul), the latter agreed to allow the head of the Commodities Division at the IMF, Duncan Ridler, to visit the Finance Ministry and the Reserve Bank to discuss computation of the export shortfall. Although Finance Ministry officials remained lukewarm to Ridler's visit, the RBI presented the Indian case in a positive light using a good deal of flexibility in the interpretation of the decision by suggesting an adjustment in the export statistics of substantial shipments to Bangladesh financed from grants provided by the Indian government. Because of the special nature of the shipments, the bulk of which were essentially re-exports of goods imported by India during the period under consideration, the IMF staff, despite the fact that no precedent of such adjustment existed in other compensatory drawings, took the line that it was in accordance with the purpose of the facility to exclude the value of such shipments from the determination of trend and shortfall. On this basis, Duncan Ridler was able to convince the top management of the IMF of his assessment of a shortfall of SDR 62 million using the export forecast method.

All along, the approach of the IMF staff to the India drawing was positive, the main plank of argumentation being that the shortfall was largely 'attributable to circumstances beyond the control of the member'. In the face of such persuasive reasoning, Economic Affairs Secretary M.G. Kaul, after consultations with the Finance Minister, informed the Managing Director of the IMF and the Indian Executive Director that the Indian authorities would shortly request a purchase of the equivalent of SDR 62 million under the CFF decision, in respect of an export shortfall for the period ended 30 June 1973. The Board considered the request on 13 February 1974. Most of the Directors agreed that the request was in the spirit of the facility rather than the letter of it, for, in essence, the exports to Bangladesh were grants. Many conceded that the adjustment relating to Bangladesh aid was a novel application of a compensatory request but described it as a 'sensible' one. The majority viewed the exclusion as reasonable and one warranting exceptional treatment. Only one Director expressed some technical misgivings, although he characterized the request as 'genuine and modest'. Prasad, while thanking the Board for its wholehearted support, sought to remove misgivings with regard to adjustments pertaining to Bangladesh aid by explaining that India provided aid to Nepal, Sri Lanka and Mauritius, but since this was aid of a regular nature, no adjustments were made for it. On the other hand, the Bangladesh operation was essentially of a different nature—it was an operation of self-denial of domestic consumption.

The cooperative attitude of the IMF management and staff and the tenacity of the Indian Executive Director in persuading the seniormost echelons, both in the government and the Reserve Bank, resulted in a satisfactory outcome: they helped, for the time being, to retain the gold tranche (SDR 76.2 million) and first credit tranche (SDR 235 million) for use at a later date.

That date was not far off, for, within two months, India had to approach the IMF again. Just as the economy was emerging from drought conditions, made possible by the 1973 bumper autumn crop and large foodgrain imports, the country was severely affected by the international oil crisis. The difficulties on the external front were further compounded by the high prices of a number of primary raw materials and supply shortages of strategic inputs such as fertilizers, with the prices of nitrogenous fertilizers rising threefold between 1970–71 and 1973–74. The foreign exchange outlay in 1974–75 on oil imports alone was placed at $1,300 million, as against $625 million in 1973–74. A large external payments deficit loomed on the horizon and, in the face of the highest rate of inflation since independence, the immediate preoccupation of the authorities was to improve the supply deficiencies both in the agricultural and industrial sectors, and to considerably reduce the rate of price increase. Thus India was faced with both an internal and external economic problem.

Two converging developments helped Prime Minister Indira Gandhi face the crisis. The first was the publication of a book by V.K.R.V. Rao,[9] entitled *Inflation and Economic Crisis* which provided a general outline of a way to solve the internal crisis; the book's recommendations became the essence of Mrs Gandhi's policies.[10] The second was financial aid from the IMF and the World Bank. By April 1974 Indian authorities concluded a major financing package with the IMF to cover the balance of payments deficit, and by June negotiated a major loan from the World Bank's Aid India consortium. In order to secure these, Indira Gandhi had to prove that the Indian authorities had a policy that would stabilize the economy. Without such a programme, as one senior Finance Ministry official remarked, 'We would not have been able to achieve either the IMF loan or the aid package.'

The policies recommended by Rao and endorsed by P.N. Dhar—money supply reduction, wage freezes, increased imports, strong exports and

[9] V.K.R.V. Rao was an economist at the Institute of Economic Growth, Delhi.

[10] That this document became the basis of her policies was confirmed by P.N. Dhar and C.H. Hanumantha Rao. See Jeremiah Novak's article, 'The Role of IMF, World Bank', published in the July issue of the *Asian Mail* (USA) and reproduced in the *Times of India* of 1.7.1977.

freeing of private capital—fitted neatly into the IMF and World Bank conditionality requirements, and were developed with a view towards the negotiations. Accepting them meant that Mrs Gandhi had to give up her pre-1974 policies, which were dubbed as quasi-socialist, but she had little choice. The opposition bitterly criticized her but, hiding behind the cover of the Rajasthan atomic test, she concluded the April 1974 negotiations with the IMF.[11] Before she could sign the loan agreement, Mrs Gandhi had to crush the railway strike, which she did with a firm hand, but for political reasons she could not announce that she had switched to a western model of development.

In view of the low consumption levels, the degree of manoeuvrability to switch resources away from consumption to productive investment and enlarged exports was distinctly limited, even though the Indian authorities were determined to traverse the difficult adjustment path. The massive deterioration predicted in the country's external accounts for 1974–75, indicating an uncovered financing gap of SDR 621 million, was sought to be partially covered by further drawings from the IMF of SDR 76.2 million in the gold tranche on 17 April 1974, and a request for a first credit tranche purchase from the Fund of an amount equivalent to SDR 235 million, which came up for Board approval on 1 May 1974. In processing the request, the IMF staff indicated that in the present situation, 'the only realistic goals for 1974–75 would be modest increases in agricultural and industrial production, slowing down of the inflation rate, a significant growth in exports and a gradual shift from imported fuel to domestic energy'. The letter of intent accompanying the request for the drawing clearly demonstrated that the objectives of the government coincided with those of the Fund.

The government and the Reserve Bank were serious about their task in designing the programme for 1974–75, which was in support of the drawing. They zeroed in on three inter-related tasks: first, a reduction in the rate of price inflation, which was 27 per cent for the twelve-month period ending March 1974; second, an adjustment of the balance of payments and the economy to the recent sharp increases in petroleum and fertilizer prices; and third, achievement of a satisfactory rate of growth. Some elaboration of these three areas of policy will go to show the determination with which the Indian authorities braced themselves to meet the adjustment challenge. Guided by the need to control inflation, the government's fiscal policies were framed with the aim of sharply reducing deficit financing. To this

[11] On 20 May 1974, the *Far Eastern Economic Review* signalled that the Indian economy was on the verge of a major overhaul.

end, the 1974–75 budget curbed not only non-developmental expenditures but even development expenditures. This was no doubt regrettable but inevitable. The budget for 1974–75 assumed a receipt of no more than Rs 4.98 billion from market borrowings and a reduction in food subsidies well below the level of fiscal 1973–74.

Against the background of large-scale deficit financing by the government, the Reserve Bank was faced with difficult decisions on its credit policy stance. The Governor met with his senior staff several mornings each week to review the monetary trends. Credit restraint was felt to be necessary but not to such a degree as to throttle production, and curb investment and exports. From 1972–73, the credit policy was progressively tightened, but, because of the high degree of liquidity, attributable mainly to the government deficits, commercial banks were able to substantially expand credit. In its credit policy for the 1973–74 busy season, the Bank sought a firmly restrictive stance. Major reliance was placed on a ceiling on expansion of bank credit for purposes other than food procurement. However, by December, it was evident that this ceiling was unlikely to hold. The partial success in the implementation of ceilings forced the Bank to reinforce its restrictive monetary stance by adopting a slew of additional measures at the end of November, covering an increase in the minimum lending rate from 10 per cent to 11 per cent, an increase in statutory liquidity requirements and an increase in the margins on advances.

The Reserve Bank's decision not to freely provide accommodation to banks, coupled with other measures, gave rise to a situation of extreme credit stringency and a sharp flare-up in the call money interest rates, which ruled as high as 30 per cent in the second week of December 1973. At no time before had the economy experienced monetary conditions as tight as those in force during the busy season November 1973–16 April 1974, and yet, by early January, it became evident to the Bank that the quantitative ceiling set for the busy season would be breached. Despite a cloud hanging over the effectiveness of its tight monetary stance, the Bank, while retaining the essential features of monetary control, recognized the ground realities and allowed for some credit expansion, to take care of the rising inventory costs in the industrial sector as a result of higher prices, by reducing the cash ratio by two percentage points. A discretionary element was introduced into the new policy, in that both the quantum of credit and the rate of additional finance for food procurement and financing of imports of crude were to be determined by the Bank. The move towards greater flexibility was understandable but added responsibility was cast on the monetary authorities to maintain greater vigilance in operating a tight monetary policy. There was a strong lobby at the IMF that was pressing hard for the need to pursue a dear money policy and advocating a more aggressive use of the interest rate instrument, arguing that the nominal high interest rates had been rendered negative in real terms as a result of price increases. But the Bank preferred to move cautiously. The Indian Executive Director, in his defence of the Indian authorities' policy stance, pointed out to the IMF Board that interest rates had been raised all along the line and, even though exports was a priority sector, the rate for export credit had been raised. The Bank, after careful consideration, remained of the view that the burden resulting from the increase would be insignificant, as the cost of credit for exports formed a very small element of total exports. Nevertheless, from then on the interest rate became an important instrument of monetary management.

On the balance of payments front, there was general acceptance of the fact that but for the increase in the price of oil and fertilizers there would be no financing gap, and that, apart from the oil facility, the increase in fertilizer outlay of SDR 375 million meant that India would have access to resources larger than allowed for under the oil facility. International economic policy was the subject of intense discussion within official circles. Although the government had an eye on the oil facility, in view of the debt burden, which was already substantial, it was reluctant to incur fresh debt and preferred to limit external borrowing to the minimum. This helped to keep the country's debt profile at manageable and sustainable levels, and created a favourable impression on the international community. Thus the package of adjustment measures put in place to progress towards achieving balance of payments viability in the medium term received the approval of the Board, and support for a first credit tranche drawing of $235 million was given. The bottom line of the IMF staff's assessment was that: 'in the light of food scarcities, crucial importance of fertilizers for agricultural production and high degree of unutilized capacity in industry, the authorities had acted correctly in planning to maintain the level of essential imports', and, while continuous adaptation of trade and payments policies was warranted, 'long-term aid on highly concessional terms will be essential'.

While briefing the government and the Reserve Bank on the tenor of the discussion and clearance of the request, Prasad, in the final paragraph of his letter, informed them that the request to retain the deutsche mark component without converting into dollars had been granted, on the assumption that the currency was needed for making future payments. Accordingly, it would be appropriate for the Reserve Bank to keep this fact in mind and not utilize it as an opportunity to diversify foreign exchange reserves.

The thrust of his advice was accepted and the Bank, in its deployment of foreign exchange reserves, respected the spirit of the Fund's rule *in toto*.

In July 1974, at Bangalore, Mrs Gandhi announced the new policy, which included impounding dearness allowances along with impounding profits. According to P.N. Dhar, the Bangalore speech was a 'critical moment in our policy', for it announced the beginning of a new era. But Bangalore was a beginning without a follow-through. Ruddar Datt, in his *Indian Economy* (1976), summarized the situation well.

> Attempts to control prices since the Bangalore speech[12] in July 1974 had borne fruit and the general price level was falling, but the government could not take advantage of the situation and consolidate its control over inflation. By June 1975, the economy was poised to take a deep plunge. The various steps taken by the government against tax dodgers and smugglers were thwarted by the courts on technical grounds. Many welfare measures the government brought . . . did not succeed due to opposition of the vested interests. . . . Superimposed over these economic problems was the political instability arising out of the revolt of the opposition and the internal dissentions in the ruling party.

As recounted earlier, the unprecedented rate of inflation constituted the central problem of the economy in 1973–74, overshadowing all else. And the central issue that emerged from the performance of the economy in 1974–75 was restoration of a modicum of stability and balance in the economy. Good economic management through adoption of fiscal, monetary and administrative measures helped to bring prices down from the high levels recorded earlier, and, together with steps to improve the availability of raw material supplies and relieve transport bottlenecks, enabled the resumption of industrial growth and investment despite a decline in domestic savings. But probably the key element in the return to stability was the buoyancy in export earnings despite the deterioration in India's terms of trade and the sizeable inflow of external resources. This gave the authorities the ability to import the necessary raw materials and appropriately augment the aggregate supply. But there was a growing strain on India's

[12] According Jeremiah Novak, Ruddar Datt saw clearly how what began in Bangalore as the IMF programme needed the Emergency to be fully implemented. 'Bangalore and the Twenty-Point Programme are related', said P.N. Dhar, and so were the IMF–World Bank programmes related to the Emergency.

foreign exchange reserves stemming from the rising import bill: the reserves recorded a drop of Rs 176.2 crore during the half year ended December 1974, despite their replenishment by Rs 192 crore towards the end of October 1974 by drawals from the IMF.

1974–75 was technically the first year of the Fifth Five Year Plan. The attempt to judge the performance of the economy by the Plan yardstick of savings, investment and growth, as admitted by the authorities, was far from satisfactory, for there was barely 1 per cent real growth in the national product. But, as rightly pointed out in the Reserve Bank's *Annual Report*, it was incorrect to evaluate the performance in terms of targets. The fact that had to be reckoned was that the economy had inherited massive problems in the preceding couple of years, disrupting the long-term growth process. Again, 1974–75 had its own share of natural calamities and the domestic difficulties were compounded by external factors, namely, the quadrupling of oil prices and rise in world prices of foodgrains and fertilizers, imports of both of which needed to be stepped up. Thus, in the Bank's judgement, 'the restoration of normalcy in itself becomes an impressive achievement'.

HANDLING OF THE OIL CRISIS

The oil price explosion in the last quarter of 1973 brought into sharp focus the spectre of a worldwide crisis, reminding the global community that supplies of crucial raw materials were finite and the days of availability of cheap energy had abruptly come to an end. It portended massive shifts in international payments positions and a slowdown in economic activity at a time when inflation in all countries, particularly industrial countries, was at historically high levels, and posed a setback to the development aspirations of developing economies.

The redeeming feature was that the new Managing Director of the IMF, Witteveen, reacted with great alacrity to the oil crisis. At two-day meeting of the Committee of Twenty (C-20), convened in January 1974 at Rome, he mooted a proposal to introduce a temporary oil facility. The need for the closest international cooperation was solicited in the management of dramatic international payments changes arising from higher oil prices, and the Rome communique urged countries to avoid competitive depreciation and escalation of restrictions on trade and payments. There was genuine apprehension that adoption of deflationary policies to curb payments deficits could spiral into a serious global recession. With missionary zeal and determination, Witteveen confronted the massive and startling disequilibrium in international payments that faced the global economy;

he realized that adjustment for many of the developing countries would not only be painful but well-nigh impossible.[13]

Witteveen took pains to avoid any outward manifestation of his dominant role. He encouraged the Board members to speak out on issues and presented them with a growing flow of issue papers and action programmes. The oil facility was not conceived as a panacea for the deterioration in the payments situation. It was seen as a transitional bridging facility to tide over temporary difficulties, till more lasting adjustments could be worked out. An official arrangement to recycle petro-dollars was envisaged; but even this limited concept met with stiff resistance, especially from senior officials of the US Treasury, who, while conceding that the situation was unmanageable, were unwilling to consider any such option. The thrust of the US strategy rested on the belief that concerted international pressure should be brought to bear on the oil exporting countries to roll back a large portion of the price increase. At the same time, oil consuming countries should undertake the needed adjustment to reduce their demand for imported crude, and increase production and use of alternative sources of energy. The US was confident that adoption of such a policy would bring down the price of oil in a remarkably short time. In its view, agreeing to Witteveen's proposal would send out wrong signals that the international community was ready to absorb the hike in oil prices. The Germans, too, were reluctant to lend support to Witteveen's proposal or to lend to the IMF. Their objection stemmed from the belief that injecting liquid resources into the world economy at a time when inflation was on the rise was not the wisest course of action. The Fund's senior staff was also wary that it would unnecessarily cast a heavy financial burden on the institution.

Despite the heavy odds, following the mandate given by the C-20 at the January 1974 meeting, Witteveen took a trip to the Middle East in search of borrowed funds. Once he received assurance of financial support, he ventured to gain US support. Seeing that the developing oil importing countries were leaning on oil exporting countries for bilateral financial support and not vociferously objecting to the oil price increase but exploring ways to overcome the resulting payments deficit, the attitude of the US to the proposed oil facility softened.

Nothing like the oil facility existed in the IMF. The first half of 1974 saw the Fund work feverishly hard to give shape to the facility. Procedural, policy

[13] In a speech to the World Banking Conference in London on 15 January 1974, Witteveen warned that the international monetary system was facing its most difficult period since the 1930s. *IMF Survey*, Vol. 3, 2 January 1974.

and legal issues had to be addressed; terms and conditions for drawing and arranging credit lines had to be approved by the Board. The specifics of conditions of use, formula for determining access, charges on the use of funds and format for entering into borrowing agreements, all had to be addressed.

By mid-March 1974, the proposals of the Witteveen facility were given to the Board, where the first airing of views seemed to show consensus that the facility should be so designed as to primarily benefit the developing countries but not to the exclusion of the developed countries. Prior to the discussion in the Fund Board, Prasad, in a secret message to the Reserve Bank and the government, gave them the broad contours of the proposed facility, which was examined closely by both. V.B. Kadam, Director, Balance of Payments Division, RBI, was assigned the task of examining the proposals. In a detailed, well-argued note, Kadam proposed that, in principle, the scheme should be supported with pressure for early action. But the RBI had reservations on the assumption of an increase in cost of oil of only US$5.50 per barrel. The note questioned whether the assumption of a uniform increase in oil prices was appropriate in defining the extent of the strain on a net oil importer's balance of payments, and urged that some allowance be made in the formula for the proportion of direct imports. The other area where change was sought related to the matter of charges. Here, the RBI pressed the need for differentiation between developed countries and developing countries, in keeping with the differences in the ability to absorb increased oil costs through economy in oil use, through substitution by other energy sources and through increases in export earnings. For the developing countries the charges should be substantially lower than those for the developed countries, and, in any event, should not exceed the charges on the Fund's normal drawings. The RBI scrutinized every aspect of the proposal in the minutest detail but adopted a positive approach that would assist quick establishment of the facility.

Turning to the Indian scene, with the quadrupling of crude oil prices of imported petroleum products, the pressure on domestic prices intensified, as a significant proportion of those products was utilized by industries constituting the infrastructure. Apart from its bearing on the price situation, the oil crisis also had implications for balance of payments and growth. Initially, however, the precise implications were unclear. The Reserve Bank's preliminary estimate was that the annual import bill would be in the region of Rs 1,000 crore, accounting for virtually half the export earnings, as against Rs 275 crore in 1973. There was no reason to believe that reduction in imports of 17 million tonnes of crude oil and 3 million tonnes of petroleum products would not have adverse repercussions on growth. There was every reason to maintain monetary tightness. For the rest of 1973–74, the Reserve Bank held firm. The suggestion by the IMF that the interest rate notch should be tightened further was resisted; the demand of industrialists for relaxation was played with an equally dead bat.

Looking ahead, the Reserve Bank and the Treasury concurred that there were two directions in which further efforts needed to be concentrated. First, exploration of offshore and onshore oil should be intensified. Second, the possibility of substantially increasing the use of coal as a source of energy should be examined. There was, therefore, no disagreement that the energy situation had to be tackled on a war footing. The initial response to the increase in international oil prices in October 1973 was to reduce consumption of petroleum products through an increase in domestic price rather than through rationing devices. Beyond a point, this strategy had its limitations but despite this, the government continued its efforts at reduction of petroleum consumption through the offer of financial incentives to firms switching from petroleum to coal. Oil exploration efforts were expanded and private companies were invited to participate in oil exploration projects. At the same time, the domestic refinery capacity was slated to be increased. In retrospect, it cannot be denied that the structural adjustment measures undertaken by the government to adjust to the oil price rise were pragmatic initiatives in the areas of production, distribution and pricing. Admittedly, in the short run, the scope for reduction of petroleum use was limited, but the discovery around that time of offshore oil off the coast of Bombay, added a glimmer of hope to an otherwise grim scenario. It remained to be established whether the oil find was a commercially viable proposition.

As early as February 1974, while the IMF was struggling to give final shape to the creation of a special oil facility, the Indian Executive Director at the Fund informed the Finance Ministry that, based on the increase in the oil import bill minus 20 per cent of a member's reserves, and applying the price increase of US dollars 5.50 per barrel, India's entitlement, according to the Fund's calculation, would amount to Rs 379.2 million.[14] To draw on the facility, the member had to demonstrate need. While initially the

[14] The formula used to calculate the entitlement was as under:

1972 import	125 million barrels
Computed increase	SDR 569.9 million in import cost
Less one-fifth of the reserves	SDR 190.7 million
Amount available for drawing	SDR 379.2 million

conditionality attached to the drawing may not have been stringent, in subsequent years the drawings could attract stiffer conditions. Repayments would start three years after the drawing in sixteen quarterly instalments, and the interest on the drawing was fixed at 7 per cent.

The Finance Ministry's initial reaction was that such a facility that entailed short-term borrowing at 7 per cent it was not an attractive proposal. The officer on special duty, Shroff, made a cryptic remark: 'Our concern is with softer terms—lower rate and longer repayment, otherwise this facility will remain one we cannot use.' Another valid point to which Shroff drew the attention of the Finance Secretary was that, while the estimated drawings of the developing countries would be in the neighbourhood of SDR 1.3 billion, the developed countries' drawings were expected to be in the region of SDR 11 billion. Questioning the rationale for lending such large sums at concessional rates of interest to the developed countries, Shroff legitimately suggested a higher rate of interest for the developed countries and an easier maturity pattern for the developing countries. But concessional lending with differential interest rates was opposed by most of the industrial countries; as a result, proposals for subsidization of the differential between borrowing and lending rates through the Fund's income or reserves, or through the creation of a special issue of SDRs, were outright rejected.

The element of inequity in the architectural structure of the facility bothered Shroff, who remained critical of the scheme. But Bimal Jalan, also a senior officer in the Ministry of Finance, saw merit in supporting the establishment of the special facility. His basic reasoning was that, to the extent the facility helped the developed countries to meet their credit requirements without resorting to deflationary policies and competitive depreciation, it was in the global interest. The totality of the global scenario, of avoiding a major recession, prompted Jalan to be supportive. Agreeing, however, with Shroff that India needed concessionary finance, his evaluation was that it could be a useful source of supplementary finance, provided the rates were favourable to those of commercial borrowing. In short, Jalan was not for outright rejection but wanted the Executive Director to push hard for a differential interest rate, longer maturities for developing countries, adoption of equitable rationing criteria for use of the available funds, and some kind of guarantee that the use of the facility would not adversely affect existing resource collection.

The then Economic Adviser, Manmohan Singh, too, was not happy at the way the proposals were shaping up and felt that they were not an adequate solution to the problem. He requested Prasad to push hard for some of the changes suggested by the Reserve Bank and the government. But, in the face of the fairly rigid and uncompromising attitudes adopted by the oil producing and other developed countries with respect to the financing aspects of the facility, as well as the Fund's Legal Department insisting that the Articles of Agreement required charges to be 'uniform for all members and differential charges were not feasible', Prasad's job of seeking concessionary finance was rendered almost impossible. Although the IMF charging commercial rates of interest was foreign to its nature, because the facility had to be based on borrowed funds, as the Fund was already operating at a budgetary deficit, there was no way that the oil facility could be given out below the cost of raising the funds. RBI Deputy Governor Krishnaswamy also indicated that a flat increase of $5.50 per barrel was not appropriate in measuring the magnitude of the strain on net oil importers' balance of payments and some adjustment needed to be made for direct imports to total imports. The assumption of 125 million barrels for India was an underestimate, as it did not take into account the requirements of petroleum products like fertilizers. But, despite Prasad's valiant efforts to drive home the plight of the non-oil developing countries, and urging the MD to explore the possibility of two types of loans—hard and soft, he was unable to extract any special concessions for the non-oil developing countries.

On 13 June 1974, after prolonged sessions to give shape to the oil facility and to resolve the related issues of valuation of SDR, interest rate on SDR, charges and remuneration, the IMF Board approved the decision establishing the facility. The next issue that came up for consideration was: should India borrow under the oil facility? Aware of Delhi's reservations on the terms and conditions, Prasad made a strong plea to the government to avail of the drawing, and to use the money for building a small buffer stock of wheat or reinvest the amount in the Euro-dollar market, for he was convinced that, sooner or later, money would be needed. Anticipating a queue to develop because of the mild conditionality attached to the 1974 drawing—the time having been short to whip up specific adjustment programmes—Prasad urged Delhi to request a drawing. But Manu Shroff advised the Finance Secretary, M.G. Kaul, that the cost of buying time was likely to be in the region of 10 per cent of the amount drawn, which appeared excessive to the government. True, the facility was available only for a limited period and, if unused, would lapse. But the projected debt service burden of Rs 1,100 crore in 1979 excluding repayment of the oil facility drawing, coupled with the high interest rate and bunching of repayments, acted as deterrents to a drawing. In view of the large deficit projected in the foreign exchange budget for 1974–75, the Executive Director was instructed by Delhi that 'India was interested but had not so far taken a policy decision to draw.'

Prasad ventured to address a letter directly to the Finance Minister, Y.B. Chavan, stating that, despite his best efforts, it had not been possible to persuade lenders to place their funds at less than 7 per cent but that he would continue his efforts to press for a subsidized lending rate for non-oil developing countries. With little support from the other developing countries, the Indian plea for a subsidized rate fell on deaf ears, and was pointedly ignored by the developed countries. Here, an episode of interest, relating to the Managing Director, Witteveen, is worth narrating. It was Witteveen's conviction that India would need the oil drawing. Despite the Indian authorities' hesitation, he visited India in October 1974. During discussions with the newly appointed Finance Minister, C. Subramaniam, and the Governor of the Reserve Bank, S. Jagannathan, and in meetings with Prime Minister Indira Gandhi and President Fakhruddin Ali Ahmed, Witteveen reasoned that India should avail of the oil facility drawing even if its balance of payments was not so bad, for, by having larger foreign exchange resources at its command, India could relax somewhat the highly restrictive import policy that was stifling growth; additional imports could foster economic growth. The irony of the episode was that, even before Witteveen was back in Washington, India had drawn SDR 200 million under the first oil facility and, through additional imports, recorded a brisker rate of growth in 1975–76.

Hardly had the newly arranged oil facility been put in place then Witteveen was seen moving in the direction of creating another and larger facility for 1975. He was perceptive enough to realize that the need for recycling petro-dollars would remain big in 1975. Already, the commercial banks of industrial countries were channeling enormous sums of money through the Eurodollar markets. There was, however, a real danger of these banks going overboard and endangering their liquidity position through overexposure. This pushed Witteveen to find ways of strengthening official financing outlets for oil deficits; in his opening address at the 1974 annual meeting of the IMF and World Bank, he made a forceful plea for setting up a second oil facility that would help the non-oil developing countries to undertake structural adjustment measures to contain their oil deficits.

Even before the discussion on a second IMF facility for 1975 could get off the ground, the US opened a diplomatic offensive by floating the Kissinger proposals[15] for a new $25 billion oil facility outside the Fund. It

[15] The 14 November 1974 address of Secretary of State, Henry Kissinger, before the Board of Trustees of the University of Chicago.

was obviously an attempt on the part of the US, if not to torpedo the IMF facility, to reduce its role. The key feature of the US plan to recycle petrodollars was that financing for importing by industrial countries hard hit by oil prices should be done under the aegis of the Organization for Economic Cooperation and Development (OECD), rather than the IMF. Loans under US financing would be tied to the following conditionalities: a commitment to cut back on the use of imported oil, avoidance of retaliatory restrictive trade policies, sharing of risks by all OECD members on the basis of their share participation in the Fund. The main elements of the US cooperative strategy were to reduce oil imports, develop alternative energy sources and reduce consumption of oil. That was not the end of it, however, for, Kissinger, who had masterminded the strategy, suggested the establishment of a separate 'trust fund' with the IMF that would take care of the needs of the most severely affected (MSA) group of countries. The funding for the trust fund would come from contributions by Organization of Petroleum Exporting Countries (OPEC) members and other sources, and from the sale of gold by the Fund in private markets; profits from the sale of gold by the Fund would be lent to MSA countries on concessional terms.

The plan, no doubt, held out some attraction for the oil producers who could get market-related rates for the placement of their funds and whose risks would be guaranteed by the industrial countries. But the reaction of the MSA Directors was one of serious concern. Replacing an IMF facility, which operates for the entire international financial community, by a series of discrete mechanisms raised the fear of a very serious departure from international solidarity. Prasad, the Indian Executive Director, urged that the new proposal should not relieve the IMF of its responsibilities towards its entire membership and, therefore, that it was better to centre the adjustment process in the institution rather than split the process into two compartments—the IMF and industrial countries. Besides, several aspects of the gold problem had to settled first before one could count on this source to meet the laudable objective of concessionary finance.

At the OECD meeting, the US Treasury Secretary, Simon, spelt out the details of the proposed financial safety net—the OECD commitment to the second oil facility would have to be in the region of $25 billion in 1975. The Secretary General of OECD, Van Lennep, came up independently with a similar proposal, in which, instead of each OECD member contributing to the common fund, there would be a guarantee arrangement by the Bank for International Settlements (BIS). The upshot of these proposals was that the Executive Board was requested to consider the mechanisms and other details; in short, to give flesh to the various ideas floating around and pencil the outlines of an oil facility acceptable to the majority of members.

The mandate given to the Board was not easy to execute: there were both arguments and counter-arguments on the size of the facility, the source of finance, the list of trust fund beneficiaries, even the very concept of an oil deficit, which was described as an imperfect concept and radically resisted by the US. Ultimately, through the maze of different viewpoints, on 23 December 1974, the bare bones of the 1975 oil facility were settled upon by the Board and forwarded to the Interim Committee for approval. Several issues remained to be settled, however, and the Interim Committee had the uphill task of arriving at acceptable compromises and giving the lead to enable the IMF to get the 1975 oil facility in place. At its meeting in Washington, the Interim Committee, after some debate, wisely threw out the safety net idea for industrial countries and more developed countries, and instead, decided on another facility in the Fund, open to all members. The proposed loan and guarantee financing facility elaborated by the US Treasury did not find favour with the Europeans.[16] On the other hand, the oil countries were attracted to this facility, as it would give them an instrument of investment that was guaranteed by powerful nations.

The US opposition to the oil facility in the IMF was confined mainly to its use by developed countries. If the Fund could discriminate and create an oil facility only for developed countries, the US objection would have disappeared. In fact, the trust fund idea was mooted to help the developing countries. Thus, after intensive debate, the broad features of the second oil facility remained broadly the same as for the 1974 facility, but with a provision that the concessional rate of interest would be applicable to countries more severely affected.

On 4 April 1975, the requisite decisions to establish the second oil facility were taken on the following terms: assistance would be available for seven years; charges would be raised marginally to 7.75 per cent[17] to meet not only administrative costs but also provide a fair return to the lenders making resources available to the Fund; some relief in charges would be

[16] France opposed the arrangement as the scheme was confined to members of the International Energy Agency and required that the beneficiaries aim at curbing consumption of oil. It was reluctant to join a cartel of oil consumers.

[17] Charges on Transactions under the 1975 Oil Facility

(Charges in per cent a year payable on holdings in excess of quota for period stated)

Up to 3 years	7.625
3–4 years	7.750
4–7 years	7.875

provided to the most seriously affected among the oil importing developing countries. But access to the 1975 oil facility was subjected to a much stricter degree of policy conditionality than was applicable to the 1974 facility—a prospective borrower was required to give more specificity to its programme of oil energy conservation and utilization to achieve medium-term balance of payments adjustment, including greater use of the exchange rate policy. Although India and several other non-oil developing countries were unhappy and expressed their concern at the tightening of the conditionality, they were attracted to the concessional feature of the facility. The Latin American group was sorely disappointed and Kafka, the Brazilian Executive Director, remarked to the Indian officials that 'middle-income countries were left in the cold'. India drew SDR 201.34 million in 1976; thus total drawings by India under the two oil facilities aggregated SDR 401.34 million. Although the majority of the members did not sign the voluntary pledge, the most advantageous fall-out of the conditionality prescriptions was that members refrained from introducing further trade and exchange restrictions, which made adjustment to the oil crises somewhat smoother.

In sum, the skewed distribution of global energy supplies and the need for redressing world payments imbalances that may continue for some time to come, brought to the fore the need for some relief in charges to be provided to the most seriously affected among the oil importing developing countries. The idea of the IMF charging commercial rates was foreign to the Fund's traditional philosophy of relatively low charges coupled with conditionality. It may be recalled that during the discussions relating to the creation of the second oil facility in 1975, the Indian Executive Director had made a strong plea to soften the burden on developing oil importing members of charges as high as 7.7 per cent a year, but the Executive Directors had found it hard to agree.

At the 1974 annual Fund–World Bank meeting, the Governors of both developed and developing countries spoke in favour of a subsidy account in the Fund to provide relief from high charges to the developing countries; this was later endorsed by the Interim Committee. Based on the Interim Committee's directive and understanding that such an account would be set up, the Executive Board considered the staff proposal that fleshed out the idea of such an account. It was accepted in principle but, in practice, establishing such an account turned out to be an uphill task. The job entailed finding satisfactory explanations to such issues as, could the Fund, under its Articles, differentiate charges among various categories of members. Hitherto, the charges were the same for all members, as the Articles specified that they had to be uniform across members. The IMF staff paper addressed this issue and indicated that there was no legal bar to the Fund offering a separate schedule of charges to a floating facility that existed independently of the regular facility.

The other issue was, who should qualify to receive the subsidy. After extensive debate, it was decided to use the UN list of thirty-nine countries, identified as the most seriously affected members (the MSA list). This included all three members of the Indian constituency, viz. India, Bangladesh and Sri Lanka. Contributions to the subsidy account were solicited from all members, including oil exporting and industrial countries and excluding MSA countries. Switzerland and twenty-four members were contributors to this account. The US remained the most conspicuous non-contributor. A subsidy at the rate of 5 percentage point was maintained for the fiscal years ending 30 April 1976 and 1977. This reduced the effective average cost of using the resources from that facility for MSA countries from 7.71 per cent to 2.71 per cent. The MSA countries received a subsidy equivalent to SDR 13.8 million in 1976, SDR 27.5 million in 1977 and SDR 24.9 million in 1978. Of these, the subsidy received by India amounted to SDR 7.23 million in 1976, SDR 10.03 million in 1977 and SDR 7.46 million in 1978. Because of a sizeable improvement in India's balance of payments resulting in a salutary rise in monetary reserves, during May 1977 to April 1978, under the Fund's normal requirement of Article V, Section 7(b) relating to repurchase, India was required to repurchase its outstanding under the 1975 oil facility, indicating that the receipt of subsidy had ceased. To sum up, despite the enormous difficulties in setting up the subsidy account, its creation was an innovative and path-breaking step signalling greater flexibility in the IMF's operations.

Till 1972–73 India consciously eschewed the path of medium-term borrowing, but, between 1972–73 and 1974–75, as India's deficit on trade account grew, India was forced to resort to large-scale medium-term financing, essentially to finance the increased costs of imports for its current consumption of petroleum, foodgrains and fertilizer. The first such medium-term arrangement was for a wheat loan of 2 million tonnes from the USSR. This was a commodity loan in the sense that its repayment had to be in wheat. In matters pertaining to external aid and negotiations for medium-term credit, as a general rule, the government preferred to pursue an independent and characteristically more direct approach. Although no representative of the Reserve Bank was associated in the negotiations for the wheat loan, Narasimham, an RBI officer who had just assumed office as Additional Secretary in the Department of Economic Affairs in the Finance

Ministry, was included in the official team.[18] The core of the negotiations related to details about the matching quality of wheat for repayment and the modalities of the exchange. The Indian side, in the face of acute shortage of foodgrains, emphasized the urgency of expediting the shipments; this request was met by diverting supplies intended for Chile and on the high seas, to Bombay.[19] Within weeks of the negotiations, the first shipments of Russian wheat were available for government distribution.

In the case of the first oil credit negotiations with Iran in 1974, Economic Secretary M.G. Kaul requested the RBI Governor to nominate a Bank official as a member of the Indian delegation. The Bank nominated the deputy manager, who was well versed in banking law and practice; he provided valuable advice on the banking aspects of the credit arrangement. At the outset, it seemed that the Iranians were not ready to discuss the terms of the credit but were more anxious to finalize the oil supply deal. But diplomatic pressure was applied from the Indian side and full-scale negotiations followed. The initial arrangement proposed by the Iranian side was that the Central Bank of Iran—Bank Markazi—would extend credit to the Reserve Bank of India to finance the purchase of oil. The Reserve Bank representative was quick to point out that under the RBI Act, it was not permissible for the Bank to borrow from sister Central Banks for any period longer than one month. Therefore, Government of India would be the borrower and the Reserve Bank would manage the credit as an agent of the government.

At a later meeting, it was agreed to make the credit procedure simpler by making the Iranian Oil Co. extend the credit directly to Indian Oil Corporation, with a suitable guarantee from Government of India (a supplier credit type arrangement). But there was hard bargaining on the price at which the crude oil would be supplied—Iran refused to budge from the posted price—and the rate of interest to be paid. It later transpired that the Iranians were insistent that the Reserve Bank should give an undertaking that foreign exchange would be released on the due dates for repayment of credit and payment of interest, as well as join in the State Bank of India's obligation for remittance of the amounts on due date. While the RBI had no difficulty regarding the release of foreign exchange, it informed the

[18] The delegation was headed by P.N. Dhar, then the Prime Minister's Secretary, and included, besides Narasimham, the Food Secretary and the chief executive of the Food Corporation of India.

[19] M. Narasimham, *From Reserve Bank to Finance Ministry and Beyond: Some Reminiscences*, p. 61.

government that it was not legally permissible for the Bank either to guarantee due repayment of the credit by Indian Oil Corporation or join in any guarantee that the State Bank of India may give in this regard.[20]

In the agreement that was eventually signed, credit was directly given to Indian Oil Corporation without the government's intervention. This had two major implications—firstly, the government did not get any budgetary support; secondly, Indian Oil Corporation, which was the recipient of the credit, was required to cover itself in respect of the exchange risk, as there would be a difference between the sale price it would realize within India on distribution of the products and the rupee cost of the deferred instalments in foreign exchange, when the credit was liquidated. As it turned out, the Reserve Bank's involvement was minimal, as the banking aspects of the arrangements were taken care of by the State Bank of India.

Reverting to India's external accounts, the effects of the oil price increase and the dramatic deterioration in the terms of trade that had taken place since 1973 did not show up fully in the balance of payments position before 1974–75. Until 1973–74 the foodgrain deficit was largely filled by drawals from government stocks built up during periods of good harvests. The effects of the oil price increases were not reflected in the actual payment statistics before the first quarter of 1974–75. The 1974–75 balance of payments revealed a current account deficit of only Rs 955.7 crore, despite in the import bill for petroleum, foodgrain and fertilizers showing an enormous combined increase of Rs 1,265.9 crore.[21] Despite this increase, the overall deficit was contained at a sustainable level through a large increase in exports, a higher level of gross aid and continuation of a savagely restrictive import policy. Use of IMF resources in the region of SDR 497 million in 1974 and some medium-term borrowing, including the medium-term credit of $ 132.25 million from Iran for the import of oil, helped to prevent a sizeable drawdown in reserves.

[20] Government of India was prepared to issue the necessary guarantees but Iran was insistent on bank guarantees. Guarantees of the State Bank of India were offered but the National Iranian Oil Co. wanted such guarantees confirmed by the Reserve Bank.

[21] (Rs crore)

Imports	1973–74	1974–75
Food	473.9	794.8
Mineral oils	340.2	1112.4
Fertilizers	125.2	298.1
	939.3	2205.3

The Indian authorities were now faced with the difficult task of medium-term adjustment. While some marginal reduction in imports was contemplated through the adoption of energy policies and through increased agricultural production, the major thrust of the adjustment policies was directed towards promoting exports. It was recognized that the problem had to be dealt with imaginatively and skilfully; restraining imports would retard economic growth, while higher levels of medium-term borrowing could eventually land the economy in a debt trap. Keeping these factors in mind, the onus was thrown on promoting exports, for it was recognized that monetary and fiscal mechanisms were unequal to the task of protecting export capability or capacity. The government, however, was well aware of the need to rationalize export promotion measures. A study was already under way of the experience with export promotion measures. A Committee on Engineering Exports (Sondhi Committee) had issued a report in 1974, calling, among other things, for a sharp de-emphasis on export obligation as a means of encouraging exports and, in general, applying greater selectivity of both items and production on which to focus the export drive. A Cabinet Committee on Exports was set up to suggest further improvements in the export incentive system. This Committee gave effect to some of the Sondhi Committee proposals, notably increases in cash assistance, a reduction in penalties for certain types of export obligations and simplification of procedures for steel allocations. But these measures were applicable only to engineering exports. Other far-reaching measures included variations in export duties—export duties on jute manufactures were cut and a system of direct cash assistance for selected non-traditional export items were announced as part of the export promotion measures.

The Reserve Bank, too, was seized of the need for improved monetary mechanisms to promote all exports. In April 1975 it created an export cell to attend to various aspects relating to the provision of export credit by banks and to the administration of the Export Credit (Interest Subsidy) Scheme of 1968. The cell was to serve as the secretariat of the Standing Committee on Export Finance—a high-powered, policy-formulating body for matters pertaining to export finance. K.S. Krishnaswamy, then Deputy Governor in charge of the Economic Department, was the chairman of the Committee.[22] The Standing Committee met for the first time on 9 April

[22] The other members of the Committee included representatives of the Ministry of Finance, Ministry of Commerce, Industrial Development Bank of India, Export Credit Guarantee Corporation, Foreign Exchange Dealers' Association of India, and representatives from the Economic Department and Exchange Control Department of the Reserve Bank.

1975 and several times thereafter. Some valuable suggestions flowed from its deliberations. These were taken up for further examination by the export credit cell. Some of the procedural issues examined by the cell to see if they needed adjustments to facilitate export growth, were: the schedule of collection charges in respect of rupee bills, with a view to making such bills attractive; the need for extending post-shipment credit at a concessional rate for up to 120 days; the question of the Reserve Bank providing refinance to banks against sight bills; the types of export items for which concessional pre-shipment could be granted for more than 270 days. Based on the findings of the cell, the Standing Committee requested the Ministry of Commerce to take steps to increase the interest subsidy to banks from 1.5 per cent to 4 per cent in respect of deferred payment exports, and the Ministry of Finance to consider payment of interest subsidy to banks on buyer's credit extended by exporters to foreign importers. The cell acted as a bridge liaisoning between Ministries of the central government, Export Promotion Councils, Exporters' Association, the ECGC and the IDBI, and played a useful role in ironing out policy and procedural wrinkles that came in the way of export activity. It was also instrumental in building a databank on all aspects of exports, which acted as a valuable input for policy formulation. Monitoring payments as interest subsidy at the rate of 1.5 per cent to banks was also assigned to the cell. Around this time, Government of India had extended a special line of credit of Rs 25 crore to Bangladesh at a concessional rate of interest of 5 per cent per annum, for the supply of capital goods to that country. The Reserve Bank was called upon to maintain and administer this account, an additional responsibility that it willingly undertook as an agent of the government.

Around mid-1975, the regular Article XIV consultation on India was scheduled for discussion in the IMF Board. Article XIV is an annual consultation between member and the IMF Board for getting the IMF's seal of approval on the economic policies followed by a member country. That year the IMF staff report placed the developments in the Indian economy in a favourable light and commended the vigorous policy measures taken by the government to curb inflationary pressures. However, although the report was appreciative of the difficulties in managing a vast economy, in its detailed analysis of the developments of the economy (the RED, as it is referred to), it was highly critical of Indian policies relating to exports, private investment, tax administration and the exchange rate. This dichotomy between the tenor of the main report and the RED puzzled Jagannathan, the newly appointed Indian Executive Director on the IMF Board. He was in a quandary as to how to defend some of the *ex-cathedra* statements made in the report and sought the views of the Indian authorities. It was his maiden performance and he was keen to defend India's economic policies effectively. To get the reactions of the authorities, he sought postponement of the scheduled meeting to discuss the India report, from the Secretary's section.

It was obvious to Jagannathan that there had been some political arm-twisting of the IMF staff between the issue of its main report, which was dated 9 June, and the RED, which was circulated a month-and-a-half later, on 17 July 1975. So what had transpired inbetween to bring about this unhappy assessment of the Indian economy? All pointers were in the direction of political events in India and the imposition of the Emergency. The Emergency was looked upon by the industrial countries as an assault on democracy and the US, the major shareholder in the Fund, was no longer prepared to give a clean chit to India's economic policies. This disturbed Jagannathan, in whose judgement the staff assessment was not very sound, particularly with regard to the exchange rate. The IMF staff's evaluation of the exchange rate read: 'The authorities have been seeking ways of expanding exports without either a change in exchange rate policy or a major overhaul of the system of controls.' When the 1975 India report came up for discussion in the IMF Board, Jagannathan ably defended the Indian authorities' stance on the exchange rate policy by pointing out that, in relation to major international currencies, the Indian rupee had depreciated significantly since 1972, following the decline in the value of the pound sterling. This depreciation had been helpful to Indian exports (the staff report had conceded this point) and there was no need to consider the rupee as being overvalued to any extent. Citing the enormous increase in remittances through official channels, and the very narrow difference between official rates and unofficial quotations for the rupee, to show that the rupee was not overvalued, Jagannathan demolished the staff argument regarding its overvaluation.

In the light of Jagannathan's spirited defence, the thrust of India's economic policies grudgingly received the approval of the Board. The Board, while conceding that 'vigorous policy measures by the Government were successful in sharply curtailing inflationary pressures', went on to record to say that the fundamental problems of inadequate agricultural and industrial production remain to be solved. Describing the emphasis on increasing public sector expenditures as appropriate, the decision recorded was that 'it will require improvement in the buoyancy of the tax system and more would need to be done to improve the investment climate in the private sector'. Curiously, there was no direct reference on the management of the exchange rate, except an innocuous statement that 'the Fund hopes India will take additional measures to ensure a more rapid growth in exports'. Overall, there was more than a hint in the 1975 Article XIV consultation, of the application of some 'stick' to encourage decisions favourable to the industrial world.

The year 1974–75 is remembered as a year in which normalcy was restored to an economy that had passed through the traumatic experience of unusually high rates of inflation in the previous two years, and in the year 1975–76, it was possible to put the economy back on its normal path of growth in an environment of price stability. The growth rate in real output increased to 5.5 per cent in 1975–76 from the average of 1.2 per cent during the previous three financial years. The demand management measures that contributed significantly to the control of inflation were income policy measures supported by action in the monetary and fiscal fields, such as increases in salaries and wages, increase in dearness allowances and freezing of a portion of incomes in higher brackets in compulsory deposits with the Reserve Bank. The demand-side measures were complemented by efforts to improve supplies. In addition to a good harvest, supplies were augmented through substantial foodgrain imports. Action taken against hoarders also helped to increase the availability of supplies. There was a sizeable improvement in the balance of payments with the current account deficit of Rs 955.7 crore in 1974–75 narrowing to Rs 177.9 crore in 1975–76, and with gross international reserves recording a rise of as much as Rs 864 crore to Rs 1,885.4 crore, at end-1975–76.

Another landmark development influencing the external sector was the delinking of the rupee from the pound sterling on 25 September 1975. The exchange rate system was changed to one in which the value of the rupee was pegged to a weighted currency basket within 2.25 per cent margin on either side. In operating the multi-currency basket, as described in the chapter on Management of the Exchange Rate, the export-weighted effective rate appreciated by about 4 per cent between September 1975 and April 1976. The IMF remained critical of the policy of appreciation but the Indian authorities vigorously defended it by stating that adoption of the multi-currency basket had reduced uncertainty for exporters and importers by stabilizing the value of the rupee vis-à-vis currencies other than the sterling, while increasing the purchasing power of the rupee in terms of the sterling. In the perception of the Indian authorities, the purchasing power parity of the rupee and the competitiveness of Indian exports had improved on account of the favourable price performance of India relative to its trading partners. In a world characterized by violent day-to-day fluctuations, they dismissed as of little consequence a small effective appreciation of the rupee, on the understanding that developments on the export front would be carefully watched. They remained convinced that the change to a basket of currencies had to some extent contributed to the stabilization of prices of imported commodities and services.

Indeed, containment of prices was the single most outstanding achievement of 1975–76. This assessment would be incomplete without reference to a rather unique experience in the management of the economy. The declaration of internal Emergency and the inception of the Twenty-Point economic programme helped to tone up the administration and ensured effective implementation of specific time-bound programmes. There was increased emphasis on discipline and efficiency. Strikes were virtually eliminated and effective action was taken against smuggling, hoarding and tax evasion. Export promotion was given added emphasis. The improvement in the external sector was further reinforced by another international development, the movement in international gold prices, which, in 1975–76, remained under the shadow of expectations regarding the effects of the disposal of 50 million ounces of gold by the IMF. The consensus[23] reached at the Jamaica meeting of the Interim Committee on gold introduced uncertainty in the gold market. This, together with the recovery of the US dollar on the exchanges, induced heavy selling; by the third week of September 1975, gold was traded in the London market at $128.75—its lowest price since January 1974. The downward pressure appears to have touched off large-scale dehoarding and restrained smuggling, and Indian reserves appear to have benefited also from this development.

There were three features of growth in 1975–76 that lent support to the resumption of normal growth after a two-year interregnum of inflation. These were price stability, a significant rise in investment, and a move towards a viable and sustainable external payments position. On the external front, although the trade deficit was much larger than in the previous year, the payments situation underwent a healthy change, primarily on account of larger inflow of external assistance and a sizeable improvement in the invisible account. In the Bank's evaluation, these trends were symptomatic of a structural transformation in the balance of payments components, arising out of higher export capability, import substitution in the sphere of oil and energy, and a sharp step-up in invisible earnings.

[23] The Jamaica accord *inter alia* related to (i) the abolition of the official price of gold, (ii) abrogation of the obligatory payments in gold by Fund members, (iii) immediate disposal of 50 million ounces of the Fund's holding, half by restitution and half by auction.

Although 1975–76 marked the beginning of a favourable phase in India's external payments account, the Reserve Bank, as the guardian of the country's economic health and stability, sounded a note of caution in a memorandum submitted to the Board on 2 February 1976 by K.S. Krishnaswamy, on the 'Current Economic Situation and Outlook'. On future prospects, the memorandum emphasized the fragility of the supply–demand balance in terms of real resources, adding that it had been possible to restore price stability through demand management rather than through domestic supply adjustments. However, with a money supply expansion of 12 per cent recorded in 1975–76, the Bank feared a gradual heating of the inflationary cauldron and bluntly warned that 'any let up in the over-riding objective of demand management and fiscal policies may impair price stability and invite a fresh bout of inflation'.

In the mid-seventies, there were distinct signs that current invisible receipts were becoming a dominant item in the country's external payments account. Several measures were taken in 1975–76 to encourage the inflow of savings from Indians or persons of Indian origin abroad, such as permitting them to open non-resident foreign currency accounts to invest, within specified limits, in a wide range of Indian industries. In fact, there was a sharp shift in remittances from illegal to legal channels following the periodic upward adjustments in the intervention rate against the sterling, which was attributed as a factor that increased the inflow of remittances. But the Reserve Bank's reading was that this inflow was unlikely to be sustained at the levels witnessed in 1975–76. The more liberal and pragmatic attitude taken towards foreign travel and the increased foreign demand for Indian labour services brought about a larger than expected shift in net invisible receipts. According to estimates made by the Exchange Control Department of the Bank, gross non-merchandise receipts through banks alone rose from Rs 654 crore in 1974–75 to Rs 1,198 crore in 1975–76, and surged to Rs 1,586 crore in 1976–77 and further to Rs 2,117 crore in 1977–78.[24] The major components of these receipts were private unilateral transfers, travel receipts, and earnings from technical and professional services including consulting and contracting. Private unilateral transfers primarily represented remittances for family maintenance from migrants living abroad. While remittances from overseas Indians swelled from Rs 31 crore at end-March 1975 to Rs 320 crore at end-March 1978, balances held by Indians abroad with banks in India under the new Foreign Currency Accounts Scheme reached an unprecedented £12.3 million and $149.8 million.

[24] Reserve Bank of India, *Annual Report 1977–78.*

The shift in strategy from tight micro-regulation to one designed to attract and encourage inward remittances through banking channels from persons of Indian origin residing abroad, paid rich dividends. The Reserve Bank's Research Department, through analytical studies and special surveys of various components of the invisible accounts, such as the Unclassified Receipts Survey, Foreign Travel Survey and Foreign Collaboration Survey, was able to make a valuable contribution to the decision-making process pertaining to the invisible sector. No doubt, a combination of factors were responsible for the spectacular rise in invisible receipts. Although a full explanation cannot be attempted here, they included the salutary improvement of the Indian economy with containment of domestic prices at a time when inflation abroad was at a high level; stability of the external value of the rupee while there were sizeable fluctuations in the exchange values of major currencies; increase in the number of Indian workers going abroad in search of gainful employment; the management fees and agency services, along with investment income and technical know-how associated with Indian enterprises taking up a growing number of turnkey projects. Gradual nurturing of the various elements of the invisible account resulted in a phenomenal improvement in net invisible receipts, from a paltry Rs 193 crore to Rs 2,486 crore, in 1979–80.

Here, passing reference may be made to the attempts made in 1976 and early 1977 to woo non-resident Indians by deputing senior bureaucrats to visit the Gulf and South Asian countries with a view to invoking their interest in investing in India. One such high-powered team led by Finance Minister Pranab Mukherjee[25] visited the Gulf, Indonesia, Hongkong and Thailand, and even called on the ruler of Dubai (Bin Makhtoon). The impression gathered by the team was that while the non-resident Indians were keen to invest in India, they were looking for concessions in various areas, the basis for which, the delegation felt, did not yet exist. Indians in Hongkong were uncertain about their future when Hongkong would revert to China, and suggested that the Indian government should seriously consider making the Andaman and Nicobar Islands a free port and an offshore financial centre. To develop the infrastructure of those Islands, Indians in Hongkong suggested that the Indian government float bonds in foreign exchange that they would subscribe to. The Indian team was not taken in by this suggestion, as they were aware that the government had earlier constituted a study

[25] Other members of the team were P.G. Mankad, who later became Finance Secretary; M. Narasimham, Secretary, Banking; V.K. Shunglu. See M. Narasimham, *From Reserve Bank to Finance Ministry and Beyond: Some Reminiscences*, p. 91.

group to examine the feasibility of an offshore centre but the idea had failed to catch on as it was mired in a number of problems.

By the mid-seventies, there was a gradual but discernible shift in the balance of forces within the Reserve Bank, with the traditional regulators in retreat. To be sure, the weight of tradition bore heavily on day-to-day operations and there was no deregulatory lead from the government. Nor was there any clear direction in the Bank's position except the knowledge that invisible receipts could, in time, become a valuable and reliable source of foreign earnings. The increase in the number of Indian nationals going abroad for employment, as reflected in the relaxation of P form clearance, from 30,000 in 1975 to 72,000 in 1976–77, was evidence enough to indicate that the tempo of such clearances had picked up. The shift towards liberalization, although halting and hesitant, was unmistakable and, in the event, irreversible.

From 1975–76 through 1978–79, the Indian economy was in fine fettle. Real growth averaged about 6 per cent, wholesale price inflation about 2 per cent per annum, and external reserves rose from Rs 1,021.9 crore at end-March 1975 to Rs 5,820.7 crore at end-March 1979. Described as the 'golden years' of the economy, they were a period of resource ease compared to the earlier years of perennial resource constraint. Favourable weather conditions and improved technology resulted in large increases in agricultural production and a build-up of large stocks of foodgrain supplies. The balance of payments moved into a surplus, mainly as a result of accelerated exports, a sharp upturn in migrant remittances and a progressive elimination of foodgrain imports. By all counts, India's adjustment effort following the first oil crisis was remarkably smooth and well-handled, resulting in a surplus on external accounts, creation of a large foodgrain reserve and promising growth prospects.

The changed balance of payments position from recurring deficits to a large surplus accompanied by a steady increase in reserves was not without its policy travails. The Reserve Bank and the Treasury were aware that a surge in foreign exchange receipts could rekindle inflation and they were concerned that rapid monetary expansion should not lead to a re-emergence of inflationary pressures. So, control of inflation became the main focus of short-term economic policy. Given the increase in reserve money resulting from the large external surplus, the RBI sought to control other sources of reserve money expansion and to restrain the growth of bank credit. Helped by the budgetary development and modest decline in public foodgrain stocks, the authorities were singularly successful, in the short run, in moderating the impact of reserve accumulation on money supply.

But the RBI continued to be concerned about the potential for inflation in 1977–78 and thereafter. Anxious to find the most effective and expeditious avenues of using the reserve resources to supplement domestic investment, towards the end of 1977, the Bank commissioned a study on 'The Utilization of India's Foreign Exchange Resources'.[26] The study highlighted the magnitude of the reserve expansionary thrust, and suggested that reserve ease and external assistance flows need to be deployed in productive investment, besides meeting the economy's current needs through net importation of goods and services. Conceding that available external resources could be used for acquiring non-productive assets like gold, it qualified its use only in times of inflation, and provided there was reason to believe that availability of gold will increase total savings and reduce hoarding of commodities. Conversion into less liquid and potentially more remunerative assets abroad was not ruled out, but qualified resort to this approach was suggested, only if there was a dearth of domestic investment opportunities. With foreign exchange reserves equivalent to nine months' imports in 1977–78, the Reserve Bank's analysis was that steps should be taken for a 'liberal and purposive' use of these resources, with a view to encouraging and strengthening the growth potential of the economy through the needed structural changes.

At the same time, the RBI warned that the comfortable foodgrain stocks position should not lull policy-makers into a sense of complacency and advised their productive deployment in developing the rural sector. Noting that a small beginning had been made with the introduction of the 'food-for-work' programme, the Bank urged the government to press ahead with expanding public distribution of foodgrains, thereby ensuring a minimum standard of consumption for the entire population and transforming the urban-based public distribution system to a broadbased one. The government was by and large receptive to the Bank's policy direction and this found a welcome echo in its *Economic Survey* for 1977–78, wherein it concluded that the policy emphasis will have to be on increasing the output of commodities, providing incentives for larger investment in industry, and formulating an overall strategy of growth that would utilize the increasing foreign exchange reserves. It underlined that 'the last was most important, if the paradoxical situation of a poor country lending abroad—which is what growth in foreign exchange reserves had amounted to—was to be corrected.'

[26] Board memorandum submitted by Executive Director A.K. Banerji on 12 December 1977.

In the context of the substantial increase in foreign exchange reserves, RBI Governor Patel recognized that the volume of work that had to be handled by the foreign section of the Department of Accounts had grown enormously over the last two years. Earlier, the bulk of the foreign exchange reserves were held in sterling treasury bills and dated securities. The management of the reserves did not, therefore, pose any major problem. But since 1975, the Bank had undertaken diversification of reserves into various currencies, and these were being invested to a large extent in the form of deposits with the BIS, with top-ranking banks abroad, and in dated securities issued by sovereign governments, the World Bank and the Asian Development Bank (ADB). Moreover, the 1979 amendments to the RBI Act expanded the horizon by broadening the scope for investment of the reserves in government-guaranteed securities, securities issued by other international institutions like the European Economic Community, European Coal and Steel Community and European Investment Bank, and also in certificates of deposit issued by top-class foreign banks.

Certain other provisions of the Reserve Bank of India Act, which appeared needlessly restrictive, were also amended. Hitherto, the Bank was permitted to place deposits only with a foreign bank in an overseas centre; it was debarred from placing deposits with any branch of an Indian bank functioning abroad. This invidious distinction was of little consequence when the extent of deposits with commercial banks abroad was negligible and the number of Indian banks having branches abroad was small. But in keeping with the country's interests as well as furtherance of the image of Indian bank branches operating abroad, the RBI, through an amendment to Section 17(13) of the Act, sought powers that would enable it to make available foreign currencies to scheduled banks, the IDBI, the IFCI and state financial corporations, for financing international trade and for import of capital goods, in the form of a rupee loan against which foreign exchange could be purchased from the Bank or directly as a foreign currency loan. In this way, more purposeful use was sought to be made of the growing reserves for fulfilling appropriate socio-economic objectives and promoting planned development.

Bearing in mind the growing complexity of foreign exchange regulations and the vast amount of work generated, the RBI Governor was keen to initiate action to simplify, rationalize and liberalize the operational aspects of the control. The Bank management recognized the need for assistance in two areas—for handling the investment portfolio of the foreign exchange reserves, and for a systematic simplification and codification of the foreign exchange regulations. Hitherto, changes had been made in the regulations on an ad hoc basis, but from then on, the Bank's management was keen to bring about changes that would make the foreign exchange regulations more streamlined and more responsive to the changing needs. Further, the need was felt for coordinated action and decisions, after consulting the Department of Economic Affairs, other Ministries of the government and the Enforcement Directorate.

The idea of employing a foreign consultant was toyed with, but considering the sensitive nature of the work involved, it was thought best to appoint local talent. After scouting around for a suitable candidate, the Reserve Bank chose J.S. Baijal, an IAS officer, who they felt had the background and experience. Designated as officer on special duty, Baijal was appointed on deputation for one year and was made directly responsible to the Governor. At the same time, to effectively cope with the increased and diversified workload, the foreign section of the Department was suitably restructured and its staff strength raised.

In 1976–77 the gross inflow of external assistance came down by 13 per cent as compared to the level of gross aid in 1975–76, due mainly to lower assistance from the oil producing countries and the virtual absence of grants under the UN Emergency Operations Scheme. It was but natural that donors responded to India's improved balance of payments position and growing self-sufficiency in foodgrains after 1975–76. Project aid commitments continued to rise, but disbursement and utilization of this aid was slow compared to other forms of aid. This was the time when, under McNamara's stewardship, the sectoral pattern of project lending of World Bank loans shifted towards rural and social development. On the external assistance front, the period also reflected a souring of relations between the World Bank and the US administration—the major lender to this multilateral institution. In the view of US Treasury officials, 'the World Bank was getting out of control'. The US administration was concerned that the rapid growth in lending which had resulted in massive undispersed commitments was mortgaging the World Bank's future borrowing capacity, and that the World Bank management was not responsive to donor criticism.[27]

The US Treasury also raised the sensitive issue of the bankability of the new rural and poverty projects but, ignoring the criticism, the World Bank went ahead with lending to countries that it considered creditworthy. Thus, India remained one of the largest borrowers from the World Bank with a large share of official debt outstanding. In the first half of the 1970s, India

[27] See D. Kapoor, John Lewis and Richard Webb, *The World Bank: Its First Half Century*, Vol. 2.

relied heavily on the World Bank and the IMF for its multilateral borrowing, while its neighbours—Pakistan, Sri Lanka and Nepal—remained customers of the Asian Development Bank. From this, it should not be inferred that India was a preferred customer of the World Bank, for disputes arose at a substantive level on the scope of bidding, shortlisting of foreign sources and choice of technology. These disputes had their roots in India's import substitution strategy and its strong desire to maximize utilization of domestic manufacturing capabilities.

The growth in foreign exchange reserves and the consequent easing of the foreign exchange situation provided an opportunity not only to clear India's outstanding purchases from the IMF on due dates, but also enabled India to undertake advance voluntary repurchases, be included in the IMF's designation plans and make payments for gold restitution.[28] By adopting a policy of prudent debt management, India set high standards in these matters and enhanced its creditworthiness in the eyes of the rest of the world. The country's exemplary record of meeting its IMF obligations on time stood it in good stead in later years. In matters pertaining to repurchases, the government relied heavily on the Reserve Bank for its advice. This was one of the most complicated aspects of Fund transactions and from time to time several modifications were made to the purchase and repurchase policies. Normally, the Executive Director gave broad indications on the currencies that could be utilized for a repurchase or a currency package that was available for purchase. But it was the RBI's responsibility to examine the feasibility of using that currency in the context of the exchange rates, the prevailing market conditions, etc., and, by and large, the Bank's viewpoint prevailed.

It will be recalled that since the 1950s import control had been used as a rigid instrument to regulate aggregate supply and to protect international reserves. The year 1976–77 saw the beginning of a slow process of import liberalization. The import policy was gradually relaxed and greater automaticity was introduced in the features relating to imports of raw materials and components for domestic production. With the substantial expansion in non-traditional exports and improvement in the balance of payments, the authorities felt that a basic policy review was needed. The Alexander

[28] In 1976–77, transactions with the IMF comprised repurchases of Rs 303 crore (representing the CFF drawing, the 1974 oil facility and a part of the first credit tranche), Rs 21 crore against SDRs under designations and Rs 7 crore towards gold restitution). In 1977–78, payments totalling Rs 293 crore were made to the Fund (Rs 249 crore towards repurchase of gold and credit tranche drawings, Rs 7 crore on account of gold restitution and Rs 37 crore against SDRs accepted against designations).

Committee was set up in 1977 to review the import and export policies, suggest improvements in the structure and use of trade policy instruments, and propose measures to rationalize and streamline procedures. The Committee, in the course of its work, called on the then Governor of RBI, I.G. Patel. In the Bank's perception the licensing system was a temporary expedient and the conditions of the mid-seventies were appropriate for its relaxation. It therefore welcomed the Alexander Committee's recommendations, the basic orientation of which was to increase industry's exposure to the winds of international competition and stress the need for productive efficiency. Many of its recommendations constituted the basis for the annual import/export programmes since 1978.

The most important change in import policy was introduced in 1978–79, when all items not specifically restricted or banned were listed under the open general licence (OGL) category and could be freely imported for domestic production.[29] The decision was a heroic step forward for a government that remained fundamentally apprehensive of foreign competition. But official nervousness about the wisdom of the move continued and played a part in reversing some of the OGL items back to the restricted and banned list, at the first hint in 1980–81 of less favourable external payments prospects.

In 1977, following the overthrow of the Congress government, the Janata Party came to power. As with any change of government, there was a shuffle in the bureaucracy and I.G. Patel was nominated as the new Governor of the Reserve Bank. Among the ill-conceived policies that Patel was pressurized to implement was the sale of gold officially to discourage smuggling. The Janata government needed a radical crutch to show that it was discarding old baggage and was prepared to experiment with market measures. The Governor tried his utmost to dissuade Finance Secretary H.M. Patel from adopting this course as he was convinced that the measure would have little or no impact on countering smuggling. But the Finance Minister was not ready to oblige, as he was under political pressure to implement the scheme. From the outset, the Governor indicated the impracticality of the measure, for it required import of gold in large quantities. For a credible market intervention a much larger stock of foreign exchange was required to buy gold in the international markets. The Governor saw the futility of using the limited reserves of foreign exchange for this purpose but was unable to fend off the pressure. As a compromise, he suggested

[29] The new system was based on a negative list, in contrast to the earlier positive lists, and all raw materials and components not specified in the list could be imported under OGL.

that the Reserve Bank would undertake the operation of selling gold only as an agent of the government, and that it would use confiscated gold, newly mined gold and 'non-returnable gold' acquired through the gold bond scheme, and refrain from using official foreign exchange reserves. The budget of 28 February 1978 gave executive authority to the Bank to hold gold auctions. The auctions were perhaps inspired by the gold auctions on behalf of the trust fund by the IMF between June and August 1977, but the greater likelihood was that the decision was triggered and catalysed by the large uncovered budgetary gap of Rs 1,050 crore.[30]

In retrospect, it can be said that the gold auctions were, at best, a damage control exercise, for the Reserve Bank had grasped the nettle and trimmed the operation to make it virtually harmless. About the Bank's official hierarchy responsible for implementing the measure, the least that can be said is that the auctions were conducted efficiently and with probity. It involved taking some sensitive decisions, such as how to conduct the auctions fairly and objectively, how to make them leakproof, and how to avoid corruption and favouritism. Considerable care had to be exercised to ensure there was no cornering of the supplies while obtaining as high a price as possible. Senior Deputy Governor M. Ramakrishnayya, who was in charge, exercised close surveillance over the operation. In all, fourteen auctions were held from 3 May to 23 October 1978, in which 12.95 tonnes of gold were sold to the public, yielding a revenue of Rs 86.96 crore.

The Janata government, which initiated the gold auctions, failed to survive for long and the Congress party was soon back in power. The Congress, in its quest for skeletons in the Janata cupboard, appointed a one-man enquiry committee headed by R.K. Puri, a former Governor of the Reserve Bank, to substantiate claims that the gold had been cornered by a few parties. The report of the one-man-committee was as controversial as the auctions. Deputy Governor Ramakrishnayya, who had headed the Gold Sales Policy Committee and conducted the auctions, had this to say: 'He (Puri) gave me the impression of a man who had made up his mind even at the start and was only searching for evidence to confirm that gold was cornered by a few parties and that Dr I.G. Patel and I in the Reserve Bank had facilitated the process.'[31] The conclusions of the report were along expected lines. One of Puri's observations was that the Bank should have insisted on

[30] Para 109 of the budget speech justified the measure by stating that it is justifiable, in our present circumstances, to utilize a part of our accumulated gold to reduce the expansionary effect of budgetary transactions.

[31] Ramakrishnayya, *Two Administrators: Interaction between ICS and IAS*, p. 105.

a formal contract before undertaking the agency function. As Ramakrishnayya has recorded, Puri's remarks on the reserve price of gold were contrived. Although the Bank took a dim view of the findings of the Puri enquiry, the ironical fact was that both Patel and Ramakrishnayya had to submit themselves to it. All said and done, Puri could find nothing objectionable. As Patel recounted in his memoirs: 'In fairness to him I must say that in questioning me and my officers, he was scrupulously courteous and professional and not confrontational at all'—his conduct of the enquiry was irreproachable as far as the Bank was concerned (see I.G. Patel, *Glimpses of Economic Policy: An Insider's View*, p. 160). However, the episode was a sad reflection on a political system that sought to sully the reputation and honour of officers who endeavoured to execute policies faithfully and honestly and to the best of their abilities, irrespective of the party in power. The findings of the enquiry report along with comments by Ramakrishnayya were placed before a Cabinet Committee who eventually decided not to pursue the matter; thus the Puri enquiry report on the controversial gold auctions was consigned to the archives.

The payments situation changed dramatically in 1979–80 as many of the favourable aspects of the previous four years were reversed. Agricultural growth suffered a turnaround following failure of the monsoon, and industrial bottlenecks emerged owing to shortages of power, coal and cement, a deterioration in labour relations, and difficulties with port congestion and railway transportation. Infrastructural inadequacies bedevilled the economy, industrial production in particular. These inadequacies were accentuated as the poor rainfall affected hydel power generation, while the reduced coal output, as also lower turnaround of wagons from coal pitheads to power houses, resulted in a fall in thermal power generation. While the supply position weakened, demand continued unabated, owing, in part, to the effects of fiscal operations, which continued to be expansionary, and to the high degree of liquidity in the economy at the beginning of the year. Inflation soared from 3 per cent in 1978–79 to 22 per cent in 1979–80. In addition, the external terms of trade worsened significantly owing to higher prices for imported petroleum and fertilizers. The full impact of the increase in oil prices was reflected in the trade deficit, which zoomed from Rs 2,200 crore in 1978–79 to Rs 3,400 crore in 1979–80 and further to Rs 6,200 crore in 1980–81.

The emergence of inflationary pressures and the weakening of the balance of trade in 1979–80 were largely attributable to inadequate domestic supplies. The more important supply problems occurred in the industrial and services sectors, where shortages in critical industries created serious inter-industry imbalances. There was also the necessity to import foodgrains at a time when Indian exports were affected both by international recessionary conditions due to growing protectionism abroad and a weakening of export prices. To meet the short-term cyclical imbalance, India drew SDR 266 million under the compensatory financing facility (CFF), but, even so, by late 1981, the country's international reserves had slid down to about three-and-a-half months imports. In the Reserve Bank's *Annual Report* assessment for 1980–81, the conclusion categorically stated that the answer to the balance of payments difficulties lay not in curtailing imports and reducing economic growth, but in substantial and sustained efforts to promote export growth. It was equally necessary to explore commercial and other forms of external finance, even if more expensive to service, if enduring changes were to be brought about in the structure of production, which alone would ensure a stable balance of payments adjustment. Recognizing the uncertainty attached to other forms of external financing, the Bank urged for a process of adjustment that would be as speedy as possible, as also within a positive framework, to make it enduring. This obviously called for discipline in all areas of the economy, particularly in the fiscal and monetary environment. An important facet of this requirement, as the Bank saw it, was judicious containment of further additions to the present high level of liquidity in the economy. The circumstances demanded 'an apposite combination of fiscal and monetary policies buttressing improvements of a real nature pertaining to technology and organization'. In short, a comprehensive approach was advocated in which supply and demand management were seen not as alternatives but as integral parts of a long-term strategy.

That was the time when the formulation of the Sixth Five Year Plan was under way, and it was decided to weave into the Plan an adjustment strategy to rectify the structural imbalance, by accelerating the effort for import substitution of items like petroleum, fertilizers, steel and cement, and strengthening the infrastructural base of the economy.

TWISTS AND TURNS OF EFF LOAN NEGOTIATIONS

The September 1980 biennial election saw the appointment of Narasimham as the Indian Executive Director to the IMF Board. Narasimham pursued the idea of approaching the Fund for a medium-term loan under the newly established extended fund facility (EFF). In fact, even before moving to the Fund, while still an Executive Director at the World Bank, Narasimham had felt that with the second round of oil price increase and dim prospects for the creation of a new oil facility, India's economic problems would be of a different complexion, requiring heavy investment in oil and related areas. He began by sounding out his colleagues at the IMF on how the Fund management would react if India was to approach the Fund for a medium-term drawing to cushion the structural impact of the oil price increase. Emboldened by the positive feedback received from them, his next move was to convince the Indian Finance Minister Venkataraman to consider such a drawing. But Venkataraman was not enamoured of the idea, nor was the Economic Affairs Secretary, R.N. Malhotra. Narasimham, during a customary courtesy call on Prime Minister Indira Gandhi, broached the topic with her by referring to the deteriorating external payments position owing to the oil price increase, and the impact it would have on measures taken to liberalize imports and deregulate industry. He suggested that it would be appropriate to seek IMF assistance early on in the game, before a long queue of countries emerged, and to do so from a position of strength rather than allow the external payments situation to deteriorate before approaching the Fund. He argued that approaching the Fund early would make a great deal of sense for it would mean getting funds with milder conditionalites.

Seeing that there was a distinct gain in adopting such a course, the Prime Minister instructed Narasimham to flesh out his proposal and leave a note with her Secretary. A few months later, the government decided to formally nominate Narasimham to the Executive Director's post at the IMF. On assuming office, he was instructed by none other than Finance Minister Venkataraman to pursue the matter of an EFF loan from the Fund. This, then, explains the transfer of Narasimham from the World Bank Board to the Fund Board—a move that dismayed the World Bank chief Robert McNamara, who highly valued Narasimham's contribution to the World Bank Board. This is what McNamara had to say of Narasimham:

> Your dedication, your consistently thoughtful and informed views, your careful judgement, your breadth of vision and your dogged hard work have all combined to set a standard of service on the Board that deserves the gratitude, not only of India and your other constituencies but of the entire development community itself.[32]

[32] Robert S. McNamara's letter dated 28 October 1980 to M. Narasimham in *From Reserve Bank to Finance Ministry and Beyond: Some Reminiscences*, p. 131.

On assuming office at the IMF, Narasimham set the ball rolling for an EFF drawing, which was to be the largest loan to any country in the history of the Fund. Aware of the Fund's philosophy and preference for an early approach and not when a member became an emergency case, the Executive Director was confident of securing finance with the mildest of conditionalities and without measures destructive of national prosperity. The thrust of his argument was that the Fund programme represented an alternative to deflationary adjustment for India, unlike crisis cases that called for deflationary adjustment. The formal approach for Fund assistance was made in 1980. Initially the negotiations proceeded very smoothly, with both the IMF staff and the Managing Director, Jacques de Larosiere, being most receptive to the Indian request. In the course of his meetings with the Managing Director, Narasimham pointed to the sudden and severe deterioration in the payments position resulting from the oil price increase and the irreversible shift in the terms of trade. He reminded the Managing Director that India was a disciplined borrower who had prepaid its drawings from the Fund, and had even contributed to the resources of the Fund by agreeing to be included in the designation plan in periods when its external payments position was comfortable. He argued that vision and bold confrontation of its needs had prompted India to approach the Fund in anticipation of the pressure developing on the external payments front. The Indian authorities, Narasimham added, recognized that the solution lay in a major overhaul of the public sector investment programme aimed at increasing its efficiency.[33] The support that the Fund drawing would provide to the exchange reserves, Narasimham pointed out, would enable continuation of the import liberalization process that India had embarked upon.

Later, in discussions with the IMF staff, Narasimham gained the impression that the Fund management would not be averse to a drawing by India in the region of SDR 5 billion—a figure certainly larger than the SDR 3 billion earlier indicated to the Finance Minister and Prime Minister. Thus the negotiations got off to a happy start with the Asian Department fully cooperating with the Executive Director's office in expeditiously processing the request. When the request document, with a background paper on the developments in the Indian economy, was circulated for comments to other departments of the Fund, the first critical rumblings became evident. The Exchange and Trade Restrictions Department of the IMF and Ernest Stern, Vice President of the World Bank, queried the need for such a large

[33] See Joshi and Little, *India: Macroeconomics and Political Economy, 1964–91*, Oxford University Press, New Delhi, 1994, pp 58–62.

drawing and were critical of the mild conditionalities attached to the drawing. Defending the Indian stance, Narasimham argued that while it was true that the conditionalities agreed upon in the first instance were by no means harsh, all that was sought was to improve India's budgetary position, which no one could deny was necessary. For the first time in 1980, the budgetary position had revealed a revenue deficit and this was politically unacceptable to all parties in India. The only other conditionality related to the adjustment effort to reduce the current account deficit, estimated at over 2 per cent of GDP, which was wholly accounted for by the rise in the oil import bill and deterioration in the terms of trade, which was then estimated to cost SDR 9 billion. The logical requirement for this was exploitation of the Bombay High oil reserves in the medium term. There was little that was objectionable in these terms to Mrs Gandhi, despite the fact that she was then the chairperson of the Non-Aligned Movement, which was opposed to IMF conditionality.

There is some evidence to show that the Managing Director, De Larosiere, was initially satisfied with the adjustment programme negotiated by the Fund team. At the Tide Water meeting in Kuwait, he conveyed his satisfaction to Governor Patel and said that he would deliver as long as the budget for 1981–82 remained on course as per the agreement.[34] The first sparks of opposition to such a large drawing began to fly at the 1981 Interim Committee meeting in Gabon, in mid-May 1981, when the Managing Director who was hitherto supportive, went on the defensive. At the customary meeting between the Finance Minister and the Indian delegation, and the Managing Director of the Fund, the latter, obviously under pressure from the US, backtracked and hesitatingly suggested that India could consider going in for a stand-by rather than an EFF loan. To the Finance Minister, there was little justification for even suggesting such a course, and he flatly refused to consider the stand-by option. He made it perfectly plain to the Managing Director that India would go for the EFF or nothing. After all the motivation for the creation of the EFF was to help members tackle medium-term issues arising from supply-side imbalances. The Indian side forcefully argued that it was not a case demand-side management policies, it was an open-and-shut case of supply-side adjustment initiatives. Seeing that the stand-by option was vigorously ruled out, the Managing Director vaguely hinted that he had to take the Board along with him and explained that he was anxious to see that such a large drawing was favourably received by the Board, for, failure to receive the requisite support would

[34] I.G. Patel, *Glimpses of India's Economic Policy: An Insider's View*, p. 168.

tarnish the image of a large developing country like India. The Indian delegation refused to be browbeaten into acceptance of a stand-by arrangement, which would mean being on a short leash with conditionality strings attached; the Managing Director then decided to leave the door open for further discussions.

It would not be amiss to say a word here about the behind-the-scenes moves that were apparently on, to persuade the Managing Director to reconsider the Indian request. There had been a change in the political leadership of the US and President Reagan, who was at the helm of affairs, generally pushed for a tougher stand by the IMF and World Bank Boards. The Fund's largest shareholder, the US, was unwilling to support India's request and was amazed that India could dare to lay claim on IMF resources of such magnitude. US banks were apparently badgering the new US administration that they could meet the legitimate needs of all countries, both rich and poor, and that India should be forced to meet its requirements for financial resources through commercial borrowing. One of the most vocal critics of the Indian request was Charles Wriston of Citibank, who launched an attack on the proposed drawing by India.[35] But, unlike many of the other developing countries, India had wisely eschewed the path of commercial borrowing and was reluctant to traverse that route. India valued its impeccable debt servicing record and refused to get ensnarled in a debt trap. The foreign commercial banks saw India as a low-risk sovereign borrower and were angling to bring it into their borrowing net; they accused the IMF of crowding out the private banks. The US, thus, adopted tactics to push India into the foreign commercial bank arena, which the Indian authorities resisted.

Curiously, the EFF loan, which was unique in several respects, met with strong criticism and resistance even in home territory. In mid-October 1981, N. Ram, correspondent of *The Hindu*, laid his hands on the letter of intent from the Indian Finance Minister and the memorandum submitted to the IMF in support of its request. In one of his despatches from Washington, on 15 October 1981, he frontpaged a news item about the loan request, giving details of the state of the discussions and reproducing verbatim the draft contents of the letter of intent. The leak proved most embarrassing for the government as, based on Ram's report, a rabid attack was launched by Ashok Mitra, Finance Minister of West Bengal. In a White Paper entitled 'The IMF Loan: Facts and Issues', he appealed to the Parliament and the public to abrogate the loan arrangement. The attack was inspired by

[35] See I.G. Patel, *Glimpses of Indian Economic Policy: An Insider's View*, p. 168.

the 1966 experience of devaluation and the loan was viewed as a loss of economic sovereignty. Ashok Mitra went so far as to commission articles by a group of leading economists, to marshall arguments against the loan and to derail the arrangement. The whole issue assumed political colour when twenty-three chosen economists, at the invitation of the West Bengal government, met in Calcutta in August 1981 and issued a joint statement denouncing the government's approach to the IMF for assistance. The loan thus became the focus of a controversy both at home and abroad.

At home, the government and the opposition were at loggerheads on the loan issue. The opposition's demand was that the Parliament and the people should have an opportunity to examine the conditionalities included in the deal. Ashok Mitra was insistent that the centre disclose the terms on which it was trying to obtain a loan from the IMF. In response, the Finance Minister assured the Lok Sabha that in its current negotiations with the IMF, the government would not do anything 'derogatory to the country's self-respect or to the nation's interest'. While the conditions for the IMF loan could not be disclosed, as it was at the negotiation stage, the Finance Minister assured the House that the Ordinance banning strikes in essential services was not a condition for securing the loan. Denying that the Ordinance was at the behest of the IMF and that the hike in prices of petroleum products was at the prodding of the RBI, Venkataraman asserted that these measures were taken keeping in mind the national interest. But the opposition continued its tirade against the government. George Fernandes demanded that the government should not be allowed to mortgage the country, to which Venkataraman quipped, 'Mr Fernandes should know I have no authority to mortgage the country.'

Following the leak in *The Hindu*, Narasimham rushed back to India to assist the government in defending the loan. Prior to leaving Washington, the Indian Executive Director lodged a strong protest against the failure of the Fund's security system and the Managing Director ordered an investigation into the leak. Dale, the Deputy Managing Director, described the leak as 'quite possibly the most serious and damaging in the history of the Fund'. But despite the Fund management's best intentions, nothing much came out of the investigations, as the reporter claimed that he had obtained a copy of the letter of intent from an Executive Director.

In the meanwhile, the US focus shifted to preventing the loan from materializing. During the absence of the Indian Executive Director from the headquarters, the US Executive Director, Dick Erb, after prolonged interaction with his Treasury counterpart on the Indian loan request, called on the Advisor, C.J. Batliwalla, at the Indian Executive Director's office late one evening, to convey the message that his authorities would find it extremely difficult to support the Indian request for an EFF loan in its present form. The adjustment programme, in the words of the US Executive Director, lacked specificity, the balance of payments need was not clearly established and the large investment programme was sought to be financed exclusively by recourse to Fund resources. In the reading of the US administration, it was a development-type loan that would qualify either for World Bank assistance or finance from the international credit and capital market. There was also a hint in the US stand that the exchange rate was not in line and needed adjustment to reflect the true competitive situation. But the actual trigger for the US criticism was political and rather sensitive to be openly mentioned—the fact that India had placed a large order for purchase of the Mirage aircraft.[36] The substance of the US Executive Director's remarks were relayed by the advisor to the Finance Secretary, with a copy marked to the Governor of RBI and the Indian Executive Director, Narasimham.

Developments both on the home front and abroad did not augur well for smooth passage of the loan. The Indian government realized that with formal negotiations under way, an all-out effort would have to be made to seek the support of all the Fund members. In the months following Gabon, Indian officials were virtually on the road, lobbying with foreign governments and top echelons of the international banking system for support. De Larosiere, Managing Director of the IMF, was urged to preserve the independence of the Fund. The Managing Director not only stood his ground in supporting the Indian request but persuaded the French government also to support the request. In the meanwhile, during a visit to Washington, Governor Patel called on Paul Volcker, who was chairman of the US Federal Reserve, and explained to him that India's needs were large, and that the Fund drawing would provide the necessary leverage to borrow even more from private banks and the mixture of concessional and market-related borrowing would make the financial package more manageable. In the absence of a Fund drawing, India would be compelled to borrow less and compress its demand for imports, as expensive borrowing would be unmanageable. Volcker saw the logic in Patel's argumentation; however, he was unable to soften the attitude of Tony Solomon of the New York Federal Reserve and nothing much came out of that initiative.[37] Patel

[36] The IMF *Morning News* carried a news item titled 'India had placed a large order for the purchase of Mirage aircraft from France'. Source: *Le Monde*, the French daily.

[37] See I.G. Patel, *Glimpses of Indian Economic Policy: An Insider's View*, p. 169.

also called on Geoffrey Howe, the UK's Chancellor of the Exchequer, and several influential bureaucrats in the German Finance Ministry, and lobbied hard for their support. At the same time Narasimham, the Indian Executive Director, met every other Executive Director at the Fund, and explained to them the background against which India was approaching the IMF. These were more in the mode of an informal exchange of information prompted by a desire on the Indian side to assess the degree of support that would be forthcoming.

Turning to the specifics of the negotiations, the first two IMF negotiating missions came to Delhi in January and April 1981, under the leadership of Tun Thin, Director of the Asian Department. The structural nature of the payments problem necessitated a review of investment priorities to improve and place on a sustainable basis, the external sector. The Fund team, with inputs from World Bank staff, reviewed the developments and investment priorities, and the initiatives taken by the authorities to move the economy on to a path of stabilization and growth. There was no denying on either side that production and distribution bottlenecks and bureaucratic rigidities were acting as constraints on the economy and preventing it from achieving its potential. Hitherto the policy had been one of furthering import substitution in tradeables but the oil price increase had introduced a new dimension into the reordering of investment priorities.

There was also some discussion on the quantum of the loan. Based on the access limits then in force, India could draw up to SDR 7.7 billion from the Fund over a three-year period (equivalent to 450 per cent of its quota). Of that amount, up to SDR 2.4 billion would be from the Fund's own resources and the remainder from borrowed funds. The Indian authorities were initially inclined to confine their request to the portion available from the Fund's own resources, but the Fund mission's assessment was that with a bleak medium-term balance of payments outlook, a stronger and larger adjustment programme was warranted, and India would qualify for a larger drawing. Following discussions, an amount of SDR 5 billion was agreed upon, which, at that point of time, represented the largest commitment for the use of Fund resources.[38] At that point in the negotiations, several key performance criteria relating to monetary, fiscal, external borrowing and liberalization measures had not been firmed up. Before these could be settled, the news leak in *The Hindu* complicated the sensitive negotiations.

From the beginning, the Indian authorities were prepared to undertake

[38] This record was held by India till February 1995, when Mexico availed of a drawing of SDR 12.1 billion, making that the largest.

adjustment through appropriate stabilization and liberalization measures. But they were keen to proceed at their own pace and in their own way, and not to be seen as toeing the Fund line. The adjustment strategy had to bear a 'swadeshi' (nationalist) tag and be seen by the public as a homegrown product. It was sought to be achieved through self-reliance in energy, especially in the exploration and development of hydrocarbons. Accordingly, high priority was given to the objective of achieving a dynamic export growth, a sizeable step-up in infrastructural investment and higher domestic savings.

On the monetary and credit front, the Reserve Bank recognized there was an uncertain 'import element' in the form of frequent revisions in international crude prices, which imparted an inflationary impulse and widened the already large deficit in external trade. Though the liquidity effect of possible expansion in overall domestic credit was significantly offset by the decline in foreign currency assets, in the RBI's reading, given the continuing inflationary situation, it would be necessary to ensure that credit expansion was essentially for productive purposes. As early as March 1980, the Bank announced credit guidelines to banks that were indicative of a continuing concern about inflation and a need 'to continue the strict regime of credit discipline'. Over 1980–81, a highly restrictive monetary and credit policy stance was maintained with the intention of producing an overall tightening of liquidity. At the same time, the Bank maintained a balancing act, for it recognized that, while it was necessary to set a tone of stringent restraint, certain segments, notably exports, needed continued and selective refinance.

The Governor, with his team of advisors, personally monitored, on a weekly basis, the monetary and credit trends. Although the March 1981 credit policy urged a slowdown in the pace of monetary expansion, it was timid and rather accommodative: no specific ceilings were indicated. By end-May, it was evident that slowing down of the pace of monetary expansion had not occurred and that the growth of primary money in 1980–81 had been large. The RBI Governor, on his return from the IMF May 1981 meeting in Gabon and aware of India's request for an EFF drawing, recognized that there was already a potential for a large monetary expansion in 1981–82 and that, as a basic policy objective, a slower pace of monetary expansion was an ineluctable necessity. Accordingly, in the 27 May 1981 slack season credit policy, the cash reserve ratio (CRR) was raised from 6 to 7 per cent of demand and time liabilities, to be effected in two phases. At the same time, a sharp hike was effected in the refinance rates, with the rate on rediscounting of bills and discretionary refinance raised from 11 to 14 per cent; the first tranche discretionary refinance was at 14 per cent, while subsequent tranches, if any, attracted higher rates of interest.

Close on the heels of the May 1981 measures, on 11 July 1981, when the Governor, in the course of his weekly monitoring of credit developments, perceived that there was no abatement in the pace of monetary and credit expansion, a package of measures was slapped on to contain the inflationary pressures. The Bank rate was raised from 9 to 10 per cent and the statutory liquidity ratio (SLR) from 34 to 35 per cent of total demand and time liabilities, to be reached in two phases; the phased increase in CRR was also advanced. In the area of selective controls, the minimum margins against stocks of wheat, paddy/rice were raised by 10 percentage points across the board. Although the Indian authorities had not yet formally committed to the ceilings for monetary expansion with the IMF, the Governor recognized that the process of adjustment would have to be speedy and enduring. This obviously called for discipline in all areas of the economy—not just higher production to meet domestic requirements and fully exploit export opportunities, but also a rise in productivity and a fiscal and monetary environment that maintained and enhanced the competitiveness of Indian products in international markets. Judicious containment of further additions of liquidity to the existing high level was seen by the RBI Governor as an important ingredient of the adjustment exercise.

Restrictive measures in the early part of the financial year notwithstanding, the trend in credit expansion was clearly out of alignment with the RBI's guidelines to banks in respect of permissible ceilings. This followed principally from a sharp rise in deposits in contradiction to the normal pattern of deposit growth. It also reflected the unusually large drawals on available cash credit limits in anticipation of further tightening of their use. Non-food credit expansion, which was Rs 467 crore at mid-July, widened to Rs 962 crore by end-October 1981. The continuance of the credit boom was clearly inconsistent with the objective of reducing monetary expansion and, consequently, inflationary pressures. Further tightening therefore became inevitable, to reduce the signs of overheating and to dampen the expansionary pressures emanating from the primary liquidity in the system. It was obvious that the July measures did not have a sufficiently strong impact on the surging demand for credit. RBI's concern was that if the total ceiling was exceeded but the sub-ceiling on credit to the government was within the limit, the onus of failure would be on the Bank.

Governor Patel convened a series of meetings, from September 1981, of senior officers associated with credit policy. They expressed divergent views. Some officials argued that the July measures could suffice while others argued for strong measures. Some officials felt that, in the face of the busy season demand for credit, a full percentage point increase in CRR would turn out to be savagely restrictive. The Governor, however, felt that the May/July measures were inadequate and decided in favour of a full percentage point hike in the CRR, from 7 to 8 per cent, to be implemented in four stages. This October 1981 measure was lethal but pre-emptive action was resorted to, knowing that the first IMF ceiling would have to be met in November 1981 and the second by February 1982. In retrospect, it can be said that this move had the desired effect. The disproportionately large credit expansion witnessed in the first half of 1981–82 fed by a high pace of deposit growth was followed by a marked slowdown in the second half of the year. The fall in deposits caused an unprecedented resource constraint and a large number of banks defaulted in the maintenance of CRR and SLR. Several banks resorted to across-the-board cuts in limits, while some banks restricted further drawals on limits already sanctioned. A resource stringency coincided with the busy season. Once it was clear that the February 1982 ceiling had been met, the last phase of the CRR, which was to be effective from 26 February 1982, was initially deferred and later rescinded.

The difference of perception within the RBI on the appropriateness of the October 1981 credit policy measures surfaced again in discussions in early 1982 with the IMF, when Kadam, the Principal Economic Adviser, described the October 1981 move as a 'panic reaction'. What the above developments show is that even before concluding the EFF loan, the Indian authorities recognized the need for undertaking voluntary adjustment measures, and, between 1980 and 1981, a series of difficult decisions—in the areas of administered prices, industrial policy, export and import policies, credit and monetary policies, were voluntarily taken with no strings attached. At the same time, emphasis was placed on building up capacity in core areas like steel, fertilizers and cement, and growth targets in these sectors were woven into the canvas of the Sixth Plan.

It was against the backdrop of these developments and policy intentions of the government that the Indian authorities forwarded their request for an EFF loan. The focal point of the adjustment effort was reduction of the current account deficit, which, in 1981, was estimated at over 2 per cent of the GDP. The deficit translated itself into an annual figure of over SDR 3 billion. This was sought to be reduced gradually over three-year period to a level that would be taken care of by normal capital inflows. The balance of payments outlook for 1981–82 incorporated an expected fall of 11 per cent in the oil import bill. Domestic crude oil production was slated to increase by 65 per cent following the settlement of disturbances in the northeastern region which had severely disrupted oil production in 1980–81, and substantial additions to productive capacity from new offshore oilfields. The emphasis on investment in the import substitution sectors had the endorsement of the World Bank, both in physical and financial terms.

The demand management aspects of the programme related to a prescription of ceilings on domestic credit expansion, with sub-ceilings on credit to the government. Around the time that India approached the Fund in early 1981, the level of fiscal deficit was between 6 to 7 per cent of GDP, which, in the perception of the authorities was manageable. In the course of the negotiations, the Fund staff suggested pruning the ratios but, except for modest adjustments in the ceiling levels, no major or drastic reduction was insisted upon. This was because the Indian negotiators ably argued that the bulk of the investment was needed to effect structural adjustment in the public sector, and that excessive compression of the deficit could prove counter-productive to the objectives of the structural adjustment effort. Besides, the Indian authorities were alive to the danger of excessive reliance on Reserve Bank credit and had taken steps to augment domestic resource mobilization.

The issue of ceilings, however, was not easily settled. During negotiations in Delhi, the size of Bank-financed deficit remained a sticky point between the IMF staff team and the Indian negotiators, with the latter pushing for a higher figure. The Prime Minister was informed that the Fund was acting difficult, so she sent for Executive Director Narasimham to discuss the issue. Narasimham explained to the Prime Minister that the Indian side had pitched for higher ceilings as a negotiating tactic, knowing that the Fund would seek to reduce them. Since they were close to agreement on a figure, he implored the Prime Minister to accept the figure, for, in his judgement, anything higher would not be in the overall interest of the economy. The Prime Minister was convinced and the Indian side agreed to the domestic credit ceilings and sub-ceiling indicated by the IMF team.

The other quantitative performance criteria incorporated into the programme related to the ceiling on external commercial borrowings, which posed no problem for the Indian side, for India had always adopted a policy of judicious restraint in respect of external borrowing. The qualitative criteria were with regard to import policy and exchange restrictions. Since, from 1978–79, India had embarked on a policy of gradual liberalization, the authorities themselves were in no mood to reverse their stance as the intended policy was to provide more liberal access to imported inputs. As regards the exchange rate, there was absolutely no pressure whatsoever from the Fund for any adjustment; the Fund's reading was that the exchange rate policy was consistent with the declared objective of pursuing policies designed to strengthen the balance of payments. The IMF staff appraisal made no reference to the exchange rate, while the main report accompanying the request had this to say:

> They (meaning the Indian authorities) recognize the crucial role of exchange rate policy in ensuring adequate profitability of the export sector. While the authorities do not believe that a discrete change in nominal exchange rate is necessary at the present time, they intend to keep exchange rate policy under review and to make adjustments when appropriate to encourage exports and promote external adjustment.[39]

Although the negotiations dragged on for a whole year and were at times difficult, they were at all times cordial and without rancour. As indicated in the content of the programme, the conditionality was not overly rigorous, for the management of the Fund 'felt that the nature of the programme was appropriate' and the Fund would be playing a catalytic role as well as providing direct financing.[40] The structural policies described in the arrangement were not specific performance criteria but, rather, commitments by the government that were to be reviewed from time to time over the period of the arrangement. This was not unusual, yet it invited considerable criticism that the Fund would have little control over the main elements of the structural adjustment programme. But then, the financing element was backloaded and made dependent on the progress of the adjustment effort, and for this reason the full schedule was not included in the staff report.

The Fund Board met on 9 November 1981 to consider the Indian request. The discussion lasted the entire day with every member of the Board intervening in the debate. Overall, the tenor of the discussion was supportive and appreciative of the adjustment measures undertaken by the Indian authorities. This, however, did not mean that it was free from critical overtones. Anticipating the likely comments, the Indian Executive Director, in his eight-page introductory remarks, carefully provided all the argumentation to defend the request. He concluded his opening statement by venturing to state that 'the strength of the adjustment effort is worthy of the size of the loan', adding that 'where the need is demonstrable and effort at

[39] EBS 81/198, 7 October, India—Use of Fund Resources—Extended Fund Facility.
[40] *Silent Revolution—The International Monetary Fund 1979–1989*, pp. 709–15.

adjustment convincing, the size of the loan, important as it undoubtedly is, should, I believe, not be a constraining factor.'

During the debate, fulsome support came from the developing country Directors, particularly the Indonesian and Brazilian chairs. The Indonesian Director had this to say:

> From a qualitative standpoint, the direction taken by the programme was highly commendable. It provided for the cautious control of liquidity, the removal of regulations impeding the process of growth, the reduction of price controls and subsidies, the development of new sources of energy, the enhancement of agriculture, the mobilization of domestic savings and an increase in investment to make both import substitution and export promotion possible.

The measures thus introduced would provide a better balance between demand and supply. He indicated that his constituency would warmly support the request and that he was not worried about the so-called large amount. Likewise, the Brazilian Director gave warm support and demolished the argument that it was not a balance of payments loan but development assistance, by saying, 'all development finance was also balance of payments support, just as all balance of payments support was inevitably also support for development'. He added that the Indian programme was well-conceived and merited the Fund's full support.

The developed countries, other than the USA, while extending support, had reservations on some aspects of the adjustment strategy. France was positive and categorized the arrangement with India to be in accordance with the Fund's policy of requiring positive conditionality; it commended the Indian authorities for their early approach to the Fund and the scale of the adjustment measures already implemented or contemplated. The US Executive Director, Richard Erb, abstained, on the grounds that he was concerned about the need for as much money as India had requested, for he was convinced India could meet its financing needs through commercial bank borrowing. Despite attempts to persuade the G-5 against the Indian request, finding that it was isolated, the US desisted from casting a negative vote but abstained. Erb's intervention, though critical, did contain isolated remarks on the strong and positive nature of the effort. The criticism was along familiar lines: genuineness of need, mix of external resources, revolving character of the use of Fund resources and whether the Fund was getting into investment financing. Adequate and convincing answers to these were already provided in the Executive Director's opening remarks and, with equal force and conviction, reiterated in his concluding observations.

The German chair was also concerned about the size of the arrangement and its potential impact on the Fund's liquidity. His authorities had examined the request, he said, with great care and concern and considered all the risks and uncertainties inherent in the adjustment programme; and they were finally in favour of supporting the request, although they felt that the intentions were somewhat vague, leaving a measure of discretion that might be too large to receive Fund support for the size of loan proposed. Misgivings along similar lines were expressed by the Australian chair. The IMF staff, however, defended the request ably by stating that the Indian case was in line with all the requirements of the 1974 EFF decision—viz. with the alternative approach of successive stand-by arrangements, countries might hesitate to embark on major shifts of policy, an EFF facility would permit the authorities to make longer-term plans and more enduring commitment, and such a commitment would help to attract financial resources. The staff also noted that the balance of payments deficit was related to structural imbalances in production and trade, and thus qualified for support under the EFF decision. Narasimham, in his concluding remarks, responded point by point to the several reservations expressed in the course of the debate; he ended by saying, 'it was for the Indian authorities and the Indian people to perform and convince those of you who have doubts that we were right'. Thus the marathon debate concluded and the programme was approved, with only the US abstaining. India had carried the day. It was now left for it to deliver!

This was not the end of the Indian authorities' travails, for the government continued to be attacked in Parliament for subjecting the nation to IMF conditionalities. Intervening in the debate on the IMF in the Lok Sabha in December 1981, the Prime Minister convincingly defended the government's decision:

> The arrangement does not force us to borrow, nor shall we borrow unless it is for the national interest. There is absolutely no question of our accepting any programme which is incompatible with our policy declared or accepted by Parliament. It is inconceivable that anybody should think that we accept assistance from any external agency which dictates terms which are not in consonance with such policies.[41]

[41] Quoted in Pranab Mukherjee's budget speech for 1984–85.

The annual conference of the Indian Economic Association had rarely been known for radical posturing. So it came as a total surprise when, at its Tirupati meeting of December 1981, a near-unanimous denunciation of the government's decision to take an EFF loan was recorded. The eminent economist, late Dr P.R. Brahmananda, however, defended the government's decision. Through his book entitled *The IMF Loan and India's Economic Future*, Brahmananda sought to take his case to a wider audience. Reacting to the group of twenty-three economists' White Paper, he said their views were 'ideologically coloured'. The objective of his book was to fill the 'void in thinking about the loan and to rescue gullible youth from falling prey to political and ideological considerations' in their attitude towards the loan. In a systematic manner, he examined why India had gone for the loan, and a loan of this size. The clear intention of Brahmananda's writing was to correct distorted versions regarding the Indian loan and to remove the ideological bias by coming out as a strong defender of 'supply side economics'.

The first review of the programme was slated for April 1982. A high-powered Monitoring Committee was set up in November 1981 to monitor the various items of the programme and to keep track of performance criteria. Chief Economic Adviser Bimal Jalan was nominated as chairman of the Monitoring Committee.[42] The Committee assigned the task of compiling the monetary aggregates to the Reserve Bank. Within the Bank, a small group of senior officers[43] met Governor Patel regularly to take stock of the trends in total domestic credit, net credit to the government, gross credit to the commercial sector, net foreign assets, net non-monetary liabilities and total liquidity. Governor Patel took it upon himself to personally assess the trends to find out whether there was any possibility of overshooting the ceilings and, if so, to alert the government well in time. For this purpose, weekly internal ceilings were agreed upon between the Governor and the Bank officials; allowing for a wider degree of error in the weekly exercise, the idea was that if a persistent pattern of exceeding the agreed ceiling was perceived clearly week after week, then, it would be a reasonable indicator of future problems. Aside from the compilation of the data on time, the main input of the Bank was to follow a very active monetary policy and strive to see that it was possible to live within the operational ceilings.

[42] The following were the members of the Monitoring Committee: Chief Economic Adviser, Joint Secretary (Budget), RBI representative and Joint Secretary (Fund–Bank).

[43] The RBI group, besides the Governor, included V.B. Kadam, S.S. Tarapore, N. A. Muzumdar and K.L. Deshpande.

Records show that this task was taken seriously by the Bank and performed efficiently.

In April 1982, the Board of the IMF met to conduct its first programme review. As the programme was on track and all the ceilings in it had been meticulously observed, there was no room for criticism. Even so, the same concerns were voiced as during the passage of the loan, such as, too little financing from commercial sources, too much overlap with the World Bank, and that the arrangement should have been put on a contingent basis. The Scandinavian Executive Director went as far as to question whether India could afford the jets, but as the IMF history pointed out, he was a decade ahead of time in suggesting that there should be Fund surveillance over military purchases and to assess the financial viability of military spending.[44] Fortunately, no other Director backed him—but the Indian Director Narasimham displayed concern and dismay that the issue of military expenditure had figured in the Board, for, if allowed, it 'would open a veritable Pandora's box' and could have significant implications for the Fund's relations with member countries.

Likewise, the next two reviews (July 1982 and February 1983) posed little difficulty as the balance of payments and economic growth remained on track. Much of the improvement on both counts was attributable to the rapid development of Bombay High and the exploration of offshore oil fields. The boom in neighbouring oil exporting countries also resulted in the strengthening of invisible receipts, with migrant transfers displaying added buoyancy. Also, the incentives provided for non-resident deposits had proved highly successful. Overall, in the programme period (1981–83), the Reserve Bank followed a policy of gradual devaluation of the rupee against the basket of currencies. Besides, India had met all the performance criteria agreed upon under the EFF and made each drawing on time. The successful medium-term structural adjustment of the economy, including efficient import substitution, especially in the energy sector, drew widespread praise and admiration from the IMF Board in the subsequent review sessions.

The strategy for bringing about an improvement in the balance of payments after the sharp deterioration of 1979–80 had paid rich dividends. By the end of 1983, India had drawn SDR 3.3 billion of the original sanctioned amount of SDR 5 billion. Another SDR 600 million was availed of in Janu-

[44] See *Silent Revolution*—Minutes of EBM 82/48 and 82/49, for the remarks of Sigurdsson and Narasimham.

ary 1984, leaving a balance of SDR 1.1 billion to be drawn, subject to negotiation of the fourth year's programme. But, tactically, the government decided to forego the drawing and make an honourable exit from the arrangement. Finance Minister Pranab Mukherjee, while introducing the budget for 1984–85, had this to say about the EFF loan:

> Belying the prophecies of many a self-styled Cassandra, the economy has emerged stronger as a result of the adjustment effort mounted by us. None of the dire consequences that we were being warned about has occurred. We have not cut subsidies. We have not cut wages. We have not compromised on planning. We have not been trapped in a debt crisis. We have not faltered in our commitment to anti-poverty programmes for the welfare of our people. We entered this loan arrangement with our eyes open. We come out of it with our heads high.

The Finance Minister expressed the hope that the Indian decision to forego the balance of the IMF loan would enable the Fund to provide larger assistance to other developing countries. On 15 January 1984, in a nationwide radio broadcast, the Prime Minister announced that since the balance of payments was now strong enough, the government had decided to forego the third tranche drawing on the loan from the Fund. There was, however, a view that that was not the sole reason for giving up the last tranche: the further measures needed to meet the required financial discipline would have proved politically difficult and to avoid embarrassment, it was decided to exit graciously.[45]

A sequel worth recording here was the controversy that arose between the Reserve Bank and the Planning Commission on how the EFF drawing should be reflected in the budget. The Planning Commission was in favour of taking credit for this drawing, arguing that it was a real resource and should go towards enhancement of resources for the Plan. But the Bank refused to see it in that light. The Prime Minister was informed that the RBI Governor was adopting old-fashioned accounting norms and refusing to yield thus constraining the Plan size. The Governor, however, stood his ground and rejected the Planning Commission's approach with crystal clarity. He explained that the Fund drawings were not loans but purchases of foreign currency with Indian currency. In budgetary terms they balanced

[45] I.G. Patel, *Glimpses of Indian Economic Policy: An Insider's View.*

out and there was no net effect on the budget just as there would be none when the Fund drawing was repaid. To take budgetary credit for this transaction now would only make matters appear worse when repayments were made. The need to abide by established accounting conventions was recognized by the Ministry of Finance, which strongly supported the stand taken by the Governor.

India's EFF experiment was a classic case of a country's readiness to accept self-imposed conditionality in adjusting its economy to a changed structural scenario and aimed at tackling the root cause of the problem. It could legitimately be claimed as a precursor, even a model, for the now-acclaimed Fund objective of fostering a member country's ownership of conditionality and adjustment programmes. The success of the EFF programme was evident in the progress of the investment programme, particularly in containing the oil deficit, the mobilization of domestic resources and the resumption of growth of the economy. And this was achieved without injecting any deflationary bias into the economy.

14

Anatomy of Exchange Control

Exchange control was introduced in India immediately after the outbreak of World War II in September 1939. There was no shortage of foreign exchange at the time of introduction of exchange control. The Exchange Control was conceived and designed by the British primarily for conserving non-sterling area currencies, especially the US dollar, in order to meet the war-time requirements of the British empire. In the thinking of the Bank of England, exchange control was a temporary measure, which would disappear with the end of the war. But such expectations faded and control, which was regarded as an intrusive activity, lingered much after the termination of the war.

Government notifications embodying the exchange control measures were issued under the Defence of India Rules. India, being a part of the sterling bloc, was requested to introduce similar regulations. From the outset, the Exchange Control was administered by the Reserve Bank of India, in accordance with the general policy laid down by Government of India in consultation with the Bank. The objective of the Control was to restrict the outflow of foreign exchange and to ensure that inflows of foreign exchange were promptly surrendered to the Control. Another aspect of the restrictive system was monitoring prompt realization of export proceeds. From the beginning, the Bank's involvement with exchange control was entirely technical and monetary in scope; it administered the country's gold and foreign exchange reserves, and acted as an agent of the government in matters pertaining to the administration of the Control. Much of the routine work of exchange control was delegated to certain commercial banks which acted as authorized dealers. These authorized dealers were permitted to buy and sell foreign exchange for specified purposes under regulations laid down by the Bank. Detailed control was exercised over the manufacture, acquisition, possession and disposal of gold in various forms through an organization headed by a Gold Control Administrator. Import and export of gold, gold coins and gold bullion by residents was prohibited except under special authorization from the Reserve Bank. Established jewellers, however, were granted licenses to import gold for the manufacture of jewellery for export.

Initially, the government did not impose any restriction on the import of goods and merchandise. Foreign exchange was freely provided for the retirement of import bills. A legal basis for the import and export control system came into force with the Import and Export (Control) Act, 1947, which enabled the authorities to prohibit, restrict and control imports. From time to time the policy was tightened and reshaped to meet the development needs of the economy. From a war-time policy instrument, it was gradually transformed to meet development priorities. Schedule I of this order, which was periodically amended, listed all the imports for which a license was required. The Chief Controller of Imports and Exports was made responsible for administering the import policies formulated by the Ministry of Commerce. It was the task of the Ministry of Commerce to lay down, each year, the import policy to be followed, which was decided on the basis of availability of foreign exchange, the degree of shortages of commodities in the economy and the availability of domestic import substitutes.

The Reserve Bank assisted the government in the preparation of the foreign exchange Budget based on the balance of payments forecast, in which projected allocations of foreign exchange were made on an annual basis with mid-year reviews. The foreign exchange allocations were made according to an agreed system of priorities. The topmost priority was accorded to food, fertilizers and defence stores as well as for external debt service payments. Thereafter, priority was given to the imports of raw materials, and the capital equipment and goods required for executing various Plan projects. A bulk allocation was made in favour of channelizing agencies like the State Trading Corporation (STC), for imports of non-ferrous metals, iron and steel, etc. In the early and mid-1960s, when the foreign exchange situation was particularly tight, it so happened that after allocations were made for the priority items, there was hardly any exchange available for imports on private account. A study conducted by the Reserve Bank at the request of the Finance Ministry, of the licences issued, utilized and outstanding, revealed not only that the licences record maintained by the Commerce Ministry was in poor shape, but also that, at times, licences for imports were issued and revalidated against zero availability of foreign exchange. The RBI alerted the Finance Ministry to this and, with the assistance of the Bank, timely computerization of licensing data was undertaken, which went a long way in detecting the breaches and in giving a more accurate indication of the availability of exchange as well as information on utilization of the licences.

Apart from import payments, other current account remittances, such as freight, royalties, profits, insurance premia, etc., were also tightly controlled. Restrictions were imposed on travel abroad. Repatriation of export proceeds was closely monitored to ensure that the proceeds were promptly realized and surrendered to the Exchange Control. The introduction of such restrictions in a vast developing economy like India, naturally gave rise to innumerable problems. The initial task faced by the Control was answering colossal number of enquiries from the lay public. The Exchange Control staff handled this under the able guidance of Jeejibhoy and Maluste. Since the pressure of work was exceedingly heavy, as time went by, the staff had to be steadily augmented, both by engaging temporary hands and by appointing more qualified and professional staff particularly with banking experience. And as the staff increased, so did the regulations. As loopholes in the original provisions came to light, one by one, they were pulled tighter. The technical nature of this aspect of the work called for a high degree of professionalism and initiative, and it became necessary to build a team of professionals with a high level of integrity. To facilitate the administration of the Control, the notifications and instructions issued by the Bank from time to time were codified in the form of an *Exchange Control Manual* for the guidance of both authorized dealers and the Exchange Control staff. The first such compilation was undertaken in June 1940 and thereafter, as amendments and revisions were effected, the *Manual* was updated from time to time. In course of time, the *Manual* became an indispensable reference document—a bible, so to say, for the staff handling exchange control matters.

In the late 1960s and early 1970s, as the foreign exchange reserves position became difficult, an edifice of further regulations was built on the foundations of the early measures; and instructions, definitions and arrangements essential for their enforcement were continually refined. A brief outline of the main developments in the exchange control policy as it evolved in that period might be helpful. The policy aspects of control maintained the basic framework introduced in the 1950s and 1960s. The emphasis continued to be to support the development of the economy. But, owing to the low level of foreign exchange reserves, payments and receipts of foreign exchange remained under strict control, with only marginal simplification in the early 1970s to facilitate the export efforts of certain industrial sectors. Basically, micro-decision-making characterized the Indian exchange control regime of the seventies.

Pressure on the Exchange Control Department to make the working of the control as simple and efficient as possible first came from RBI Governor L.K. Jha, who was not at ease with the way the control was administered. He was particularly keen to simplify the foreign exchange regulations that impinged on individuals. He was of the view that the Reserve Bank was basically organized to deal with corporates, especially banks, but discovered that a high percentage of the time of officials and staff of the Control was taken up in dealing with individual cases, involving petty amounts, resulting in delays in dealing with important cases involving large sums of foreign exchange. He observed that in formulating rules and procedures at the technical level, both the Finance Ministry and the Bank had made a conscious attempt to plug all possible loopholes. Consequently, the minute checks prescribed for the administration of exchange regulations had rendered the system top-heavy and time-consuming. The barnacles surrounding the controls required to be loosened and simplified, and broad judgement needed to be exercised in place of rule-based administration. In Jha's thinking, the Bank needed to move towards a new pattern of responsibilities, in which it was seen as an essential link between the interests of business and the demands of officialdom. In a letter dated 17 June 1968, he shared his thoughts on the matter with I.G. Patel, Special Secretary, Department of Economic Affairs, particularly in respect of the complicated travel regulations and the P form clearance procedures. As we shall see later, the P form relaxations were slow in coming and it was only towards the close of the 1970s, when the foreign exchange reserves position improved, that the Treasury had the nerve to scrap the P form altogether.

Before sketching the outlines of the major developments in the control system in the seventies, the major highlights of which are dealt with in the earlier volume, it is necessary to describe the legislative framework on which it was anchored. As mentioned earlier, exchange control was introduced in India at the outbreak of World War II and was regarded merely as a '*pis aller*' to be dropped at the end of the hostilities. As such, no need was felt for a separate legislation that would provide a legal backing to the various regulations. The post-war period witnessed gradual relaxation of controls in the developed countries but not in developing countries like India. In the case of India, exchange control had to be retained and made more stringent owing to the widening gap between the supply and demand of foreign exchange. Although India had accumulated large sterling balances, their use was highly restricted by the British in order to conserve the foreign exchange holdings of the sterling area. At the same time, efforts were under way by the UK authorities to remove or modify restrictions on the transfer of sterling between countries outside the sterling area. Moves were also on to unify the many types of non-resident sterling into 'external sterling'. In the light of these developments, the need was felt by the Indian authorities to place exchange control on a statutory footing and provide legal backing to the measures taken by the government and the Reserve Bank. The Foreign Exchange Regulation Act (FERA) was passed in March 1947, bestowing legality on Indian exchange control measures. It was initially made valid for five years and, after two such five-year extensions, was put on a permanent footing in 1957. To begin with, a relatively simple system was in place but as experience was gained, the regulations were tightened. FERA, 1947, remained in operation for a quarter of a century, during which time it regulated the receipt and payment of foreign exchange and securities, and the import and export of currency and bullion. The legislation conferred on the authorities powers of search and seizure.

The first whiff of criticism about the inadequacy of control measures and the problem of leakages of foreign exchange came from the findings of the 56th report of the Public Accounts Committee for the year 1968–69. So as not to appear unconcerned or cavalier, the government promptly appointed a Committee to examine the leakage of foreign exchange through invoice manipulation, under the chairmanship of M.G. Kaul, Additional Secretary, Department of Economic Affairs. The Kaul Committee made certain vital recommendations in this regard.

The Committee estimated, on the basis of what it described as an 'educated guess', that the total yearly leakage through unauthorized foreign exchange transactions was in the region of Rs 240 crore. Identifying the components, it placed smuggling at Rs 160 to 170 crore, travel at Rs 35.40 crore, and over-invoicing of imports and under-invoicing of exports at Rs 25–30 crore. The demand for foreign exchange, the Committee indicated, was met from four sources—sale proceeds of goods smuggled out of India, like silver, precious stones and antiques; deflection of inward remittances to unauthorized channels; foreign currency obtained unauthorizedly from foreign tourists visiting India; and manipulation in relation to exports and imports. The Committee claimed that smuggling was the largest culprit, yet it confined its examination of the leakage through manipulation to the trade area. Thus the core of the problem remained outside the purview of FERA.

Experience gained from the working of FERA, 1947, for a quarter of a century indicated that it was not a very comprehensive legislation; several of the exchange control regulations prescribed by the Reserve Bank over the year were not incorporated into the provisions of the Act and this made it difficult to enforce the provisions effectively. Both the Bank and the government were conscious of the fact that 'control' was neither logical nor complete, and that they were being criticized for permitting anomalies and winking at leakages. They took a joint view to explore the feasibility of amending and consolidating the Act, and to set right some of the glaring deficiencies and lacunae that prevented proper administration of FERA. The areas identified for strengthening were branches of foreign companies and foreign-controlled concerns, activities of resident foreigners including their terms of appointment, control over prompt realization of export proceeds, elimination of larger outgo of foreign exchange under imports, and enforcement powers to nab deliberate evaders. The Enforcement Directorate, taking into account court judgements and the difficulties in enforcing exchange control regulations, suggested to the government that certain amendments to the Act were desirable for proper administration of FERA. Likewise, proposals from various arms of the Control, viz. the government and the Reserve Bank, were put forward and these were intensively discussed at meetings attended by officials of the Department of Economic Affairs, Exchange Control Department and Legal Department of the Bank, the Ministry of Law, Ministry of Foreign Trade and the Directorate of Enforcement.

The question of amending FERA, 1947, was first discussed at a meeting held in May 1969 between I.G. Patel, Secretary, S.S. Shiralkar, Additional Secretary, both from the Department of Economic Affairs, and L.K. Jha, Governor of the Bank. At this meeting and subsequent ones, the officials were preoccupied with regulating the activities of branches, subsidiaries and foreign-controlled companies operating in India, and the employment of foreign nationals by business concerns in India. The Department of Economic Affairs prepared a draft summary of the discussions for the Cabinet Committee, which was earlier circulated to the Bank and the concerned Ministries for their comments. This was the beginning of an exercise that ultimately provided shape to FERA, 1973.

The Reserve Bank's influence on the shape of FERA, 1973, is difficult to ascertain, but there can be no doubt that its Exchange Control officials and Legal Department staff were actively involved in examining the proposals and in submitting revised draft amendments. The revised draft with an explanatory note forwarded to the Department of Economic Affairs bore testimony to the hard work and careful examination undertaken by the Bank. But the fact remains that the key players were all civil servants drawn from the government—I.G. Patel, S.S. Shiralkar and L.K. Jha. While Jha was then the Governor of the Bank, leaving for an ambassadorial assignment in 1971, Shiralkar was appointed Deputy Governor in 1970, and was involved in coordinating the amendments and directly associated with framing the new Act. Jha, as Governor, closely monitored the progress of the FERA amendment exercise and, towards the end of 1970, requested the Exchange Control Department to give a tabular status report on the purpose and position of each proposed amendment, which was duly produced. A wide measure of consensus had emerged on the key amendments needed to give a comprehensive look to the new legislation. But the challenge of drafting the precise amendments remained; the government and the Bank were preoccupied throughout 1971 and much of 1972–73 in arriving at an acceptable version of the draft amendments, taking into account the oral evidence given by trade, industry, representatives of the RBI and others before the select Joint Committee on the Foreign Exchange Regulation Bill.[1] To one and all of the questions raised, the Bank furnished relevant replies, complemented by statistical data wherever possible.

At the conclusion of the oral evidence given by the Reserve Bank representatives, the chairman of the Joint Select Committee directed the RBI to prepare a note indicating the new powers contemplated to be granted to the Bank under the amended FERA Bill and how these would prevent evasion of exchange control.

The basic structure of the new Bill was no different from the existing FERA, 1947; the new provisions and amendments were woven into this existing basic structure. The proposed provisions were classified into five groups: (i) transactions requiring the Bank's approval, (ii) provisions for giving a legal basis for some existing procedures, (iii) deeming provisions placing the onus of proof on parties concerned, (iv) provisions enhancing penalties, and (v) clarificatory provisions.

The provisions covered under group (i) entailed conferring new powers on the Reserve Bank and, by and large, formed the met of the FERA revisions.[2] Exports shipped on consignment basis was one area of concern and evasion. The findings of the Kaul Committee had indicated that the realization effected in overseas markets after the goods had reached there and been sold provided considerable scope for abuse and evasion, as there was no provision in FERA, 1947, to enable the RBI to refuse permission for 'on account sale', which, in the Bank's judgement, was unreasonably low. Under the 1947 Act, an exporter was required to repatriate the sales proceeds

[1] Reserve Bank representatives appeared before the Joint Select Committee on 21 September 1972.

[2] Clauses falling in this group include: 13(1), 17, 18, 24, 25, 26, 27, 28 and 29.

within the prescribed period. But this did not always happen. In many cases, the foreign exchange earned was stashed away abroad. As a matter of administrative practice, the Bank permitted export on a consignment basis only after satisfying itself that adequate arrangements had been made for repatriation of the proceeds, and after seeing that the foreign importers had opened letters of credit covering the export consignment. But such administrative devices failed to check evasion. The need was therefore felt to fill the gaps by introducing suitable provisions in the Bill. Clauses 17(9) and (10) made it incumbent on the exporter to repatriate export proceeds within the prescribed period, failing which non-repatriation would be regarded as default. The onus to prove that the default was beyond the exporter's control was placed on the latter and not on the prosecution.

Likewise, there was a suspicion that in the case of imports, goods were over-invoiced, the objective being to build up unauthorized foreign currency balances. Provisions of the customs law dealt with cases where importers made remittances for imports, but either no imports were made at all, or the goods imported were inadequate or of inferior quality. The provisions of Section 4(3) of FERA, 1947, were suspect. The difficulty was in providing for the presumption that in the event of non-import of goods or import of substandard quality, the importer had misutilized the foreign exchange.

The entry of foreign capital was another area that needed strengthening. The FERA, 1947, provision was effective enough for regulating the entry of foreign capital in the form of acquisition of shares of companies in India by foreigners, but foreign investments, which were in the form of branch investments in India by companies, firms, individuals and residents abroad, remained outside its purview. The need was also felt to impose control over foreign capital that had already established a foothold in the country. The Reserve Bank pressed for legislation through the proposed amendment of FERA, to close this loophole. The incorporation of Clause 27 sought to bring all branches of foreign companies within the purview of the revised Act.

Likewise, FERA, 1947, prohibited acquisition by non-residents of shares issued in India without the specific or general approval of the Reserve Bank, but there was no direct provision regulating the transfer by non-residents of such shares to residents. Furthermore, there was no provision regulating the holding of real estate. The proposed amendment sought to bring such transactions within the ambit of the Bank's permission; permission would be needed to acquire, hold or transfer or dispose of immovable property.

Another lacuna in FERA, 1947, was there was no restriction on a resident giving a guarantee to a non-resident in respect of the liability of another resident. This was rectified by the addition of sub-clauses 6(i) and 7(ii) to Clause 25.

Employment of foreigners was another area of concern. Under the provisions of Section 18A of FERA, 1947, restrictions of an indirect nature were imposed on the employment of foreigners, whether in India or abroad, in the trading or commercial fields or as technical or management advisers. Outside these limitations, it was found that arrangements entered into prior to 1 April 1965, as also those made to appear like principal-to-principal transactions, escaped the control net. Resident foreigners also remained outside the purview of Section 18A. Hitherto, the check on the entry and employment of foreigners was exercised more through the visa procedure. The loophole in the visa procedure was that British and Commonwealth nationals, who did not require a visa, could enter and take up employment in India without the knowledge of the Control. To exercise stricter control over the employment of foreigners and to monitor the foreign exchange liability arising therefrom, comprehensive enabling provisions were proposed through the addition of clause 26 in the proposed new Bill. Clause 28 made it part of law that a person could not, without the permission of the Reserve Bank, employ or continue to employ a national of a foreign state. Appointments prior to the enactment of the new Act also required the Bank's permission to continue such employment, failing which the Bank was empowered to close down the branch or place of business and terminate the appointment. The obligation was cast on the person or company so affected to approach the Bank for permission to carry on the activities. The 1947 provision required declaration of only foreign currency notes brought in by incoming passengers. Since the bulk of the amount was carried in the form of travellers' cheques, the new provision was extended to cover all forms of foreign exchange, enabling the Bank to demand a declaration for all forms of foreign exchange including travellers' cheques.

The Reserve Bank and particularly Governor Jha had been always uneasy in administering the provisions of P form applications, which were based on a terse provision of the law saying that 'no airline, shipping company or travel agent shall, except with the general or special permission of the Reserve Bank, and subject to such conditions, if any as may be specified therein, book for any person a passage for a journey outside India.' Experience of working with P form applications had revealed that the directions given in Section 20 of FERA, 1947, required proper legal underpinning. Further, the Bank had to be empowered to deal effectively with restrictions relating to overstay, or visits to countries not included in the original Bank approval. Doubts were also expressed regarding the procedure in force for issue of licences to steamer/airline companies and travel agents. It was not clear whether Section 18B clearly authorized the Bank to require a travel agent to take out a licence. Suitable provisions for the granting and revocation of licences were therefore proposed. The Bank's management was clearly exercised that a considerable amount of the Control Staff's time was taken up in handling P form applications. What was more, the clearance and approval procedure in an overwhelming number of cases entailed exercising a wide degree of judgement and discretion. The machinery for aligning decisions at various levels, too, needed strengthening, and could be expected to function smoothly only if the Control staff and customers understood the accepted procedure and complied with it; every effort had to be made to help them do so. The Bank was aware that the P form for travel abroad—be it for business, pleasure, medical treatment or studies—was a constant and irksome reminder to the general public that they could not travel without that clearance. The Bank was therefore anxious to avoid the blame of administering the P form in an arbitrary and tyrannous manner, and sought, through an amendment of FERA, 1947, the requisite legal authority to administer the provisions in a fair and impartial manner.

In 1947, when the FERA was first enacted, only authorized dealers were permitted to conduct foreign exchange transactions. At a later stage the need was felt for granting licences with restricted facilities of changing foreign currency into Indian currency and vice versa. Money changers' licences were given by the Reserve Bank to firms operating at international airports, at the Indo-Pakistan land border, and at hotels and at tourist places, where such facilities would prove useful. As there was no provision in FERA, 1947, for such restricted dealers in foreign exchange, the Bank regulated the money changers through executive orders by treating the provisions in the *Manual* as directions under Section 20(3) of the Act. This anomalous situation was to be corrected and regularized through the introduction of a specific provision on 'money changers' in the FERA amendments.

Apart from the substantive amendments, there were a few provisions that related to administrative practices which were given a legal basis, such as clause 30 regarding P forms, licensing of passage agents, putting exporters on a caution list, blocking of assets of emigrants and imposing restrictions on the operations of non-resident accounts.

The set of provisions to help prevent evasions were of interest to the Directorate of Enforcement and the Reserve Bank had little to do with them. By putting the burden of proof in certain cases on the parties concerned, the provisions were intended to facilitate the task of the Directorate. The provisions covering penalties for contravention of the 1947 Act were considered relatively mild. The revised amendments sought to enhance the penalties, inflicting more than ordinary punishment, including imprisonment, on the grounds of what the Law Commission called the social implications of the crimes. However, a major drawback of the deterrent provisions was that there was no evidence of the wider approach recommended by the Kaul Committee. The latter had stressed 'the importance in the entire field of educating public opinion about the grave economic consequences to the country of the activities of malefactors, who divert foreign exchange illegally. At the moment, suffering social odium does not attach to this malpractice.' In the view of the Committee, 'a properly directed and sustained campaign to create public consciousness about what is at stake in terms of the economic well-being of the country would yield rich dividends.' But this suggestion was not given very serious thought; instead, the authorities continued to rely on policing and punishing rather than educating public opinion.

The first note for the introduction of an Act consolidating and amending FERA, 1947, was submitted by I.G. Patel for consideration by the Cabinet at its meeting on 24 May 1972. The Cabinet decided that a more detailed consideration of the proposals contained in the note would be necessary before any decision could be taken. Some of the comments/guidelines that emerged from the Cabinet discussion were: the term non-resident needed to be defined; the proposal to provide for interception of postal articles and telegrams by the Directorate of Enforcement to facilitate the tracking down of illegal transactions involving foreign exchange, as recommended by the Law Commission, required to be discussed further with the Ministry of Law by the Minister of State in the Ministry of Home Affairs. In this latter matter, the Finance Ministry and the Personnel Department of the Home Ministry were at loggerheads. While the Department of Personnel was keen to incorporate the provisions on the lines of the Law Commission's recommendation into the Act, the Ministry of Finance had reservations on the grounds that custom authorities were already armed with the necessary powers to intercept and examine postal articles. The Ministry was apprehensive that interception of inland mail and telegraphic messages under cover of the Act would invite criticism from the opposition as an invasion of personal liberty.

On the general need to amend and consolidate FERA, 1947, the Reserve Bank and the Finance Ministry were in complete agreement. Close and regular contact was maintained through middle-rank officers, and a comfortable working relationship existed between the Bank and the Department of Economic Affairs. In August 1965, the Bank sent to the Government a draft Bill for amendments to Sections 12 and 18B of FERA, 1947, and the insertion of a new Sections 12A. Several other amendments were suggested from time to time. In November 1967, Y.T. Shah, Joint Secretary, Ministry of Finance, in a letter to Deputy Governor Adarkar, suggested that, instead of piecemeal amendments, the Bank should undertake a comprehensive review of the Act and forward its recommendations to the government.

Thareja, Controller, Exchange Control Department, impressive in his command over detail and committed to the philosophy of a controlled exchange regime, was assigned the task. With the aid of middle-line colleagues, the Department prepared a tabular statement extending over thirty sheets indicating the position in regard to various amendments, and forwarded a copy to the Bank's Legal Department for its consideration and comments. R.M. Halasyam, the legal adviser, carefully studied the suggested changes and recorded his detailed comments across thirteen pages. After further scrutiny and processing by the Exchange Control Department, he forwarded the same to P.K. Kaul, Director, Department of Economic Affairs. For over a year there was no response from the government; on 15 November 1969, the Bank was informed that the government had considered the proposals and wished to introduce a Bill in the forthcoming session of Parliament to amend a few of the provisions of FERA, 1947.

The difference between the Bank and the Treasury was not only a matter of emphasis but of substance. Through a telex message, the Bank conveyed that the amendments suggested by the government for the forthcoming session of Parliament were not material or necessary as the policy issues were 'neither too pressing nor of great importance in comparison with other proposals'. In the meanwhile, concerned officials in the Legal and Exchange Control Departments gave a second look to the earlier tabular proposals and, after some modifications, they were discussed with Y.T. Shah of the Ministry of Finance during his visit to Bombay in January 1970. After the discussion, the rough edges of the proposed changes were smoothened out and forwarded, in mid-January 1970, to Y.T. Shah.

Based on the suggested amendments, the Finance Ministry directed the Ministry of Law to prepare a draft Bill, a copy of which was forwarded to the Exchange Control Department for their comments. Officials of the Exchange Control and Legal Departments of the Bank discussed the draft provisions of the Bill among themselves. Thereafter, the legal adviser, Halasyam, recorded a note on 21 April 1972, setting forth the Bank's comments. Every provision was scrutinized in the minutest detail before the

Bank's version was forwarded to the government. The draft Bill was discussed for the first time at an inter-ministerial meeting convened by the Department of Economic Affairs that was presided over by S. Krishnaswamy, Joint Secretary, and attended by representatives of the Ministries of Finance and Law, and the Directorate of Enforcement and Reserve Bank. The Bank was represented by the controller, Thareja, and the legal adviser, Halasyam. In drafting the Bill, the Bank's advice was sought and accepted in technical matters but some of the changes were determined by inter-ministerial considerations and by the perceived notion to retain the levers of control with the different Ministries.

The marathon three-day meeting discussed as many as 63 issues pertaining to various clauses of the draft provisions. Drawing on its experience and the difficulty encountered in justifying to the courts the need for regulation of transactions in the Indian currency and their indirect effect on foreign exchange resources, the Bank advised that the preamble should also refer to 'transactions indirectly affecting the foreign exchanges'. Keeping in mind the court judgement in the Vasanthi Raman case, it was agreed to accept the suggestion. The Bank also advised having an enabling provision to take care of the situation, should it prove difficult to bring the whole Act into force on the same date. It was also accepted that a company in India whose foreign equity was 40 per cent or more would be deemed foreign-controlled; that provision would be made to regulate foreign-controlled companies operating in India and accepting deposits from residents in India; to call for particulars of immovable properties held; and to require holders of foreign securities to submit periodical returns. The Bank's suggestion to empower the Exchange Control to inspect the books of money changers, airlines and steamship companies licenced by the Bank was accepted.

The Bank opposed, in no uncertain terms, the bestowing of legal powers on the Directorate of Enforcement to inspect the books of authorized dealers. Deputy Governor Shiralkar, after discussing the issue with the Governor, tried to dissuade the government. In a longish noting, Shiralkar recorded:

> The Directorate of Enforcement has the power to search premises and also to call for documents and examine persons. Moreover, under existing Section 19H, the Central Government and the RBI can get authorized dealers' books inspected by their officers. If in any particular case, the Central Government wants the books of an AD to be inspected otherwise than through the

> RBI for some reason, it can always get it done officially by appointing an officer who could be an official of the Directorate of Enforcement if necessary. A special authorization in favour of the Director is, therefore, not necessary as the requirements can be met under existing provisions. Further, we would prefer a general provision of the kind present in Section 19H rather than one where the Director of Enforcement can inspect AD's books without reference to anybody. This will ensure that only in somewhat special circumstances, the Central Government would utilize the powers and have the inspection carried out, otherwise than by the RBI. A dual authority in respect of inspection of ADs is likely to lead to confusion.

These were sensible remarks based on the Bank's experience of regulating authorized dealers intelligently and efficiently. Even the Indian Banks' Association, whose members were authorized dealers, appeared before the Joint Committee and deposed that special authorization by law, enabling the Enforcement Directorate to inspect the books of dealers, was not necessary. The views of the RBI were upheld and the authority of the Control was in no way diluted.

The revised Bill, with which Bank officials Thareja and Halasyam were closely associated at the inter-ministerial level, was by and large acceptable to the Reserve Bank, barring a few reservations—these related to the definition of residents, the P form and transfer of property by/to non-residents.

Regarding the P form, the Control drew the attention of the government to the fact that clause 30(8) of the draft Bill elaborated that a P form application would be rejected only if, in the opinion of the Bank, such travel directly or indirectly involved the accrual of or expenditure of foreign exchange. Hitherto, the practice had been to give passage clearance for visits on the basis of invitations extended by foreign governments but after seeking the concurrence of the Indian government. This meant that the P form regulation was being used as a means for enforcing a non-exchange control measure which could be struck down by the courts. The RBI's position in the field of exchange control policy was quite different from its position as the Central Bank. In exchange control matters, it was no more than an agent for executing the government's policies, there being very little or no delegation. It therefore advised the government to take note of this observation.

With reference to the Enforcement Directorate's proposal to have a definition of the term 'resident' incorporated in the Bill, the Reserve Bank was of the view that it was difficult to formulate a precise definition of the term that would meet the requirements of exchange control; it was, therefore, not in favour of defining the term. Definition along the lines of the Income Tax Act was considered inappropriate and unsustainable, for under FERA, the relevant issue was whether the person concerned was a resident or a non-resident on the date he did an act or entered into a transaction, and not whether he was in India during the 365 days prior to the transaction. Even the Code of Civil Procedure, which used the term resident, had not attempted a definition of the term. It was further pointed out by the Bank that the UK Exchange Control Act contained no definition of the term resident.

The fact that FERA, 1947, did not contain a definition of the term resident was not due to any inadvertence on the part of the framers of the Act but because of the genuine difficulty in formulating a precise definition. In 1963, when large-scale amendments were sponsored, this issue was taken up but abandoned due to the difficulties inherent in attempting an appropriate definition of the term. The Reserve Bank had always approached the administration of exchange control in the spirit of avoidance, wherever possible, of bureaucratic complexities, seeking to be helpful, rather than obstructive, while applying the rules in good faith as agents of the Treasury. On this issue too, it had provided some guidelines in the *Manual of Exchange Control* for determining the 'resident' status of persons. Including a definition in the law itself, the Bank felt, could make for lack of flexibility. But, despite the Bank's reservations, when the draft amendment Bill was discussed by the Cabinet on 24 May 1972 consensus was in favour of defining the term resident, and the Control was directed by the Finance Ministry to attempt a definition 'incorporating such conditions as the Bank considers necessary in such a definition in the light of the experience gained till now'.

Reluctantly, the Reserve Bank set about the task assigned to it. It proceeded on the basis that the definition should be such as to accommodate the procedures then followed in the matter of affording facilities to and imposing restrictions on various types of persons, as, otherwise, some persons may get an advantage, while additional restrictions may be imposed on some others, giving rise to complaints of hardship. The legal adviser, in consultation with the Control authorities, evolved a definition of the term 'resident' that appeared to suit the requirements while avoiding the deficiencies in the definition suggested by the Enforcement Directorate. The Bank, however, cautioned the government that under the proposed definition, there could be only two classes of persons—persons resident in India and persons resident outside India. Foreign nationals staying in India on employment or business or vacation and treated as temporarily resident in India, would now have to be treated as resident in India and, by administrative decisions based on policy, be eligible to enjoy the same facilities currently enjoyed by them. The Bank also pointed out to the government that the proposed definition would not be applicable to corporate bodies, their offices and branches. This was because the question of when a branch or office of a corporate body should be treated as in India or outside was a settled issue under Section 20(i) of the Act and the need for such a provision in the definition was not necessary.

The definition of the term 'person resident in India' was finalized after taking the approval of the RBI Governor. Deputy Governor Shiralkar, while forwarding the definition to the government, advised that it had not been possible to define the term precisely or to avoid a certain amount of roundaboutness. The Bank had done the best it could, but it had not been able to work out the full implications of the definition in relation to the various clauses in the draft Bill. No doubt, the Bank had formulated the definition carefully and after considerable discussion, but including the definition in the law itself remained a worrisome aspect for the Control. Shiralkar confessed to the haunting thought that 'conceivably some persons may be able to take advantage of it to avoid coming under the mischief of the restrictions, which they would under the Act as it now stands', and concluded his message on the note that the Bank 'feels it is desirable to exclude such a definition from the new Act'.

As a consequence, another inter-ministerial meeting was organized in the third week of July 1972 between officers of the Reserve Bank, the Ministry of Finance, the Ministry of Law and Justice and the Directorate of Enforcement, at which a few modifications were made in the definition as proposed by the Bank, including a separate provision to cover citizens of India who had never been in India after 25 March 1947 (the day on which FERA, 1947, came into force).

Transfer of property by/to non-residents was another grey area for the Control. The Enforcement Directorate invited the attention of the Control to the fact that several non-residents were transferring their savings to India through unauthorized channels for investment in real estate. With a view to plugging this weak spot, the Directorate suggested that FERA, 1947 should be amended in such a manner that the Registrar of Immovable Properties would register transfer documents relating to immovable property in excess of Rs 50,000, only after the non-residents secured a 'no objection' certificate from the Reserve Bank. Informally, the Bank had been observing such a practice but it lacked legal backing. Henceforth it was decided to ensure that neither of the parties in a property transaction was a non-resident, and a new clause to that effect was inserted in the revised draft Bill. The clause would be applicable in the case of both sale/transfer to and sale/transfer by a non-resident. If either of the parties in a property deal was a non-resident, a 'no objection' from the Bank was made a legally binding requirement.

To safeguard the Bank's position, Governor S. Jagannathan asserted that the RBI would not get involved in the determination of residential status of the parties to the transaction. In the event of a registering officer refusing registration on the ground that a party to the document was resident outside India, the contending party could raise the matter only by way of an appeal that was available to him under the Registration Act. The Bank would confine itself to the question of whether it could agree to the transaction, even if one of the parties was a non-resident. Accordingly, clause 29 of the draft Bill was recast to provide merely that a non-resident could not transfer property in India without the approval of the Reserve Bank. At a later meeting, clause 29 was substituted by a new clause that sought to regulate in a direct way, the acquisition and holding of immovable property by a foreign national or company in which the non-resident stake was 40 per cent or more.

The modified draft Bill came up for Cabinet discussion on 17 August 1972. The Cabinet cleared the Bill for approval of the Lok Sabha with a proviso that the guidelines for implementation should be worked out in advance to facilitate implementation as soon as the Act came into force.

The Foreign Exchange Regulation Amendment Bill was introduced in the Lok Sabha on 24 August 1972 by Finance Minister Y.B. Chavan. The highlights of the 73 clause Bill, intended to regulate dealings in scarce foreign exchange, were: to plug exchange leaks arising from invoice manipulation in trade and in property deals, and to place a bar on foreign companies, particularly branches of foreign firms in trading activities. Under the new law, the latter would now have to get converted into Indian companies. Chavan clarified that cases of foreign investment in India that were then functioning without prior permission or in non-priority sectors would be reviewed on a case by case basis, but added that it would not be necessary or desirable to review cases of recent approvals, particularly in highly sophisticated technology or export-oriented industries. By an amendment, the Reserve Bank was empowered to exempt certain companies and persons from the provisions of this clause, based on the nature of their activities. However, the Bank could not exercise this power of exemption where the activity was solely of a trading nature. A comprehensive list of restrictions was drawn up to cover the transfer and use of foreign exchange, export of gold and foreign currency, and control over immovable property owned abroad by residents and immovable property owned by non-residents in India. As foreign investment in landed property and buildings offered considerable scope for capital appreciation and consequently increased the nation's contingent liability by way of capital repatriation, the new policy stance was not to allow foreigners and foreign companies to enter into the real estate business. Together with foreign currency 'mobilization' through timely repatriation of export proceeds, close monitoring of exports on a consignment basis and tighter surveillance on over-invoicing of imports, these provisions gave the Central Bank extensive control over the external monetary resources of the country. They reflected the psychological reaction to the external liquidity crunch of the early 1970s and the defensive posture towards the international economy in the face of the development needs of the Indian economy.

Since the Bill was sure to attract explosive political reactions, with the concurrence of both Houses of Parliament, it was referred to a Joint Select Committee of Parliament. The Committee was comprised of thirty MPs from the Lok Sabha and fifteen from the Rajya Sabha, and was presided over by Satish Chandra, a Lok Sabha MP. Influential and weighty members of Parliament of varying shades of political ideologies, like Jyotirmoy Basu, Pilloo Mody, Indrajit Gupta, Y.B. Chavan and Manubhai Shah were a part of the forty-five-member august body that was assigned the task of vetting the draft Bill. The Joint Select Committee invited presentations from the public, government institutions and associations, like the Indian Banks' Association, Federation of Indian Chambers of Commerce and Industries, Associated Chambers of Commerce and Industries of India, Indo-American Chambers of Commerce, Travel Agents' Association, All-India Importers' Association and even the Reserve Bank Employees' Association. Several of the associations submitted memoranda, while representatives from several organizations appeared before the Committee to give oral evidence. The Exchange Control Department bore the brunt of the work in furnishing comments to the flow of memoranda that emanated from the Committee's deliberations. Deputy Governor Shiralkar was the seniormost Bank official to appear before the Committee to ensure the validity of the new legislation, while other Bank representatives fielded replies on the technical workability of the new legislation.

In the course of the oral evidence, several MPs voiced concerns and sought clarifications. Babu Bhai Chinoy wanted to know if the Reserve Bank maintained any record of cases where Indians had taken up citizenship of foreign countries, got companies registered abroad and used such an avenue for foreign exchange manipulation. The Bank's response was that FERA was not applicable to Indians residing abroad and who had acquired citizenship of foreign countries. Jyotirmoy Basu queried whether the Bank maintained a detailed account of incoming remittances, particularly those pertaining to foreign missions and missionaries. It was explained that there were no restrictions under the exchange control regulations on inward remittances through banking channels and, according to the Bank's record, Rs 22–24 crore remittances received by Christian missions and missionaries. Another matter raised was how many cases had come to the notice of the Bank where exporting firms had not repatriated their earnings, misappropriated the foreign exchange and disappeared. The Bank procured the list from the Enforcement Directorate and furnished the same to the Joint Select Committee. Another MP wanted to know whether the Bank was armed with sufficient powers to prevent and control leakages of foreign exchange, and how these powers compared with those of other Central Banks. It was clarified that the Reserve Bank's statutory powers were basically of a regulatory nature, enabling it to lay down rules and tighten procedures with a view to minimize the scope for leakage of foreign exchange. On the other hand, the enforcement provisions of FERA, covering investigations, pursuit and punishment of breaches, were vested with the Enforcement Directorate functioning under the Cabinet Secretariat, while the checking of smuggled goods fell in the domain of the Customs Department. Since control over physical imports and exports of goods was exercised by the Import Trade Control authorities and the Customs Department, the Bank had no means of checking over-invoicing of imports or under-invoicing of exports. Likewise, authorized dealers (banks) who handled only trade documents were not equipped to control or detect leakage of foreign exchange on those counts. Clause 8(4) of the Bill, it was explained, would not help in preventing leakage of foreign exchange; it would only strengthen the hands of the Directorate of Enforcement in pursuit and punishment of such offences, after they were detected.

Through its sittings in Delhi, Calcutta and Bombay, the Joint Select Committee collected a pile of evidence from persons representing a vast array of organizations. At its twenty-first sitting on 15 February 1973, the Committee stated that the draft Bill required further amendments so as to widen its scope. It suggested plugging foreign exchange leakages through tourism, placing more checks on Indian joint ventures abroad, even takeover of foreign banks and a ban on the use of foreign brand names. Differences within the Committee, however, came in the way of a unanimous set of recommendations and sparked dissenting notes by Jyotirmoy Basu and Indrajit Gupta. Shorn of the radical recommendations, the Bill was a modest attempt at plugging the loopholes and, except for a couple of substantive changes from the earlier proposals submitted to the Cabinet, most of the other amendments were of a minor and technical nature.

On 5 March 1973, the Cabinet was informed by M.G. Kaul, Secretary, Department of Economic Affairs, that, in light of the evidence given and presentations made before the Joint Select Committee, some of the proposed amendments would have to be rewritten to make the legislative provisions more comprehensive. The major change related to clause 27, which proposed to control the entry of foreign companies into India for carrying on trading, commercial or industrial activity, or for setting up a branch or office for carrying such activities. The restrictions laid down in the clause were made applicable to companies in which non-resident holdings were 40 per cent or more. All such persons were required to obtain the permission of the Reserve Bank for continuing to carry on such activities.

However, considerable apprehension was expressed by the various Chambers of Commerce on how this clause would impact on industrial ventures set up with specific government approval under relevant statutes, such as the Industrial Regulation Act, 1951. Conferring such wide powers on the Reserve Bank to review past cases and to direct discontinuance of activities carried on with specific government approval, was seen as the surest way to restrain future foreign investment in highly sophisticated areas where foreign technology and participation were essential. The government recognized the need to soften the provision and amend it suitably to allay the genuine fears expressed by many. It was proposed to introduce an amendment to sub-clause 2 of clause 27, empowering the Bank to grant general or special exemption to a specific party. The thinking was that pre-1951 foreign investments that were operating without prior permission should be examined first and necessary discipline, like export obligations, slapped on them, and, thereafter, to review the approved investments to bring them in line with the framework of the guidelines. Likewise, in sub-clause (3) of clause 27, relating to non-resident holding of shares of 40 per cent or more, an amendment was proposed that would exempt holdings with specific approval under FERA, 1947. The majority in the Joint Select Committee viewed the provisions of clause 28 which sought to place an embargo on employment in India or abroad of a national of a foreign country, as going beyond the scope of the Bill. The clause was amended to confine the Bank's permission for future employment of foreigners/non-residents to cases that entailed liability for remittance of foreign exchange arising from such employment. A new sub-clause 8 was added to clause 25 exercising some control over the setting up of joint ventures abroad and ensuring repatriation of dividends.

To assure the public that the Reserve Bank was not being given arbitrary powers, the Ministry of Law suggested incorporation of a provision in the draft Bill laying down the guidelines to be observed by the Bank in the exercise of its powers. The Legal Department of RBI was entrusted the job of formulating suitable guidelines, the crux of which was to ensure that all foreign exchange accruing to the country was accounted for and utilized to the best advantage of the country, and, in this context, to check attempts at evasion.

The Foreign Exchange Regulation Amendment Bill, 1973, was introduced by Finance Minister Y.B. Chavan in the Lok Sabha on 24 August 1973. Chavan's tactic was to present the main provisions for general discussion in the House, without any direct indication of his own party's clearly formed views. He relied on the strength, as he saw it, of the case for the specific proposals. And he succeeded in steering the legislation through, marginalizing the 'official connivance' lobby that vociferously attacked the operations of multinationals like ITC and Coca Cola, and harped on the inadequacy of the proposed legislation to curb exchange violations. Jyotirmoy Basu (CPI–M), who initiated the debate, described the Bill as an eyewash with too many loopholes, and accused the government of being hand-in-glove with those who violated foreign exchange regulations by under-invoicing and repatriating more than the permitted percentage of foreign companies' profits in India through dubious methods. The Parliament discussed the 81-section Bill for several days, so that there was no excuse for not understanding what was involved, at least in political terms. When the Bill was passed by the Lok Sabha it went to the Rajya Sabha, where it had an easy passage despite a last-ditch stand by the anti-foreign lobby. The Bill received the assent of the President of India on 19 September 1973 and was published in the government gazette the following day; a notification followed from the Ministry of Finance that the Foreign Exchange Regulation Act would come into force from 1 January 1974.

The Bill also received a hostile reception at the hands of the press. The *Times of India* editorial dubbed it a 'damp squib'. The assessment was that the new law would do little to curb the repatriation of excessive profits, dividends, royalties and technical fees by foreign companies operating in India. Accusing the government of not being serious in the matter and citing the Finance Minister's reluctance to accept Madhu Limaye's proposal for banning the use of foreign brand names by Indian companies, the editorial was sceptical of the efficacy of the guidelines to be framed for the Reserve Bank to force foreign firms in low-technology industries to reduce their share of the market. The fixing of foreign non-resident holdings at 40 per cent was considered too liberal and on the high side to have any decisive impact on the expansion plans of foreign-controlled companies. The thrust of the editorial was to point an accusative finger at a whole gamut of foreign-controlled companies, branches, joint ventures, even foreign banks, who, in its view, would continue to enjoy far greater privileges than Indian firms.

The comments on the proposed legislation were an over-reaction. They were motivated by political prejudice rather than an analysis of the country's monetary and economic needs, and drew their inspiration from an outdated vision of self-sufficiency and the capacity of regulators to tightly control every foreign exchange transaction.

In the intervening period between clearance of the Bill in Parliament and the new legislation coming into force, the Exchange Control Department of the RBI was preoccupied with giving detailed instructions to its regional offices regarding the administration of the Act. It pointed out that while several sections of FERA, 1947 were intact and were carried over to the new Act, there were a few that called for clarification. The regional offices were advised that in view of the provisions of Section 81(2) a of FERA, 1973, there would be no need to call back licences issued to authorized dealers and money changers under Section 3 of FERA, 1947. However, as and when the licences were due for renewal and applications made for the purpose, the Control must issue licences with reference to the new Act.

Likewise, the Directorate of Enforcement, through a circular, advised its offices that FERA, 1947 had been repealed and replaced by FERA, 1973; that the new Act would become operative from 1 January 1974; and that additional powers had been conferred on the central government and the Reserve Bank to regulate all foreign exchange transactions. It further clarified that rights and liabilities of a substantive nature, arising out of transactions prior to the promulgation of the new Act, would continue to be governed by the old Act, while matters relating to procedure would be governed by the new Act. While provisions of the new Act were to be invoked while calling for information, making searches or seizures, a person could not be punished for anything done prior to 1 January 1974 if it did not constitute an offence under the old Act. Similarly, pre-1974 contravention would attract penalties as per the old Act.

Soon after FERA, 1973 came into force, the government issued guidelines for dealing with applications under Section 29 of the Act. All branches of foreign companies and Indian companies that had more than 40 per cent interest were to obtain fresh permission to carry on their business, and had to comply with directions given by the Reserve Bank on foreign participation in capital structure, borrowings, foreign exchange payments relating to repatriation of capital. The new law required all such companies to bring down their non-resident shareholding to 40 per cent within two years. Following the debate in Parliament and the Finance Minister's promise to come up with guidelines that would assist the RBI in dealing with applications pertaining to Section 29, the government issued the same, according to which companies engaged in basic and core industries, or export-oriented industry (where exports were 60 per cent or more of total production), or companies engaged in manufacturing activities using sophisticated technology or running tea plantations would be allowed to carry on business with resident interest up to 74 per cent. For other activities, such as internal trading and commercial activities, construction and consultancy work, foreign holdings should not exceed 40 per cent. In exceptional cases, where units had developed expertise or distribution network facilities that were not available indigenously and were contributing significantly to exports, foreign holdings up to 74 per cent were allowed, depending on the merits of each case. For the Control, efficient administration of the guidelines had the effect of increasing rather than decreasing work.

It is indeed a coincidence that both FERA, 1947 and FERA, 1973 had a life-span of twenty-six years each. Just as FERA, 1947 was replaced by FERA, 1973, FERA, 1973 was replaced by FEMA, 1999. A vital difference between the 1947 and 1973 Acts was that, post independence, till 1972, the work of the Control had been mainly negative and concerned with preventing any expenditure of foreign exchange that was not immediately necessary. With the passing of FERA, 1973, the work of the Control took a different turn—it became more positive and selective. It needed to closely align with government policy, be it in development of exports, oil, travel, foreign investment, or foreign collaboration, to name but a few. In all these cases the foreign exchange factor loomed large, and they had to be handled expeditiously and in better perspective; this called for more coordination between the Control staff and the government, and much more interaction between the two. With the adoption of a holistic approach, a tighter regime of exchange control became inevitable, and the period after 1973 till liberalization in 1999 may be characterized as 'savagely' restrictive, with many more clients knocking on the Control's doors for clearances.

Long before the liberalization phase of the 1990s, as early as in 1982, the then RBI Governor recognized the essentially uneasy relationship between the Control and India's foreign trade efforts, and the need for another searching examination of its work. Under the terms of the Governor's memorandum dated 23 November 1982, the Reserve Bank set up an Expert Committee under the chairmanship of M.S. Patwardhan, Managing Director, National Organic Chemical Industries, to review the exchange control regulations relating to the export and import of goods and services mainly from the user's point of view, and to suggest measures for rationalization and simplification of regulations, procedures and practices. Members of the Expert Committee were drawn from private industry, the Indian engineering industry, two commercial banks, the Export–Import Bank of India, the Ministries of Finance and Commerce, and the Reserve Bank. In his address to the Committee's inaugural session on 10 December 1982, Governor Patel was at pains to explain the reasons behind the decision to appoint the Expert Committee and said, exchange control was 'a dynamic subject and its policies and procedures needed to be responsive to changes in a variety of external factors'. No doubt, the policies and procedures were subjected to constant departmental studies and reviews, but such internal studies and reviews tended to suffer from limitations, for, among the authorities responsible for administration of controls, there was a natural tendency to eschew drastic changes and to show a preference for status quo. Since the Department of Exchange Control was a service-oriented department, the Governor was keen on giving it a 'user-friendly' image, not one that appeared arbitrary and tyrannous. He was aware that foreign exchange control was bound to seem intrusive to those who were required to abide by the regulations, and felt there was good scope for simplifying and rationalizing the various procedures relating to imports and exports and for further delegation of powers to authorized dealers as well as decentralization of work within the Bank. This, then, was the rationale for setting up a broad-based Committee of experts. Although the findings and recommendations of the Committee fall outside the scope of this volume, it can be said that it set exchange control on the road to greater exposure to international banking practices, sharpening the skills of the personnel of the department through intensive training and adopting a more flexible and need-oriented approach in the opening of new Exchange Control offices. But the process of dismantling controls was nowhere in sight.

HIGHLIGHTS OF EXCHANGE CONTROL POLICIES

This section traces the direction in which exchange control policy, particularly with respect to mobilization of non-resident Indian funds, was shaped and reshaped to meet the challenges of development and growth of the economy. In the post-rupee devaluation period (1967 to 1970), there was some improvement in India's external payments position but overall it remained tenuous with the foreign exchange reserve level hovering below a billion dollars. The rise in reserves in 1967–68 was partly due to an improvement in exports but mainly due to the continued shortfall in payments for imports financed by authorized dealers. The difficulties faced by the dollar and the pound sterling also contributed to the speeding up of export receipts but this favourable turn in the lead and lags, as pointed out by the Reserve Bank, was not expected to continue for long. At the then prevailing exchange rate, India's cost structure compared favourably with that of its major trading partners. Of course, much of the inflationary pressure had been repressed rather than removed; continuing to hold the line against inflation was the Bank's main policy plank in the post-devaluation period.

In this period the Reserve Bank's balance of payments division rapidly became engaged in work relating to exchange control on behalf of both the RBI and the government. It compiled a statistical commentary on gold, foreign exchange and major components of balance of payments like exports and invisibles, which, together with other material available, enabled the Exchange Control Department to identify the areas that needed liberalization or additional tightening. Area-wise forecasts prepared by the division were also of vital importance in the formulation of exchange policy.

The comparatively modest level of foreign exchange reserves acted as a brake on liberalization of the exchange control regime. Despite this limitation, every effort was made, through appropriate policy liberalization, to raise larger export and invisible receipts. In order to encourage exploration of export markets, an export market development allowance was proposed to be granted to tax payers other than foreign companies, at the rate of one-third of the revenue expenditure incurred for the purpose. The government also liberalized the rules for blanket release of exchange to exporters: the minimum export performance in the preceding year was lowered to Rs 25 lakh for exporters of traditional goods and Rs 5 lakh for non-traditional export items, as against the earlier requirement of Rs 1 crore for tea and jute goods exports, Rs 20 lakh for non-traditional items and Rs 50 lakh for other items. Exporting firms that were registered as export houses with Government of India were made eligible for grant of a blanket exchange permit, irrespective of their past performance. In view of the difficulties experienced by exporters in raising funds locally for export financing, permission was accorded to receive advance remittances from overseas buyers, provided the rate of interest did not exceed 8 per cent and shipments were effected within a year of the advance. The liberalized scheme was also made applicable for purposes such as market studies and marketing research, advertisements abroad, participation in trade fairs, collection of samples, and technical information relating to export products and commodities.

Although the thrust of the control policy was in the direction of liberalization, overall it entailed micro-monitoring of export receipts. To boost exports of technical services and know-now, the budget of 1968–69 came up with income tax concessions for the entire income earned by Indian companies in the form of dividends, and for royalties and fees that were earned through the supply of technical know-how or services rendered to foreign countries. These measures were meant to promote exports and soften the rigours of a draconian system. The earliest recorded communication of how the Reserve Bank viewed the edifice of control was a letter written by Governor Jha in mid-1968 to I.G. Patel, in which he gave the reason why the machinery of exercising control worked so slowly. According to Jha, the rules were very complicated and so, at the technical level, in an attempt to plug all loopholes, too many tests and conditions were imposed, each of which could be justified on merits and could only be relaxed on wider considerations of administration and policy. This was a fact that could not be denied but then in the context of the development needs of the economy, wholesale modification and easing of rules were considered both difficult and impractical.

Around this time, the Finance Ministry turned its attention towards attracting investments by non-residents of Indian origin. A beginning was made in May 1968, when it was decided to permit withdrawals from the National Defence Remittance Scheme (NDRs). It will be recalled that in the wake of the India-Pakistan war of 1965, the government had crafted this scheme to attract inward remittances of non-residents in convertible currencies and Rs 71 crore were garnered under the scheme. The rupee proceeds of inward remittances received under the NDRs were held as deposit accounts designated as NDRs Special Account. In May 1968, relaxations were made for withdrawals from the NDRs Special Accounts, for payments to close relatives or dependents. Withdrawals were also permitted for meeting the expenses of the account-holder and his family during visits to

India, and a sum of Rs 20,000 was allowed for meeting marriage expenses within the family. The withdrawal amounts permitted were neither very liberal nor indicative of the undue leniency with which exchange regulations were devised and enforced. From time to time, the quantum of withdrawal amounts were raised but a measure of hesitancy was evident in going the full way. For instance, investment in plantations or for purchase of immovable property through withdrawals from NDRs Special Accounts was not permitted.[3]

The first breakthrough in allowing investments of NDRs Special Accounts in fixed deposits or Government of India securities or UTI units or shares of Indian public limited companies came in May 1968. But the investments were made subject to conditionalities: investment was allowed only in an industrial concern; profits earned could not be repatriated abroad; the earnings from such investment would be credited to the NDRs Special Account; in the case of investment in a private limited company, the non-resident would progressively associate resident Indian participation, at least up to 49 per cent, over a five-year time frame. Towards the close of 1968,[4] further relaxation was offered to non-resident investments by throwing open investments in trade or business. Hitherto, investments were confined to companies engaged in industry and not to trade or business. This stipulation was withdrawn; however, the requirements of non-repatriation of dividends and crediting the sale proceeds of the investment to the NDRs Special Account were retained. Both these were intended to see that non-resident Indians do not convert their rupees into foreign currency in the black market or, conversely, did not sell their foreign exchange earnings in the black market against credit in rupees. Later in the year, it was decided to allow investments by non-resident Indians in partnership and proprietary concerns, which was earlier prohibited. Once again, there was a proviso that profits and sale proceeds were to be credited to the non-resident blocked account of the investor till such time as the non-resident took up Indian citizenship.

In Governor Jha's view, this aspect of exchange control could, with suitable instructions, be delegated to authorized dealers, thereby reducing such references to the Reserve Bank to the minimum. Also, references to the Bank should emanate from the authorized dealer and not individuals. Jha had a distaste for operational procedures of an intrusive kind. At the

[3] See ECD circular No. 27 of 9 March 1968.
[4] ECD circular No. 106 of 24 December 1968.

prodding of the Bank, the government, with the approval of Finance Minister Morarji Desai, delegated the maximum possible powers to authorized dealers to deal with such requests on their own. Around the same time, with a view to find suitable outlets for the blocked rupee holdings of non-resident Indians, they were encouraged to book their passages against debits to their non-resident rupee accounts. This concession was allowed only for sectors where Air India operated and not for other sectors. Other token concessions were granting permission to take personal effects of a value not exceeding Rs 500 per family on production of a certificate from the authorized dealer, and automatic drawals from their bank accounts of Rs 200 per week or up to Rs 10,000 per annum.

In retrospect, it can be said that there were several relaxations to attract non-resident Indian funds but they were hamstrung by an equally large number of labour-intensive micro-regulations. In September, in the spirit of Jha's suggestions, and with a view to minimizing inconvenience and delays, further powers were delegated to the authorized dealers for undertaking transactions such as payment of membership fees, meeting legal expenses related to dishonoured export bills, university admission fees, and grant of loans or overdrafts to non-resident constituents of Indian origin, without the approval of the Reserve Bank. But certain specified ceilings were prescribed, beyond which RBI's intervention became necessary. The Governor directed the Control to embark on a policy of simplification to exercise judgement rather than strive for the government's approval on big and small matters. This was a significant policy initiative to keep the administration of controls within sensible bounds.

In mid-June 1972, in order to entice Indians residing abroad to return to India to settle down and open their own business or small-scale industries, exemption was granted for a period of three years from their date of return from the requirement of surrender of foreign exchange. What was more, surrendered foreign exchange would qualify for retransfer within the period of three years of their arrival; in other words, if adjustment proved difficult, they had the option of going back without losing control of their foreign funds. Initially, there was considerable difficulty in implementing the scheme. Through a press note, it was clarified that approval for reconversion of rupee funds representing the net amount of foreign exchange brought in by the account-holder would be decided by the Reserve Bank on the merit of each case, which would be decided on the basis of the guidelines publicized in the press release of 12 September 1975. The press release was followed by detailed operative instructions issued to the regional units of the Exchange Control. In May 1976, the facility was extended to Indians holding foreign passports and to holders of FCNR accounts. Despite the assurances, fears were expressed regarding reconversion; K.B. Lal, India's Ambassador to Hongkong, in a letter to Deputy Governor Luther, said that the assurance on reconversion given by the Bank was not adequate. Peeved at the communication received from Lal, Luther shot back that he failed to understand how the reconversion assurance of the balance held in FCNR accounts was inadequate, it was given by the Bank in writing on the duplicate copy of the application.

Overall, the major relaxations in the operation of ordinary non-resident accounts came slowly. The next major change after 1968 came in March 1976, allowing authorized dealers to credit rentals received on flats and houses owned by non-resident Indians to their non-resident ordinary accounts without limit. In 1978 there were further enhancements in the payment limits for family expenses and allowances for relatives and dependents. In October 1980, the controller, T.N. Iyer, felt there was need to review the implementation of the non-resident ordinary accounts to see if further relaxations were warranted. He felt the time was opportune to free debits to ordinary non-resident accounts from all restrictions, barring payments for international passages and for investments made in India. The proposal, in principle, was cleared by Deputy Governor Nangia, with a proviso to go slow on the changes. The liberalized scheme was put into operation in 1981,[5] giving authorized dealers the latitude to debit all payments other than for investments in India and booking of international passages. Debits exceeding Rs 10,000 had to be reported to the Bank; however, payments towards approved investments, such as units of UTI, National Savings Certificates and central and state government securities, could be made freely. For loans and overdrafts against non resident rupee accounts, prior approval of the Bank was required, as before.

The proposal for opening of bank accounts in foreign currencies in India by overseas Indians was forwarded by K.C. Pant, Minister of State for Finance, to Governor Jha, in 1968. The proposal was initiated by the chairman of United Commercial Bank, Hongkong. The RBI Governor was not enamoured by the proposal; after careful consideration, he concluded that there were no special benefits that would flow from such an arrangement. Jha was at a loss to fathom how and why overseas Indians would want to maintain a foreign currency account with an Indian bank, when they could do so more easily by banking with an overseas branch of an Indian bank. If

[5] Vide circular No. 6 dated 16 March 1981.

banks in India accepted deposits denominated in foreign currencies, they would not be in a position to lend the foreign currency to any borrower in India, except to those to whom a foreign exchange loan was approved. Even assuming that the banks decided to lend for short periods, it would mean converting the foreign exchange into rupees. And what was the guarantee that it would be able to reconvert the rupees into foreign exchange without an exchange loss? All in all, the Governor saw no clear advantage; if anything, it would be a clumsy and cumbersome arrangement of little material value.

The Governor conveyed his reservations to the Minister. The latter, while accepting the Bank's reasoning, instructed Y.T. Shah, Joint Secretary, Ministry of Finance, to advise the RBI that banks should be permitted to open external rupee accounts, provided these were credited with inward remittances and on the understanding that funds lying in such external accounts would be given automatic repatriation facilities. To remove the perception of excessive formality and undue delays, the Minister was eager to give publicity to this aspect. But the Bank's official hierarchy had the apprehension that, should the flow of funds via the external rupee account route assume large dimensions, it could pose serious strains on the vulnerable balance of payments position. By way of abundant caution, the Exchange Control was asked to monitor the position and it was decided that if the total in all such external rupee accounts exceeded Rs 10 crore, discussions would be held between the Bank and the government to decide on the future course of action.

In August 1973, T.R. Varadhachary, Managing Director of State Bank of India, during a visit to the Beirut branch, was surprised to find advertisements in the Middle East papers by Pakistani banks soliciting foreign currency deposits. He requested the Reserve Bank to consider enhancing the popularity of the external deposits by allowing deposits in foreign currencies and accepting the exchange risk. His evaluation was that the cost of funds raised would be cheaper than a straight borrowing in the Eurodollar market.

The Reserve Bank examined Varadachary's proposal with an open mind. As details of the Pakistani scheme were not available, the Control undertook a study of the working of the Indian non-resident external accounts, to find that the scheme was not very popular; there were barely 9,718 such accounts, whose aggregate balance stood at Rs 14 crore spread over 87 countries. Another disturbing aspect was that, considering the sizeable Indian population residing in the US and Canada, the total volume of non-resident external (NRE) deposits from those countries was extremely insignificant.

Obviously, the incentives of tax exemption and repatriation had not proved attractive enough to entice an inward flow. The conclusion that emerged from the examination was: since the deposits were denominated in Indian rupees, the depositors were exposed to the risk of capital depreciation in the event of devaluation of the rupee or revaluation of foreign currencies, and this inhibited the transfer of savings of non-residents to India.

Recognizing that the existing NRE scheme had not yielded the desired results, the Control turned its attention to issues that would need to be resolved if external accounts were to be maintained in foreign currencies. The modalities fleshed out were as follows. The Reserve Bank would retain the foreign currency needed for its immediate requirement in its accounts with banks abroad and would sell the remaining foreign currency. The sale of foreign currency would affect its exchange position and this would call for squaring of the operations. In the event of an exchange rate change of the rupee or of the foreign currency, the Bank would have to book the exchange gain or loss depending on its overbought/oversold position. Servicing the foreign currency deposit would entail a higher cost but this could be ignored in the interest of additional inflow of foreign exchange. The office note also suggested that foreign currency accounts be denominated in fourteen currencies under the category of the external account group, and depositors could remit in any of the prescribed currencies. A further suggestion was that foreign currency deposits should accrue to the general reserves and authorized dealers should not be allowed to retain these funds in their normal foreign currency balances for meeting their day-to-day expenses. In the event of a non-resident Indian wanting to utilize a part of the deposits for local disbursements, the banks should purchase the foreign currency amount at the buying rate ruling on the purchase date. Depositors were required to draw foreign currency cheques in favour of the banks with instructions to pay the beneficiaries. This was deemed necessary to avoid misuse of funds.

On an earlier occasion, when the Bank had examined the proposal of allowing the opening of a non-resident account, warning had been given that the difficulties in doing so were real and should not be lost sight of. Following a re-examination of the pros and cons of maintaining a non-resident external account, the Control indicated it was not in favour. Deputy Governor Shiralkar endorsed line and wrote to Narasimham, Additional Secretary, Department of Economic Affairs, on 13 November 1973, that considering the real difficulties faced in administering such a scheme, the Bank was not inclined to view the proposal favourably. Once again the Bank shied away from finding an answer.

But the government remained adamant. Its over-riding concern was the sharp fall anticipated in foreign exchange reserves. The reduction in reserves to the near amber-light zone evoked the traditional anxiety. M.G. Kaul, Economic Secretary, in a letter to Governor Jagannathan dated 2 January 1974, wrote: 'in view of the pressure likely to develop on the balance of payments in the next few years all avenues need to be explored to attract foreign deposits including the exchange risk factor that had inhibited the inflow.' Government of India remained of the view that the exchange risk would have to be borne for the gain that would be derived from such deposits. Kaul wanted the Bank to once again examine the administrative feasibility of such a scheme and find alternative ways of overcoming them.

The Reserve Bank undertook a fresh evaluation. Ruling out Varadachary's proposal of permitting banks to accept foreign currency deposits and utilizing these funds abroad, the Bank pointed out that the same result could be achieved through borrowings in the Eurodollar market. Acceptance of short-term repatriable deposits from abroad with the value guaranteed in foreign currency was another method of borrowing. But then, it was essential to evaluate the cost of 'retail' and 'wholesale' borrowing, to decide where the special advantage lay. The difficulties of permitting piecemeal withdrawals through cheques were also considered to be cumbersome and impracticable. In short, the bottom line of the Bank's response was that operating such a scheme was not feasible.

In the Bank's judgement, the simplest course would be to go in for fixed deposits for specified periods and to make the deposits eligible for interest at the prevailing rates, which were attractive enough compared to the rates obtaining abroad. With interest rates ruling high in the UK, it was easy to see that persons of Indian origin residing there would not be lured to the Indian scheme. No doubt these deposits would have to be guaranteed for their value in terms of the foreign currencies involved. But the difficulty of announcing a guaranteed scheme was that the holders of accounts under the current non-resident external account scheme would demand similar guarantees, and if these were not conceded, they would repatriate the deposits, which were estimated at Rs 14 crore at end-March 1973. The quantum of deposits that would accrue under the reinforced guaranteed scheme was a matter of conjecture.

In the 1970s, the Bank was the main advisory body to the government on matters relating to foreign exchange but, in this matter of high policy, the Finance Ministry's voice was decisive. Discarding its reservations under pressure from the government, on 24 May 1975, Hazare, Deputy Governor, indicated to the government that the Bank was ready to introduce the non-resident (external) account scheme in specified foreign currencies at marginally higher rates than those applicable to domestic deposits of corresponding maturities, and that a suitable scheme could be devised with appropriate safeguards.

Thus, on 1 November 1975, within a matter of six months, the modified FCNR scheme[6] became operative. Its highlights were: the exchange risk was eliminated; deposits, together with interest earned, were repatriable in foreign currencies; the income earned was tax-free; deposits could be opened in pound sterling or dollars. The earlier non-resident external accounts maintained in rupees were also covered by the new scheme. The maturity period was refixed from a minimum of one year to a maximum of five years, from 1 March 1976. Later, in mid-1979, the five-year cap was removed.

Despite detailed procedures spelt out by the Exchange Control through umpteen circulars, the scheme was not free from operational hassles. Complaints were lodged regarding the rate of exchange applied for conversion of the FCNR deposits by the authorized dealers. For instance, *Business Standard* reported that in the case of a non-resident who had returned to India prior to the maturity of the fixed deposit, the authorized dealer holding the deposit had redesignated the account as 'resident' and conversion of the deposit was made at the rate prevailing at the time of deposit and not on the interpretation given by the Control. The Control advised the dealer that FCNR accounts should be converted into rupees at the TT buying rate on the date the account was actually converted into rupees, irrespective of the date of arrival of the non-resident in India. Such procedural wrangles were not uncommon, and sorting them out became part of the working of the Control. Likewise, misgivings continued to dominate the minds of non-resident Indians regarding the guarantee of repatriation. These were unfounded but, motivated by the large Indian populations residing in Hongkong, Singapore and the Middle East, proposals poured in to consider various options to make the scheme more attractive and flexible. The Bank examined these but conventional wisdom prevented it from accepting them.

Another attractive feature of the NRE account was that the income earned on it was exempt from tax.[7] On 10 February 1970, rules governing the NRE

[6] AD circular No. 82 dated 6 October 1975 outlined the modified scheme and procedures to be followed by authorized dealers.

[7] In terms of an amendment to clause 4A of Section 10 of the Income Tax Act, 1961, the Finance Act of 1968 exempted from tax any interest received on moneys standing to the credit of Non Resident External Account—AD circular No. 15 of 16 April 1970.

account were codified and, as a follow-up measure, the Reserve Bank issued an AD circular on 16 April, permitting authorized dealers, without prior permission of the Bank, to open such accounts. However, it was not till 1978 that permission was given to the dealers to open external accounts against tender of foreign currency notes and coins and travellers' cheques by eligible persons during their temporary visits to India.

The need for moving away from the excessively detailed regulations that characterized the Control in the early 1970s was recognized, and relaxations in the rules governing NRE accounts was a beginning in that direction. No doubt, the labyrinth of controls were odious to an entrant but then, in a tightly controlled and planned economy, where the ideological fervour for Indian-style perestroika was dominant, relaxations were slow in coming. In keeping with the stress on the objective of self-reliance, alongside some of the relaxations, the tempo of inspections was stepped up. To illustrate, in the course of inspections of authorized dealers, it was observed by the Control that external accounts were opened and credited with large rupee funds in cash that were claimed to be of external origin. The Reserve Bank was clearly uneasy about these cash credits in rupees. In mid-July 1980, it reiterated that these dealers had no authority to credit the external accounts with such rupee funds and the Control's regional offices were instructed to caution banks not to encourage such rupee credits. Between 1978 and 1980, a spate of circulars pertaining to NRE accounts were issued, which gave the impression that while seeking to enlarge the sphere of operations of this category, there was simultaneously a move to micro-manage the accounts.

To begin with, both NRE and FCNR accounts were on par with interest rates on domestic deposits. But in mid-1977, it was decided to lower the rates on NRE deposits while retaining the rates on FCNR deposits, pending a detailed review. All along, the Reserve Bank viewed the FCNR scheme basically as a high-cost borrowing. Karan Sharda, an MP, had also suggested that considering the rising trend for foreign exchange reserves and low yields thereon, there was little justification of encouraging inflows into FCNR accounts by offering higher rates and exchange risk protection. The Bank examined the issue and found that the incentives offered were attractive and that this had encouraged the inflow. However, Governor Naraismham realized that abolishing the FCNR scheme *in toto* could have undesirable and far-reaching repercussions on the overall inflow of funds from non-resident Indians, and, in November 1977, decided against abolition. While retaining the scheme, he got rid of some of its attractive features, shortened the tenure of FCNR deposits from 61 to 37 months,[8] enhanced the lock-in period for the deposits and aligned the interest rates on FCNR deposits with those applicable to NRE deposits.

Surprisingly, the government remained of the view that the favourable foreign exchange reserves position as compared to 1975 justified lowering the interest rates of FCNR deposits to even below those payable on NRE accounts. So, in March 1978, marginal downward modification was effected; but, in March 1982, with an unfavourable swing in the reserves position, the interest rates on FCNR term deposits were hiked 2 percentage points above the rates fixed for domestic deposits.

In 1981, with a weakening of the external payments position, the Reserve Bank was constrained to warn authorized dealers to be vigilant with regard to credits put through the NRE accounts, and advised that no third party credits should be allowed as that could facilitate unscrupulous elements to acquire travellers' cheques and foreign currency in India with a view to transferring rupee funds out of India. Acceptance of travellers' cheques with third party endorsements was not to be entertained, and frequent credits and debits to these accounts were to be handled with extra care. Also, transfer of funds from one NRE account to another was against the rules. The Bank records show that requests even for nominal amounts of transfer were summarily rejected.

Likewise, joint NRE accounts where one party was a resident Indian were not legally allowed. In 1975, the central office of the Exchange Control discovered that one of its regional offices was giving approvals freely for such joint accounts; the concerned regional office was reprimanded and, on 24 May 1975, a clarificatory circular was issued that the NRE Rules of 1970 contained no provision enabling a resident to hold an external account jointly with a non-resident. Regional offices were instructed to forthwith cancel all approvals for external joint accounts with residents. However, for operational convenience, NRE account-holders could execute a power of attorney in favour of residents to operate such accounts, which would imply that the resident was acting merely as an agent of the account-holder.

Despite the clarification, suggestions were made from time to time for opening NRE accounts jointly with residents in India, but the rule-bound Reserve Bank refused to budge from its stated position, as in the case of an Indian national residing in the UAE. This individual had requested permi-

[8] Reducing the tenure of the deposit meant the effective cost of servicing the deposit came down from 10 per cent to 8 per cent.

ssion to open an NRE account with the State Bank of India in the name of a family trust in Dubai and to appoint SBI as a co-trustee to manage the trust on behalf of his family as his wife would have difficulties in doing so. SBI indicated its willingness to manage the trust. The income of the trust was to be utilized for the beneficiaries as and when needed, and for their visits to India. The Exchange Control examined the case but rejected it on the ground that trust companies formed abroad by non-residents were not beneficial to the country.

15

The International Monetary System and the Developing Countries

This chapter presents an overview of the key issues that dominated the discussion on the reform of the international monetary system, following the collapse of the Bretton Woods System in the 1970s. Although the developing countries were marginal players in this debate, India, through its interventions provided the lead in voicing the opinions of the developing world. India regarded the placing of international monetary reform on the official agenda as a historic opportunity to record and set right the fundamental asymmetry between the experiences of the developed and developing countries in the functioning of the international monetary system. Throughout the seventies, Reserve Bank and Finance Ministry officials were preoccupied with various issues and aspects pertaining to the reform. The entire exercise reflected both the complexity and importance of the reform debate, and the Bank and the government played a role in this path-breaking debate. This chapter attempts to provide a perspective on the developments as seen and evaluated by the Indian authorities.

NEED FOR REFORM

To understand the need for reform of the international monetary system, it is necessary to recapitulate the causes that led to the collapse of the Bretton Woods system. In the twenty-five years since the system was created, the conduct of international trade and investment had changed radically. The rise of multinational corporations, large-scale capital flows, technological advances, greater mobility of capital and labour between the US and Europe, had all made it difficult for the economies of the key currencies—the dollar and the pound sterling—with excessively large deficits in their external accounts to adhere to the Bretton Woods system of fixed par values. The unipolar world in which the US singlehandedly was prepared to direct and maintain the system had changed economically, and the US was no longer able or prepared to perform that role. The upshot was that the decade of the 1960s was punctuated by recurring crises, first of the pound sterling from 1964 to 1968, followed by the gold crisis of 1968 and finally the collapse of the dollar in 1971 with suspension of dollar convertibility.

The crucial factors that had led to a breakdown of the old system and its eventual demise were little understood. The US faulted the par value system for its lack of an adjustment mechanism, that is, its failure to trigger appropriate changes in exchange rates. In its view, the system suffered from a devaluation bias: it placed pressure on countries in deficit to devalue their currencies, whereas countries in surplus were let off the hook and were not forced to revalue and appreciate their currencies. Monetary experts attributed the problems to unrest in the foreign exchange markets produced by disorderly capital flows brought about by a crisis of credibility of exchange rates. The Europeans pinpointed the cause of the breakdown to the inflationary implications of large capital flows; they argued that European economies were forced to protect their economies from imported inflation and described the par value system as an 'engine of inflation'. In 1970, the Managing Director of the IMF, Pierre Paul Schweitzer, in an address to the International Financial Conference, described the international monetary system as having gone through an 'ordeal by fire'; three years later, Otmar Emminger, Deputy Governor of Deutsche Bundesbank, described the crisis of 1970–73 as 'an ordeal by holocaust'.

According to the IMF, the basic reason for the collapse of the system was that industrial countries were not willing to coordinate their policies affecting international transactions, nor were they willing to give or transfer effective control over world reserves to the Fund. Cognizant of this, the Fund, in the second half of the 1960s directed its energies towards solving the problem of shortage of international liquidity through creation of the SDR—the first major innovation towards reform of the system. It was hoped that availability of SDRs as a supplement to traditional reserves would mark the beginning of eventual control by the Fund of international liquidity. It was visualized that, in course of time, the SDR would become the principal reserve asset of the system. However, even as of now, the monetary system is yet to emerge with improved foundations, and the SDR represents only a miniscule proportion of world reserves.

Around 1971, the US lost faith in the par value system and started to believe that its interests were jeopardized by preserving that system. On the other hand, in the thinking of the IMF, the measures needed to correct the burgeoning US balance of payments deficit were liberalization of trade and non-tariff restrictions, and changes in the exchange rates. The strong differences of views between the US and Europe increasingly convinced US officials that bilateral rather than multilateral negotiations would prove beneficial in resolving the problem. With a European Managing Director heading the Fund, US officials felt that the Fund management would be more receptive to arguments made by the European countries.[1]

With pressure building up on both sides of the Atlantic, how did the developing countries react to the emerging situation of floating rates? Towards the end of the 1960s, the developing countries had become staunch supporters of fixed rates, and the IMF Managing Director made a conscious effort to see that their viewpoint was not brushed aside and their voice was heard. Both the Fund and the developing countries believed that floating rates would divide the world into currency blocs and would fail to produce a satisfactory pattern of exchange rates. Moreover, widespread floating would prove a stumbling block for reform of the monetary system.

At the annual meeting of 1971, the Board of Governors of the IMF directed the Executive Board to study the problem and come up with suggestions to improve the working of the monetary system. The mandate given to the Board included studying the role of reserve currencies, gold and SDRs, convertibility, necessary modifications in the Articles of Agreement relating to exchange rates, and problems relating to destabilizing capital flows and suggestions and recommendations on coping with such flows. The IMF staff, at the request of the Executive Directors, prepared a draft outline of a report, which was placed on the agenda of the Board for informal discussion in mid-May 1972. The majority view was that the draft outline was fairly comprehensive. A few suggestions were made with regard to rearrangement of the chapter design: the chapter on disruptive capital movements should figure at the end of the report, SDR and development was an important topic and merited a separate chapter, and the portion relating to principal reserve holdings should precede the discussion on convertibility.

The Indian Executive Director, Prasad, while accepting the suggestions pertaining to changes in the structure of the report, emphasized that, since the document would be available for public consumption, it should not be just a technical volume, as suggested by some Directors, but state clearly the policy options from differing approaches. For instance, under the role

[1] At the 1970 annual Fund–Bank meeting in Copenhagen, Schweitzer, the Managing Director of the Fund, publicly called upon the US to use its reserves to settle its growing deficits rather than enlarge its liabilities. Again, in 1971, in a television interview, he suggested devaluation of the dollar. Frank utterances such as these, it is believed, spiked Schweitzer's reappointment for a third term as Managing Director of the Fund.

of different types of assets, not only did the concept of excess reserves need discussion, but also the concept of shortfall. Agreeing with the German and Dutch Directors that SDR and development finance should be treated separately, Prasad warned that the 'link coach' should not be detached from the 'reform train', for he firmly believed it represented the one area that was likely to illuminate the new path along which the world would have to tread in the future. As he saw it, the concept of exchange stability had to give way to wider concept of stability with growth and expanded trade.

Initially, the US Director was for ignoring the report but, sensing the mood of the Board, he eventually indicated that it should be 'short', to the point and lacking in conclusions. Obviously, his authorities were for glossing over the issues unpalatable to them. But he was overruled by the Fund Governors' mandate, and the green signal was given for preparation of the report.

Between August 1971 and the early months of 1972, there was no clear awareness of the features that a reformed monetary system ought to have and what features were required to be negotiated. The thrust, it appears, was in the direction of holding together the system of par values and trying to maintain the new realigned exchange rates to see if the system would hold. Officials of Western European countries were aiming at persuading the US to re-establish some degree of convertibility for the US dollar. The US, on the other hand, was reluctant to take on such an obligation till it could turn around its external payments deficit into a surplus. The upshot was that the main features agreed upon were prompter and smaller changes in par values, use of wider margins around parities and an escape clause that legalized temporary deviations from par values resulting in the emergence of a non-system.

Before the IMF Executive Board submitted its report, it was decided to set up a special Committee of Twenty (C-20) to negotiate a reformed system. Here, too, there were considerable differences with regard to the structure of the Committee. The US wanted the reform discussions to be centred in a forum other than the IMF and the G-10. There was also a conflict regarding which countries and which officials were to be representatives on the special Committee and what powers they would wield. In mid-1972, agreement was reached that Governors of the twenty Fund constituencies would form the C-20.

The initial resolution prepared by the IMF staff on setting up a Governors' Committee was deadlocked in the Board discussion. To break the impasse, the Managing Director of the Fund set up a small informal group of Directors to consult and advise him on a draft that would have a reasonable chance of success. This group included four Directors from the developed countries and two from the developing countries—P.S.N. Prasad, the Indian Executive Director, was one of the six. The disagreements on the draft resolution were not so large in respect of the composition and structure of the proposed Committee. The main disagreement related to the mention of an inter-relationship between trade and monetary reform. France had serious objections to linking these two issues of monetary reform, although the majority of the Directors were prepared to accept the formulation and willing to go along with the draft version, fearing that prolonged discussions could kill the concept of a Committee of Governors. Another hiccup that arose was from the US Director, who said that, in the event of a difference of opinion, weighted voting should decide the issue. This was strongly contested by the developing countries; they argued that the Governors' Committee was only a recommendatory body and it was unnecessary to decide issues on a weighted voting basis.

When the resolution came up for discussion, although eighteen of the twenty Directors were willing to accept it, the American and the French Directors, each for different reasons, said their authorities could not go along with the draft of para 2(b), which related to matters of substance. In order to achieve a consensus, the Managing Director tried his hand at a further revision of para 2(b). The new draft was approved by the Board on 23 June 1972, with France and India abstaining. India's abstention related to the revised formulation of para 2(b), which appeared neutral and colourless, and did not specifically refer to the Fund's objectives as stated in Article I and so lacked the positive elements of the earlier draft.[2] In the Indian Executive Director's view, the second draft had significantly weakened the substance. And, despite the best efforts of the Managing Director to get the first draft accepted, stating that it was more in the spirit of the UNCTAD resolution, the French and the Americans remained adamant.

[2] *Paragraph 2(b) of the first draft*: 'In its consideration of matters covered by (a) above, the Committee shall give full attention to the inter-relation between these matters and existing or prospective arrangements among countries with respect to the expansion and balanced growth of international trade, an appropriate flow of capital, development assistance and other widely recognized objectives of international economic cooperation, including in general those referred to in Article I of the Articles of Agreement of the Fund.'

Para 2(b) of the second draft: 'In considering and reporting on matters covered by (a) above, the Committee shall give full attention to the inter-relation between these matters and existing and prospective arrangements among countries, including those that involve international trade, the flow of capital, investment or development assistance, that could affect attainment of the purposes of the Fund under the present and amended Articles.'

Even though the revised draft did not appeal to many, the fear that any delay could result in the US bypassing the Fund prompted them to support it. The news about flotation of the sterling and apprehension that the Smithsonian agreement was cracking up added to the urgency, and everyone was willing to settle for the establishment of the Governors' Committee. But one thing was certain: there was enough of an undercurrent of diplomatic pressure from the developed countries to weaken the developing countries' solidarity and soften the attachment of Latin American and African countries to the latter.[3]

The ad-hoc Committee of Governors was to consider and deliberate on the report presented by the IMF Board to the Governors at their 1972 annual meeting, and to arrive at an agreed understanding for a reformed monetary system. At its inaugural meeting on 20 September 1972, the C-20 chose Ali Wardhana, Minister of Finance of Indonesia and Governor of the Fund for that country, as chairman. To assist the Governors, a deputy-level committee of senior officials was created, with its own bureau and staff, to help with the technical and preparatory work and who could draw on experts from various countries for advice.

Informal exchanges at the deputies' level revealed to the Indian authorities that the deputies from developing countries were unable to take any common positions relating to substantive issues on the agenda. Not very familiar with the topics, many of them had not carefully formulated their views. Unfortunately, the composition of the C-20 and the group of deputies was heavily slanted in favour of conservative countries easily amenable to influence from the developed countries.

Realizing this weakness—in the composition and in the representation of developing countries as a group to articulate their views—the Indian authorities decided to set up a high-powered Technical Advisory Group at Delhi, to make an in-depth study of the issues and to aid the Indian constituency at the deputies' level to formulate their views. The Technical Advisory Group, which was to provide back-up support to the Indian delegation and make specific suggestions relating to the Indian response, comprised both official and non-official members, ranging from Secretary, Economic Affairs and Principal Economic Adviser, Reserve Bank, to the Director of the Institute of Economic Growth, and professors of econo-

[3] Rumours were rife that America had offered Brazil some kind of an informal role for consultations in a small group, and the Africans were given an assurance that the size of the IMF Board could be increased to ensure the return of the two African Directors.

mics at Bombay and Calcutta universities. The creation of the Technical Group was an indication that India viewed the deliberations seriously and was not prepared to treat the exercise lightly. The initial address of India's Finance Minister to the Technical Group stressed: 'India as a leading country had a crucial role to play and so it was essential for her to carefully work out specific ideas and strategies on issues pertaining to the restructuring of the international monetary system.' Recognizing that this was an area where purely technical and economic problems were linked with political considerations, he cautioned that conflicts and differences of opinion could not be ruled out, and advised that it was therefore necessary to keep in view the interests of the third world and work out feasible alternative solutions to ensure that the developing countries were not exploited by the richer nations.

Dr I.G. Patel, Chief Economic Secretary, who chaired the first meeting of the Technical Group on 21 November 1972, in his opening remarks, stated that the developing countries had succeeded in their efforts to acquire an active role in the decision-making process concerning the international monetary system and it was, therefore, essential for them to formulate their views on all major aspects of reform, adding that India had to give a lead in voicing the opinions of the developing countries.

The Indian delegation to the deputies committee of IMF Governors was a group of seven officials drawn from India, Sri Lanka and Bangladesh, with Dr Manmohan Singh as leader.[4] At the first meeting of the deputies, it was decided that there would be two vice chairmen—one from the developed and the other from the developing countries. The African countries publicly announced their intention to put up an African candidate. Two names were suggested but as agreement among the Africans was not forthcoming, India made it known that it was nominating P.S.N. Prasad, the Indian Executive Director at the IMF, for the second post of vice chairman. Prasad was widely respected and many developing countries recognized that his membership of the bureau of the group of twenty deputies would be a source of strength to the developing countries. However, important developed countries and their satellites among the developing countries had a vested interest in ensuring that the developing countries' representa-

[4] The Other members of the delegation were: 1. Dr Lal Jaywardane—Deputy, Sri Lanka. 2. Dr P.S.N. Prasad—Executive Director for India at the IMF. 3. Dr A.M.A. Muhith—Alternate Executive Director at the World Bank from Bangladesh. 4. Dr W.M. Tilakratna—Alternate Executive Director at the IMF from Sri Lanka. 5. Shri V.B. Kadam—Reserve Bank of India. 6. Shri R.H. Patil—Reserve Bank of India.

tion in the bureau remained weak. The fact that an Asian had been chosen to be chairman of the C-20 was effectively used by the major powers to support the claims of an African candidate for the second post of vice chairman. Sensing the mood, India gracefully withdrew in favour of the African candidate Duncan N. Ndegwa and Governor of the Central Bank of Kenya was appointed. Not very happy with this outcome, Manmohan Singh and Lal Jaywardane were determined to see that the bureau was not out of step with the aspirations of the developing countries, and seriously tried to bring in the political weight of the Group of 77 to influence the course of negotiations within the C-20.

With the setting up of the C-20, hopes ran high. Despite conflicting views, there was an air of expectation. It was a challenge to evolve a new international monetary system and initial expressions of views in the C-20 revealed a determination to make rapid progress towards this. The 1972 annual meeting speeches of Shultz, Barbar and Schmidt[5] seemed to suggest that agreement on the main features would be hammered out before the next year's annual meeting in Nairobi. But the Indian officials tempered their optimism with caution. Theirs was a difficult task—to safeguard the interests of the developing world. This was not easy in the face of the intense desire of the major powers to protect their employment and external trade, with many of the developed countries favouring floating rates.

The first meeting of deputies was held in Washington on 27–29 November 1972. The terms of reference of the committee, as outlined by the Board of Governors, were all-embracing, viz. to advise and report on all aspects of reform of the international monetary system and, in so doing, to include international trade, the flow of capital investment, asset settlement and transfer of real resources for development purposes. Manmohan Singh, leader of the Indian constituency, effectively voiced the concerns of the developing countries. A work programme was proposed by the Morse Bureau for consideration by the deputies. While broadly in agreement with the suggested topics—adjustment, asset settlement, etc.—Singh pressed for inclusion of the topic of the present structure of the IMF in the work programme. If the present structure of the IMF was to be responsive to the needs of all its members, Singh insisted, there was need to re-examine the relative shares of various groups in the Fund quotas, voting rights and the institution of appointed Directors.

[5] See summary proceedings of the 1972 annual meeting, pp. 44, 53 and 31, for statements by the Governors of the US, the UK and Germany.

The ideas of the US about reform of the system were radically different from those that India had in mind. The US officials' priority was to design an adequate mechanism to adjust balance of payments disequilibria; in other words, the system ought to contain some method of forcing even countries with persistently large payment surpluses to revalue their currencies. For them, the crucial factor in the reform exercise was how could it be applied to correct an undervalued exchange rate. The US game plan also included establishment of a new centre for decision-making, for, in their perception, the IMF staff had an excessive influence on the decision-making process of the IMF Board. The US was therefore keen to establish a new centre for decision-making away from the Fund, by appointing a high-level committee of national representatives who would meet periodically and give directions to their Executive Directors.

India was not in favour of any diminution in the authority of the Executive Directors and took the bold line that the management functions of the Executive Board should in no way be eroded. India, however, was aware that tough opposition on this aspect could not be ruled out, and conceded that the odds were heavily stacked against it and other countries not favouring this course. The Europeans held the view that the US payments deficits were due to relatively easy money policies and the resulting inflation. They believed that the special role of the dollar in international payments had encouraged the US to live beyond its means. They were no longer willing to accumulate unconvertible dollars indefinitely; asset settlement, according to the Governor of France, Giscard Estaing, was 'the touchstone of reform'.

In November 1972, the Morse Bureau circulated the annotated agenda for consideration by the deputies. It was more in the nature of an exploratory exercise to test out the ideas and views of the deputies to decipher the direction in which the wind was blowing. The agenda covered such aspects as the need for balance of payments adjustment through a change in par values, use of sanctions, legalization of floating, controls, use of multiple exchange rates, capital movements, etc.

From the beginning India sensed a real danger in that the developed countries could form small cohesive groups for conducting effective negotiations, leaving the C-20 to function as a debating club. To forestall this, the Indian Finance Minister, in his annual address to the IMF, sounded a note of caution: 'The Committee of Twenty should not be a forum where all are heard but only a few are listened to.' Fearing that the history of the Kennedy Round may repeat itself, India's strategy was to strengthen the unity of the developing countries by seeking to reactivate the Group of 24, instructing the Indian representatives in New York and Geneva to start canvassing for a joint statement by the Group of 77, and requesting the chairman of G-24 to immediately set up a technical group to work out a common position paper on the various issues of reform including the SDR–aid link, in which the developing countries had the largest stake.

Manmohan Singh, in his initial observations on the annotated agenda circulated among the deputies, stressed that the greatest asymmetry in the functioning of the international monetary system was the stark divergence of experiences of the developed and developing countries. Whereas the former had succeeded in maintaining full employment and reasonable rates of growth, as well as dismantling trade restrictions, the experience of developing countries in these areas was highly unsatisfactory. This imbalance needed to be redressed by explicitly facilitating the achievement of internationally agreed trade and aid commitments in support of the development efforts of developing countries. Conceding that the development of developing countries rested with the people themselves, Singh hit the nail on the head by stating that 'the task of removal of mass poverty was complicated by historic inequities of the world trading and monetary arrangements'. In short, these inequities had to be borne in mind in redesigning the international monetary system.

In the discussion on the adjustment process, the US, the UK and Italy attributed the breakdown of the Bretton Woods system to the failure of the adjustment process. Proposing that the system of par values should not be retained, they favoured small and frequent changes in parities as also a regime of wider margins. In their thinking, greater flexibility would promote orderly and smooth adjustment, and also act as an effective mechanism for dealing with speculative capital movements. The Germans, on the other hand, struck a cautious note. Traditionally favouring greater exchange rate flexibility, the German view was that the exchange rate alone should not be the dependent variable that was adjusted whenever national policies moved apart. There should be a continuous endeavour to keep national policies in line with each other on the basis of generally accepted objectives such as avoidance of inflation or deflation. Manmohan Singh said that the criteria for exchange rate adjustment worked out in the context of the developed countries were not readily applicable to developing countries. Citing the contingencies to which developing countries were traditionally subject, such as crop failures and wide fluctuations in world market prices for the primary products that they exported, Singh explained how accumulated reserves of developing members would strengthen their ability to undertake commercial borrowing which would give them the needed flexibility in timing development projects. Likewise, Singh pointed out, because of the relatively slow response of both imports and exports to changes in relative prices, whether induced by tariff or exchange rate changes, developing countries needed the freedom to retain and use quantitative import controls as instruments of balance of payments policies.

On internationally agreed guidelines or criteria to induce countries to swifter balance of payments adjustment, the US proposed presumptive criteria based on movement in reserves. The Europeans, on the other hand, suggested basic balance as a more appropriate criterion for judging the need for adjustment. The British were opposed to any automatic criteria and India, through Manmohan Singh, conveyed strong misgivings about the usefulness of any presumptive criterion, be it reserves or market rate.

The US proposals also envisaged a strict system of inducements and sanctions to encourage or force countries to adopt the desired measures of adjustment. The Europeans were not in favour of any automatic procedure leading to sanctions and warned against repeating the mistake of the scarce currency clause in the Bretton Woods agreement, which was so lethal that no one dared to use it. India, too, made it abundantly clear that developing debtor countries' policies had already been submitted to more than necessary surveillance by donors and international financial institutions. Despite this, surprisingly, some Latin American countries favoured a system of sanctions. India warned the developing countries that while the developed countries would always be able to break the ground rules of the system when it was in their interest to do so, the developing countries would be the ones most likely to be coerced into submission. In view of the division in the ranks of the developing countries, India remained firmly of the view that any system of guidelines and sanctions that may be agreed upon would not be applicable to the developing countries—a reasonable demand taking into consideration the fact that the exchange rate regimes of the developing countries had few international repercussions, and that there were already in place effective arrangements for an audit of their performance by the international financial institutions.

On the role of trade and capital controls as part of the adjustment process, India took the line that restrictions by the developed countries on imports from the developing countries or on capital flows to these countries were indefensible measures. No new burdens should be imposed upon them; if anything, it was the developing countries that needed to use both trade and capital controls to conserve their limited foreign exchange resources for development. To relieve the mounting debt burden and assist orderly adjustment, international acceptance of a bisque[6] clause in all new loan agreements was also mooted.

The SDR link idea found little favour with many of the developed countries, and the proposal to establish a link between SDRs and development assistance did not figure in the discussions at the second meeting of the deputies. At the insistence of the representatives of developing countries, the subject was relegated for discussion to the fourth meeting as, by then, arguments against the link would have ceased to be intellectually respectable. India's apprehension was that, should intellectual defences against the link crumble because of disunity among the developing countries, the SDR may elude the developing world. Solidarity among the developing countries alone would make the SDR link a reality. It was therefore essential that, at the third meeting of the deputies, the developing countries unitedly express their firm support for the SDR link. The world community, too, had to muster the necessary political will, for only then could technically sound and virtuous solutions be found to meet the aspirations of the developing countries. Quoting Bacon, Manmohan Singh appropriately quipped: 'Hope is a very good breakfast but a very poor supper.' Later developments confirmed that the challenge and opportunity offered to the international community was ignored.

As the date for submission of the Outline of the Reform of the International Monetary System was slated for the September 1974 annual meeting in Nairobi, the third, fourth, fifth and sixth meetings of deputies were devoted to thrashing out an agreed version of the outline. To avoid repetition, the narrative here will principally focus on the Indian response to the outline prepared by the Morse Bureau. As a whole, the Indian authorities had no great difficulty with the Bureau's formulation. Their insistence was that the new monetary order had to be so devised as to meet the needs of all members. Viewed from that perspective, socially acceptable growth of the developing countries was as necessary as the need to counter inflation. Likewise, transfer of real resources to developing countries and greater equity in the adjustment process had to figure as specific references in the objectives of a reformed system. Accepting that multi-currency intervention was not undesirable in principle, the Indian representative took the lead to point out that it would entail a larger volume of reserves, especially as it

[6] A bisque clause involves postponement of debt service payments in the face of a deterioration in the balance of payments similar to the one incorporated in the provisions of the Anglo American Loan of 1946.

was envisaged that permissible margins for fluctuations would be wider. On the currencies to be included in the multi-currency intervention package, the authorities of the currencies included would need to consciously accept the obligations attached to the role of an intervention currency. More work on this was indicated before a definitive position could be taken.

On adjustment, the Indian viewpoint was, ideally, one needs to know the outlook for all key aspects of a country's internal economy and balance of payments position before a definitive judgement concerning the accuracy of its prevailing exchange rate can be made. The basic problem, as Manmohan Singh observed, was when a country ought to adjust its exchange rate rather than use demand management policies to achieve equilibrium. Furthermore, no single set of indicators, such as movement in spot rates, changes in reserves or in price indices, could analytically provide adequate guidance for policy purposes, for they could be influenced by speculation, lead and lags or hedging or government intervention in the foreign exchange market. There has, therefore, to be internationally defined criteria for intervention. In view of the great differences in the level of development between the developing countries, India remained sceptical about the efficacy of the use of indicators as a tool for facilitating adjustment. Also, reforms should not involve compelling the developing countries to undertake exchange rate adjustment, and should safeguard their freedom under Article XIV to impose quantitative restrictions.

On sanctions and pressures, India took the line that, in the case of the developing countries, there was no way to go beyond the existing procedures followed by the Fund. On the freedom to impose controls on capital flows, India demanded that the developing countries be completely exempted from any controls adopted by the developed countries.

Floating rates were not advocated as a preferred adjustment, nor were they to be an instrument of first resort; they were supportable only where changes in the exchange rate had long been delayed.

On the settlement of imbalances issue, consolidation of the dollar overhang into SDRs—whether compulsory or voluntary—was not favoured, as Indian technocrats believed that it would have adverse consequences both on the future allocations of SDRs and on interest charges levied on SDR borrowings. Bilateral settlement of the overhang remained the preferred choice of the Indian constituency as the way to reduce the bloated quantum of liquidity.

The outline also touched on the issue of reserve assets, and on making the SDR, rather than gold, the numeraire of the reformed system. India plugged hard in favour of the SDR. It also sought removal of the reconstitution and acceptance obligations and pressed that, progressively, the role of reserve currencies should be reduced.

On the link proposal, India supported the variant of direct allocation of SDRs to development financial institutions (DFIs) but, in the interest of solidarity among the developing countries, was prepared to support a compromise formula. It also pressed for widening and liberalizing the general account facilities.[7] On swap financing arrangements, India maintained that such financing should remain under comprehensive control, in view of its impact on total global liquidity.

When the deputies met at their sixth session to consider the revised outline, to Manmohan Singh's total surprise, the relevant sentence relating to finding effective solutions to the problems of developing countries in the areas of both trade and aid was neutral and watered down to the point of being inconsequential. This provoked him to lash out at the deputies and question whether they were really serious about tackling the problems of the developing countries. If that was so, he added, there must be a commitment to deal with the inter-related aspects of monetary issues in the areas of aid and trade. He suggested appropriate amendments in the wording of the draft under consideration. The delegate from Sri Lanka, Lal Jaywardena, lent strong support to Singh's amendments and said that the developing countries attached great importance to this issue. They saw the need for coordination between the various elements of reform and hoped that the proposed amendments would receive serious consideration. But the developed countries regarded the original text of the Bureau a balanced one and were disinclined to try their hand at a redraft; they left it to the Bureau's chairman to include some part of Singh's suggestions in the final version.

On the aspect of capital controls, Singh was guided by the views expressed by the Technical Group set up in India: that, in elaborating a new code of conduct for capital flows, the international community must recognize that restrictions on aid, including tying aid to procurement in donor countries, were inappropriate methods of adjusting for balance of payments imbalance. On the other hand, due to the great shortages of savings in the developing countries, if necessary, these countries must be allowed to make use of capital controls to conserve their foreign exchange. Pointing to the fact that balance of payments adjustment had become exceedingly difficult in developing countries in the face of massive debt service obligations causing

[7] These were the compensatory financing facility, the buffer stock facility and the enlarged access facility.

reverse flows of capital, Singh urged that provision be made for postponement of debt service obligations for such countries, as had been advocated at UNCTAD II.

Incidentally, to add political muscle to the C-20 negotiations, India had spearheaded a proposal that the G-24 developing countries should meet prior to the C-20 meetings, to coordinate their strategies. So, just before the third meeting of deputies of the C-20 in Paris on 23–25 January 1973, the inter-governmental group of G-24 developing countries met, with Carlos Rafael D'Silva of Venezuela in the chair. The agenda comprised four topics: creation of a technical secretariat, coordination between the G-24 and the G-9 developing countries represented on the C-20, consideration of the agenda for the forthcoming C-20 meeting in Paris, and substantive issues.

On the setting up of a technical secretariat, Manmohan Singh favoured using the nine Executive Directors of the IMF representing developing countries to prepare, with the assistance of the UNCTAD, background papers on topics such as revision of quotas in favour of developing countries, the modus operandi of the SDR and development finance link, improvements in conditional liquidity facilities, inter-relationship between monetary reform, trade and development finance, and the adjustment process from the standpoint of the developing countries. It was further agreed that the G-24 should meet at the deputies' level on the occasion of every meeting of deputies of the C-20, and questions that needed political decisions would be considered by the Ministers of the G-24.

On substantive issues, Singh took the opportunity to push the Group to adopt a resolution reaffirming their strong support for an SDR link. It authorized the chairman to issue a statement to the press restating the aspiration voiced by the G-24 Ministers at the Caracas meeting for a link between the creation of special drawing rights and development finance.

The period between the second and third meetings of the C-20 was an unsettled one for the world economy. In business and political circles, the feeling grew that in an environment of floating exchange rates, the world economy could not be left in automatic drive. Massive dollar outflows in the first two months of 1973 had created serious instabilities in world financial markets, placing the international financial order in a new and threatening light. Calls for progress in the building of an organized system increased and this, it was felt, was of considerable significance for the task of monetary reform. It was recognized that this task had long suffered from a lack of political thrust such as was necessary to over-ride the numerous technical obstacles and conflicting interests that by and large tended to make the task of restructuring immensely difficult.

A word in passing about the events that caused the instability. A significant feature of the early 1973 disturbances in the international financial markets was that they occurred in the very largest economies, which graphically brought to light that large economies were not immune from external shocks under the cover of floating rates. The second devaluation of the dollar by 10 per cent in mid-February 1973 triggered the turmoil. The devaluation, however, failed to halt dollar outflow, and the first and second weeks of March 1973 witnessed massive outflow of dollars, forcing Europe and Tokyo to close their exchanges. The declaration by the US President that there would be no further devaluation of the dollar implied that such devaluation as was inevitable in the near future would have to take the form of an appreciation of European currencies and the yen against the dollar. At an EEC ministerial meeting, it was decided by fourteen EEC countries that there would be a joint float of seven currencies against the US dollar. The alternative to the float was comprehensive European control over capital imports but this, it was realized, was useless unless it was savagely restrictive.

Apart from a general interest in a global system that had clear-cut obligations, the developing countries also had a special interest in a reformed monetary order. The uncertainty and political instability of a regime of zigzag floating rates posed real difficulties for countries whose currencies were pegged to a reserve centre, and which clearly complicated the basis on which these countries were to maintain their own exchange rates. This was an important problem for a number of sterling area and francophone countries, as it complicated their relationship with neighbouring countries, many of whose currencies were linked to different financial centres. As a result of the developments of the early 1970s, many of these countries found themselves in the backwash of the fluctuations of the dollar, the pound sterling and the French franc. In the absence of a stable international monetary asset with an assured and attractive valuation, reserve accumulations by Central Banks became inherently speculative. They were, therefore, keenly interested in the establishment of a reserve unit such as the SDR.

As a result of the setting up of the C-20 forum for reform negotiations, the developing countries believed that they had secured an influential position in the future design of the monetary system. As full partners in the bargaining process, they believed such a universal approach would help to safeguard their interest and position. But they were sadly disillusioned when the G-14 bypassed the C-20 and the common float decision of seven European currencies was made known to the rest of the world through the Paris communique of the G-14, with no reference to the desirability of an early return to a system of stable values. What was more, there was no adequate information on the duration and range of the float or on how the floats would be managed.

On learning of the joint float, the Chief Economic Adviser, Manmohan Singh, called upon the Reserve Bank to assess its possible impact on the Indian currency. In the absence of adequate information, the then director of the division of international finance, V.B. Kadam, had to examine the problem in a general way. He indicated that there would be a significant diminution in the purchasing power of Indian foreign exchange reserves following the depreciation of both the dollar and the sterling vis-à-vis other important developed currencies, and that this would be accentuated if there were massive speculative outflows of short-term capital, pushing down the value of these currencies further. This, in turn, could push down the value of India's reserves to unacceptable levels. There was, in the reading of the Bank, need to control the range of the floats through restrictions on speculative movements of short-term capital. Those who were opposed to capital controls on philosophical grounds had to appreciate that the attempts to stabilize exchange rates since early 1971 without comprehensive controls had failed. The uncertainties of exchange rates under the floats could have adverse effects on developing countries' exports and, through that, on their planning of imports and economic development. Depending on how the floats were managed, they could vitiate the climate against creation of liquidity, development assistance flows and management of international liquidity, with inevitable consequences on the distribution of the burden of adjustment. Speeding up the work of the C-20 was therefore imperative.

A meeting of the G-24 developing countries was convened in Washington, prior to the meeting of the C-20, at the end of which, the Ministers, in a strongly worded communique, stated that the manner in which the 16 March decision was taken by a limited number of countries, outside the framework of the IMF, represented a departure from the spirit behind the creation of the C-20, and was a setback to the process of international consultation. It warned that the developing countries would not support a decision-making process in which they had no participation. Expressing concern at the arrangements that would disrupt collective management of the international monetary system and the difficulties these would create for the developing countries, the G-24 reaffirmed its strong faith in a system of stable rates based on adjustable par values, collective management of international liquidity by strengthening the role of the SDR and the creation of a link between SDRs and development finance. At the suggestion of the Indian delegation, the Group set up a working party to work out a common position on the link for presentation to the C-20.

The original agenda of the fourth meeting of deputies was to discuss the special interests of developing countries in international monetary reform but, in the context of the events of 12 March 1973, it was decided to put the original agenda on the back-burner and devote time, instead, to an exchange of views on the decision taken at Paris by the fourteen developed countries. It was reported that six of the EEC members had agreed to stabilize their exchange rates within a margin of 2.25 per cent, and for two members who had two-tier exchange rate systems, the agreement would apply only to the official rate. Although the UK, Ireland and Italy would continue to float individually, they indicated that in the long run they would associate themselves with the group arrangement. It was further stated that Central Banks had been freed from the obligation of intervening in support of the US dollar. Stability of exchange rates within the Group would be secured through multi-currency intervention. Despite the fact that the structure of interest rates in Germany was not attractive, it was pointed out that the German mark was singled out as the main currency of refuge; however, the source of speculative inflows was not attributable to the Euro-dollar market *in toto* but more to leads and lags in exports and imports, hedging operations and shifts in working balances out of dollars by corporations with foreign subsidiaries in European countries, and transfers by monetary authorities of reserve holdings coupled with a speculative thrust. On the issue of how long would the float last, the view held out by the German Chancellor was, as long as the dangerous combination of a big US payments deficit and a huge volume of liquid dollar funds existed. Floating rates were seen as a necessary defensive mechanism to safeguard orderly conditions in the market. On control of liquid dollar funds, the European view was that consolidation of the dollar overhang was not likely to affect those dollar balances that were a potential source of disturbance. The general viewpoint of the major developed powers was that the new exchange rate arrangements were the beginning of a new era of monetary reform, and whether these were makeshift arrangements to tide over a critical period, time alone would tell.

The sentiments expressed by the developing countries at this meeting were generally along the lines of the G-24 communique. From the diverse views expressed, one thing was clear: the degree of emphasis to be placed on flexibility as opposed to stability was not yet a settled issue.

The deputies' meeting was followed by the meeting of the Ministers of C-20 on 26 March 1973. At this meeting, the Finance Minister of India stressed that there was general agreement that the exchange rate mechanism would continue to be based on par values but would be more flexible than the Bretton Woods system in its operations. Similarly, management of liquidity would be in accordance with the needs of an expanding global economy and the SDR would, in time, become the principal reserve asset and numeraire of the reformed system. While sharing the desire to improve the working of the adjustment process, Chavan indicated that he could not agree to any approach that involved the exercise of coercion. He reiterated that adjustment must take into account the special needs and problems of the developing countries. Stating that everything should be done to maintain confidence in the SDR, he underscored the need to make a distinction between problems arising in the realm of SDR creation and problems arising from liquidity generated through other sources. On the role of reserve currencies and gold, he was categorical that both should be phased out. He warned that, in the absence of an internationally agreed code of conduct, there was a real danger that the race towards competitive depreciation and trade restrictions could gather added momentum. Prolonged uncertainty about the direction of reform was liable to encourage ad hoc responses without regard to the international repercussions of such action. The Indian Finance Minister's intervention was not in vain; the G-20 Ministers' communique that followed reflected many of the concerns expressed by him and other representatives of the developing countries.

The fifth meeting of the deputies of the C-20 started with consideration of the special interests of developing countries. Seeing that the prospects for full reform of the international monetary system were receding, the developing country representatives repeated that they wanted an early agreement on an improved international trading system, and also a strengthened system for transferring real resources from developed to developing countries. The discussion was of an exploratory nature. Based on the Morse Bureau's agenda, the special interests of developing countries were considered under four heads: (i) a possible link between SDR and provision of development finance; (ii) developing countries' access to capital markets and international credit; (iii) IMF quota structure; and (iv) related trade issues.

With a view to facilitate the adoption of a link as part of the reformed system, the Indian constituency was active in fostering a common position. At the G-24 meeting in March 1973, it had set up a working group headed by P.S.N. Prasad for the purpose. The Indian preference was for a part of the newly created SDRs to be allocated to development financial institutions, who would provide resources for investment in the developing countries. This variant of the link, the Indian representative felt, would be acceptable to the IMF's non-developing country members, because the resources thus transferred could be expected to be used in a reasonably efficient manner. Also, the pressure for raising interest charges could be better resisted if the SDRs were made available, and SDR allocations through development financial institutions would ensure a reasonable and uninterrupted flow of SDR for development finance. The disappointing aspect of the debate was that wholehearted support from the other developing countries was not forthcoming. The Latin American and African groups favoured the direct variant of the link, whereas the others gave muted support to the Indian proposal. To maintain developing countries' solidarity, the Indian constituency fell in line with the position advocating a direct link.

Taking advantage of the lack of unanimity in their ranks, the developed countries opposed the link proposal citing its potential inflationary pressure and negative effect on the confidence of the dollar, and they went so far as to even declare that it was not in the developing countries' own interests. On hearing this, in an effective, well-reasoned intervention that was universally appreciated for both its content and form, Manmohan Singh, the leader of the Indian constituency, sought to demolish the arguments marshalled against the link. He said that the argument that the link would weaken confidence in the SDR was entirely misconceived. After all, SDRs were held only by national authorities and were backed by international obligations created by a mutual contract executed by national authorities; he asserted that there could therefore be no question about weakening the confidence in SDRs as a result of their link with development finance. Furthermore, the link was unlikely to result in any pressure on SDR creation in excess of liquidity needs. In any event, given the voting strength in the Fund, he said the developed countries would always be in a position to negate with ease any such pressure, and queried why the transfer of resources remained at all times the residual element in the national expenditures of developed countries. In his view, acceptance of the link was a question of political will and he called for its unreserved acceptance.

Outside formal meetings, in private conversations, Singh clinched the argument about fears of an adverse impact of the link on confidence in the SDR by citing the triple A rating enjoyed by IBRD bonds, the proceeds of which were used for providing resources to the developing countries.

Following the arguments advanced in favour of and against the link, it was agreed to set up technical groups to analyse the technical aspects of the proposal.

On access to capital markets, the developing countries' demand was that no controls should be imposed on Euro-currency markets and on developing countries' access to them. There was general agreement on this, but with a proviso that such exemption should not cover controls on placement of official reserves in foreign currencies.

The developing countries also desired significant liberalization of both the quantum of financing and the duration for which it was made available for such IMF credit facilities as the CFF and buffer stock financing. As regards the IMF quota structure, while conceding that the present quota structure was not appropriate, they were not in favour of wholesale revision. There was lukewarm support for the view that it was not logical to have a single quota structure to serve various purposes and that the possibilities should be explored of devising different quota structures for different purposes such as voting in the Fund and SDR allocations. Pleas were also made for the opening up of developed countries' markets for secondary exports of the developing countries.

The deputies thereafter broke up into six technical groups to continue advanced consideration of such topics as adjustment, intervention and settlement, global liquidity and consolidation, development of the SDR numeraire and gold. The Indian constituency was represented at various group discussions.[8] But the interconnection of controversial issues inhibited progress and the hope of presenting an agreed Outline on Reform at the 27 September 1973 in Nairobi appeared to be fast receding.

When the deputies of the C-20 assembled for their eighth meeting, it was evident that the C-20 was floundering and unable to produce an agreed version of the report; it seemed to have reached the nadir of its existence. To salvage whatever work had been done and not court dismal failure, The Morse Bureau decided to set up four technical groups—one on adjustment to study the indicator structure; the second one on intervention and settlement with the possibility of linking settlement with a multi-currency intervention system; a third one on global liquidity and consolidation; and the last one on transfer of real resources.

Here we will outline some of the diverse viewpoints to show where the debate was headed. At the July 1973 meeting, the debate on adjustment turned out to be a straight repetition of the earlier one. There was no change in the old position of the US that international consultations, adjustment

[8] Group A: P.S.N. Prasad and V.B. Kadam.
Group B: Lal Jaywardena and W.M. Tilakratna.
Group C: Manmohan Singh and V.B. Kadam.
Group D: P.S.N. Prasad and W.M. Tilakratna.
Group E: Lal Jaywardena and Prasad.
Group E: Manmohan Singh and V. B. Kadam.

action and graduated pressures should be calibrated to movements in official reserves. Nor was there any change in the European opposition to the reserve indicator system and preference for a presumptive assessment procedure. France held the view that action would be triggered in too simplified and a mechanical manner if one relied only on reserve movements; a more holistic approach would give a better picture. Italy argued that under the assessment procedure, the market would not be certain about what currencies were considered to be in imbalance and this would give less room for speculation, whereas the reserve indicator procedure would facilitate speculation.

On the issue of pressures, the US remained wedded to a more or less automatic system of pressures, whereas Japan was prepared to accept pressures as a measure of last resort and wanted that they apply not only to inaction, but also to action and inappropriate action. Many of the countries felt that individual pressures in the revised Outline were unuseful, undesirable or unenforceable. India, Malaysia and Latin America had strong reservations about publication of the Fund report but the US stated that it was essential. Surplus countries regarded graduated charges and lending to international organizations at low cost, unenforceable.

On the asset settlement issue, whether mandatory or voluntary, Dr Emminger, who was invited to report on the OECD discussions, pointed out that multi-currency intervention was not merely a technical question but had implications for relative initiatives for changing exchange rates, for the asset settlement system and for the symmetry of adjustment. If a multi-currency intervention system was to be adopted, a number of knotty questions had to be resolved, such as symmetry of adjustment, rules for holding currencies and how the actions of central participants would be coordinated. It was apparent from the exchange of views that there was little common ground on which to build a multi-currency intervention system. The major elements of a settlement procedure that needed to be considered were: how effectively the currency balances could be controlled and whether the system had adequate elasticity to meet contingencies. Compromise on these issues was not even remotely possible.

On the topic of primary reserve assets, there was not enough discussion on the SDR as the numeraire while the position on gold remained largely unchanged. Nor was there any consensus in regard to new procedures for decision-making on SDR allocation and cancellation. Likewise, agreement on consolidation and reserve management was not forthcoming, except for general support for consolidation through a Fund substitution facility on a voluntary basis.

The fourth technical group on transfer of real resources to developing countries fared no better. There was great reluctance on the part of the deputies of the developed countries to discuss the link and credit facilities in favour of developing countries, with the result that both the principle and form of the link remained unsettled issues.

The deputies agreed that they had reached an impasse and needed ministerial direction for work on the reform to move forward. No matter how hard Morse, the chairman of the Bureau, tried to put in place even a few elements of the new economic order, lack of political will marked the Committee of Governors of the C-20. By the end of 1973, it was clear that the hopes entertained at the annual Fund–Bank meeting at Nairobi in September of an early agreement on overall reform of the international monetary system would not be fulfilled. At its meeting in Rome in January 1974, therefore, the Committee of Governors of the C-20 decided to take up issues of more immediate significance, leaving full reform of the system to be evolved over a period of time. The steep rise in petroleum prices that became effective in 1974 led to radical changes in the structure of international balance of payments. Developments such as these provided a strong stimulus to deal with immediate problems, as well as a justification to defer agreement on the overhaul of the monetary system as a whole.

A word in passing about the contribution of the C-20 to the reform exercise. Although the Committee failed to reform the international monetary system, it was a colossal effort on the part of financial officials to study in depth the various techniques and options, and to prepare the ground on which to build the monetary edifice. It entailed intensive work on the part of the officials, of drafting and redrafting to accommodate divergent viewpoints. For the developing countries, it afforded an opportunity to air their views and grievances, as well as to be exposed to the thinking of the developed world and to realize that hard bargaining was needed to protect each country's own economic turf. It was not an exercise in vain but events overtook the reform. As pointed out by the new Managing Director in his address to the Board of Governors, 'The problems and uncertainties that' then 'confronted the world economy called for international cooperation of a rare quality', which, unfortunately, was missing.

HOLDING OPERATION AND THE IMF's RESPONSES

Conceding that a satisfactory solution to many of the basic ills plaguing the international monetary system since the collapse of the Bretton Woods arrangement in the latter part of 1971 was not in sight, the Committee of

Twenty, at it sixth and final meeting in 1974, accepted departures from fixed parities and only stressed observance of agreed guidelines for the management of floating exchange rates during the transitional period before arriving at a reformed system. At the same time, the new Managing Director of the Fund, Witteveen, explored ways of instituting special consultations on exchange rate policy with the major industrial members whose external policies had important repercussions on international currency relations. Another, more formal response to the evolving system in November 1973 was to revise the central rate decision. It will be recalled that the concept of central rates was introduced in December 1971 because many members were unable to establish effective par values but were eager to maintain exchange rates within specified margins. But, following widespread floating, the declared central rates for many members had become ineffective. Under the revised central rate decision, a member was permitted to establish a new central rate with or without wider margins, if it maintained a stable rate in terms of its own intervention currency or currencies. This hybrid type of exchange rate arrangement, for want of anything better, received approval from the Executive Board in November 1973.

Other measures initiated through the programme of immediate action adopted by the C-20 included: (i) the establishment of a facility in the Fund to assist members to meet the initial impact of increases in oil import costs; and (ii) a voluntary pledge by countries not to introduce or intensify trade or other current account measures for balance of payments purposes. These were essentially directed towards meeting the grave problems then faced by the world economy. The C-20 also proposed the setting up of a Council within the structure of the Fund, with powers delegated to it by the Board of Governors, for supervising the management of the monetary system, overseeing the operation of the adjustment process and dealing with sudden disturbances that might threaten proper functioning of the system. Thus the Committee of Twenty proved its usefulness as a forum for policy-making and acted as a forerunner to other committees of the Board of Governors—the Interim Committee, the Development Committee and the Council—which, in later years, became the policy-making machinery of the Fund. In retrospect, the new institutional set-up that was conceived in 1973 assisted in bringing the Fund Board and Management to the centre of the stage and back to the mainstream of policy-making.

As for the experience with floating rates, some of the drawbacks of such a regime were already discernible. Until then, floating had hardly led to exchange rates that were reasonably stable and that could be considered as 'appropriate' in the overall economic context. Speculative capital movements and the ravages of inflation had subjected foreign exchange markets to frequent periods of turbulence and wide fluctuations in rates. During the first two months of the float in 1973, the average dollar value of ten major world currencies was some 20 per cent above the exchange parities that had prevailed in the spring of 1971. But after mid-May 1973, the dollar declined sharply with fluctuations becoming more pronounced from day to day, and, in July 1973, the dollar value of the ten major world currencies was 33 per cent higher than in the spring of 1973. However, by the end of January 1974, the average dollar value of the same ten currencies was only 11 per cent above its 1971 spring level—a drop of 22 per cent from July 1973. Fluctuations of this magnitude were regarded by many as intolerable.

In the first half of 1973, it appeared that the downward drift of the US dollar would abate with the measures taken by the major surplus countries against inflows of capital from abroad. But in the context of inflationary tendencies the world over and lack of confidence in the viability of the current monetary arrangements, liquid funds increasingly sought a haven in important world traded commodities, reinforcing the price rise particularly of industrial raw materials. Thus floating, on the one hand, did not insulate the strong countries from imported inflation; on the other hand, it promoted a rise in international prices by inducing suppliers to add larger premium as cover for exchange risks. With the wage levels in the surplus countries also moving upward, a measure of cost inflation was superimposed on the adverse terms of trade faced by countries with relatively weak currencies. Nor did floating rates free countries with external deficits from the necessity of monetary fiscal policy to support their exchange rates, as the UK and Italy discovered.

The above developments clearly portrayed the difficulties in arriving at an agreed reform of the international monetary system, despite the adoption of a deadline for achieving an agreement and a work programme to meet the deadline. Even though the US Treasury Secretary was a party to the decision of the C-20 to set a deadline for agreement on reform, at the 1974 Fund–Bank annual meeting, he made it known that the reform agreement could not be finalized until the US had run a payments surplus, for full restoration of confidence required it to encourage the dollar reflow to the US.

Another factor that delayed the consensus on reform related to a wide gap between the US, on the one hand, and Europe and Japan, on the other, over convertibility, and the differences between them on the future role of gold. The Common Market countries had already committed to using gold in their scheme of the European Union. What was more, at Nairobi, the West Germans had added their voice in favour of a back-door revaluation of gold through Central Banks by permitting them to freely deal in gold, uninhibited by the then official price. Here, the perceptive remarks of Ossola, Deputy Governor of the Italian Central Bank, on an agreed reform system are worth recalling. He warned that negotiations on reform 'could drag on for a much longer period of time than was then being forecast'. His gut feeling was that if the current floating arrangement proved reasonably stable, there would be no support at all for a return to fixed rates, and that the ultimate agreement might be in favour of a polycentric world monetary system, with groups of trading partners creating ad hoc currency areas, and with regional monetary funds eventually taking over the surveillance of respective areas, leaving the IMF the more distant task of arbitrating between them. This, obviously, was not an encouraging scenario for the developing countries who had high expectations of the reformed system.

The only silver lining that was discernible at the Nairobi meeting was the announcement by the World Bank President of the agreement between donor governments to recommend to their legislatures a three-year IDA replenishment arrangement at the rate of US$1.5 billion a year.

The Committee of Twenty had recommended amendments in specific areas to the Fund's Articles of Agreement, on which discussions were continued by the Interim Committee and the Executive Board of the Fund. While substantial agreement emerged in respect of amendments regarding improvement in the Fund's general accounts and the characteristics of the SDR, the exercise of amending the Articles got bogged down because of differing views on vital issues such as arrangements relating to gold and to exchange rates.

The proposed improvements in the general accounts related to: liberalization in the use of Fund resources, more flexibility in repurchase obligations, use of SDRs in discharging obligations payable in gold, and more flexibility in investments. The Indian representatives welcomed all these proposals with an important exception: that where SDRs were permitted to substitute gold in the discharge of obligations, the member's own currency but not other members' currencies could also be used. In their view, any suggestion that conferred a reserve role for just one or two currencies should not be encouraged.

Suggested improvements in special drawing rights included, among others, voluntary transactions between participants and greater freedom for transactions without designation.

On the question of gold, there was general agreement that the SDR should ultimately replace gold as the centrepiece of the international monetary system. There was also general agreement on abolishing the official price of gold, and on abrogating the obligatory payments in gold between member countries and the Fund. In principle, there was also support for the use of profits from the sale of a part of the Fund's gold holdings for the benefit of the developing countries, but there was no agreement on the specific arrangements that would have to be evolved in this respect. As a result, the situation of the gold market in mid-1975 continued to be by and large uncertain. The emerging strength of the US dollar on the exchanges and the realization after US Treasury sales that the demand for US private gold holdings was modest, discouraged any upswing of the market price of gold. But this was strongly underpinned by the agreement between the French and US Presidents on 20 December 1974, to permit the Central Banks and monetary authorities to revalue their gold holdings at market-related prices, and by the South African decision not to sell on the markets its current output or any of its official holdings so long as improvement in its balance of payments persisted.

A word about India's attitude towards different aspects of the gold question. The brief prepared by the Reserve Bank for the Interim Committee meeting in Paris on 11 and 12 June 1975, clearly argued in favour of gold sinking to the bottom of the reserve pile and the SDR replacing gold as an international reserve and payment instrument. The RBI's advice was to continue to oppose moves to mobilize gold and raise the effective price of monetary gold over the official price. Its suggested strategy was not to discourage monetary demand *for gold thoroughly*. In that case, profits from sales of Fund gold were unlikely to be material. For this reason, a trust fund supported by such profits would be of little benefit to the developing countries and the proposal to set up such a trust fund should not be supported. Likewise, support for a gold substitution account should also be withheld, the reasoning being that such an account would strongly favour large official holders of gold in mobilizing their holdings at prices higher than the market prices plausible in the context of erosion of monetary demand for gold, and give a decent investment return on the holdings mobilized at such higher price levels; those not holding large stocks of gold would indirectly contribute to such a higher investment return. A further consequence could be receding possibilities of fresh SDR allocations.

On floating and exchange rates, the thrust of the draft amendment was to legalize floating. Although no consensus could be reached at the Paris meeting, there was general agreement that members should cooperate with the Fund and with each other to promote exchange stability. The members were generally against legalization of independent floating, except in exceptional circumstances. The preference appeared to be for a return to a system of par values with provisions for establishment of central rates. In practice, the world's major currencies continued to float, and exchange rates continued to move both ways by fairly wide margins.

At the Paris meeting, modifications in the Fund's facilities for compensatory financing of export fluctuations and for assistance to members' contributions in respect of international buffer stock operations were recommended. These topics were already under active consideration in the Executive Board and there was general agreement that assistance drawn under the buffer stock facility should not impair the member's credit position in the Fund.

Under the sixth general review of quotas, it was agreed that the overall size of quotas would be increased by 32.5 per cent, allowing a doubling of the share of oil exporting developing countries as a group without a change in the present collective share of other developing countries.[9]

On the other hand, the Joint Ministerial Committee of the Board of Governors of the World Bank and IMF on the transfer of real resources to developing countries (Development Committee), at its meeting in June 1975, expressed concern over the pressing problems of developing countries arising from adverse terms of trade, and took the first concrete step to mitigate their problems by lending unanimous support to the establishment for one year of an intermediate financing facility in the IBRD, to be known as the third window, to provide long-term loans to developing countries on terms between those of the IDA and the World Bank. The World Bank was urged to establish this facility effective from 1 July 1975, to lend $1 billion to the developing countries. This assistance was to be provided at a subsidized rate of 4.5 per cent to countries with per capita annual incomes of under $375. Funding for these loans was to be raised from the international capital markets and the funds to be lent at a subsidized rate by creating an interest subsidy fund. Some of the major oil producers and a few industrial countries agreed to contribute $120 million for setting up of the $100 million interest subsidy fund.

Between the Paris Meeting of the Interim Committee in June 1975 and its next meeting at Kingston in Jamaica on 7–8 January 1976, intense preparatory work was undertaken by the Fund staff and the governments of industrialized countries to iron out differences. In an effort to get maximum support, towards mid-December 1975, the Managing Director

[9] For a detailed discussion of quota revisions please see the chapter on quotas.

of IMF circulated some new proposals,[10] covering both the use of the Fund's resources and the trust fund. On use of the Fund's resources, his proposals were extremely disappointing. He himself had earlier proposed that the first credit tranche would be doubled and this had found considerable support among half or even more than half the members of the Executive Board. However, for his fresh proposals, he had apparently paid much more attention to the views of certain industrial countries and had gone back to proposals that were distinctly niggardly. The upshot was, all the G-9 developing country Directors, without exception, opposed the new proposals and requested reconsideration of the earlier proposals as a minimum.

From the paper on the trust fund, it was apparent that the sale of the Fund's gold may not fetch more than SDR 1.5 billion, and that the sale would be spread over three to five years. At best, the Fund could disburse no more than, say, SDR 300 to SDR 500 million per year for five years or three years. The smallness of the amount made the proposal unattractive for some of the larger developing countries, such as India. To overcome the legal obstacles raised by the IMF, that direct gold sales by it would be a violation of Fund rules, Denis Healey, Chancellor of the Exchequer of UK, following the G-10 meeting of Finance Ministers convened to resolve some of the intractable issues coming up before the Interim Committee at Jamaica, in a press briefing stated: 'The Bank for International Settlements was prepared to purchase part of the IMF gold offered under the gold reform package and auction this to central banks, if they were interested.' The way was now open for the sale of gold by the special trust fund, provided this was accepted at the Jamaica meeting of the IMF Interim Committee. The G-10 Ministers, after intense discussion and some compromises, endorsed the drafts relating to exchange rate arrangements, surveillance over exchange rate policies, gold, transfer of resources to developing countries—the major issues that would have to be tackled at the Jamaica meeting.

The fifth meeting of the Interim Committee was scheduled for 7–8 January 1976 at Kingston, Jamaica. In preparation for this meeting, Reserve Bank of India and Finance Ministry officials had worked feverishly hard to prepare a comprehensive brief for the Indian delegation giving the state of play on the various issues, detailed comments on the suggested proposals and the line of reasoning to be adopted. As it turned out, the meeting at Kingston endorsed the new quotas and adopted the formulation of amendments to the Funds' Articles. It was a historic meeting in the sense that it

[10] 1. Buff 75/137; 2. Buff 75/134.

brought down the curtain on an exercise upon which the international community had embarked at the beginning of October 1971—to reform the international monetary system after the suspension by the US, in August 1971, of the official gold convertibility of the US dollar.

The Jamaica decisions brought about radical changes in the working of the international monetary system and went far beyond the recommendations of the C-20. The latter had visualized a reform based on stable but adjustable par values, an adjustment mechanism ensuring prompt adjustment action with the adjustment burden equitably borne by countries in payments imbalances, an SDR-centred system with a diminishing role for gold and reserve currencies, and adequate real transfer of resources to developing countries.

The agreement reached at Jamaica abandoned a system of stable but adjustable par values and permanently enshrined the right of members to have exchange arrangements of their choice, by legitimizing independently as well as collectively floating exchange rates, and by drawing up stipulations for future introduction of widespread exchange arrangements based on stable but adjustable par values. The Indian authorities were not entirely happy with the solutions agreed upon. In their view, the reserves discipline which, under fixed exchange rates, undoubtedly applied with rigour on countries with payments deficits, was not necessarily entirely without effect also on countries with sizeable payments surpluses and averse to domestic inflation. Despite the floating members' undertaking to follow exchange rate, economic and financial policies contributing to adjustment, and the Fund's surveillance of compliance with such an undertaking, the question was: would the undertaking adequately substitute for reserves discipline? The fear was that, in practice, compliance with the undertaking would be secured with greater vigour from small and poor economies and from economies in deficit seeking Fund assistance. The Indian assessment was, under the new arrangements, there would be no improvement but there could well be further deterioration in the distribution of the adjustment burden among economies in payments imbalances.

The right of members to float collectively as well as maintain exchange values independently or cooperatively with other members, of their currencies in terms of the currencies of other members, in the reading of the Indian authorities, would promote the reserve role of some currencies instead of reducing it. Experience had shown that the reserve role of the country issuing the currency was to avoid adjustment action and that it would do so even under new undertakings relating to exchange arrangements. It would also detract from the objectives of international control of international liquidity—of making the SDR the principal reserve asset of the system.

The Jamaica meeting took some far-reaching decisions on gold. The official price of gold was abolished. The provisions in the then existing Articles on members' obligation regarding gold purchased at par values—the expression of the par values of members' currencies in terms of gold as a common denominator or in terms of the US dollar of weight and fineness as on 1 July 1944; the valuation of the SDR in terms of gold; and the requirement that members sell their currency to the Fund to replenish the Fund's holding of currencies—were all, at one stroke, deleted. From then on, the Fund, in all its transactions with members, was to be guided by the objective of avoiding the establishment of a fixed price for gold or the management of the gold market by the Fund. Also, gold sales to members were to be at prices agreed upon for each transaction on the basis of prices ruling in the market. By an 85 per cent majority, the Fund would be authorized to accept payments from members in gold instead of SDRs or currencies in any operation or transaction with members, but only on the stipulation of such payments being at prices agreed for each transaction on the basis of prices prevailing in the market.

Another major problem of interest to the developing countries related to the trust fund. It will be recalled that a consensus was reached by the Interim Committee on 31 August 1975, regarding the immediate disposal of 50 million ounces of the Fund's gold. At Jamaica, the Committee agreed to restitute 25 million ounces of the Fund's gold to members, in proportion to their quotas on that date and at the then official ruling price of SDR 35.00 per fine ounce, and to sell the balance 25 million ounces at market-related prices. The share of developing members in the profits from the gold sales would be given to them directly in proportion to their quotas. The remainder of the profits would go towards providing resources for the trust fund (which resources would be augmented by voluntary national contributions), for use as concessionary balance of payments assistance to low income members. In the assessment of the Indian authorities, the scheme as summarized above fell far short of the promises and anticipation aroused in September 1975, when the offer of a trust fund to the less developed countries was in effect traded by the affluent G-10 countries, so as to enable them to increase the freedom of their own operations and the availability and liquidity of their own resources, without resorting to any further creation of SDRs.

It was also agreed to authorize the Fund, by an 85 per cent majority of the total voting power, to restitute at the then official price to those who were members on 31 August 1975 in proportion to their quotas on that date, or to sell part of the gold left after the disposal of 50 million ounces. Profits from such future sales were to be transferred to a special disbursement account, resources from which could be used, with a 70 per cent majority of the total voting power, to augment the general resources of the Fund for immediate use in its ordinary operations and transactions, and by an 85 per cent majority of the total voting power, to make balance of payments assistance available on special terms to developing members in difficult circumstances.

Further, it was agreed to delete the requirement in the Fund's Articles relating to payment in gold of 25 per cent of the increase in a member's quota, whenever quotas were changed. From then on that portion became payable in SDRs, in currencies of other members or in a member's own currency. Charges, too, earlier payable in gold or convertible currencies, became payable in SDRs or currencies acceptable to the Fund. The maintenance value of the Fund's holdings in members' currencies in terms of gold was also changed.

Apart from the substitution of gold by SDR in several provisions of the Articles, an important change agreed upon related to rules for reconstitution of the SDR, which were modified. It was also agreed that the method of valuation of the SDR would be determined by a 70 per cent majority of the total voting power, but an 85 per cent majority was needed for a change in the principle of the valuation.

The arrangements made for gold in the mid-1970s was at best be seen as a pragmatic compromise, for the solution agreed upon had something for everybody. They failed to please the developing country members who, at the January 1976 meeting of the G-24, expressed 'strong dissatisfaction' with the arrangements. India's disappointment with the arrangements was on several counts: they neither made the system SDR-centred nor promoted international control of international liquidity. Use of gold in transactions with the Fund was not eliminated, as, with an 85 per cent majority of the total voting power, the Fund could accept payments from members in gold instead of SDRs and currencies. Also, given the highly inequitable distribution of monetary gold holdings, additions to effective international liquidity ensuing from gold decisions would be distributed among members of the international community with extreme unevenness and inequity, particularly in the context of postponement of possible SDR allocations. According to the Reserve Bank's estimate, international liquidity of industrial countries could rise by up to about SDR 60 billion and that of less developed countries by about only a tenth of that amount, as a result of the valuation of official gold holdings at market-related prices for gold. The agreements relating to gold, the exchange arrangements and the SDR valuation, in fact, had made the international monetary system even more US dollar-centred than the gold-based dollar-centred Bretton Woods system. The passage of time had proved that the lure of gold had never really ended, with demands for resurrection of its role in the monetary system persisting till as late as 1983. In 1983, Robert Mundell, in a paper entitled 'Floating Rates Lead to Monetary Chaos', against the backdrop of the global recession, was again advocating stabilization of the price of gold as the principal way to stabilize exchange rates and contain inflation.

The objective of promoting a real transfer of resources to the developing countries through the reform of the international monetary system was also not furthered by the gold arrangements, adjustment action and SDR agreements and by the absence of the link between SDR creation and development finance. Indeed, inasmuch as the arrangements were put back further in time, possible future allocations as assessed by the Indian authorities were hindered by the Jamaica decisions. Later developments have adequately proved that the Indian assessment was correct. The idea of a linked SDR was never allowed to germinate or grow.

The developing countries had also expected an enhancement of their share in decision-making in the Fund. The revised quotas endorsed at Jamaica involved only a marginal improvement in this share. The entire improvement, in itself modest, went to a sub-group of the oil-rich members. The share of non-oil developing countries as a group remained unchanged, while the quantum of their access to Fund assistance increased very modestly through quota increases, liberalization of compensatory finance and availability of resources out of profits from the sale of the Fund's gold for balance of payments assistance on concessionary terms. But this had to be set off against the disappearance of the oil facility, under which drawings by the developing countries had amounted to SDR 1.1 billion in 1974 and SDR 0.8 billion in 1975. Also, this improvement needed to be viewed in the context of developed countries' quotas and their access to Fund assistance, which had risen by much larger amounts—the developed countries were not precluded from availing of the liberalized compensatory facility, as also from the benefit of temporary enhancement in each tranche from 25 per cent of the quota to 36.25 per cent, and the freedom of official monetary authorities to enter into gold transactions at market prices. All these factors taken together raised the developed countries' owned liquidity vastly—an evaluation that could not legitimately be disputed.

Following the Jamaica accord, the IMF Board was preoccupied with implementing the arrangements for gold, including evolving guidelines and arrangements for holding gold auctions, establishing a trust fund and determining its features, and finishing the unfinished task of the second amendment of the Articles of Agreement.

Early in February 1976, the Fund management put out the revised proposals on gold. There were no surprises; in fact, there were one or two favourable features from the viewpoint of the developing countries. For instance, the proposals did not contain a provision that any part of the trust fund's resources should be set apart, either for compensatory financing of shortfalls in exports or for subsidizing such shortfalls. The proposal that the Germans put forward and which the Americans supported was criticized by all the G-9 members from the developing countries, who pressed for its deletion.

As decided at the Interim Committee, eligible members would be those with a per capita income of up to SDR 300 and this criterion would be reviewed annually. The annual review was to give an opportunity for reconsideration because of an improvement in per capita income and because of inflation. The rate of interest proposed was 1 per cent, but a higher rate was a distinct possibility. The duration of the loan would be ten years, with a grace period of five years. Any attempt to harden these terms, the Indian brief indicated, had to be resisted. It had earlier been decided that the trust fund resources would carry a conditionality that was equivalent to a first credit tranche drawing; later, however, it was suggested that the conditionality should be increased with each successive drawing. This suggestion was vigorously opposed by the Indian Executive Director and, with the support of a few developed and developing countries, the management was forced to drop it. The most objectionable part of the earlier proposal by the Managing Director was that trust fund disbursement would be linked to a member's use of Fund resources under the ordinary credit tranches. Because of the solidarity displayed by the developing countries, this proposal was not repeated in the revised proposals. The most welcome feature of the proposals was that in assessing need, account would be taken of the repurchases made or due to be made by a member.

On the option to receive a share of the profits from the sale of the Fund's gold, either in the form of gold at the official price or in the form of currencies realized through the sale, the Reserve Bank indicated its clear preference for receiving the share in the form of gold. In the RBI's reading, nonmonetary demand for gold, in all probability, would comfortably absorb the existing South African production and the 200 tonnes or so predicted in the case of the Soviet Union. In the absence of significant net sales out of monetary stocks, the medium-term outlook for market prices of gold would hold fairly close to the ruling level. Based on this reasoning, the Reserve Bank advised the Indian Executive Director Jagannathan to support the proposed restitution of gold.

However, the Bank had reservations on the proposal that gold should be restituted to the developing countries with the obligation to provide in exchange freely usable currencies or currencies acceptable to members with a superior gold tranche who, in turn, would provide the Fund with currencies that were acceptable to it; in other words, it should be possible for members to pay the Fund SDRs in exchange for the gold restituted to them. The IMF staff's approach on the Fund's gold—both restitution and sale for the benefit of the developing countries—essentially as an exercise in replenishment appeared questionable. The Indian interpretation was that the replenishment technique was part of the current Articles of Agreement, which were squarely anchored on fixed parities and an official gold price. Replenishment provisions were essentially a technique of augmenting the general resources of the Fund. But the agreement arrived at by the Interim Committee relating to the immediate disposal of 50 million ounces of the Fund's gold was clearly an essential ingredient of the agreement to abandon the Bretton Woods fixed parities and to change the role of gold in the monetary system.

UNBORN REFORM INITIATIVES: PROPOSALS FOR A SUBSTITUTION ACCOUNT

The establishment of a substitution account was first considered in 1974 and then again in 1980, in the context of the international monetary reform. The idea first arose when the US dollar displayed persistent weakness in the early 1970s and Central Banks were looking for alternatives to the dollar-based system of reserves. Setting up such on account in a more broadbased form was an important element of the reform exercise considered by the C-20. Even though no such account existed at that time, its operational implications and modalities received careful consideration by at least two technical groups,[11] and there was willingness to accept the idea as a realistic possibility but at a future date.

Substituting US dollars with the SDR as a reserve asset was offered as a solution to the dollar overhang but was discarded at first owing to US

[11] The Technical Groups on intervention and settlement and on global liquidity and consolidation.

indifference. In retrospect, the Fund's reading was that it was not a viable solution as nearly 70 per cent of all official reserves were held in dollars. If a Central Bank was to reduce the exchange risk on its reserves, the obvious way would be to diversify into other widely traded currencies, which, in the early 1970s were the Japanese yen and the German deutsche mark. But reluctance on the part of these other currencies to take on the role of reserve currencies rendered the proposal a non-starter. In the assessment of the Fund, such diversification contained the seeds of potential destabilization, for shifting the composition of reserve portfolios for monetary gain could destabilize currency markets and erode the confidence of the monetary system. The C-20, as part of its study then, also considered proposals that would require members to replace a portion of their existing reserves with SDRs. Some members favoured, mandatory scheme while others plugged for voluntary substitution. As no consensus was forthcoming, the final report, while endorsing the idea, failed to draw up a specific proposal. The substitution proposal was then put into cold storage until circumstances were appeared more propitious for its consideration.

With the US attitude of indifference gradually turning into positive interest, the idea was revived in 1977. The continued pressure on the US dollar and the reluctance of other major powers to take on the role of a reserve currency, provoked the IMF Managing Director, Witteveen, just before his retirement, in the spring of 1978, to reopen the issue informally with groups of the Fund's Executive Directors. Two differences marked the new proposal: the substitution account, to gain approval, would have to be voluntary; and to minimize the inherent asymmetry between the effects on the US and on other countries, the US should be excluded or discouraged from participating. If any country could deposit dollars in exchange for SDRs, then alone the US could finance a deficit by issuing its own currency and bypassing the foreign exchange market. At the Mexico meeting of the Interim Committee in April 1978, the formal and attenuated version of Witteveen's proposals did not receive much support. Even the US resisted the resurrection of the idea, somewhat haughtily citing the numerous thorny and complex questions such an account would raise, and averring that it would not be feasible to implement the scheme.

It took some time for the new Managing Director, de Larosiere, to reassume his predecessor's initiative; by February 1979, he had become an equally ardent crusader. There had also been a distinct softening of attitudes, particularly in US official circles. The US indicated that it had no basic objection to the idea, while not wanting to peddle it. In fact, the US was seen publicly giving its qualified support to a plan that would increase the role of the SDR and reduce that of the dollar. The US Treasury Under Secretary, Anthony Solomon, at a symposium in Austria, was reported to have said that the substitution account would be a concrete move forward towards wider use of a full international asset, the SDR. However, it was made clear that on no account should US support be construed as designed to bail the US out of its currency problems.

The change, it would appear was attributable, in part, to the unrelieved instability in exchange markets and the severe pressure on the US dollar towards the end of 1978. The new policy presumption was that stability of the monetary system would be served better through increased reliance on a single internationally created and managed asset. In the changed world economy, there was need for rethinking on the innate strength of the almighty dollar, and a controlled and systematic reduction in the dollar's role as the ultimate calibrator and settler of payments imbalances was seen as an option worth considering.

Capital markets outside the US had grown considerably in importance and this had resulted in a loosening of capital flows. The formation of the EMS, with its emphasis on intervention in the currencies of participants rather than the dollar, was another important shift to be reckoned with. Despite these underlying shifts, the US continued to supply the world's liquidity needs to a disproportionate degree and this, to some extent, prompted the US to gradually reduce its currency's international role. The substitution exercise was seen as the first modest step in the evolutionary process of securing a stable monetary system.

Several European countries felt that the creation of such an account involving deposit of the US dollar and issue of SDR claims would promote the accepted objective of making the SDR the principal reserve asset. Oil surplus countries saw in the substitution account, a safer avenue for investment of their surpluses. In the developing world, the initial reaction was one of deep-rooted suspicion about the compulsory character of a package stamped 'voluntary'. They were not enthused about 'locking in' significant portions of their freely useable reserves largely in the form of working balances and saw some risk with regard to the maintenance of the capital value. Their attitude softened somewhat as they directed their efforts at extracting the maximum concessions out of an interested US. Their participation in such an account was made conditional upon the adoption of other measures. Advocating a package approach, Directors from India and Brazil demanded a satisfactory structure to the account, a special SDR allocation and measures to allay fears of stringency in the capital markets.

By March 1979, the Interim Committee was able to support the proposed diversification of official foreign asset holdings and give a mandate to study the setting up of a substitution account. At this point, it might be useful to sketch the outlines of the proposed account. A prerequisite for its creation was that a minimum number of countries and a minimum amount of deposits would have to be forthcoming. The account would receive US dollars and issue in exchange claims denominated in SDRs. It would be set up as a trust administered by the Fund, with an assembly of participants who would exercise effective control in certain matters, and with voting power linked to the size of the participants' deposits. Participation in the account would be voluntary. The dollar receipts would be deposited in a special account in the US Treasury and the latter would pay market-related rates. This point turned out to be a troublesome feature of the negotiations. In turn, the account would pay interest to the holders of SDR claims at the combined market interest rate used to determine the interest payable on SDR.

The most irreconcilable problem was that depositors were to bear the exchange risk for an account that would hold dollar assets and SDR liabilities. The IMF staff's evaluation was that the financial design of the account precluded the presumption that, in the long run, losses were more likely than profits, but the British and German simulations indicated that the possibility of losses could not be ruled out.

At a later stage in the evolution of the proposition a further complication was thrown in, in terms of using Fund's gold for maintaining the financial balance of the account. Such gold backing, it was felt by many, had an element of inequity. From the outset, the Indian authorities were opposed to sale of the Fund's gold and utilization of the proceeds to meet an interest liability or capital shortfall during the life of the account. They remained firmly of the view that the Fund's gold should not be deployed to underpin the proposed substitution account, either by way of guaranteeing exchange risks relating to the asset of the account or for covering the deficit on interest receipts in relation to the SDR claims. In one of his interventions, the Indian representative, I.G. Patel, categorically asserted that the substitution account had to be viewed as a limited operation and the Fund's gold should not be permitted to be used for such limited purposes. Instructions were given to the Indian Executive Director to oppose any move that sought to use the Fund's gold as a backing for the substitution account. The proposal to use gold strengthened the demand of the developing countries for a package approach, requiring that any use of the Fund's gold was matched by a corresponding benefit for the developing countries. Since the establishment of the substitution account using the Fund's gold required an 85 per cent majority, the developing countries possessed a trump card to press for a package approach to extract the maximum concessions.

The revised proposal that emerged in the first half of 1979 was that the Fund would establish and administer an account in which Central Banks would voluntarily deposit dollars.[12] In exchange, they would receive SDR-denominated claims, which could be used by the participants in a limited manner. The account would convert its assets into longer-term dollar-denominated claims on the US Treasury, which would pay a suitably long-term interest on them. To the depositors, interest would be paid[13] at the official SDR rate,[14] thus covering the exchange risk through the difference between the long-term US bond rate and the official rate.

Two supplementary mechanisms—designation and encashment—were designed to ensure liquidity of the SDR claims; but these were made subject to balance of payments need and a transaction charge. The Germans and the Americans wanted a restricted use of designation and prior challenge regarding existence of need, so that undue resort to this device would not inhibit the growth of a secondary market and unwind the substitution effect. The developing countries, on the other hand, argued against the need criteria and designation mechanism, and pressed for the right to encash their claims. India opposed the levy of a transaction charge but favoured the use of a back-up mechanism that was wide enough to cover the desire of participants to change the composition of their reserves. The suggestion was examined but it was felt that use of the designation mechanism as a tool for diversification of reserves could adversely impact on designees as well as on the market, and would not prove helpful.

With these broad indications but nothing concretely settled, De Larosiere decided to present the idea to the Interim Committee, which exchanged views over a working lunch in March 1979. The parleys reflected an openness to the idea and a go-ahead was given to the Managing Director for active consideration of such an account. This was the first sign of a general willingness not only to make the SDR the principal reserve asset of the monetary system, but also to combat the weakness of the dollar through diversification of reserves.

Hitherto, the IMF Board's discussion on the account had revealed an excessive concentration on minute technicalities with little evidence of the

[12] Short-term US Treasury bills.

[13] In 1979 the official SDR interest rate was below the market rate.

[14] The proposal was to levy a charge of 1 per cent.

major powers wanting to come to grips with the broad issues—much less to commit to them. On the side, however, the Central Banks of several developed and developing countries, with the bulk of their reserve assets in US dollars, were conveying to the Fund that their preference lay in diversifying their reserves and that they were prepared to bear some cost in exchange for a stable investment vehicle. But this was not the thinking of the US administration. No doubt, its interest lay in stabilizing the demand for dollars and removing the overhang, but the rate of interest to be paid by the US to the account remained a fuzzy area.

In Board discussions, several Directors had argued that, taking into account the non-negotiability of dollar deposits with the US Treasury and the almost non-terminable nature of the deposits, the US should pay an interest rate higher than the market rate. This additional amount, they argued, was not a premium; it reflected the virtual interminability of the dollar deposits. Most Directors, including the Indian chair, showed preference for an interest rate that was higher than the market yield on three-month US Treasury bills and on long-term US government obligations (say, twenty years). But the US consistently argued that any 'premium' would not be acceptable, for it was not justified and would be frowned upon by US Congress; market yield on three-month paper was all that the US was prepared to offer. Besides, simulations of past data had shown that short-term values were more attractive. The other issue raised related to encashment of the instruments: would they be on face value or at the going rate? The US response was that encashment had to be market-related. The issue was crucial, for encashment at a discount would adversely impact the viability of the account.

On the formula for sharing profits and losses on liquidation of the account, the Indian viewpoint was that losses should be shared between the US and the holders of claims in the ratio of 75 to 25, and profits in the ratio of 25 to 75, as the dollar was one-third the value of the SDR.

The summer of 1979 saw support gradually broaden for the account. This was reflected in the Interim Committee's communique of October 1979, which directed the Executive Board to give priority to designing such an account. But the support was shortlived, despite the Managing Director's frantic efforts to build bridges of understanding and remove the barnacles that threatened to clog progress. At the G-10 deputies' meeting in Paris on 25 March 1980, Economic Counsellor Polak put forward a new draft outline based on the replies provided by the members to the comprehensive questionnaire circulated by the Fund staff towards the end of December

1979.[15] The draft was conceived in such a way as to aim at maximum progress at Hamburg towards agreement on the substitution account.

The US authorities refused to accept the idea of converting short-term liabilities of Central Banks into a long-term liability of the IMF. They saw no merit in such conversion, for the costs would far outweigh the benefits. On the other hand, would-be depositors baulked at converting US Treasury bills into assets by paying the lower official SDR interest rates. They argued that the gains of a stable SDR claim were inadequate compared to the direct financial loss resulting from SDR claims. What was more, the IMF scheme provided no guarantee regarding the future financial viability of the account. The Indian demand was that the US should pay a premium over market rates, in view of the fact that the funds would be invested in non-negotiable instruments virtually in perpetuity. India also opposed any charge being imposed for encashment; as encashment would be availed of only in times of balance of payments need, the levy of a charge would result in SDR claims being quoted at a discount in the market. The asymmetry in the treatment of participants, with losses being made good by the participant immediately at the time of withdrawal but having to wait until liquidation of the account for securing a share of any gain was seen as a ploy to prevent participants from opting out easily. This went against the grain of voluntariness that had been universally agreed upon. Finally, India said the share in decision-making should not be calibrated entirely to the quantum of participation.

The debate revealed that neither side was willing or ready to compromise on absorbing the risk or the cost. The IMF staff then came up with an alternative plan: for the Fund itself to absorb a part of the risk by pledging part of its gold stock. Under the new proposal, 7–9 million ounces of the Fund's stock of 103 million ounces of gold would be sold, and another 23–32 million ounces would be placed with the substitution account as a backing for the account. The sale proceeds would be invested in interest-bearing assets, and the income earned would go to subsidize the cost of credits given from the SFF and to finance the rising cost of remuneration to creditors. Although the proposal had something for all members, it failed to catch on. Members were wary of disposing of a part of the crown jewels.

[15] The Reserve Bank and the Finance Ministry prepared replies in conformity with the view expressed by the Indian representatives at earlier meetings, and forwarded the same to the Indian Executive Director as his brief for the forthcoming negotiations.

In March 1980, the Executive Board met to consider the Managing Director's proposal as given above. There was support for use of the Fund's gold, but conditional upon the main participants undertaking to shoulder the responsibility of sharing the costs relating to the account. The US Executive Director made it plain that his authorities were in no position to provide any budgetary support for the account. The developing countries, including India, were equally categorical that they did not favour use of the Fund's gold for underpinning the substitution account or for maintaining the financial balance of the account. The Indian Executive Director, Deshmukh, based on the brief provided by the Finance Ministry, went on record to state that 'the Fund should not compromise its ability to reserve its gold for the benefit of low-income developing countries'.

Seeing that the Board representatives had little leverage to settle politically sensitive issues, the Managing Director, de Larosiere, not wishing to let the opportunity slip by to set up the substitution account, decided to throw all his energies into securing a political settlement. Enlisting the assistance of the Interim Committee chairman Fillippo Maria Pandolfi, he first sought to assuage the fears of the developing countries by explaining that the systemic benefits of the substitution account would outweigh narrow concerns.[16]

Here mention may be made of two developments, of which cognizance needs to be taken for a complete historical record. First, a research paper looking at the matter from the point of view of developing countries, was produced[17] by the Fund. Second, UNCTAD commissioned V.B. Kadam, a senior official of the Reserve Bank of India and counsel for the G-24, to produce a study on the pros and cons of the proposal for a Substitution Account as seen from the developing countries' viewpoint. The Fund document did not add materially to the arguments already advanced by the defence. But the UNCTAD study by Kadam ably and appropriately launched a fresh attack on the manner in which major propositions were reasserted by the Fund without satisfactorily dealing with the concerns of the developing countries. While recognizing that it was necessary to evolve substitution arrangements, Kadam underlined that these arrangements should, at the minimum, meet the requirements of liquidity, protection of value

[16] Pandolfi and Polak made a whirlwind tour of several Latin American capitals to explain the value of the proposed scheme for the developing countries. Although they were not completely successful in removing doubts, they apparently succeeded in defusing overt criticism. See *Silent Revolution* p. 942.

[17] A Substitution Account and the Less Developed Countries SM/79/236 August 1979.

and the rate of return-points, which the Indian Governor had time and again stressed in his interventions at earlier Interim Committee meetings. Since the revised Fund proposals failed to meet the concerns of the developing countries and he saw little possibility of that happening given the logic of the proposals, Kadam advised the Governor and Finance Ministry officials to withhold support till the minimum requirements were met.

Deshmukh, the Indian Executive Director at the IMF, in a letter of 6 September 1979 addressed to Manmohan Singh and copied to I.G. Patel, adopted a pragmatic approach and advised the government to extend more than lukewarm support to the substitution account. Admitting that the scheme would not be a giant step forward towards monetary perfection, he said that it nevertheless might enable the countries to progress diagonally to a more satisfactory payments system. Adopting a somewhat different stand from Kadam, Deshmukh urged the government to look at the scheme with an open mind, for he was persuaded to believe that the substitution account would place in the hands of the participants an asset that would in time appreciate in value vis-à-vis the US dollar and sterling. In Kadam's assessment such a proposition was not tenable. Substitution as embodied in the Fund proposal, according to Kadam, did not move in the direction of reform and he failed to see even a semblance of a logical step towards it. Deshmukh, however, cautioned the government to not look at the scheme with distrust, the proposed instrument was bereft of all debilitating features and once the minimum requirements, both positive and negative, were met; in other words, to keep the door open for negotiations to move forward. His advice was based on the positive feedback he had been privy to in his interactive exchanges with the Directors.

In January 1980, there were indications that the G-5 Finance Ministers had agreed on many but not all the substantive issues. This was further corroborated by the utterances of the German Finance Minister, Hans Mattofer, who signalled the strong support of his government. The March 1980 interactions with US officials also confirmed that negotiations on some of the thorny issues were proceeding smoothly. This was further strengthened by the strong endorsement of support conveyed by the US Treasury Secretary, G. William Miller, in his meeting with de Larosiere. There was thus every indication that the forthcoming Interim Committee meeting in Hamburg would set the stage for wrapping up an agreement. At that point of time, the Managing Director had no inkling that major players would renege on their support to the proposal. It came as a rude shock to him when, at Hamburg in April 1980, the expected support from the US and

Germany evaporated without any warning, with the representatives of both these countries and of Australia declining to speak on the matter. The other industrial countries who supported the proposal did so on the assumption that the US would shoulder a part of the cost. The developing countries that offered their support did so on condition that the proposal would be adopted along with the Programme for Immediate Action of the G-24.

Hamburg turned out to be disaster that aborted the substitution account and sealed its fate for all time. It is legitimate to question why reform of the international monetary system through the creation of a substitution account did not become a reality. The reason was that although people clamoured for it and talked as if they were yearning for it, they were really chary of ushering it in. The debate, lasting over two years, a classic illustration that the will to do something concrete was missing.[18] The US was unable to make a tangible and objective demonstration of its faith in this part of the reform exercise. Lack of agreement on how to cover the risk and lack of consensus on the use of the Fund's gold as a burden-sharing solution were the key reasons for the withering away of support. Without the active support of the US, it was hardly possible to bring about far-reaching constitutional changes. The continued and decided opposition to the substitution account, in retrospect, has to be seen as implying a release from any moral obligation to assist in any manner, any monetary moves. Creation of the substitution account would have changed the monetary landscape as it would have helped to strengthen the role of the SDR in the monetary system. It is indeed ironic that the Polak–de Larosiere plan fell through because of concern over its potential cost. An *ex poste* simulation by the Fund staff revealed that had the substitution account been established in 1980, by 1985 it would have generated a cumulative profit in SDRs equal to more than 40 per cent of the initial deposits, and that profit could have been invested to ensure the future sustainability of the Account. The opportunity missed was an opportunity lost. Moreover, the SDR, which in the 1970s was seen as a promising primary reserve asset of the system, has, over the last two decades, lost much of its lustre and relevance with no allocations and with its share in total world reserves sinking to a low of about 1 per cent.

[18] The Fund attributed the withering away of American support partly to the exit of Soloman from the US Treasury. See *Silent Revolution*.

IMF QUOTAS

Quotas, a basic constituent of the International Monetary Fund's original financial structure, assumed increased significance in 1966–78. Each member, upon joining the Fund, was assigned a quota and was required to pay a subscription equal to that quota. Until the second amendment of the Articles of Agreement of the IMF, which became effective on 1 April 1978, all subscriptions were paid partly (25 per cent) in gold and partly (75 per cent) in the members' own currencies. The significance of the quota rested on the fact that it determined the amount a member could draw from the Fund and the member's voting rights, and, if a member was a participant in the special drawing rights (SDR) scheme, it provided the distribution key for multilaterally created international liquidity, viz. SDRs.

Quotas acquired added significance in the period covered by this volume because the members made heavy use of the Fund's resources during these years. This was a period of great uncertainty and turbulence, and, with the need for international liquidity on the increase, it witnessed a heightened distinction between conditional and unconditional liquidity; the volume of conditional liquidity was related to quotas. Quotas also became the yardstick to determine a member's SDR allocations. As a result, the quinquennial quota reviews were subject to minute scrutiny, intense debate and considerable negotiation in the twelve years that ended with 1978, with the larger industrial quota countries less inclined than earlier to contribute to IMF resources because of their own financial difficulties. The gold problem also rendered payment of gold subscription to the Fund difficult in connection with the quota increase, and studies were on to find alternative ways to mitigate this difficulty.

In the six years ended 3 December 1971, the aggregate of Fund quotas almost doubled, increasing from a little under \$16 billion to nearly \$27 billion. The increase brought about in its wake considerable changes in the relative position of members within the structure of quotas; it also brought about changes in the distribution of votes cast by the Executive Directors and in the constituency-wise representation on the Fund's Executive Board.

This section captures the developments that influenced the quota increases and seeks to bring out how the ensuing discussions and negotiations impinged on India's representation on the Fund's Executive Board. It all began in 1964 with talk about the need for radical changes in the world's monetary system. High-level confabulations among the 'big ten' yielded no concrete solutions, for they were still not ready at that point in time to entrust the Fund with any significant and unconditional liquidity-creating powers. The only substantive issue that arose out of these deliberations was an increase in the IMF quotas in the wider context of international liquidity.

At the fourth quinqennial review of 1965–66, the US, the UK and the developing countries favoured a 50 per cent general increase but the Europeans were prepared to agree to only a 25 per cent increase. France, however, remained unconvinced regarding the need for increased quotas, for in its view, there was no shortage of international liquidity. From the Indian standpoint, a 50 per cent increase was the most useful option because India was interested in strengthening IMF resources, particularly since the role of the US and the UK as providers of international liquidity was dwindling and France and Germany were poor substitutes. Developing countries like India, which faced special balance of payments problems, regarded strengthening of IMF resources as the most beneficial option.

In a note jointly prepared by C.S. Krishnamoorti, Joint Secretary, Ministry of Finance, and V.G. Pendharkar of the Reserve Bank of India, it was emphasized that India's interest lay in safeguarding its permanent seat, which could be in jeopardy if the selective quota increases were large. At that point of time, India had the lowest quota of the permanent five—US$600 million. India's fear was that if the general increase was small, there was every possibility that Italy, Canada or Japan, who were fast-growing economies, would battle for large selective increases, and, if this happened, India would be dislodged from its permanent position. The note urged that, to circumvent such an eventuality, the best course would be for the Indian Executive Director at the Fund to plug for a substantial general increase in quotas, with suitable limits for gold payment and a modest selective increase (bearing in mind that the *inter se* position organizationally did not get affected); and, finally, if support for the large general increase was not forthcoming, then, to press for a selective increase for India, on the ground that in terms of strains and short-term liquidity problems relating to development and trade accounts, India too should be considered for a selective increase.

If none of these alternatives seemed probable, then a last-ditch effort to protect India's permanent seat would be to press for an increase by, say, four to five in the total number of permanent seats through an amendment of the charter. Apprehensive that larger selective increases would be given to Canada, the Federal Republic of Germany and Japan to reflect their faster growing trade and economic strength relative to that of other members, as in the earlier 1959 quota revision exercise, and aware that prestige considerations would weigh with the fast-growing economies to press for permanent seats, the Indian authorities wanted to forestall the situation by mooting four to five additional permanent seats. Although this would safeguard its permanent membership, such an outcome, India was well aware, was a remote possibility, as it would reduce the excessive Anglo-Saxon influence the UK and the US wielded in the IMF and which those two powers would hawkishly want to protect.[19]

Anticipating that the Tokyo annual IMF meeting would call upon the Fund's Executive Board to study the question of general and selective quota increases, the Reserve Bank advised the Indian government that 'strategically India should make her voice heard before Tokyo', so that no consensus was privately arrived at between the western powers to unseat India, and to informally let the US, the UK, Canada, Germany and France know India's very strong views on the organizational aspect of this exercise. The RBI's brief was insistent that high-level diplomatic manoeuvres should begin right away, so that India's views were not discounted as last-minute fears. It also suggested special follow-through discussions at the Commonwealth Finance Ministers' conference at Kuala Lumpur. As part of the strategy, the Indian Ambassador to the US was to call on the Managing Director of the Fund and the Treasury Secretary of the US to seek their support.

Initial studies conducted by the staff recommended a general quota increase *of 58 per cent* but in the final analysis this was scaled down to 25 per cent, at the insistence of the G-10 industrialized countries. After an intensive debate on mitigating the impact on the developing countries of the gold payment portion of the quota increase, it was finally agreed that members with low reserves could avail of Article III4(a). Although India had pushed for the mitigation option in the debate, on the advice of RBI Governor Bhattacharyya, it did not avail of the option and instead went for outright payment of gold with a view to strengthen its position as a nominated 'first five' member, as well as to aid its 'tranche position'. In this way, India scored a tactical victory by appearing as a spokesperson for weaker countries. A compromise solution was finally hammered out that offered relief through the technique of special drawings, which would not take the borrower into a higher credit tranche.

The fourth quinquennial review of quotas resulted in another round of general increase in quotas of 25 per cent, plus a special selective increase

[19] The relative positions with an increase of five permanent seats would be as follows: USA 4125, Canada 550, West Germany 787.5, Japan 500, India 600, UK 1950, China 550, France 787.5, Italy 500, Australia 400.

for sixteen members, raising the total quotas to $19.411 billion as on 30 April 1966. India managed to retain its fifth position and the right to nominate its Executive Director by a wafer-thin margin, mainly because Canada and Japan were persuaded not to press for the entire increase determined on the basis of their calculated quotas. This was primarily the outcome of India's lobbying that the formula for quota determination was heavily biased in favour of the developed nations.

It may be of interest to note that the question of India's position in the Board of Directors in relation to the quota revision was considered way back in 1958, to accommodate Germany's and Japan's demand for a revision of their quotas. The special increase then provided to Germany had raised its quota to $787.5 million and placed it among the 'big five'. India agreed to the special quota increase of Germany, provided China's quota was frozen at the then existing level of $550 million. Through this fiat, India was able to retain its right to appoint an Executive Director. Prime Minister Jawaharlal Nehru observed in 1958, 'I am particularly interested in India retaining a permanent seat on the Board of the Fund, and, sternly reprimanded the lobby that had complacently argued that 'no serious harm will be done' if India ceased to be a permanent member, for the sheer size of India's quota was so large that it would have no difficulty in getting elected regularly on the Board. Nehru sharply retorted that he 'entirely disagreed with this weak attitude. It was essential that India should have a permanent seat and if deprived, it would be an insult, not only to us but to Asia.' After all the fuss of holding the last annual Fund–Bank meeting for the first time in a developing country, it would be amazing if India was deprived of a permanent seat. He was reluctant to take Taiwan into consideration. In no uncertain terms, Nehru insisted that it should be made clear that India cannot compromise on this issue. The expression of these sentiments resulted in the Canadian authorities refraining from pressing their demand for a nominated seat for well over a decade after 1958, as they did not wish to offend India's susceptibilities. Besides, Canada did not wish to find itself unable to join with Ireland and Jamaica, which countries it would have had to drop if it became entitled to an appointed seat.

The fifth general review of quotas was due for completion by end-December 1970. However, in view of the prospective activation of the SDR and realizing that the fifth review was likely to raise some intractable issues, the Board decided to advance the review with an informal exchange of views to mid-1969. From the interaction between the Executive Directors, it was evident that interest in the fifth general review would be intense and that some hard bargaining was in store about issues such as: should more adequate consideration be given to economic factors, and should the emphasis be on general or selective increase?

The mid-sixties had witnessed a rapid increase in world trade and shortage of international liquidity. The developing country Directors were plugging for a large general increase in the range of 25 to 50 per cent. Madan (India) and Kaflka (Brazil) contended that the world's need for liquidity—conditional and unconditional—had increased, and that the Fund should keep pace with the growing world economy. They were influenced in their reasoning by the large selective increases that would become available to a number of developed industrial countries. They saw clear danger in a trend that would affect the structure of Fund quotas in terms of reducing the share of the developing countries. In the subsequent quota revision discussions, Madan, on the instructions of I.G. Patel, kept hammering the point that the proposals under consideration placed weight in favour of the industrialized countries and away from the less developed countries. Already, two-thirds of the voting power was vested in the developed countries, and 86 developing countries held just one-third of the voting power and share in SDRs. This would be reduced further in the new pattern of quota increases and there was need to prevent such slippage of the voting power of the developing countries. Furthermore, linking SDRs with quotas and changing the latter in a way that might reduce the weightage of developing countries in decision-making would be a retrograde act, not conducive to international cooperation. If the present situation was not to be aggravated, some rectification by way of a link between SDR creation and assistance for development should find place in the scheme of things.

On the other hand, Directors representing the industrial countries were for a much smaller general increase with selective increases of a similar size; one extreme position was to limit the entire increase in quotas to selective increases. With such radically contrasting views and no consensus in sight, the chairman of the deputies of the Group of Ten, Ossola, obtained the support of the G-10 for an overall increase of 30 per cent, plus or minus 3 per cent. This figure was subsequently endorsed by the Ministerial group of the G-10 and communicated to the Executive Board by the European Executive Directors as a compromise, with the upper limit of 33 per cent regarded as non-negotiable. Some of the developing country Directors articulated their annoyance and displeasure by saying that the IMF Board ought not to be faced with non-negotiable issues.

To assist the Board to come to a decision, the IMF staff provided several permutations and combinations, ranging from a 25 per cent general increase and the balance selective, to a 20 per cent general increase and

$4.5 billion in selective increases. The US, the UK and Germany indicated that they would refrain from taking up their full potential quotas, while no quota was calculated for China—even so, the total exceeded the 33 per cent limit. The idea of a differential general quota increase by country groupings was suggested but the idea failed to get support as the majority of the Directors rejected the differential principle on the ground that it smacked of discrimination.

While the search for a solution continued, the outcome of the Canadian proposal, which was played out on the sidelines, needs to be documented, as it was of direct relevance for India. Even before the 1970 quota negotiations started in right earnest, in 1968, Canada informally sounded out its Executive Director, Hansfield Jones, on a proposal to abolish the distinction between appointed and elected Directors. At that time, India's quota was $750 million, Canada's $740 million and Japan's $725 million. Canada was not entitled to an appointed Director and was keen on securing the right to do so by getting its quota raised. While communicating Canada's proposal to I.G. Patel, Special Secretary, Economic Affairs, Madan, the Indian Executive Director at the Fund, also stated that Canada had made it plain that 'this time it could not withhold its claim to a larger quota than India's and was therefore initiating the proposal to overcome that difficulty'. According to Madan, informal soundings showed that Japan and the EEC were strongly in favour of the proposal. The US was not willing to reveal its card but hinted that Canada was keen to continue to represent other countries. Presumably such a procedure would also do away with the reserved seats for Latin American countries. The Canadian argument was that such a procedure would be ostensibly more democratic.

Madan's evaluation too was that it would be most sensible way of handling the problem, for it would be difficult for India to resist any longer the demand for a special increase in Canada's quota. Secondly, it was unlikely that a proposal to increase the number of appointed Directors would have the required support. Thirdly, with an all-elected Board, India could represent other smaller countries, which it was precluded from doing as a nominated Director. Fourthly, the pressure for higher quotas emanated on account of US balance of payments deficits and the Fund's need for more reserve currencies of strong countries. Madan's assessment was that 'India's election was an arithmetical certainty.' The Canadian proposal was examined in depth by the Reserve Bank and it agreed with Madan that instead of seeking an enlargement of the number of permanent Directors, it would be better to abolish altogether that class of Directors. While there was a contrary view in the Economic Affairs Department, according to a noting by

Governor L.K. Jha, I.G. Patel, with whom he discussed the subject, seemed to agree with the RBI view. But he had sought clarifications on two counts: first, if permanent Directors were done away with, what were the chances of India retaining a seat without reliance on anybody else's support, since such support may not be forthcoming and may be conditional on reciprocal support from India in subsequent years; second, what would be the repercussions of the change in India's position on the World Bank.

Jha requested Deputy Governor Anjaria to give thought to the issues raised by Patel. After a detailed examination of the issues by Pinto of the Research Department, Anjaria confirmed that a move to abolish the appointed category in the Fund would evoke a similar move in the Bank. What was not acceptable to India in the Canadian proposal, however, was the Canadian desire to continue to have within its fold, the three countries it currently represented. This was untenable; Anjaria was averse to giving large quota countries a position from which to corner more votes from the 'aligned' countries. Pinto's note suggested regional distribution of seats and gave hypothetical calculations to show that regional distribution would be an elegant way for India to retain its seat without assistance from any country. Anjaria suggested that, for a while, India should argue for geographical representation, expounding the dangers of making the Fund a replica of economic power distribution. However, it was realized by all that it would not be possible to retain India's seat on the basis of its own vote, and, sooner rather than later, it would be necessary to seek the votes of two or three other countries.

In the late 1960s, during the discussion on the 'Programme of Work', Madan took the opportunity to make a reference to the relevance of population in future quota formulae from the point of view of the developing countries. The Board's and staff's attention was drawn to the following pertinent points: the developing countries' ratio of population to that of developed countries was less than 3:1, whereas the aggregate of their quotas in relation to the total of developed countries was not much above 1:3. He underlined that the individual was the unit for production and consumption and the hub of all economic activity, and that the relative size of a country's population was a factor to be reckoned with in any quota formula. Madan further suggested that the debt servicing burden should also figure as a factor in the quota formula. While Directors from the developed countries were averse to reopening the quota formula, the developing countries commended Madan's suggestions for consideration by the IMF staff.

But the more difficult and contentious question related to the size and structure of the Executive Board. One or two of the Directors were in favour of a staff paper that would cover many issues, apart from size, like the question of basic votes, reservation of seats for the Latins, appointment of Executive Directors, reorganization of the Board on a geographical basis, etc. The heavyweights on the Board were reluctant to open up what they felt was a Pandora's box, for the subject by its very nature was one that ran up against entrenched positions and would stir strong reactions. On the issue of an increase in the number of basic votes, the Indian view was that the proposal need not be revived. On the reservation of (three) seats on the Board for the Latins, two possibilities were raised: (i) of doing away with the reservation altogether; (ii) of extending the reservation to other continents. Although the first solution was technically an easier one, no one was willing to dislodge the Latins from their pedestal of privilege, as they had thrived under the protective wing and preferred treatment of the largest Fund member. No one was willing to upset the historical nature of this relationship. On the appointment of Executive Directors, although regarded as a non-democratic feature borrowed from the United Nations constitution, any change in this, it was apparent, would get bogged in the quagmire of Capitol Hill. The majority view appeared to be that even if India was dislodged from the appointed position, standing at the head of the elected category was sufficient assurance, and, therefore, the abolition of appointed Directors was not favoured. On reorganization along geographical lines, the problem seemed to assume staggering dimensions in the eyes of many and the natural inclination was to shy away from such an exercise. The admirable analysis given by Madan greatly facilitated the task of both I.G. Patel and L.K. Jha to come to grips with this problem.

Again, in mid-1971, in a somewhat desultory informal discussion on the size and structure of the Executive Board, the idea of doing away with the category of appointed Directors and fixing a rigid minimum of votes for all Directors was brought up, but enthusiasm for the idea was distinctly lacking. Other matters discussed related to: (i) the implications of mini states joining the Fund for the structure of the Board; (ii) the feasibility of adopting a geographic or regional basis for selection; (iii) the problem of basic votes; (iv) additional assistance to Directors representing a large number of countries; and (v) new election rules for the nominees of large groups of members.

In preparation for this discussion, at the initiative of P.S.N. Prasad, the Indian Executive Director who succeeded Madan, the developing country Directors met to evolve a common strategy, keeping in mind the diversity of interests that existed among the various groups. After two long sessions, a common statement was agreed upon. Prasad and Kafka (of Brazil) were instrumental in helping to formulate the statement, the substantive part of which was that the endeavour of the quota revision exercise should be to at least stabilize 'the present equilibrium', as Kafka put it, and 'the present weight and distribution', as Prasad described it. In concrete terms, this meant preserving the three Latin and two African seats and not less than three seats for Asia, which meant creating one more seat for Asia and by enlarging the size of the Board to twenty-one. This formula had the endorsement of the developing countries.

At the informal Board meeting, the developed countries opposed expansion of the Board and also groupings on regional considerations. Prasad pointed out that the original Bretton Woods design had provided for India and China to each have an appointed seat and that that had ensured fair representation of the developing countries, which was later eroded. As a result, 91 developing countries today carried 32 per cent of total votes, while twenty-six developed countries exercised over 67 per cent of votes. The present weightage was thus heavily skewed in favour of the developed countries and came in the way of efficient working of the Fund. This could partially be corrected by adding one more seat on the Board which could be occupied by countries now floating in Southeast Asia and elsewhere. The upshot of the discussion was a mandate by the Board—not terribly specific or clear—to prepare a resolution reflecting the views expressed by the members.

On the issue of mini states, there was agreement that a decision was inevitable but that, in no way should it entail enlarging the size of the Board. There were no takers for an increase in basic votes. On the subject of amending the election rules, the consensus was that there was no need. In the light of this discussion, Prasad advised the Indian authorities that the only practical way of handling the quota increase issue, as far as India was concerned, was to seek out and cultivate countries like Ceylon and Burma or Afghanistan and, if that was not possible, Mauritius and Fiji could be aimed for. He was doubtful of Burma joining the Indian constituency, as the Thais were known to have been aggressively cultivating them for some time. In Prasad's assessment, a Fijian partnership was a possibility, for Fiji was disenchanted with Australia after the latter withdrew from a large sugar venture; Prasad hinted that if India made appropriate overtures to assist Fiji in the running of that project, it may prove fruitful. This showed that certain amount of 'horse-trading and behind-the-scenes' manoeuvrings were necessary in the quota revision exercises.

To revert to the fifth quota general review, the question again surfaced as to whether the burden of the members' gold payments to the Fund should be alleviated and, if so, how? The possibility of using SDRs for gold in this connection had been ruled out earlier, at the Stockholm meeting in March 1968, by the G-10 Governors. On this occasion, it was decided to exercise the discretion given to the Fund by Article III Section 4(a) to reduce the proportion of quota payable in gold, depending on the member's monetary reserves in relation to the increased quota to which the member had consented. Although mitigation techniques for payment of the gold portion of quotas had been considered on two occasions, the Executive Board had rejected the proposals on both occasions. At the fifth general review, although total waiver of gold payment was not agreed to, the Executive Board conceded to invocation of Article III Section 4(a), requiring a member to undertake to repurchase the excess holdings of the member's currency in five annual instalments.

In a brief memorandum to the Central Board of the Reserve Bank on the outcome of the fifth review, the Deputy Governor stated that it had given India an increase of US$190 million, raising India's quota in the Fund from $750 million to $940 million, and that India had communicated its consent to the increase on 30 November 1970. As in the past, special increases in addition to general increases were offered to some members, in recognition of their relative strengths. The memorandum further pointed out that special increases had resulted in India ceasing to have the fifth largest quota in the Fund, as, under the Articles, only the five largest quota holders were entitled to permanent seats on the Board; India would lose its appointed seat at the next election in 1972. Between the fourth and the fifth quota revision exercises, India had slipped from the fifth to the eighth position,[20] and although it would have an assured elected seat, India would need to seek out other friendly partners to join its constituency.

A supplementary grant covering the additional subscription was voted by the Parliament and non-negotiable non-interest-bearing rupee securities worth $142 million were handed over to the Fund. The Reserve Bank's gold was not to be used and gold subscription of the value of $47.5 million would be paid out of the non-monetary gold stocks held by the government. The implication of the new quota increase, it was explained, would enable India to meet balance of payments deficits subject to Fund's usual requirements. As SDRs were allocated on the basis of quotas, and the second allocation was due to be made on 1 January 1971, payment of additional subscription before the end of 1970 had made India eligible to the second SDR allocation on the basis of a higher quota.

[20] Japan, Canada and Italy having bagged the fifth, sixth and seventh positions.

Towards the end of 1970, it was further decided, as on the previous occasion, to purchase $30 million worth of gold at the IMF parity from the Federal Reserve in New York and to send the same through Air India to Bombay, the intention being that the gold received would go towards replenishing the non-monetary stocks utilized for payment of India's gold subscription to the Fund. Madan at the IMF and Seshadri at the RBI were instructed by S.V. Ramakrishna, Director, Ministry of Finance, to coordinate the transaction regarding purchase of the gold, its insurance from vault to vault and transport by Air India, and to charge the Reserve Bank for all expenses incurred.

Following the increase in IMF quotas under the fifth general review to $940 million—which took effect in December 1970—the IMF's financial position strengthened marginally in 1972. This strengthening occurred through both the increase in quotas and the steady increase in membership. The increase, however, turned out to be inadequate with the sudden and precipitous increase in oil prices and the turbulent global exchange rate scenario of the early 1970s. The demands for IMF financial support increased and these were met through the creation of the oil facility and borrowing arrangements made with some of the surplus industrial and oil producing countries.

Wittaveen, the new Dutch Managing Director of the IMF, noted for his skill and energy, quickly perceived the need for a further increase in quotas in order to strengthen the Fund's liquidity. Aware of the time taken on the earlier occasion to come to a decision and of the 1969 requirement through the amended Articles that the general review of quotas was to take place at intervals of not more than five years, he initiated the sixth general review in early 1974, so that the review could be completed before February 1975. Wittaveen realized the unexpected impact the oil crisis would have on the non-oil producing countries, the growing danger of marginalization faced by the most vulnerable non-oil producing developing countries, and the need to resolve the oil crisis through the establishment of the oil facility, by borrowing from the oil economies and the creation of the extended fund facility which would help these countries overcome their balance of payments deficits. Accordingly the Committee of the Whole, comprising of all the Executive Directors, with the Managing Director as the chairman, was constituted a year in advance, to decide on the size of the total increase of quotas, its distribution and the mode of discharging the increased subscriptions that would become payable upon the increase. It was generally understood that there would be a spurt in the demand for the Fund's resources and hence the quota increase would have to be sizeable.

Another issue that needed to be settled was how the gold portion of the subscriptions should be paid—in SDRs, foreign exchange or in the member's own currency—and, arising therefrom, the legal status of the gold subscription. The whole exercise bristled with numerous difficulties. Based on the broad general directives of the January 1974 communique of the Interim Committee, the Fund staff presented illustrative quota calculations based on various assumptions. At the very first meeting of the Committee of the Whole on review of quotas, it was evident that there were wide-ranging views. The nine developing countries' Directors unanimously favoured an increase in the region of 70–100 per cent, as recommended by the Managing Director. Knowing that substantial increases in the voting power of the oil exporting countries and the Indonesian group were in the offing, the developing country members demanded that the collective share of the non-oil countries should on no account be reduced to accommodate the larger share of the major oil exporters. Prasad, supported by one or two others, rightly pointed out that the proportion of the developing countries' quotas in total Fund quotas had remained more or less stagnant since Bretton Woods, but, taking into account the fact that allocation of SDRs would depend on the quotas, it was more important now than ever before, that the industrial and other primary producing countries were agreeable to bear the brunt of the decline needed to accommodate the increases in the share of oil producers.

At the other end of the spectrum, diametrically opposite views were expressed by the industrial country Directors, notably the German Director, who opted for no or a small increase, and harped on the inflationary character of a large increase. The US position was in favour of a very small general increase, buttressed by the argument that balance of payments financing needs could be met by recourse to private banks. Some of the European Community Directors took a middle position. Complicating the issue was the US demand that it would not stand for any reduction in its existing share. The US quota was 22.5 per cent of the total which gave them 20.80 per cent of the voting power in the Fund. Its main concern was to protect the possible erosion of its veto power. With the growth in Fund membership, and the probability of China soon rejoining the Fund with an enlarged quota, the US was perceptive enough to realize that the relative share of the US quota would be reduced. The US officials hinted that the lowering of US voting power to below 20 per cent would be counter-productive, as it would weaken the US commitment to the Fund and such a development would prove contrary to the interests of the Fund itself. The firing of this salvo by the US was yet another factor that narrowed the scope for the manoeuvring needed to settle the conflicting claims made by the twenty members.

Such contrasting views made the task of arriving at a consensus that much more difficult and the greater part of 1974 was spent in discussions on these issues. As time was running out and with no solution in sight, the Interim Committee, in January 1975, reached an understanding on some of the aspects that would guide the deliberations of the sixth review of quotas. There was agreement that the Fund quotas would be increased by 32.5 per cent[21]—an increase of SDR 10 billion. This was much below the increase favoured by the Directors from the developing countries and the Managing Director but their disappointment was moderated by the agreement that the seventh review would commence immediately, and that the seventh quota increase—'a fairly sizeable increase'—would become operational in three instead of five years. The Netherlands chair argued that, on balance, there was a need for increase in conditional liquidity and that it would not impact on total liquidity. At the other extreme, the French Director argued for revaluation of gold at higher prices, which would obviate the need for a large quota increase.

Prasad, the Indian Executive Director, apprised Finance Minister C. Subramaniam of the possible implications that the new configuration of quota distribution could have on India, based on some preliminary calculations made by his office.

His analysis was as follows. (1) The five largest quota holders and the Latin Americans would have eight seats amongst them, leaving twelve seats for the remaining members (2) The substantial increase in voting power of the oil exporting group would enable the Middle Eastern countries, together with the Indonesian group, to have four seats instead of the three they were then holding and it was for them, based on certain assumptions to obtain a significantly larger voting power for each of these four seats than what the Indian constituents would be able to have. (3) The Nordic and the Canadian group would continue to retain their present seats, while the other European countries, with the assistance of South Africa, could form four instead of three groups. The constituency that could have difficulty in retaining its seat was the Australian group. They may decide to throw in their lot with the other European group, and if they did that, it was possible for all four European seats to have more votes each than the Indian group. This would leave two seats to be shared among the Africans and Indians. Should the Africans press for guaranteed seats, like the Latins, then India

[21] Rounded to SDR 39 billion.

would be in difficulty. In the past, there had been an unwritten understanding that the two African seats would be maintained and there was a move to exercise that guarantee. No doubt the situation was fluid and could evolve differently. Prasad therefore, advised the Indian government to press for a twenty-first seat on the Board, and also to consider other possible alignments, like joining hands with Australia or with radical oil countries like Libya, Iran or UAE, or other developing countries in the neighbourhood like Nepal, Burma or Afghanistan. Later, during a visit to India, Prasad called on the Finance Minister and, in the presence of Governor Jagannathan, clarified that there may be no threat to the Indian seat in 1976 but one could develop in 1978—in short, he alerted the authorities to weigh their options carefully and evolve a strategy that would be both practical and desirable.

There was an unusual flurry of behind-the-scenes activity, particularly confabulations between the IMF staff, the industrial country Directors and the Managing Director, to arrive at a consensus. Apart from, numbers, there were, on this occasion, other technical points for debate. For instance, the Resolution of Understandings reached at the second meeting of the Interim Committee in Washington read: 'There was a consensus that because an important purpose of increases in quotas was strengthening the Fund's liquidity, arrangements should be made under which all holdings of currency would be usable in accordance with its policies.' Prasad was quick to perceive the implications of this. He queried whether it meant all members would accept convertible currency obligations, even if the currency was an Article XIV currency, making it convertible in fact. This, he pointed out, would pose grave difficulties for countries like India. Prasad, however, was assured that it was not the intention of the Fund to sell weak currencies even if the legal position was that a currency was usable.

For formulating a package of recommendations before June 1975 on quota increases and amendment of the Fund's Articles of Agreement, another issue that needed resolving was amendment of Article III Sections 4(a) and 4(b) with regard to the mode of payment for the increased subscriptions. Discussion in the Board threw up a heterogeneous set of alternatives. There were some who pressed for payment in primary reserves and leaned heavily in favour of an SDR-based system that would reinforce the Fund's liquidity and yield some income. There were others who wanted the mode of payment to be spelt out in the Articles and not left to the Board of Governors to reopen at each review. There were yet others who pitched for a flexible approach including allowing payment up to 100 per cent in local currency; but there was one Director who was vehemently opposed to this type of flexibility and wanted everyone to pay their 'pound of flesh' in primary reserves. Ultimately, broad agreement emerged that as far as 25 per cent of the increase in subscriptions was concerned, members could have the widest available choice of media and if any member chose to pay the amount in its own currency in excess of 75 per cent of the quota, the excess holdings of member's currency would not be subject to the usual repurchase provision.

The Interim Committee meeting in Paris in mid-June 1975 noted the progress made in arriving at an agreement on principles but, despite several quota calculations put forward by the Managing Director, agreement on the final hard numbers was not forthcoming. Among the developed countries, the US was not satisfied with the size of quota allotted to it. Australia was unhappy that the ceiling of 45 per cent on special increases for developed countries should also be applicable to the developing group, some of which were receiving substantially large special increases. According to the guidelines provided by the Interim Committee, the share of 'other developing country groups' was to remain the same, at 20.85 per cent of the total, which Prasad described as unfortunate. The adjustments made to arrive at this result, Prasad argued, were 'unnatural' and 'artificial'; he voiced dissatisfaction at the manner in which so many developing countries were allotted no greater proportion of the quotas than before and insisted that in quota adjustments, some degree of 'political negotiating was inevitable'. But the fact was, several developing country constituencies had opted for a smaller general increase and there was little support for a higher general increase. Failure to put up a united front resulted in the developing country group having to yield to accepting a symbolic general increase from 20 to 20.85 per cent. Despite Prasad's insistence to give adequate weightage to other considerations, this was not seriously considered; and, so, India's quota was reduced from 3.22 per cent of the total quota to 2.94 per cent.

The month of July 1975 was spent by the groups in tinkering around with potential quota increases, and in distributing the windfall amounts that became available on Lebanon declining to pick up its offered share and the IMF staff discovering an error in the quota for Panama. Together with the rounding off of the new total quota, in all, SDR 64 million became available for distribution to the other developing countries' group. As pointed out by S. Jagannathan, who by then had taken over as Executive Director from Prasad, in a letter to M.G. Kaul, special increases were given to sixteen 'growth countries' among the other developing countries' group, of which Brazil, Mexico and Korea benefited the most. It was apparent that the increases had all gone to countries on which the USA looked with favour.

The Indian constituency came out of this marginal adjustment with Bangladesh and Sri Lanka's shares unaltered and India moving down from 2.94 to 2.72. The rounding exercise, however, did not take into account the 'China kitty' (i.e. the quota available to but not taken up by Taiwan). Against the view of the non-oil developing countries that the China kitty should be distributed among them, Wittaveen ruled that China stood, as it were, in a group by itself, and so should be excluded. He closed the matter taking shelter behind the Interim Committee guideline of January 1975. In speaking for the non-oil developing group, Jagannathan made the point that populous countries like Egypt and Pakistan were hurt by the Managing Director's new approach and that the rounding exercise should not increase disparities or bring down anyone's quota percentage.

As the time approached for the 1975 annual meeting, 111 members had agreed to the quotas offered to them but agreement on quotas for the fourteen industrial members was still wanting. This was achieved at a G-10 meeting where Finance Ministers and Central Bank Governors met, and, in a spirit of compromise, agreed to a reduction in the group's share in the total Fund quotas from 63 per cent to 59 per cent. The burden of this reduction fell on the US, whose share declined from 23 to 21 per cent and the UK, whose share moved down from 10 to 8 per cent.[22]

The sixth general review of quotas was a tedious and tortuous exercise, and took over five years to complete. It entailed, for the first time, acceptance of differential treatment of groups. For the Indian constituency, the outcome was a real disappointment, the relative positions of all three members—Bangladesh, India and Sri Lanka—having declined. Even though the resolution on an increase in the quotas by SDR 10 billion to SDR 39 billion was adopted by the Board of Governors on 22 March 1976, it took till 31 October 1978 for all the Fund members' legislatures to approve the increase.

Anticipating a delay before the new quotas became effective, Wittaveen proposed to the Board a temporary technique for increasing members' access to the Fund's resources: widening each credit tranche by one half, so that each tranche would be equivalent to 37.5 per cent of the quota instead of 25 per cent. The Fund Board was receptive to the proposal, but when it came to the size of widening of each tranche, differences surfaced. The developing countries pushed hard for larger widening, particularly of the

[22] Others similarly affected were France, Austria, Canada, Denmark, Italy and Norway. On the other hand, Belgium, Germany, Japan, the Netherlands and Sweden came out of the tricky balancing exercise with marginally increased shares.

first tranche, as that was the tranche most used by the them because of its relatively low conditionality. On the other hand, developed countries like the US and Germany were apprehensive of the new concept and its impact on the Fund's supply of useable currencies. The Managing Director, aware of the fact that the oil facility would soon come to an end, was eager to empower the Fund to allow members to draw larger sums through temporary enlargement of credit tranches. As agreement was not forthcoming, the matter was referred to the Interim Committee who upheld the arguments of the industrial members and agreed to a temporary enlargement of credit tranches from 100 per cent to 145 per cent with the tranches'[23] conditionalities remaining unchanged.

SEVENTH QUOTA REVIEW

Disappointed with the outcome of the sixth general review, which had produced a lot of heat, arguments and statistical computations but little liquidity for the Fund, Wittaveen, in mid-1977, in a buff statement, chalked out for consideration by the Board, the procedures and issues that required to be addressed for a quick and satisfactory resolution of the seventh general increase of quotas. As on the previous occasion, he advocated a substantial quota increase that would bring the size of the Fund nearer to SDR 80 billion. To cut short the debate, on this occasion, the Managing Director suggested a procedural change. There would be informal consultations with individual Executive Directors, in order to reach a consensus expeditiously, and, based on the Managing Director's informal exchange with them, a status report would be placed before the Board for submission to the Interim Committee. On the controversial selective increases issue, he indicated that a few special adjustments would be justified but did not spell out which countries would qualify for such increases. As the concept of country groupings had posed problems on the earlier occasion for a meaningful and acceptable classification of countries, and since it had introduced its own form of inflexibility in effecting quota adjustments, the Managing Director advised the Board to leave unchanged the shares of the vast majority of members and confine the special adjustments to a few countries.

The Managing Director, having secured sufficient support from the Board, began his informal consultations. On the size of the overall increase, it was apparent that agreement on a very large increase would be difficult.

[23] The overall size of each tranche was increased from 25 per cent to 36.25 per cent of the quota.

The main hurdle was the US administration's inability to take a position on this, as the Congress was still debating the proposed supplementary financing facility. On the one hand, the US, Canada and Germany favoured a modest increase of 25 to 33 per cent; on the other hand, there were a good number of members, particularly from the developing countries, that argued for a larger increase in the range of 50 to 100 per cent.

At this point of time, with the exit of Jagannathan as the Indian Executive Director at the Fund and the delay in the appointment of a new Indian Executive Director, Rasaputram, the Alternate Executive Director from Sri Lanka, who was holding charge, sought the viewpoint of the Indian authorities on a number of important issues coming up before the Board. On the proposed informal discussions with individual Directors, the RBI Governor Narasimham instructed the prospective Executive Director, S.D. Deshmukh, to advise Rasaputram on the strategy he may adopt. On the overall size of the increase, the Indian viewpoint was in favour of a moderate but not too large increase, in the range of 35 to 45 per cent and an overall increase to SDR 50–55 million. Deshmukh felt that a moderate increase would be to India's advantage, as it would give some leeway for unconditional liquidity creation. On the distribution aspect, Rasaputram was instructed to agree with the Managing Director that selective adjustments would raise difficulties and so the seventh quota exercise should be confined to a simple equi-proportional increase. The idea was to throw in India's lot with those who agreed that a large-scale realignment in relative positions was not necessary. On the suggestion of a few special adjustments, the instructions were to oppose piecemeal adjustments, which would benefit only a handful of members. This would mean identifying countries whose quotas were seriously out of line, using techniques and formulas used in the past. India was rightly opposed to the use of a formula that measured only one characteristic, viz. the economic strength of countries. This formula had succeeded in undermining the relative position of the developing countries, particularly the Indian constituency, at every round of negotiation. The time had come to break new ground and the Fund staff had to be pressed to include new variables, such as share of agriculture in national income, liquidity needs and debt service payments. In short, every effort had to be made to prevent a further slippage and, to do this, selective increase had to be shelved to the next round, by which time appropriate, need-based formulae could be evolved.

Armed with these instructions, Rasaputram, in his informal exchanges with the Managing Director, cited two factors that needed to be taken into account in settling the size of the overall increase: the supplementary credit facility was unlikely to achieve the target of SDR 14 billion, and the third basic period for SDR creation would, in all probability, be an empty one. The other arguments for a substantial increase rested on the premise that it would help the Fund scale down its reliance on external borrowing. But those arguments weighed little with the US authorities, who argued back that the Fund officials had to recognize the ground realities confronting industrial countries in obtaining large amounts of money for the Bretton Woods institutions.

On the distribution issue, to avoid controversy, the Managing Director had proposed that the vast majority of members should get equi-proportional increases and only a few, whose quotas were seriously out-of-line with their global standing, could be considered for special increases. The eligibility criteria suggested were: (i) if a member's calculated quota by the new calculation exceeded the sixth review by a substantial margin; (ii) if a member had contributed to enhancement of the Fund's liquidity; in other words, increasing quotas that would strengthen the Fund's liquidity. The tilt of the informal exchange was evident—the majority favoured an equi-proportional increase but of modest dimensions, for fear that if it was large, it would, in turn, spark demands for special increases. India's was the lone voice battling and pleading for modification of the Bretton Woods formula but virtually with no support. The Indian authorities were decidedly opposed to piecemeal adjustments that would benefit a handful of members and result in protracted wrangling over who should qualify. Contribution to the Fund's liquidity was strongly supported by Germany, Japan and the oil producing countries. The informal meetings sent out strong signals as to which way the wind was blowing. They further indicated that till the US decided on the size of the increase, no agreement would be forthcoming.

As there was little progress, the informal discussions were halted and the IMF staff reverted to the tedious task of calculating quotas by measuring the extent of out-of-lineness.[24] The computation showed nine major oil producing countries as having the largest excesses. India, Bangladesh and Sri Lanka figured in the lowest excess category. The results naturally provoked intense debate on the formula underlying the computation. The non-oil developing members came out rather poorly—and their relative share came down substantially. The bigger and more intractable issue was

[24] It involved measuring the excess of a member's calculated quota over its actual quota. This excess was expressed not in absolute amounts but as a percentage of the quota agreed upon in the sixth review.

the extent to which the excess of a member's calculated quota over its actual quota should determine the eligibility for a selective increase. While the major oil producers, supported by Japan, pushed for the use of calculated quotas to determine selective quota increases, the USA, the UK and several others favoured equi-proportional increases in the region of 25–30 per cent with few a selective quota increases. There was considerable opposition to giving selective increases to Japan and Germany. These countries were seen by many of the industrial countries as aggravating the balance of payments adjustment by refusing to adjust their large balance of payments surpluses. Rewarding them, therefore, seemed unjustified. The question of the form in which the additional subscriptions had to be paid also needed to be considered. The diversity of views that surfaced made agreement before the meeting of the Interim Committee in Mexico in April 1978 well-nigh impossible. All around, disappointment was evident that after one-and-a half years of discussion, no agreement was in sight.

Meanwhile, Wittaveen left and it fell to the lot of the new Managing Director, de la Rosiere, to iron out the wrinkles and present a proposal before the 1978 annual meeting.

Through an aide memoire, de la Rosiere put forward a proposal in the hope of finding a solution. He recommended a 50 per cent general quota increase (SDR 19.5 billion) as the minimum required to restore a reasonable relationship between the size of the Fund and the balance of payments financing needs of all the members over the next five years. He further suggested that an understanding could be reached that there will be no general adjustment in quotas for the next five years. This was a clear concession to the firm stand taken by the US and some developed countries. On the other hand, he suggested selective increases to eleven developing countries whose calculated quotas exceeded by four times the actual quotas.[25]

While forwarding the Managing Director's aide memoire, Deshmukh advised the RBI Governor that the 50 per cent increase in quotas seemed a reasonable compromise and that, since selective increases were given to eleven developing countries, India should go along with the proposal—particularly because, even with the selective increases, the voting strength of the developing countries would reflect a decline from 37.9 per cent under the sixth quota review to 36.8 per cent under the proposed seventh quota increase. In the first, rather brief round to consider the aide memoire,

[25] The selective increases would go to Iran, Saudi Arabia, Kuwait, Libya, Korea, Iraq, Singapore, the UAE, Qatar, Oman and Lebanon. The selective increases would not exceed SDR 388 million, derived as the sum of the China (SDR 275 million) and Cambodia kitties.

there was little thawing of entrenched positions. The US Director harped on the point that the Fund's liquidity position had improved and that it had useable currencies. Also, the supplementary credit facility would soon be activated and with a weak demand for resources the need for a quota increase was not evident. Germany, too, questioned the need for a 50 per cent increase and considered 25–30 per cent adequate for the next five years, while the Japanese chair was not convinced that an airtight case had been made for a 50 per cent increase in quotas. On selective increases, there was considerable support for the Managing Director's proposal, except for Brazil, who vehemently opposed selectivity, as also linking the size of the share of each country to the credit extended by that country.

The US wanted the entire process to be delayed by a few months on account of the serious domestic and international problems facing the US economy; the US administration was reluctant to support measures that would force confrontation with the Congress. As US support was crucial for any proposal on quota increase, the prospects of positive agreement emerging on SDR allocation or quota increase appeared remote.

Deshmukh apprised RBI Governor I.G. Patel and Economic Secretary Manmohan Singh on the ramifications of the Managing Director's proposal to link the size of the share of each qualifying country to the credit extended by that country to the Fund. This, as mentioned, was strongly opposed by the South American constituency, which insisted that only acceptable way of distributing the available SDR 388 million was to divide it on a pro-rata basis among all developing countries, regardless of how thinly the margarine would be spread. The Latin fear was that, as Saudi Arabia and other Arab states required only a few thousand votes to bag a total of three seats in the Fund Board, the fall-out of such a development could be either one Latin American or one African country being unseated. To prevent this from happening, the Latin American Director called on the Indian Director to seek his support.

Knowing that both the Reserve Bank of India and the government were opposed to selective increases and taking into account the political configurations and sensitivities, Deshmukh suggested abstention rather than a negative vote as tactically the more appropriate option, and sought the approval of his authorities. While agreeing with the line of action suggested, the Reserve Bank advised the Executive Director to forcefully reiterate the position taken by the RBI Governor at Mexico City, that the criteria used by the Fund in quota calculations needed a thorough review and that additional factors needed to be taken into the calculations. In order that such a review did not delay the seventh review, the Governor had urged that the exercise could be taken up after completion of the seventh review. The Governor had also severely criticized the practice in the Fund of making calculations of absolute levels of individual member quotas on the occasion of every increase in the size of the Fund, as if there was a clean slate to write on every time. Deshmukh was further instructed to state that calculations of the kind attempted by the Fund so far should not be resorted to in connection with special increases.

The Executive Directors held further discussions on the seventh general review of quotas but, although a certain convergence of views was in evidence, complete agreement was not forthcoming. The outcome that was forwarded to the Interim Committee by the Executive Directors once again reflected differences. To the surprise of many, the Interim Committee, which met in Washington just before the 1978 annual meeting, gave its assent to a 50 per cent general increase for all members except China and Democratic Kampuchea; agreed on selective increases for eleven developing members; and indicated that 25 per cent of the increase in quotas was payable in SDRs for participants in the SDR department, while a non-participant was required to pay 25 per cent in the currencies of other members but as specified by the Fund. Regarding distribution of the special quota increases, the impression was that a consensus had been reached at a closed session of the Interim Committee. But at a later meeting of the Board, the Managing Director explained that the Interim Committee did not get the opportunity to address the issue of alternative forms of distribution, as presented by the staff in Tables I and II, and the issue was open and needed to be decided by the Board. While Italy, Australia, Argentina, France, the African group of countries and India favoured Table I and were opposed to Table II, which sought to correlate the quantum of credit provided by a member to the Fund to the quantum of the special increase, the USA, UK, Canada and Indonesia supported Table II. According to a reliable source, only Table II was circulated to the Interim Committee and this was strongly criticized by the countries opposed to increases on the basis of Table II; in fact, the Managing Director was at pains to emphasize the complete innocence of the staff and management in handling this matter at the Interim Committee, and said that Table II reflected the feeling of the Board at an earlier meeting. He discounted the allegations made that the distribution of Table II at the meeting would have influenced the views of the big powers and, to appease ruffled feathers, assured that it would not be made a precedent for subsequent reviews.

The final report of the Executive Directors was submitted to the Board of Governors on 11 October 1978. Communicating the despatch of the report and outlining the drill to be followed by a member consenting to an increase in the quota, the Indian Executive Director invited the attention of Governor Patel and Finance Secretary Manmohan Singh to the reference in the report that, 'in the context of the Eighth General Review of Quotas, the Executive Board will examine the quota shares of members with a view to adjusting the shares to better reflect members' relative economic and financial positions in the world economy'. This formulation was inserted to satisfy countries which were disappointed with the small special increases agreed to in the seventh review, and Deshmukh suggested adopting a low posture in this regard.

After two years of intensive discussion, the resolution on the seventh general review of quotas was adopted by the Board of Governors on 11 December 1978. All that remained was to have the consent of individual members to the quota proposed for them. This too was long in coming, principally because the United States, the single largest quota contributor, had not completed legislative action and not notified the Fund of its acceptance of its quota increase. With the passage of each quota review it became increasingly apparent that expansion of the Fund's resources through increases in quotas was a politically difficult exercise, subject to non-economic pulls and pressures.

As a result of the seventh quota review, Fund quotas, which added up to $9 billion at the start, came up to a level of SDR 61 billion as on 1 January 1981, while the total membership increased from thirty-nine countries at the start of the IMF to 146. To sum up, quota increases during the 1970s threw up two issues concerning the structure of Fund quotas: the relative position of individual members and the relative position of the developing members as a group. The sixth and seventh general reviews effected profound changes in the structure of quotas. The revision of quotas placed Germany, Italy, Japan, Canada, Mexico, Iran, Iraq and Korea at a higher ranking among member countries by upward revision, not only of absolute amounts, but of shares in the total quotas of all countries. On the other hand, the quotas of countries like the USA, the UK, Australia and India declined in terms of percentages of the total quotas of all countries.

India lost its nominated seat and had to settle for an elected seat. India's position even within the elected category was further eroded when the government of the People's Republic of China sought to re-enter the Fund in April 1980 and China's quota was raised from SDR 550 million to SDR 1.2 billion under the sixth general review and to SDR 1.8 billion under the seventh review, thereby making it the eighth largest quota country in the Fund membership.

On the second issue, namely, the relative position of developing countries, the sixth general review in 1974–75 further agreed that the relative collective share in Fund quotas of non-oil developing countries should not go down, in order to satisfy the demand coming from the oil producing countries for enlarged quotas. But the fact remained that the demand of the oil producing countries had to be accommodated and this naturally resulted in upsetting the long-standing relative quota structure of the Fund and, correspondingly, voting shares. Such changes were a reflection of political realities—apart from the financial aspect of how much funding would be available to the Fund. The seventh review of quotas recognized this situation and opened the door for a review of the customary method of calculating quotas in the eighth quota review—a demand that had been repeatedly made by India. It was now left for the eighth review to grapple with this knotty issue.

To sum up, by the early 1980s, reform of the monetary system had become an evolving process. Considerable changes that were made included the creation of new facilities that accelerated use of the Fund's resources, transformation of the surveillance process, improvements in the characteristics of SDRs, creation of the trust fund, holding of gold auctions and restitution of gold. Quota negotiations also assumed considerable significance during the period. It was a challenging era, no doubt marked by frustrations and disappointments, but behind the façade of nationalist attitudes lurked the desire for international cooperation. That spirit needed further energizing in the years to come.

Conclusion

To be convinced of what is right even if the reasons are wrong is more than half the battle won. This is not, it should be noted, the same as saying that the end justifies the means. The distinction is important because, over the last two decades, the perception has been fostered that the nationalization of banks in 1969 by Prime Minister Indira Gandhi belonged to the latter category. As those who have read this volume carefully will be able to testify, it was only the *timing* of that decision which was prompted by the end, namely, wresting control of the Congress party. The debate about the role of the state in banking, on the other hand, had been going on for almost a decade, and it was only a matter of time before the government took charge. It is arguable, of course, that nationalization was a rather extreme step when other options were available. But it can equally be asked if social control, which in legal terms as encoded in company law, really meant nothing. It would have, at best, enabled the government to tinker at the margin and hope for the best, rather than use brute force to take banking deeper into the country and spread its reach wider. Doubtless, given time, the private sector too would have achieved somewhat similar results, possibly even more efficiently. But, for the political leadership, it was time that mattered most. In the end, it had to be a trade-off between the gradual but more efficient spread of banking and a rapid but somewhat less glittery extension. The government of the day chose the latter option and exercised it at a time when it could derive the maximum political advantage from it. It can be faulted for turning a major economic decision into a political exercise. It can also be criticized for not taking into account the practicality of the operational elements of the decisions. At a more fundamental level, there can also be grievance that bank nationalization essentially meant the end of monetary policy because captive banks would be unquestioning sources of funds for government paper.

However, where the core logic of the decision itself is concerned, one would have to be more careful in judging. There were a very large number of positive externalities, broadly captured in the rubric 'deepening and widening' of the financial system, which also need to be kept in view. For, subsumed in the idea of state control of banking was an even deeper notion that sat well with the national ethos of the time, namely, that the poor must not be forced to rely only on the goodwill and whims of the rich: instead, they must have properly defined entitlements that are not purely socially determined. This was a new and in some ways noble idea. It fell victim later on to vested interests but that must not be used to judge an event that took place in a different context. There can be no gainsaying that without nationalization things would have been different. But whether they would have been better is an altogether different question, which can never be properly answered.

When the 1960s began, Indian banking was concentrated in the cities and major towns. In the rural areas, there was practically nothing. This had led to the growing perception that rural savings were not being tapped by the banking system, which was also not providing credit to agriculture. Bank managements were considered insensitive to the needs of society. These perceptions of the political class led to demands for state intervention. At first the idea was confined to 'social control', whatever that meant, but soon it gave way to outright nationalization. This gave a strong push to branch expansion, especially in the rural areas. The number of branch offices increased from 5,098 at the end of 1961 to 5,858 by the end of 1964, or by 14.9 per cent. But this was not considered satisfactory. Governor Jha in his address to Bombay bankers on 18 August 1967 went to the extent of suggesting 'slowing down of branch expansion in urban areas'. The bankers privately told the Governor that they would welcome this so long as their competitors as well as foreign banks were also kept in check. However, foreign banks were, as Jha observed, 'obliged to confine themselves to port towns only' in order to make profits. A week later, in a policy note to Morarji Desai, Jha noted that more bank offices be opened in smaller places rather than in urban areas. In the context of the 1960s, the enhancement in the geographical coverage of banks implied the opening of additional branch offices in the country. Banks were required to observe a 2:1 ratio between banked and unbanked areas for opening their offices within their geographical spheres of operation. This meant that for every branch they opened in a banked area, they had to open two in an unbanked area.

The essential point to note is that it was a period of experimentation and trial-and-error. But it also becomes quickly apparent that some of the best brains in the country were applying vast energies to the problem. There was a huge outpouring of ideas and some of those were implemented. It is true that most of them were deeply bureaucratic in their provenance. But that did not make them any the less innovative. For example, the Lead Bank Scheme provides a vivid example of how banking became an instrument of social and political policy. The concept can be traced to the recommendations of the Study Group whose report became the template for banking policy after nationalization. The report addressed itself mainly to the task of identifying the major territorial and functional credit gaps, and making recommendations to fill them. As of April 1969, said the report, as many as 617 towns out of 2,700 in the country had not been covered by commercial banks. Of these, 444 did not have cooperative banking facilities either. And, worst of all, out of about 6,00,000 villages, hardly 5,000 had banks. While the credit–deposit ratio was as high as 89 per cent in centres with a population above 10 lakhs, the declining trend in lower population centres was equally glaring. Centres with population groups with less than 10,000 averaged a credit–deposit ratio of 41 per cent. It was an inevitable step to designate a lead bank for each district to carry out the task of expanding credit to hitherto unserved customers. The efforts in this direction were truly heroic. With the benefit of hindsight, it can be argued that this or that was wrong or right. But the fact remains: the 1970s saw credit going to the poor and the issue ceased to be a political stick to beat the government with. The failures would come later, but for the moment a sea change had been achieved in the economic sociology of the country.

The problem was not restricted to the uneven spread of banking. There was not enough credit to go round either. Even if bank branches expanded, they did not have enough to lend. This led, inevitably, to the only solution that was possible in a democracy, even though it was a political solution: the rationing of credit while deposits were being 'mobilized'. Once this had become the cornerstone of policy, the next step was to determine who would get how much, for what purpose and, most importantly, at what price, that is, the rate of interest to be charged. But who was to decide all this? Central to this worthy endeavour was the concept of the priority sector. The problem was that no one ever asked, whose priority and for what purpose? But the answer became clear when the Differential Interest Scheme was introduced for the very poor. The scheme was based on the budget speech for 1970–71 by Prime Minister Indira Gandhi, who had kept the Finance portfolio with herself after the split in the Congress party in July the previous year. She had said, 'The weaker sections of the society are the greatest source of the potential strength and with our limited resources, a balance has to be struck between outlays which may be immediately productive and those which are essential to create and sustain a social and political framework which is conducive to growth in the long run.' The scheme was probably the brainchild of Ashok Mitra, Chief Economic Adviser at the Finance Ministry. In 1977, he became the Finance Minister of West Bengal under the first communist government of the state. Politics entered banking through these two doors and has still not gone away. The logic of the situation also led to the Finance Ministry and the Reserve Bank becoming the arbiters of India's financial destiny in ways that had never been envisaged, at least in the manner that took shape over the 1970s.

With this role came power, to be used or misused. In the event, during the period under consideration, barring a few isolated cases involving some well-connected political figures, there was no misuse. That was to come later. But there was plenty of what the British so charmingly call muddling along. One question that can be reasonably asked: is if the Bank did not become overly accommodative of the government in these years. On balance, after a full consideration of the evidence, it appears difficult to conclude otherwise. Equally, however, it would be wrong to say that the process started during the early years of the 1970s, immediately in the wake of the nationalization of banks. The Bank's autonomy in certain matters had been rudely snatched away as far back as 1956 when the Finance Minister, T.T. Krishnamachari, had berated the Governor, Sir Benegal Rama Rau, in front of the Cabinet room, and the Prime Minister, Jawaharlal Nehru, had sided with TTK [A full account of this incident is available in Volume 2 of this history). But it cannot also be gainsaid that a qualitative change in the relationship between the Bank and the Finance Ministry occurred in the 1970s.

Just how imperious the Finance Minister (Ministry) had become was clear not just in the appointment of Governors but also in the tone and tenor of its routine dealings with the Bank. Worst, perhaps, of all was the perception that the Bank was standing in the way of progress when it was doing no more than its duty by being faithful to its charter, contained in the Reserve Bank of India Act, to maintain the monetary stability of India. However, the Bank's relationship with the government was not exceptional. Other institutions seeking to apply the law as it stood (most notably the Supreme Court) had their brushes with a government impatient for change. The solution lay in changing the law or the rules so that the institutions could apply those with equal diligence. Until that happened, however, there was tension. The 1970s witnessed this tension in full because it takes time for new laws and rules to be put in place.

Perhaps the single most important consequence of this subtle struggle was the abandonment of monetary policy as a tool of economic policy and corrective intervention. Throughout the 1970s and much of the 1980s, it was fiscal policy that held centre stage. The inflation threshold was regarded as being 7 per cent and it was only beyond that level that efforts to reduce money supply started. But even these usually consisted of non-price instruments, such as raising the SLR and the CRR. Such changes in interest rates that were made mostly impacted on the private sector, which, in any case, was faced with over 200 rates by the middle of the 1980s. The idea of a benchmark rate was known but only as something that other countries had. It was not until the late 1980s that the structure of rates at the short end began to be unified. Monetary policy thus had a very small role to play in overall economic management. Fiscal policy came to dominate the field and would continue to do so for two decades.

One of the most significant developments in the early 1960s was the establishment of the Industrial Development Bank of India (IDBI) and the Unit Trust of India (UTI) in 1964. The former was intended to provide long-term capital to industry; the latter was designed to provide a safe haven for small savers. The Bank's initiatives in their setting up were discussed in Volume 2 (1951–67). By the end of the 1960s, both institutions had begun to function well; and, in the 1970s, a certain amount of tension developed between the Bank, these institutions and the government. Coordination was a major irritant and the eventual consequence of this tension was the 'delinking' of IDBI and UTI from the Bank in 1976. There were four areas of relationship between the Bank and the two financial institutions. From the Bank's point of view, they were: management participation, staff and organizational support, financial support and policy support. Of these, the first two areas were not critical—they were expected to be fulfilled because both IDBI and UTI were, after all, set up by the Bank. It was only in respect of the latter two that the relationship became a little fraught owing to its flexible nature. This happened despite the fact that the Bank's participation at the highest management level in the two differed. Thus, the RBI Governor was ex-officio chairman of the IDBI, and a Deputy Governor acted as the vice-chairman. The Bank and IDBI had an identical board of directors. However, in the case of UTI, although the chairman, the executive trustee and four other trustees were nominated by the Bank, the chairman was not from it. Also, the executive trustee was of the rank of executive director of the Bank. This created some anomalies. The financial and policy support, meanwhile, was influenced by the culture that the Bank exported via the secondment of its clerical and officer-level staff.

This was also a period when foreign exchange shortages were endemic and severe. Coping with the uncertainties of the time took a great deal of effort and sagacity, and the Bank played an important role here, especially in the dealings with the IMF. The abandonment of the Bretton Woods system in 1971 created problems for all countries, but for the developing countries these were especially severe. The Bank had to cope with the adjustment challenges in a period of huge uncertainty. The anatomy of exchange control and exchange rate management are analysed in this context. The developing countries were also pressing for reform of the international monetary system and the Bank made several important contributions to the debate.

Safety and prudential issues also came to the fore and the Bank dealt with them in a satisfactory manner. Of late, there has been some criticism that these tended to be overly bureaucratic and process-driven, with the result that even normal risk-taking in banking was discouraged. There is some truth in this but before arriving at a judgment it is important to bear the context in mind, an important feature of which was that the country did not really have a very large cadre of trained bankers at the time. In the absence of skills, experience and market knowledge in the quantities required, rule-based banking was the only option.

DOCUMENTS

This section contains a selection of documents/notes from the Reserve Bank of India's records.

1

No. 22nd May 1967
1 Jyaistha 1889

Hon'ble Shrimati Indira Gandhiji
Prime Minister
Government of India
New Delhi

Dear Madam,

On behalf of the Indian Banks' Association, of which all the large Indian commercial banks, except the State Bank of India, all medium-sized banks, including the State Bank Subsidiaries, and a majority of the small-sized banks are members, and of which I am the Chairman, I may kindly be allowed to make the following submissions to your good self and to the Government of India regarding the resolution passed by the Congress Working Committee a few days ago requesting the Government of India to implement the promise of the Congress Party in its Election Manifesto for extending social control over the commercial banking institutions.

The following brief enumeration of the powers given by the Banking Regulation Act to the Reserve Bank over the banks shows clearly that the powers are so extensive and comprehensive that there is hardly any scope for adding to them or for extending further the social control over banks:

(a) It is authorized to determine the policy in relation to advances to be followed by banks generally or by any bank in particular;
(b) It can give directives to banks either generally to all or to any one in particular regarding the purposes for which advances may be made, the margins to be kept and the rates of interest to be charged;
(c) No bank can remit, without the prior approval of the Reserve Bank, any debt due to it by any of its directors or by any firm, company or individual in which any of its directors may be interested;
(d) It can issue directives regarding the maximum amount of advances to, or guarantees that may be given on behalf of, any one company, firm, association of persons or individuals, by any bank;
(e) It can remove the Chairman or any director or any employee of a bank, appoint its own nominee to take his place, dictate the terms and conditions of service of the chief executive and approve or disapprove of the person chosen for this position;
(f) It is empowered to inspect a bank thoroughly and without previous notice and to order the bank to rectify actions which it considers unsound, unsafe or antisocial;
(g) It is empowered to and does actually keep a close watch over the advances of large amounts made by banks and its prior consent has to be obtained for all advances of Rs 1 crore and over to any one borrower;
(h) It is authorized to appoint observers to watch the affairs of any bank and to make periodic reports to the Reserve Bank regarding its working; and

(i) It is empowered to issue directives to any bank in order to safeguard public interest and the interest of depositors and to secure the proper management and working of the bank.

In addition to the above powers given to the Reserve Bank, the Act requires the banks to disclose all their advances, secured or unsecured, to their directors, officers or to companies etc. in which they are interested. Further, the Act prohibits them from granting unsecured advances to any company in which the Chairman of the bank, appointed for a fixed term, is interested as Chairman or Managing Director or Managing Agent or director or partner of the managing agent of the company.

The annual reports of the Reserve Bank entitled 'Trend and Progress of Banking in India' and the numerous directives which it has been issuing to the banks from time to time for the purpose of ensuring their functioning on sound lines and in the interest of the nation show that the above powers of the Reserve Bank have not remained on paper, but have been and are being used by the Reserve Bank whenever thought necessary by it.

The chief reasons given for demanding increased social control over banks are two: (1) the banks in the private sector are neglecting the credit needs of the small industries, and (2) they do not finance agriculture. The assumption here is that, once the social control over banks is increased, small industries and agriculture will get bank credit liberally and progress faster. The experience of the Banks in the public sector shows that this assumption is incorrect.

Banks in the public sector were brought into being as a part of an ambitious integrated scheme for institutionalizing rural credit and relieving the farmers from the clutches of the usurious moneylenders and for giving a fillip to small industries. Although this part of the scheme has been in operation for more than a decade now, it has not made any significant progress. This is striking evidence of the immensity of the problem and of the limitations on what the commercial banks can do in this sphere, in spite of the best possible intentions and efforts.

The main handicap in lending to small industries lies in the difficulty of assessing the creditworthiness of individual borrowers and the economic viability of their activities. The risks that banks, whether in the private or public sector, can take, have to be consistent with considerations of safety and liquidity, because the banks are only the trustees of the people who keep their money with the banks. Despite this handicap, the banks in the private sector have, in recent years, been stepping up their advances to small industries and their record in this respect does not compare unfavourably with that of the State-owned banks. This is shown by the fact that the outstanding advances of scheduled banks, other than the chief Bank in the public sector, to small industries were Rs 55 crores at the end of March 1965 as against Rs 19 crores in the case of the chief Bank in the public sector.

In spite of these difficulties, there is now greater awareness among banks than before of the need to serve small industries. Several of them have established separate departments for this purpose and liberalized their lending procedures and techniques. They are endeavouring to accelerate progress in this direction.

As regards agriculture, banks are already financing, on a large scale, plantations run on a commercial basis and the marketing of agricultural produce, and will not find it much difficult to increase this finance in the immediate future with the help of the Agricultural Refinance Corporation. They have also been subscribing liberally to the debentures issued by the Land Development (Mortgage) Banks. The real problem of financing agriculture is the provision of finance for the agricultural operations of millions of small individual farmers, the vast majority of whom are engaged in subsistence farming and are helplessly exposed to the vagaries of the monsoon. It has been estimated that there are more than 60 million agricultural households, the average size of the operational holding of a household being about six acres only. What is more, about 70 per cent of the households have landholdings below this average. Every thinking person can appreciate the great difficulties of banks, in the public and private sectors, whose resources are already fully stretched, in catering to the credit needs of this vast multitude spread over this large country. Increase in the social control over commercial banks is no solution to this problem. Nearly a third of commercial banking is already State-owned, but it has not been able to touch even the fringe of the problem so far.

Some of the best brains of India have given deep thought to this problem. They do not think that commercial banks can be of much use in this direction even if the social control over them is extended further, on account of their obligations to their depositors. Their opinion is that cooperative banks provide the best possible approach. This has been tried for nearly a decade now and some progress has been made, although at a considerable cost to the public. A good part of the loans provided through the cooperatives has not been repaid. The overdues in 1962–63 were as much as 22.5 per cent of the outstanding loans. Moreover, a large diversion of loans taken for productive purposes to non-productive purposes is a common feature. The best way to deal with the problem would be to improve, extend and strengthen the cooperative movement.

Another assumption, on which the demand for extending further social control over banks is made, is that economic power in the private commercial banking sector is concentrated in the hands of a few families, who have been managing to make the bulk of its finance available to themselves and their concerns. This is not correct, because the advances made by the banks to their directors or to the concerns in which they are interested form a very small proportion of the total advances of the banks. Moreover, these advances are granted openly, in the ordinary course of business, are disclosed in the balance sheets of the banks and are subject to the control of the Reserve Bank. Even the public sector Banks have not been able to eliminate them. Indeed, if a bank directorship were to be a disqualification for obtaining bank credit, no businessmen could become a bank director and the quality of the management of banks, whether in the public or private sectors, would be very poor.

The boards of directors of banks consist of men of eminence, who have made their mark in various fields, like industry, business and the professions. Their varied experience, mature judgement and insight into the working of different kinds of industry and trade are available to the banks, in the formulation of the policies and in the conduct of the business of the latter. They control the functioning of the banks and ensure that the latter are run on sound lines, in the interest of the depositors, the shareholders and the public.

The large amount of credit granted by the banks may create the impression that their boards of directors have vast powers. Actually, however, the boards dispose of a very small proportion of the applications for credit. All the other applications are dealt with by the managers of 6,400 branches of banks in the country, within limits allowed to them, administrative instructions issued to them by their head offices and directives issued by the Reserve Bank of India from time to time. Bank lending is highly individualistic and decentralized, because managers of branches have to process and sanction thousands of applications for credit every year in accordance with their intimate knowledge of local conditions and their judgement regarding the solvency and profit-earning capacity of the various kinds of business which they are financing.

With extensive controls wielded by the Government over capital issues, industrial production, distribution and prices, banks do not have much choice in determining the industries, for the development of which, they provide the finance. With planned development, the banks necessarily finance those industries which are encouraged by the Government. In this way, the banks promote the planned development of the country, as desired by the Government.

Finally, the Reserve Bank itself, which enjoys the confidence of the Government, has made it known publicly through its annual reports and the speeches of its Governor that the Indian banking system is now working on sound lines and in the interest of the nation and is giving an excellent account of itself.

For the reasons mentioned above, I submit most respectfully, for the kind consideration of your good self and the Union Government, that there is absolutely no case for extending further the social control over commercial banks. I request that a small delegation of the Indian Banks' Association may kindly be allowed to wait on your good self and the Hon'ble Finance Minister to enable it to explain the above considerations more fully.

Yours faithfully,
K.M.D. Thackersey
Chairman

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No. D.O.No.G.8–68 June 2, 1967
12 Jyaistha 1889 (S)

Dear Shri Morarji Desai,

A paper regarding the social control of the commercial banking system was recently forwarded by Anjaria to I.G. Patel. I have received since then Shiralkar's letter dated 18th May 1967, asking for our views on certain specific suggestions. This question was also discussed informally at the last meeting of our Central Board and I think that it will be useful, if I were to indicate our preliminary views on this subject at this stage.

2. Before doing so, I would like to make a brief reference to our earlier observations regarding nationalization. The case for the nationalization of the

commercial banks has been urged on the ground that in relation to the results which may be achieved, the cost is not considerable, and can easily be met from the dividend income or residual profits, which now accrue to the private shareholders. This assessment may not turn out to be quite correct. Even if it were true, however, that an investment for the purpose of acquiring all the banks at present will be justified, it is doubtful whether the Central Government can now find the resources, which may be needed for the acquisition of all the banks other than the State Bank of India and its subsidiaries. The diversion of funds to this extent by cutting down other expenditure will not be desirable. The cost of compensation in foreign exchange, on account of the exchange banks, in case they are also taken over, will also be heavy; and the wider repercussions of acquiring them cannot be ignored. The compensation, whether it is paid in cash immediately or at the end of any period, may, under certain circumstances, increase the volume of liquid funds in the economy; and it is by no means certain that the resources which are thus released will be usefully employed. The possibility of the loss of some deposits to the banking system, while alternative forms of investment like trading in real estate or speculation in commodities are available, or the risk that the constituents of banks may, in the event of nationalization, prefer to handle some of the transactions in cash, instead of through the banking system, thereby adding to the volume of unaccounted money, cannot also be overlooked. For these and other reasons, which have been already indicated more fully in our earlier detailed note, the nationalization of all the banks is not desirable, and is likely to hinder rather than help our economic growth and progress at the present stage.

3. I, however, understand that the present approach is that only some leading Indian commercial banks, and not the entire commercial banking system, should be nationalized. This will mean that the exchange banks will be allowed to continue as they are. This approach to the problem is, I think, even more unsatisfactory than complete nationalization. If the exchange banks are allowed to continue, there is bound to be a drift of business, especially in the port towns and other urban areas, from the Indian banks to the exchange banks. If the diversion of deposits and accounts (which may be due to several reasons like the services which the exchange banks may be in a position to offer, or the expectation that the secrecy of information in respect of accounts in this sector of banking will normally be respected) turns out to be substantial, there will be a recurring burden in foreign exchange, attributable to the profits, which may be made by the exchange banks on this additional volume of business. It is not desirable that we should incur this additional liability. It is not also advisable that we should expose the Indian banking system to the risk of the loss of its business to the exchange banks, thus reversing, in effect, our consistent policy over a number of years of strengthening the Indian banks vis-à-vis the foreign institutions.

4. Assuming that the decision which may finally be taken will not be in favour of nationalization, a somewhat more effective degree of control, having regard to the present objectives, can be considered. It has been alleged that the shareholding, at least in the case of some banks, is closely concentrated, that large loans and advances are made to favoured groups, and that the needs of vital sectors like small-scale

industry or agriculture tend to be neglected; and it has been pointed out that the quality of the service provided by the commercial banking system has to be improved very considerably. Some of this criticism may be exaggerated, but the allegations have not been entirely or in all cases baseless. Further, it is also necessary that promotional or development work to a much greater extent should be undertaken by our commercial banking system. Having regard to this, we might, perhaps, consider the question of some further changes in the law and also some other measures within the general framework of our control.

5. In our present set-up, the Chairman or Vice-Chairman of a bank exercises considerable influence over a bank's affairs, but the existing law does not provide for the same control over his appointment or re-appointment as in the case of managing directors and chief executive officers. An amendment of Section 35B of the Banking Regulation Act 1949 can, therefore, be promoted to provide for a Chairman or a Vice-Chairman to be appointed or re-appointed in future, only with the prior approval of the Reserve Bank. In order to ensure that those who are appointed to these key posts will, as far as possible, be independent persons with no active connection with business or industry, it may be provided that the Chairman or the Vice-Chairman should not be the director of any other company. It may also be provided, in addition, through an amendment of Section 20 of the Banking Regulation Act, that no unsecured loans can be granted to any company or concern, in which a Chairman or Vice-Chairman is interested in *any manner* (conformably to the provisions of the Companies Act 1956, a shareholding to the extent of 2 per cent or less in a borrowing company may, however, be ignored for this purpose).

6. Under Section 36AB of the Banking Regulation Act, 1949, the Reserve Bank has, at present, the power to appoint not more than five additional directors under certain conditions in the case of any banking company. This power can, however, be exercised only if the appointments are necessary in the interests of the banking company or its depositors. It is not clear whether an appointment on the Reserve Bank's own initiative, as in the parallel case of the nomination of directors under Section 408 of the Companies Act will be possible. If any clarificatory amendment is necessary to ensure that the Reserve Bank can appoint one or two directors as its own nominees, in the usual course, in the case of all the bigger commercial banks, Section 36AB may be suitably modified; and a policy decision to make such appointments in future may also be taken and announced for the information of the general public.

7. Any legal restriction on transfers of bank shares, with a view to preventing the concentration of ownership will result in dislocation and inconvenience, as the shares of the existing private banks are bought and sold on a much larger scale than in the case of the State-associated banks. This object can, however, be achieved indirectly to some extent by the prohibition, through an amendment of the law, of unsecured loans to all substantial shareholders, with shareholdings in value of more than 1 per cent of the total value of all the shares issued by a bank. It may also be provided that secured loans granted to such substantial shareholders should be disclosed in sufficient detail in the balance sheets.

8. There may be occasions, when it may be desirable to provide for an extra-

statutory special audit of particular transactions or accounts of a bank. An investigation of the accounts of any specified branch, or of the bank's dealings with certain borrowers or business groups, or of its investments or loans against specific securities may, for example, be necessary, and the extent to which the bank has been able to comply with the Reserve Bank's directions regarding selective credit controls or other matters may also have to be ascertained. The Reserve Bank's inspection machinery, at present, is not adequate for the purpose of undertaking these special investigations; and a regular audit by a qualified professional auditor of standing may, in any case, be preferable to an ad hoc inspection. Provision may, therefore, be made, in the case of all the banks, for a special audit to be undertaken, if necessary, at the instance of the Reserve Bank, but at the cost of the banks concerned.

9. According to the prescribed form of the balance sheet, banking companies are required to disclose the outstanding debts and the maximum total advances during the year, due from or granted to managers or officers or directors or the concerns in which they are interested. It may be useful, if the present provisions could be amplified, so as to require the banks to show separately, and in greater detail, particulars of loans and advances to concerns in which directors of the banks are interested, as managing directors, or as ordinary directors, or as shareholders, or as managing or ordinary partners. Particulars of secured advances to substantial shareholders, with shareholdings of more than 1 per cent, may also be required to be disclosed. It is not necessary to amend the law for this purpose, as the changes in the prescribed form of the balance sheet can be made by notification under Section 29(4) of the Banking Regulation Act.

10. I have considered carefully the question whether any directives should be given to the commercial banks to grant loans to small-scale industries or to agriculture up to any prescribed extent. The loans and advances, which may be sanctioned by a commercial bank to any particular sector, will depend on various considerations, such as the business potentialities of the area in which the bank operates, the demands of its various constituents and the extent of the credit risks which may be involved. Having regard to these considerations and also the depositors' interests, it is not practicable to issue any rigid or statutory direction. As far as small-scale industries are concerned, there is, however, a genuine need for increasing very substantially the promotional effort by the commercial banking system, particularly with a view to providing assistance to artisans, skilled workmen, trained engineering graduates and other individuals, who may need very small sums as clean loans, at least in the first instance, while they are building up their business. I propose to suggest to all the larger commercial banks that they should, like the State Bank of India, create development departments or cells, which, in coordination with the State Bank's own organization, can cater to the needs of small-scale industries under a liberalized scheme and that concessions similar to those provided by the State Bank should also be granted by the other banks. In order to facilitate the grant of loans by the commercial banks to the smaller individuals and establishments, our credit guarantee scheme for small-scale industries will however have to be decentralized; and clean loans of relatively small amounts may have to be guaranteed on a much larger scale. We are also tentatively of the view that the

benefit of protection, in the form of a guarantee cover, should be made available directly to the non-scheduled commercial banks, urban cooperative banks and the relatively well-managed non-banking financial companies, like loan offices and nidhis so that these institutions can play a much larger role than at present in the field of financing small industries. These institutions (which besides being localized and in intimate touch with the smaller borrowers also have the advantage of being able to operate on the basis of relatively small margins) can also be encouraged to obtain financial assistance from the commercial banking system, if necessary, against loans for productive purposes, which may be granted by them.

11. As regards agricultural credit, the urgent need, at present, is to provide for the establishment of the proposed agricultural credit corporations in the states, in which the cooperative credit structure has been proved to be inadequate. Our recommendations in this regard are still pending, and the bill, which will be necessary for this purpose, has not yet been introduced in Parliament. As far as commercial banks are concerned, they will, I feel, be in a position to supplement the assistance provided by the cooperative banking structure and by the agricultural credit corporations, by financing certain essential inputs like fertilizers, hybrid or other improved seeds and agricultural machinery and implements. In order to reduce the risks of lending for this purpose by the commercial banks, it may be desirable for us to formulate a scheme of guarantee or insurance, in respect of bills relating to the purchase and sale of these commodities. The benefit of protection under the guarantee or insurance scheme can be made available to commercial banks or other specified institutions. The scheme can be conveniently operated by the Reserve Bank, which may be granted the necessary authority for this purpose through an amendment of Section 17 (11A) of its statute. The size and volume of commercial banks' assistance for financing these essential inputs for increasing agricultural production can be coordinated, to the extent possible, with the working of the crop loan system.

12. The modification of the existing credit guarantee scheme for small-scale industries and the addition of a further guarantee scheme, in respect of self-liquidating bills relating to specified agricultural inputs, will enable the commercial banks to lend much larger sums to these neglected sectors. The Reserve Bank can, however, operate these schemes only as an agent of the Central Government, or of the State Governments, in case the financial responsibility for the existing or proposed guarantee schemes is passed on, in future, to the State Governments, in respect of loans or bills within their respective areas. Our ability to operate the guarantee schemes, without any great loss, and our inducement to the commercial banks or financial institutions to lend increased sums of money on the basis of these guarantees, will depend on the extent of the cooperation which we may be able to get from Government, and especially from the State Governments, which are vitally concerned with the development of these neglected sectors.

13. We have been encouraging commercial banks for the last two years to invest more in debentures of land mortgage banks. This process can be carried further and banks may be persuaded to extend their support not only to debentures of land mortgage banks but also to debentures issued by all financing institutions set up to assist agriculture and small industries. Such an approach is bound to result in

funds of commercial banks flowing to support agriculture and small industry on a much larger scale than hitherto.

14. I have mentioned earlier the need for improving the quality of the service provided by the commercial banks. While the changes suggested in the foregoing paragraphs, if they are brought into force, will to a large extent, improve the management of the commercial banks and make them more oriented to finance agriculture and small industry, it is not adequately realized that the initiative and enterprise of the management may often be set at nought by the lack of cooperation from the employees, and especially from the staff governed by the Industrial Disputes Act. It has been our experience that quite often the service to the customers has been disrupted, cheques have, from time to time, remained uncleared, demonstrations have been held in or near the premises of banks and in the case of one bank, even some propaganda against the bank, with a view to bringing its credit into disrepute, has carried on by its employees. It is our view that the opportunity afforded by any amendments relating to social control, which may now be promoted, should be utilized to bring about a certain amount of discipline in the personnel working in banks. For this purpose, it will be desirable to provide for the prohibition by law of gheraos and go slow methods, which take the form of the abandonment of work or disobedience of reasonable and lawful orders or demonstrations with a view to impeding the transaction of business or propaganda against the interests of the bank and other similar activities. If this view is accepted, we shall suggest a suitable new provision for this purpose, to be included in the Banking Regulation Act, 1949.

15. One or two suggestions have also been made in the present context regarding the Reserve Bank and the State Bank. The Central Board of the Reserve Bank already represents several varied interests; and businessmen and industrialists are actually in a minority on this Board. The only action, which can usefully be taken at this stage, so far as the Reserve Bank is concerned, is to abolish the Local Boards, which in the present set-up do not have much work to do. As regards the State Bank, an attempt should, I think, be made to ensure that in making future nominations to its various boards other interests besides business and industry are more adequately represented.

16. In making the proposals contained in this letter, as an alternative to complete or partial nationalization, we have taken into consideration the objectives, which are now intended to be served. Our proposals, if they are accepted and implemented, will effectively strengthen our control, having regard to these objectives. I understand that your intention is to appoint a special officer to examine this problem in somewhat greater detail and to make recommendations regarding the action to be taken. I hope that the comments and views expressed in this letter as well as the proposals which we have made will be taken into consideration, before Government arrives at any decision on the basis of the special officer's report.

Yours sincerely,
P.C. Bhattacharyya

Shri Morarji Desai
Deputy Prime Minister and Finance Minister
Government of India
New Delhi

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Bombay
August 4, 1967

My dear Prime Minister,

It was good to hear from you and to find that amidst all your other worries you could still find time to write not only to me but also to a young man who felt a little sore over the abrasive officialese of a letter from the Reserve Bank.

I have not yet had a chance of discussing with Morarjibhai all the points I had touched upon in the notes I had left with you. On coming to Bombay, I got more preoccupied and concerned with the immediate problem posed by the rising tide of unemployment, particularly in the engineering industry. It is my feeling that the deterioration in the law and order situation in Calcutta has to no small extent been due to retrenchment and lay off which became inevitable with the curtailment of Railway orders on which the bulk of engineering industries in the Calcutta area are heavily dependent. In Bombay too Chief Minister Naik tells me the retrenchment figure is already around 50,000. Fortunately, with better and firmer administration there have not been the same kind of disorderly manifestations here which we have witnessed in Calcutta. So when I was in Delhi last, in my talks with Secretaries and also with Morarjibhai, I concentrated on the way in which the recession could be halted. I was happy to find a good deal of responsiveness among my old colleagues and Morarjibhai also in his speech incorporated some of the suggestions I had made. I have since taken some follow-up action on the credit front with which Gadgil also agrees. However, I am still worried.

The measures which Government or the Reserve Bank take to arrest recessionary trends and to stimulate production and employment in the engineering industry must go hand in hand with a reduction, however small, in the prices of their products. While I have been talking in this strain to industry, a positive lead can only be given by Government. I know there are difficulties in the way of a price reduction. Industry argues that compared with the upsurge in agricultural prices and the price of raw materials, the price of manufactures has not gone up much. The increase in dearness allowance also makes it difficult for industry to take a cut in present prices. Nevertheless, I am convinced that some reduction in prices of engineering goods particularly is justified. This is an occasion when engineering industries in the public sector should set an example. I was a little unhappy about the reported statement of the Managing Director of Hindusthan Machine Tools that he could not afford to lower prices when his profits were down to 10 per cent! 10 per cent may be a low level of normal profits, but in the present state of the economy, working even without profits for a few months would not be a bad thing in my opinion.

How right you are when you say that everyone agrees about appointing the right men in the key posts in the public sector, but when it comes to implementation it is another matter. Can we not at least advertise rather boldly and prominently in the

Press that we are on the lookout for executives to fill key posts in the public sector? If people can write in confidence to Cabinet Secretary expressing their interest in taking up such assignments, we might be able to pick up some really good candidates.

Last time when I was in Delhi you were intervening in the Foreign Affairs debate and I did not wish to take up your time. If I happen to come after the Parliament Session, I shall inform Seshan in advance.

With regards,

Yours sincerely,
L.K. Jha

Smt Indira Gandhi
Prime Minister
New Delhi

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September 26, 1967

My dear Shiralkar,

Raman is carrying with him four copies (plus one for himself) of a Memorandum we have prepared on Social Control *Vs* Nationalization. We could not get ready today an Appendix in which we propose to deal with certain observations in Dr Panandiker's Report which we are unable to endorse. This Appendix will be forwarded to you tomorrow, but I would suggest that even if it does not reach you in time, you should not hold up the transmission of the main Memorandum to Paris. In the Memorandum, we have taken care to deal with some of Dr Panandiker's findings with which we are not in agreement. We have, however, done so without referring to the Report.

2. I would request you to kindly arrange and send at least one copy of our Memorandum to Governor along with any material you may send to Secretary. Governor would probably arrive in Paris at the same time as the other members of the Delegation.

3. You will observe that in respect of a few recommendations already accepted by Government, we have offered comments which would indicate the need for further consideration of certain aspects. With regard to the National Credit Council, although we have not elaborated the point in the Memorandum itself, the general opinion in the Bank seems to feel somewhat doubtful about the need for establishing a regularly constituted body for the purpose in view. It is felt that the Reserve Bank's consultation may have to include different interests at different times, so that a Council with a fixed composition may not allow for sufficient flexibility in the operation of credit policies. Further, discussions in an open forum may not always be an advantage. There is also the possibility of pressures developing to influence credit allocations in favour of particular sectors. I have personally found the idea of the Credit Council very attractive and useful but feel that the practical points raised above should also be given careful consideration.

4. I had a brief conversation with Dr Panandiker who has suggested that if any

summary of the Report is to be forwarded, a revised version should be prepared. You may like to entrust the job to him. The transmission of your material need not be held up on that account.

5. Perhaps a copy of the Note which was put up to Cabinet may be of use to Governor and Secretary in considering how the matter should be presented on this occasion.

6. We would appreciate if you could favour us with a copy of any revised note that you may be forwarding to Paris.

With kind regards,

Yours sincerely,
B.N. Adarkar

Shri S.S. Shiralkar
Additional Secretary
Ministry of Finance
Department of Economic Affairs
Government of India
New Delhi

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D.O.No.G.8–311

Bombay
December 6, 1967

My dear Morarjibhai,

I have had occasion to see a draft of the Bill to introduce social control over banks. The draft will, of course, undergo many changes and improvements before it is submitted to you. However, there are two points of substance about which I feel I should write to you.

When you decided that a bank which misbehaves should be taken over, it was my impression that you wanted to see such a bank nationalized in the true sense of the term and that Government will take over the shares from the shareholders. The draft which I saw is in the nature of an extension of the existing powers to amalgamate one bank with another, so that nationalization would mean merger with the State Bank.

I do not feel happy about this. The State Bank is already a huge mammoth organization and it would not be very desirable to make it even bigger by merging any large bank with it. More important is the consideration that the power to nationalize and therefore the liability to pay compensation must rest with the Government and not with the Reserve Bank. It is one thing for the Reserve Bank to amalgamate a bank which is financially in a bad shape with a bigger bank in order to protect the interests of the depositors and without employing public funds in the operation; it would be quite a different thing for the Reserve Bank to undertake a nationalization operation and provide the resources for compensating the shareholders without Parliamentary scrutiny, control and approval.

The second point which I wanted to put to you is of a somewhat practical nature. In regard to the composition of the Boards, it is easy to provide in the law that industrialists will be in a minority and that agricultural and small-scale interests would necessarily be represented. However, it is not easy to define all the categories of people who would be deemed to be eligible to serve as directors of a bank. No matter how large a list one would draw, it is always possible to come across other categories which would seem to be equally suitable for serving on a bank Board. The categories included in the draft which I saw were lawyers, economists, accountants and one or two others. There was no mention of engineers who can be very useful in appraising projects. The same could be said of chemists. Then again, can we say that an educationist or even a well-respected citizen who may not be a specialist of any kind has no place as a bank director? Can we also, by law, rule out people with a labour background?

The point of my driving at is that it is impossible in the law to define all categories of people who alone will be deemed to be eligible as bank directors. I think, the purpose you have in view will be better served without creating difficulties in practice if the law merely limited the representation of industrialists to a minority position and enjoined the representation of certain sectors which deserve priority, viz. agriculture and small-scale industry—to which I would also add exports. If we have these three elements represented, then banks will not continue to neglect them. In regard to the remaining members, if at all they are to be described in the law, it would suffice to say that they should possess knowledge and experience which will be useful to the bank in the transaction of its business. With such a formulation, the informal advice of Government and the Reserve Bank can ensure that the right type of Boards does come into existence and once the pattern has been set up, there should not be any difficulty in making banks adhere to it.

As both these are matters of substance rather than of drafting, I thought I would bring them to your notice so that you can give the necessary guidance to the people concerned.

Yours sincerely,
L.K. Jha

Shri Morarji Desai
Deputy Prime Minister
Government of India
New Delhi

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14 December 1967

The Statement in Parliament by the Deputy Prime Minister and Minister of Finance on Social Control of Banks

With your permission, Sir, I wish to make a statement outlining the major steps that the Government has decided upon to implement the decision to have an effective social control over banks. A good deal of concern has been expressed in recent months in this House and elsewhere about the functioning of commercial banks in the context of our economic and social objectives. Our fundamental aim, within the framework of democratic socialism, is to regulate our social and economic life so as to attain the optimum growth rate for our economy and to prevent at the same time any monopolistic trend, the concentration of economic power and the misdirection of resources.

The banking system is an important intermediary through which the savings of the community are channelized and is a key constituent of our economic life. We are all sure that its policies and practices must serve the basic social and economic objectives. It is in this context that the Government took on hand an examination of the functioning of the banks with a view to taking such steps as might be necessary to achieve social control over banks. We had kept an open mind on this issue and examined the various alternatives, including nationalization, and have decided upon a set of measures which would fulfil the objective in the most effective manner.

I think, it would be appropriate, before detailing the measures, to analyse what is at the root of the public concern over the way the banks function. There have been persistent complaints that several priority sectors such as agriculture, small-scale industries and exports have not been receiving their due share of bank credit and that the bulk of the bank advances is diverted to industry, particularly to large and medium-scale industries and big and established business houses.

It is a fact that over the years a greater proportion or additional resources accruing to the banking system has gone to industry, but it has to be borne in mind that banks supply primarily their working capital requirements; and once an industrial unit has come into being, it would have been a waste of national resources, in an underdeveloped economy like ours where capital is so scarce, to deny it working capital requirements and stifle its growth.

Nevertheless, the importance of sectors like agriculture, small-scale industries and export cannot be overlooked, particularly from the point of view of the national income generation, the provision of employment opportunities, the decentralization of economic power and the earning of foreign exchange. This underlines the need for ensuring credit to all productive sectors of the economy within the framework of our planned economy.

This is the crux of the problem. The demand for bank credit from all productive sectors has been growing apace and will continue to increase further, both in range and depth, but bank deposits have been growing at a slower pace. The level of savings in our country, because of the poverty of the population, is low. While long-term measures are needed to stimulate a larger volume of savings and attract them to the banking system, it is important to ensure, in the immediate future, an equitable and purposeful distribution of credit, within the resources available, keeping in view the relative priorities of developmental needs.

It is against this background that doubts have been expressed whether the banking system, as it is at present owned, constituted and controlled, can be relied upon to discharge this responsibility. Historically, the banks in our country have been started by industrial and business houses and they have close traditional links with them. The boards of directors mainly consist of industrialists and businessmen; small-scale industries, agriculture and other sectors of our economic life hardly have any influence in the overall credit decisions taken by the banks.

A good proportion of advances is given to directors and the concerns in which they are interested. It is the Government's considered opinion—and I am sure the House will endorse this—that the link between a few industrial houses and banks has to be snapped or at least made ineffective, the exclusive orientation of the banks towards industry and business has to be changed, and the credit decision by the bank management must be made to conform to the priorities of our economic development.

It is in this context that many honourable members have supported the idea of nationalization of banks. It has been argued that the necessary orientation in the Banks' pattern of lending and investment cannot be brought about except through public ownership. As I have been explaining, the basic issues which require attention are to evolve appropriate guidelines for the bank management and to ensure their implementation by orienting their decision-making process.

It is the Government's considered opinion that a mere acquisition of banks would severely strain the administrative resources of the Government while leaving the basic issues untouched. What is of prime importance is to ensure that particular clients or groups of clients are not favoured in the matter of distribution of credit and whatever the character of the shareholding, its influence is neutralized in the constitution of the board of directors and in the actual credit decision taken at different levels of bank management. The social control scheme, as conceived and formulated, is built on this basic postulate.

As I have already explained, the first major requirement is to assess periodically the demand for bank credit and indicate the priorities for lending and investment between all sectors of the economy that require credit, in particular the priority sectors such as agriculture, small-scale industries and export. For this purpose, it has been decided to set up a high-level body at the all-India level to be called the National Credit Council consisting of the representatives from large-, medium- and small-scale industries, agriculture, cooperative sector, trade and bankers and professional groups such as economists, chartered accountants, etc.

The Minister of Finance will be the Chairman and the Governor of the Reserve Bank, the Vice-Chairman. The council will be a compact deliberative body, and its deliberations, particularly because of the association of different interest groups, will help the Government and the Reserve Bank in taking appropriate decisions on the budgeting and planning of overall credit. A Government resolution laying down the composition, the terms of reference and other allied matters will be laid on the table of the House shortly.

It has, however, to be ensured that the decisions on the monetary and credit policy formulated by the Reserve Bank, in the light of the deliberations of the council, are implemented by the commercial banks. I shall be introducing in Parliament within the next few days a Bill for conferring additional statutory powers on the Reserve Bank. The powers which have been conferred in the past from time to time on the Reserve Bank have been primarily conditioned by the objective of protecting the depositors' interest. The new powers which are now proposed to be conferred on the Reserve Bank are more positive and purposeful. I would prefer to confine myself only to the important provisions as honourable members would have an adequate opportunity of discussing the various provisions of the Bill when they are taken up for consideration and I would welcome at that stage any constructive suggestions which they would have to make after studying the Bill.

The Bill provides for a major change in the management of a commercial bank. Each bank will have a full-time chairman who will be a professional banker and not an industrialist. The Reserve Bank will have the power to appoint its own nominee as chairman, if the bank's nominee is not acceptable to it and will also have the power to remove him, if the Reserve Bank considers it necessary. The board of directors of banks will be reconstituted and the majority of directors of the reconstituted boards will be non-industrialists and persons from sectors such as agriculture, small-scale industries, cooperatives and other persons whose knowledge and experience will be useful to the banking company. The Reserve Bank will have the power to appoint a director or observer on the board of a commercial bank. In the initial stages, these powers will be exercised only in the major banks with deposits of over Rs 25 crores and gradually over a period, these will be extended to all banks.

Another important provision of the law will be to prohibit all advances or guarantees to directors and the concerns in which they are interested as directors, partners, managers, employees or managing agents or substantial shareholders.

No person or group of persons would, therefore, be able, by reason of their being on the board of directors of the bank, to get any loan for themselves or their concerns. Honourable members have expressed genuine concern, on more than one occasion, that the directors of banks exercise an undue influence on bank managements in getting loan for themselves and their concerns. I am sure that this statutory prohibition will go a long way towards eliminating the influence of any dominant group or persons in getting loans for themselves or their concerns.

I understand that there is, in some banks, the practice of setting up local or advisory committees which scrutinize loan applications and make recommendations to the board; I should like to make it clear that it is our intention that the borrowers of a bank should not be represented even on such a local or advisory committee of the bank. This will be taken care of by the issue of a directive by the Reserve Bank.

Honourable members would be interested to know how our scheme of social control would apply to foreign banks. These banks are incorporated outside India and their affairs in India are looked after by a chief executive who is a professional banker in their employ. The provision regarding wholetime chairman and reconstitution of the board of directors would not apply in their case. However, each foreign bank would be expected to set up an advisory board, consisting of Indians and following more or less the same pattern as that prescribed for Indian banks. They would be expected to conduct their lending policies and practices in the light of the guidance of the advisory boards. I have had discussions with some foreign bankers, and they have readily agreed to fall in line with our wishes. Further details are being discussed by them with the Governor of the Reserve Bank.

I have no doubt that the measures outlined above will achieve the object in view. I do not, however, rule out recalcitrance on the part of an individual bank. If there is a persistent default by an individual bank in complying with the provisions of law or directives issued thereunder, or if it is felt that for the better provision of banking facilities to particular sectors or particular areas, it is necessary to acquire the business of a particular institution, the Government would not hesitate to do so. Suitable provision is being made in the forthcoming Bill.

I am confident that there would be better planning of credit through the establishment of the National Credit Council and more effective institutional control over the decision-making apparatus of the banks. I would, however, like to utter a word of caution. The change in the orientation of the lending policies of the banks has to be gradual. Too sudden a change may disorganize the delicate economic mechanism. One should not, therefore, expect a miracle overnight.

This covers the short-term measures which I have in mind to achieve a reorientation of the outlook of the banking system. I would now come back to what I had mentioned earlier. It is the inadequate level of savings which is a matter of serious concern. All efforts have to be made to mobilize deposits from rural and semi-urban areas whose potentialities are yet to be fully tapped. It is, no doubt, true that the commercial banks, particularly the State Bank of India and its subsidiaries, have been carrying out a programme of branch expansion in rural and semi-urban areas. More vigorous efforts are, however, needed in this direction.

Perhaps, the long-term objective should be the development of the banking system on the lines of regional banks which would be not only in a better position to mobilize deposits in rural and semi-urban areas but will also be in a better position to assess and meet the needs of the small entrepreneurs and the agriculturists in these areas. Such a development cannot, however, take place in the short term and the advantages and disadvantages of a change in the structure of the banking system have to be carefully weighed. There are other areas which require attention. The operational efficiency of the banking system has to be improved and their working modernized. I propose to set up a commission to have a close look at these and other related matters which affect the development of the banking industry on right lines. The terms of reference of the commission, its composition and allied matters are being worked out and will be announced soon.

There is also the need for improving the technical expertise of the banking executives and instilling a sense of independence and integrity in the banking profession. To this end I am considering the setting up of a training institute at the highest level and a working group has been appointed to go into this matter and to make recommendations.

The Indian banking system has attained stability and strength over the last fifteen years. The banking system, as an integral part of the money market, has given a good account of itself. But its orientation and outlook have to be changed, and it has to function as an effective vehicle for the implementation of the monetary and credit policy of the Reserve Bank, whose primary purpose is to realize, with support from other areas of fiscal, industrial and economic policy, the broad economic and social objective inherent in our ideal of democratic socialism. I am confident that the implementation of the measures I have outlined will lead to a positive reorganization of the banking system on sound lines and enable it to fulfil the role that is required of it.

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Indian Banks's Association
17 Horniman Circle
Bombay - 1
No. 302

5th February, 1968

The Honourable Shri Morarji Desai
Deputy Prime Minister and Finance Minister
Government of India
New Delhi - 1

Dear Sir,

THE BANKING LAWS (AMENDMENT) BILL, 1967

We have the honour to observe that most of the provisions of the Banking Laws (Amendment) Bill, 1967 (Bill No. 174 of 1967) introduced in Lok Sabha on 23rd December 1967 are in conformity with the conclusions arrived at, at the informal meetings of the representatives of our Association with you. In a few cases, however, the language of the Bill, as it is drafted, is at variance with the intentions or objects of the Bill and different from the conclusions arrived at, at the informal meetings with you. Moreover, certain other provisions of the Bill are such as to cause hardships in genuine cases. May we, therefore, kindly request you to have the following points considered again and the language of the Bill redrafted, or its substance altered suitably? We also submit respectfully to refer the Bill to a Select Committee so that these and other points could be considered by the Committee clause by clause and properly at length.

1. *Clause 5 of the Bill Substituting a new Section for Section 20 of the Principal Act*

(a) The proposed Section 20(1) prohibits all loans or advances or guarantees (whether secured or unsecured) to any of the directors or to firms or companies in which any of the directors is interested in the specified manner (even as an employee), *or* in which he holds a substantial interest or to any individual in respect of whom such director is a partner or a guarantor.

A strict interpretation of this provision would give rise to various anomalies. Thus, a bank director cannot discount at any office of the bank even a cheque drawn by him on his own account at any other office of the bank where he may have a substantial credit balance, for, such discounting may amount to an 'advance' made by the bank to its director and constitute a contravention of the law.

Again, there are quite a few big industrial units which are either semi-Government concerns or have been set up by the Government, and which have on their Boards of directors persons possessing special qualifications and experience in industry, business and commerce. Such industrial units may enjoy various credit facilities from a number of banks simultaneously. It is quite probable that some of the directors of such industrial units may also be directors of one or the other banks who are bankers to the Government company. According to the proposed Section, it would be obligatory for such persons to relinquish either their bank directorship or their company directorship. To take a specific instance, the case of Gujarat Fertilizer Corporation Ltd. may be cited. The Gujarat Government have a majority shareholding in this Corporation and it was at the desire expressed by the Gujarat Government that a number of leading industrialists were specifically invited to join the Board of the Corporation so as to give it the benefit of their business expertise, and to enable it to operate on strictly commercial and business lines. Because of the magnitude of its operations, a number of banks have issued or participated in issuing guarantees on behalf of the Corporation for a few crores of rupees in favour of the Japanese suppliers of machinery, and have extended or will be extending other banking facilities. Some of the directors of this Corporation also happen to be the directors of one or the other of the banks who have issued such guarantees. If the proposed Section becomes effective, it would necessarily mean that these persons shall, in the event of their retaining their seats on the Boards of banks, have to give up their directorships in the Corporation if the Corporation were to continue to enjoy the large guarantee facilities extended by the banks. Such a development would deprive the Corporation of their valuable expert guidance for which they were specially invited to join.

We would, therefore, request you to kindly consider our suggestion that ordinary, normal and genuine loans, overdrafts, cash credits, and guarantees to concerns in which directors of banks are interested or with which they are connected may be allowed so long as the interest of the banks' directors in such concerns is not substantial and so long as such facilities satisfy the usual credit appraisal standards of the banks. In other words, where the interest of any of the directors of banks in the borrowing concerns is only nominal, and where such facilities are normal and usual, banks may be allowed to grant them within such limits as may either be specified in the Section itself or within such limits as may be determined in each case by the Reserve Bank of India in its discretion.

We also suggest for your kind consideration that loans or advances may be allowed to be granted to directors of banks against the security of their own Fixed Deposits and the prohibition under Section 20(1) should not be applied to such loans or advances.

(b) We would further suggest that loans or advances to or guarantees on behalf of certain classes of borrowers such as public sector undertakings, a bank's own subsidiary company (such as an Executor and Trustee Company which is bound to have common directors with the bank itself), small-scale industrial concerns, and non-profit making companies which are registered under Section 25 of the Companies Act should be exempted from the prohibition contained in the proposed new Section 20(1).

(c) We wish to point out that while Sub-Section (1) of the proposed Section 20 refers to loans and advances, Sub-Sections (2), (3) and (4) refer only to loans.

It is suggested that for the sake of consistency and to avoid ambiguity or doubt in the construction of the Section, the reference should uniformly be to both loans and advances in all the Sub-Sections of the proposed Section.

(d) As already pointed out, in paragraph (a) above, under the proposed Section, as drafted, even the purchase or discount of a director's cheque may be construed as an advance and may consequently come within the scope of the prohibition under this Section. Similarly, a doubt may arise whether there is an element of guarantee involved when a bank opens L/Cs on behalf of a director or a concern in which he is interested or with which he is connected. It is, therefore, suggested in order to avoid any doubt or ambiguity that the terms, 'loans', 'advances' and 'guarantees' should be defined in the proposed Bill, so that such facilities are excluded from the scope of the prohibition under this Section.

(e) It had been agreed that the existing facilities or assistance to the directors of banks or to the concerns in which they are interested or with which they are connected would be allowed to continue for a period of three years. Sub-Section (2) of the proposed Section 20 and the relevant Note on clause also provide that where no period has been stipulated for the <u>repayment</u> of any loan, steps should be taken for the recovery within a period of three years from the date on which the provision is brought into force.

The wording of the Section, however, appears to suggest that renewals of or operations on the existing loans, overdrafts, cash credits, etc. may not be permitted within the stipulated period of three years. The renewals of guarantees, where such guarantees require annual or periodical renewal, are also specifically prohibited. We, therefore, suggest that in order to put the matter beyond doubt, Sub-Section (2) may please be redrafted so as to allow all the existing limits on loans, overdrafts, cash credits and guarantees to be renewed as and when they are due and/or to be continued, operated and drawn fully, until the stipulated period for the repayment of the loan or until the specified period of three years where no period has been stipulated for the repayment of the loan. Similarly, all guarantee limits sanctioned may also be allowed to be renewed or continued in the same way. We may point out in this connection that except in the case of term loans, it is the common practice of all banks to treat all their advances as repayable on demand. As a corollary, it is also the practice of all banks to review the conduct of loans and advances periodically in order to satisfy themselves that the accounts are being conducted satisfactorily, before renewing them. Similarly, guarantees which are of a periodical or recurring nature come up for review or renewal from time to time in the normal course of business.

In other words, it may kindly be clarified that the proposed Sub-Section (2) would not prevent reviews and renewals of all the existing <u>limits</u> or facilities at their present levels, or operations or withdrawals under the existing limits, during the specified period of three years from the date of commencement of this Sub-Section but would prevent only the grant of absolutely fresh limits or facilities or any enhancement in their present levels.

We also suggest that in suitable cases, where extra facilities, assistance or guarantees are required by such borrowers, the Reserve Bank may be authorized to permit at its discretion the limits to be increased. Likewise there may arise occasions where for reasons beyond anyone's control the amount of assistance, facilities or guarantees may have to be increased suddenly. Thus, for example, deferred payment guarantees on foreign imports may go up on account of devaluation or any other unforeseen developments. We suggest that in all such cases the provisions of this Section should not apply and the additional facilities, assistance or guarantees may be granted. There is another aspect of this question to which we would like to draw your kind attention. The provision in Sub-Section (2) regarding repayment within the stipulated period may cause difficulties where the repayment is by fixed instalments and one or more of the instalments are in default and the bank desires both in its interest, and in the interest of its customers to give additional time for repayment. In all such instances, the final repayment of the loan may go beyond the period originally stipulated. It is, therefore, submitted that a suitable amendment may please be made to Sub-Section (2) to include a provision to enable a bank to reschedule the instalment payments with the approval of the Reserve Bank of India. Similarly term loans sanctioned prior to the commencement of the Amendment Act may involve disbursements of unutilized portions thereof during the period of three years after such commencement and also after the expiry of the said period of three years. We therefore suggest that banks may kindly be permitted to make disbursements of such loans sanctioned prior to the commencement of the Amendment Act, at any time thereafter.

(f) With reference to Sub-Section (2) a contingency may arise where a person, who is a director of a bank on the commencement of the said Amendment Act ceases by death, retirement, resignation or any other disabling reason to be a director either of the bank or of the company or to be a partner of the concern, firm or to hold substantial interest therein. We would suggest that the Sub-Section be amended to make it clear that in such a case the prohibition contained therein shall cease to apply thereafter and the loans, advances or guarantees will be allowed to continue or be renewed in the normal way. While this position seems to be implicit in the Sub-Section, a doubt has arisen whether the prohibition contained in the said Section has once been attracted, the same would continue when the circumstances which originally caused the said prohibition to be effective have ceased to exist. It is suggested that the said Sub-Section (2) may be suitably amended to prevent any doubt.

2. *Clause 3 of the Bill Inserting New Sections 10A and 10B in the Principal Act*
Section 10A

We presume that the word 'employee' in Sub-Section 2(b)(1) of Section 10A does not refer to persons obtaining a fee or a retainer for giving advice or providing consultation services.

Section 10B

(a) We suggest that the proviso to Sub-Section (2) of Section 10B should be suitably altered so that no disqualification shall attach to the chairman of the Board of Directors of a banking company in the following cases also:

(i) Where under the terms of contract of a loan or an advance the bank is authorized to nominate its representative on the Board of the borrowing company, in order to safeguard the interest of the bank.

(ii) Where the chairman of a bank is appointed a director of companies or corporations like the Industrial Finance Corporation, Industrial Development Bank of India, Unit Trust of India, Life Insurance Corporation of India or the Agricultural Finance Corporation proposed to be floated by scheduled banks, or such other institutions which may be approved by the Reserve Bank.

(b) The disqualification contained in the proviso (c) to Sub-Section (4) of Section 10B is likely to operate rather harshly against the Chairman of the Board of Directors of a bank. As the provisions stand, he is disqualified if he has a substantial interest in any other company or firm. Thus, it will be difficult for the Chairman to hold any shares or interest, for example, in a small-scale industrial concern started or run even by any of his close relatives.

We, therefore, suggest that the above Sub-Section may be suitably redrafted. In case it is not possible for any reason to modify this Section as suggested above, we request that the definition of substantial interest in relation to chairman of a bank may partly be modified so that any share or interest of his spouse or minor child in a small-scale industrial concern does not amount to a disqualification for the chairman.

3. *Clause 15 of the Bill Inserting a New Section 36 AD in the Principal Act*

The Indian Banks' Association welcomes the intention of the Government to give protection to the banks against the obstruction of business or against indecent demonstration within or in front of bank offices. The Association, however, feels that the drafting of the Section is inconsistent with the intentions and objectives of the Section, namely to ensure that no inconvenience is caused to members of the public and that the creditworthiness of a bank is not affected. As the Section is drafted, it would still be possible to hold demonstrations and shout slogans within or in front of the premises of the banks as long as they are not indecent. Moreover, no cognizance of any obstruction or offence under this section would be taken by police or courts except on a complaint from the Reserve Bank of India.

It would be physically impossible for the Reserve Bank to certify whether any indecent demonstration or obstruction of business took place or not. Moreover, it would be extremely difficult for the Reserve Bank to prove an offence under this section in a court of law. In so far as the banks would not be able to move a Court without the intervention of the Reserve Bank of India, the managements would feel deprived of the remedy at present available to them. As the law stands today, it is open to a bank management to go directly to a Court and obtain an injunction restraining its workmen from obstructing the business at its offices or holding demonstrations, etc. The proposed Sub-Section (3) in Clause 15 of the Bill appears to impinge on this remedy.

We, therefore, suggest that the wording of the proposed Section 36 AD may please be modified suitably so as to simplify the procedure for taking disciplinary action and to eliminate the necessity for a certificate from the Reserve Bank of India being obtained.

4. *Clause 2(iii) of the Bill Inserting a New Definition of a Small-Scale Industrial Concern*
The proposed definition of 'small-scale industrial concern' applies to a manufacturing or a processing industry, but does not apply to a small company or a firm carrying on any trade or commerce, because such a company or firm would not have any investment in plant or machinery.

We suggest that the scope of the definition should be expanded so that a small-scale business, trading company or a firm is also included within the definition of the small-scale industrial concern if its assets are within the prescribed limits.

5. *Clause 3 of the Bill Inserting a New Section 10B in the Principal Act*
We suggest that the proposed Section 10B may be suitably amended so as to provide that the Chairman of the Board of Directors of a bank, being in its whole-time employment, shall not be deemed to hold an office or place of profit under the Company within the meaning of Section 314 of the Companies Act, 1956.

We also suggest that the proposed Section 10B should further be suitably amended so as to provide that Section 309 of the Companies Act shall not be applicable to the determination of remuneration payable to the Chairman of a banking company. It should also be provided that such remuneration may be determined by the Board of Directors of the bank subject to the approval of the Reserve Bank of India.

We further suggest that Sub-Section (3) of the proposed Section 10B may be altered so as to provide that it will not apply in cases where the office of the Chairman and Managing Director is held by one and the same person.

6. *Clause 8 of the Bill Amending Section 30 of the Principal Act*
The proposed Sub-Section (1A) of Section 30 of the Principal Act requires previous approval of the Reserve Bank before appointing, re-appointing or removing any auditor or auditors. We suggest that the word 'previous' may be deleted from the above phrase, with a view to avoid any technical difficulty which may arise if previous approval of the Reserve Bank cannot for any reasons be obtained. We are advised that a subsequent approval would not remedy the defect in the original appointment, re-appointment or removal, if it was made without prior approval.

7. *Clause 11 of the Bill Amending Section 35B of the Principal Act*
We suggest that the words 'previous' recurring in the proposed clause (b) of Section 35B of the Principal Act may also be deleted for similar reasons as stated above.

8. *Clause 20 of the Bill Adding a New Section 55A to the Principal Act*
We would also suggest that specific powers may be given to the Reserve Bank in the proposed new Section 55A to give directions to do or ordering to be done for the purpose of removing any difficulty which may arise in giving effect to the provisions of the amending Bill. We are aware that the proposed Clause gives such powers to the Central Government. Since, however, all the difficulties which may arise after the proposed Bill becomes operative cannot be anticipated and since there may be delays if reference to Central Government is necessary in all such cases, it is essential that the Reserve Bank may be empowered as suggested above. We are of the view that it would help expedite disposal of concerned matters if such powers are given to the Reserve Bank.

The provisions of Section 53 of the Banking Regulation Act will not be very helpful for this purpose since they empower the Central Government on the recommendation of the Reserve Bank to declare by a Notification in the official Gazette that any or all of the provisions of this Act shall not apply to any banking company or any class of banking companies. What the banks are requesting in this paragraph is not an exemption from any of the provisions of the proposed Bill but a power to the Reserve Bank to remove the difficulties, if any, which may arise in practice when this Section comes into operation.

Yours faithfully,
KRISHNARAJ M.D. THACKERSEY
CHAIRMAN

8

CREDIT PLANNING—THE ISSUES

To assist the deliberations of the Council, this paper attempts to outline some of the important aspects of the problem of allocating bank credit so as to make it a more efficient instrument of development. The problem arises principally because of two reasons. First, there is an overall shortage of savings in the economy. Second, only a relatively small proportion of the total savings in the community come to financial institutions which can deploy them for productive and developmental purposes.

The principal tasks before the economy in the credit field are firstly to increase the flow of savings into the banking system, and secondly to ensure that the lending policies of the banking institutions are aligned to the requirements of production and development.

In the initial stages, the Reserve Bank's directions to banks regarding their advances were mainly intended to ensure that all lending was safe and free from any risks which would jeopardize the safety of the depositors' money. The main accent was on the nature of security against which bank advances were made and the kind of margins which should be fixed so as to minimize, if not eliminate, all risks. Over time, the purposes for which loans were sanctioned began to assume greater importance relatively than the nature of the security offered.

There have been three broad principles followed by the Reserve Bank in providing the general guidance that it does to the banking system. In the first place, banks have been asked to conduct their credit operations in such a way that the banking system remained healthy and the confidence of the depositors in it was not impaired. Secondly, from the point of view of maintaining stability in the economy, banks have been asked to see that their resources are not used for commodity hoarding and speculation. Whenever necessary, appropriate control measures have been used for the purpose. Thirdly, banks have been encouraged to allocate a reasonable share of their resources for such purposes as exports, small-scale industries, term finance for agriculture through appropriate cooperative institutions, and so on.

The instruments which the Reserve Bank uses for controlling credit either by limiting the volume of its expansion overall or by imposing restrictions on particular types of advances, for example, against specified commodities, are the conventional ones which most central banks use. Thus, a check on the overall volume of credit is maintained through what is called the net liquidity ratio system. The principle of this system is: the more a bank borrows from the Reserve Bank of India, the less its net liquidity and the higher the rate of interest it has to pay to the Reserve Bank. Penal rates are charged if the borrowing is in excess of its entitlement which is fixed from time to time. A watch is also kept on the credit–deposit ratio of individual banks so as to see that their credit operations bear a reasonable proportion to the deposits they are able to mobilize. Then, in regard to specific purposes, limits are imposed and margins prescribed. Through these devices, the use of banks' resources for commodity and share market speculation is checked and they become available for purposes which are considered to be more conducive to economic growth. More recently, certain devices have been introduced to stimulate the flow of bank credit to certain sectors which are judged to have a priority and to which the availability of bank credit needs special stimulation. These comprise mainly the offer of additional finance from the Reserve Bank at the Bank Rate or at concessional rates lower than the Bank Rate to those banks which enlarge their lending to the priority sectors and some relaxation in the liquidity requirements under the net liquidity system.

In operating the system of selective credit controls and giving guidance to the banking system in regard to priorities, the Reserve Bank has had the advantage through constant informal talks and consultations at various levels to know the minds of Government and the Planning authorities. Consultations with the users of credit have also been taking place. The Reserve Bank is also represented in various committees and conferences where problems relating to industry and trade are discussed either specifically in relation to particular sectors of the economy or from a wider angle. In addition, the Reserve Bank maintains a close and constant watch on developments which have a relevance to credit policy such as the trend of prices and production of individual commodities, the situation in the capital and money markets, developments in the export sector, the movement of principal imports, etc. Credit policy has to be responsive to seasonal and short-term factors. The Reserve Bank has been following the practice of having meetings with bankers at the beginning of what are known as busy season and slack season when the policy for the coming months is discussed and settled. In addition, whenever changing conditions in the economy require, such meetings are called at other times as well. Further, the directives and guidelines given to banks are constantly under review and are modified from time to time as and when necessary.

With the establishment of the National Credit Council, there is, for the first time, a forum in which the long-term policy and the priorities in the credit field can be discussed jointly with representatives of the banking system including the cooperatives on the one hand and the main users of credit on the other. The deliberations of the Council should help in developing a long-term strategy for credit planning and priorities.

The long-term impact of selective credit controls operated by the Reserve Bank has been, as will be seen from the paper on 'Pattern of Bank Credit', to stimulate the flow of bank credit to industry which now occupies the first position with nearly two-third of the total bank credit being used by it. This position has been built up at the expense mainly of credit to trade as well as to individuals for their professional or personal activities. This change which has been a natural consequence of the desire to promote the industrial development of the country does raise a number of questions in the perspective of long-term planning. Some of these are briefly touched upon below.

Bank credit to agriculture remains at a very low figure of 2–3 per cent of the total even after including credit to plantations. The question, therefore, does arise whether in the context of the emphasis which is being laid on agriculture today and the greater requirements of finance for introducing modern techniques into agriculture this is at all a reasonable figure and in what way it could be changed. Before considering this question, it is necessary to appreciate why this is so. Several expert committees appointed in the past to examine the problem of providing cheap and adequate credit for agriculture had been of the view that the enormous number of cultivating units and the wide variations in the size and type of their operations made provisioning of credit to them a very difficult task for institutions like the commercial banks which had neither the expertise in these matters nor the resources in terms of manpower and deposits to provide credit to the general run of cultivators. It is in the light of the recommendations of such committees that the Reserve Bank had attempted to handle this problem through the cooperative credit system which has the advantages of a wide network and, therefore, knowledge of local conditions.

However, in the more recent past, the Reserve Bank has been encouraging commercial banks to take up agricultural financing with due regard to the following points. First, the major agency for this purpose should continue to be the cooperative mechanism. The commercial banks cannot be expected to have either the expertise or the resources on the scale that this mechanism has. At the same time, methods should be devised whereby commercial and the cooperative banking system can work closer together and supplement each other's resources. Thus, commercial banks could expand the area of their indirect financing of agriculture through subscriptions to the debentures floated by land mortgage banks. Second, the fact that industries producing inputs for agriculture such as fertilizer, farm implements, pesticides, etc. will become increasingly important suggests a fruitful line of activity for these banks. They could be asked to allocate a share of their resources for financing the distribution of such inputs. Third, where the cooperative mechanism has remained weak or is in a moribund state, commercial banks could attempt to fill up the gap. The Council may wish to consider the direction in which commercial banks could expand their area of their assistance to agriculture.

Turning from agriculture to industry, although it has the lion's share of bank advances, the fact remains that there are complaints both about the inadequacy of bank credit for industry as a whole and also about certain special problems which particular industries face. It is obvious that to sustain a high and increasing rate of production, an increasing amount of credit should be available to industry. Moreover, our experience has shown that with the increase in the production of large machinery and other capital goods, the requirements of credit have increased far more than the increment in the value of production. This is because the time cycle for the production of capital goods is longer, often extending into years rather than months necessitating larger credits for longer periods. Furthermore, sales of capital goods, whether to domestic users or to users abroad, often require financing over a period. Furthermore, the general increase in prices in recent years as well as the depletion of internal resources in several industries have combined to raise the amount of credit needed by industry for working capital purposes and at the same time erode its borrowing capacity. The problem is particularly difficult for units in the medium- and small-sized range. In fact, it would be true to say that despite the increase in the share which industry has of total bank credit, industry is still not able to meet its full requirements of working capital out of credit available to it.

The overall shortage of credit for industry can only be met over time by measures of deposit mobilization and increase in the savings by the community. It would be difficult to increase the share of industry in the available supply of credit not only because, as discussed in earlier paragraphs, there are new needs in the agricultural sector to which priority must be given, but also because even from the point of view of industry itself, certain other sectors need special attention. The larger out-turn of cash crops like jute, cotton and oilseeds, which are the basic raw materials of some of our most important industries, calls for larger credits being made available to the farmer and the trader. Similarly, some increase in the volume of finance to the trader or to the ultimate consumer would also be necessary if the production of industry is to be lifted and not accumulated in its godowns. This factor has assumed special importance in the prevailing recessionary conditions which have hit so many industries. To put it differently, the growth of industry results not only in an increased demand for working capital but also for additional credit at a large number of other points outside industry but inevitably linked with it.

So we come back to the crux of the problem which is the inadequacy of resources with the banking system. While this underlines the need for having priorities, we have to recognize that a step-up of credit to any one sector of the economy would inevitably mean a shortfall somewhere else. It is highly unlikely that much by way of additional resources would become available by identifying areas of less essential employment of bank credit though clearly this process must continue. It may be more fruitful to concentrate on the deployment of the increased resources with the banking system which accrue every year with the rise in deposits. Currently, they are growing at the rate of Rs 425–450 crores a year. On this basis, bank could lend out of their own resources at the rate of Rs 300–325 crores a year since banks have to maintain at least 28 per cent in the form of cash, balances with the Reserve Bank, and investments in approved securities. The questions that need consideration are how the rate of deposit increase can be augmented and how this increase should be distributed as between different sectors.

That agriculture should receive high priority goes without saying. Further, a part of this increase must go to industry because industrial production must continue to rise. But there would be a case to see that a higher proportion of these resources goes to industries which are judged to be more deserving from an economic or social point of view. Small-scale industries clearly deserve greater attention from the banks. Same is true of the export sector. The existing system of preferential credit recognizes the special priority accorded to these sectors. The question is whether any other special areas of preferential treatment within agriculture and industry can be identified.

It has to be remembered all the time, however, that a large increase in the allocation to any sector may create problems for others and there is something to be said for a gradual rather than a radical change. This consideration becomes particularly relevant when we take into account the fact that the capacity to absorb credit, which is an essential counterpart of the allocation of credit, cannot be built up overnight. A series of steps have to be taken to establish the requisite links to examine the economics of particular schemes or projects before allocated credit actually starts flowing for the purpose for which it is meant.

In considering the long-term priorities for credit the Council will doubtless recognize that short-term factors may necessitate departures from the norms which are set up. The amount of credit required by a sector may be affected by such factors as the growth of demand in the economy, the availability of raw materials, import licensing policies, the state of the capital market and the monetary and credit policies followed by the authorities. For example, in the recent past because the capital market was depressed, many industrial units had to turn to bank finance to complete their investment programme because they could not raise funds in the market. Similarly, the recessionary conditions affecting certain industries left them with rather high unsold stocks on hand for which again they had to rely on bank finance. In its actual operation, there would seem to be a clear need for flexibility rather than rigidity in the matter of credit allocations.

One of the difficulties of assessing the needs of credit of different sectors arises because the data which are available are inadequate. It will be seen from the papers on agricultural credit and financing small-scale industries that no satisfactory estimates of requirements exist. The Council may wish to devote some thought to the kind of material that should be before it in order that it may be better able to consider the credit needs of different sectors.

In the light of what has been stated in the foregoing paragraphs and in the other papers that have been circulated, the Council may wish to discuss the following issues:

(a) What kind of steps should be taken to increase the flow of savings into the banking system so as to augment its resources and its ability to provide credit to the deserving sectors of the economy?
(b) In what manner should the likely increase in bank resources be deployed in order to be of the maximum benefit to the economy?
(c) Apart from allocations to broad categories such as industry, agriculture, small-scale industries, exports and the like, are there any specially deserving areas within these categories to which special attention and priority should be given?
(d) What kind of data compilation should be taken in hand in order to enable the Council to give further consideration to these questions in future meetings?

8.3.1968

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File No. F. 12/1/78–BO.I.

Government of India
Ministry of Finance
Department of Economic Affairs
Banking Division
BO.I. Section

Subject: Requisition for Files Regarding the Promulgation of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance and the Bill 1969 Exercised from the Ministry of Law, Justice and Co., Affairs F.No. 2 (E) 169-L-I.

The Cabinet, at its meeting held at 5.30 p.m. on 19 July 1969, approved a proposal to promulgate an Ordinance to provide for the acquisition and transfer of the undertakings of certain banking companies in order to serve better the needs of development of the economy in conformity with national policy and objectives and for matters connected therewith or incidental thereto. A copy of the Summary for the Cabinet is placed below.

Since it is not possible to get the Ordinance printed at such a short notice, a typed copy thereof is placed on the file for the acting President's signature.

S.K. Maitra
Joint Secretary to the
Government of India
Ministry of Law
Legislative Department

Special Secretary
Deptt. of Economic Affairs
Ministry of Finance

I.G. Patel
19.7.1969

P.M.

INDIRA GANDHI
PRIME MINISTER AND
MINISTER OF FINANCE

V.V. GIRI
19.7.1969

DS(E) may kindly remove the asserted copy of the ordinance for safe custody.

DS(E) 21.7.1969

On Friday, the 18 July 1969, at about 4.30 p.m., Shri S. Banerjee, Joint Secretary to the Prime Minister, requested me over the phone to come to the Prime Minister's Secretariat. He further advised me to go there as unnoticed as possible and also advised me not to disclose to any body as to where I was going. I, therefore, went to the Prime Minister's Secretariat without telling anybody where I was going. When I reached there, Shri Banerjee took me to Shri P.H. Haksar, Secretary to the Prime Minister. Shri Haksar told me that the Prime Minister has directed that an Ordinance for the nationalization of certain banks should be drafted by me immediately. He also instructed me to keep the matter completely secret and told me that I should not disclose my movements to anyone. Pursuant to the advise of Shri Haksar, I went to Shri S.S. Shiralkar, Additional Secretary, Ministry of Finance. In the meantime, I came to know that the Law Minister wanted that I should see him. I, therefore, went to the Law Minister and the Law Minister told me that the Ordinance for the nationalization of banks should be drafted by me as quickly as possible. The Law Minister further told me that some draft has been prepared by the Minister of Finance and that I am required to vet that draft only. The Law Minister, however, directed me to show to him the draft, prepared by me as soon as the draft has been prepared. Thereafter, I discussed the matter with Shri L.K. Jha, Governor, Reserve Bank, Shri Bakshi, Deputy Governor, Reserve Bank, Dr I.G. Patel, Special Secretary, Minister of Finance, Shri S.S. Shiralkar, Additional Secretary, Ministry of Finance and Shri D.N. Ghosh, Deputy Secretary, Ministry of Finance. Neither any draft nor any other paper was produced before me by the Ministry of Finance. Only three criteria were indicated to me, namely: (1) foreign banks are not to be nationalized, (2) Indian banks having deposits of not less than Rs 50 crores on the last Friday of June 1969, should be nationalized, and (3) the compensation should be the value of the assets less the liabilities.

2. I wanted to prepare the draft in my office but I was not allowed to do so. I was required to sit in a room in the Governor's Flat in the Reserve Bank. I was told that Shri R.K. Seshadri, Executive Director, Reserve Bank has left Bombay by air and he will also assist me in preparing the draft. Since the whole matter was to be kept secret, my whereabouts were not disclosed to anyone, not even to the members of my family.

3. Initially, I prepared a draft for straight acquisition of the banking companies by the Central Government. But when the draft was prepared and typed, Shri

Seshadri, who had arrived by that time, indicated that if all the banks were vested in the Central Government, then the Central Government would be required to run all the banks' departments, but the Central Government was not in a position to do so. Thereupon, we began to discuss what should be the appropriate scheme of the proposed nationalization. After some discussion, it was decided to convert the existing banks into statutory corporations so that the assets and liabilities of the existing banks could be transferred to the statutory corporations after nationalization. This scheme was discussed with the Governor and the Deputy Governor of Reserve Bank, and after prolonged discussions both of them agreed that this was the only solution. It was past midnight when the said scheme was approved.

4. Shri L.K. Jha had very kindly lent the services of his Personal Secretary to me and Dr Patel had also lent the services of his Personal Assistant to me. I began to dictate to these two gentlemen alternately and the whole night was over before the draft could be finalized. In preparing the draft, I had initially followed the pattern of the Metal Corporation of India (Acquisition of Undertaking) Act, 1966, but Shri Seshadri, insisted on following the pattern of the State Bank of India Act. Accordingly, Clause 4 was changed. The first draft, as so prepared, was shown to the Law Minister at his residence in the morning of the 19th instant, and he very kindly approved the draft without making any change therein. Later on, the first draft was discussed at a meeting held in the room of Shri Haksar. Shri L.K. Jha, Shri Haksar, Shri Bakshi, Dr Patel, Shri Shiralkar, Shri Seshadri, Shri Ghosh and myself were present at the meeting. The draft, which was prepared by me, was approved with very minor verbal changes. Thereafter, the draft was discussed by the Prime Minister, with Shri L.K. Jha and the Law Minister. Initially, provision was made in the draft for the payment of compensation in cash. Prime Minister desired that provision should be made for the payment of compensation in securities. In this connection, a question arose as to whether payment of compensation could be made in securities. The Law Minister also raised a point that the compensation provided for in the draft was more liberal than the compensation provided in the State Bank of India Act, which provided for payment of compensation on the value of shares.

5. The draft was thereafter shown to the Attorney-General and the Attorney-General approved the draft as a whole. He, however, objected to the provisions of Clause 4, which were drafted on the model of the State Bank of India Act at the insistence of Shri Seshadri, and he also suggested that Sub-Clause (2) of Clause 8 should be omitted. The Attorney-General advised me to follow the pattern of the Metal Corporation of India (Acquisition of Undertaking) Act, 1966. Accordingly Clause 4, Clause 6, Clause 8 and the Second Schedule were amended and were drafted on the lines of the said Act.

I discussed with the Attorney-General, the matter with regard to the method of compensation and he expressed the opinion that payment of compensation in cash is not essential; compensation could be paid in marketable securities. He also expressed the view that since under the Banking Laws (Amendment) Act, 1968, compensation is required to be paid for the nationalization of smaller banks on the basis of the value of the assets less liabilities, a different principle for the payment of compensation for the nationalization of bigger banks would be discriminatory. Hence, the provisions which have been made are in order. A copy of the opinion of the Attorney-General is placed on the file.

6. I have informed JS(A) about what has been stated above.

S.K. MAITRA
JOINT SECRETARY AND LEG. COUNSEL
21.7.1969

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Eastern Economist February 20, 1970
RECORDS AND STATISTICS

RENATIONALIZATION OF 14 BANKS

The President, Mr V.V. Giri, promulgated an ordinance on 14 February, renationalizing the fourteen major Indian banks whose nationalization had been set aside by the verdict of the Supreme Court on February 10, 1970. The ordinance makes renationalization effective from July 19, 1969, and the chairmen of the nationalized banks have been re-appointed as custodians. Full text of the ordinance follows:

An Ordinance to provide for the acquisition and transfer of the undertakings of certain banking companies in order to serve better the needs of development of the economy in conformity with national policy and objectives and for matters connected therewith or incidental thereto.

Whereas Parliament is not in session and the President is satisfied that circumstances exist which render it necessary for him to take immediate action;

Now, therefore, in exercise of the powers conferred by clause (1) of article 123 of the Constitution, the President is pleased to promulgate the following Ordinance:

CHAPTER I

(1) This Ordinance may be called the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1970.
(2) The provisions of this Ordinance (except section 21, which shall come into force on the appointed day) shall be deemed to have come into force on the 19^{th} day of July, 1969.
2. In this Ordinance, unless the context otherwise requires:
(a) 'appointed day' means the date of promulgation of this Ordinance;
(b) 'banking company' does not include a foreign company within the meaning of section 591 of the Companies Act, 1956;
(c) 'commencement of this Ordinance' means the 19^{th} day of July, 1969.
(d) 'corresponding new bank' in relation to an existing bank, means the body corporate specified against such bank in column 2 of the First Schedule;
(e) 'Custodian' means the person who becomes, or is appointed, a Custodian under section 7;

(f) ‘existing bank’ means a banking company specified in column 1 of the First Schedule, being a company the deposits of which, as shown in the return as on the last Friday of June, 1969, furnished to the Reserve Bank under section 27 of the Banking Regulation Act, 1949, were not less than rupees fifty crores;
(g) ‘Schedule’ means a Schedule to this Ordinance;
(h) words and expressions used herein and not defined but defined in the Banking Regulation Act, 1949, have the meanings respectively assigned to them in that Act.

Chapter II
Establishment of Corresponding Bank

Transfer of the Undertaking of Existing Banks:

(1) On the commencement of this Ordinance, there shall be constituted such corresponding new banks as are specified in the First Schedule.

(2) The paid-up capital of every corresponding new bank constituted under sub-section (1) shall, until any provision is made in this behalf in any scheme made under section 9, be equal to the paid-up capital of the existing bank in relation to which it is the corresponding new bank.

(3) The entire capital of each corresponding new bank shall stand vested in, and allotted to, the Central Government.

(4) Every corresponding new bank shall be a body corporate with perpetual succession and a common seal with power, subject to the provisions of this Ordinance, to acquire, hold and dispose of property, and to contract, and may sue and be sued in its name.

(5) Every corresponding new bank shall carry on and transact the business of banking as defined in clause (b) of section 5 of the Banking Regulation Act, 1949, and may engage in one or more forms of business specified in sub-section (1) of section 6 of that Act.

(6) Every corresponding new bank shall establish a reserve fund to which shall be transferred the share premiums and the balance, if any, standing to the credit of the reserve fund of the existing bank in relation to which it is the corresponding new bank, and such further sums, if any, as may be transferred in accordance with the provisions of section 17 of the Banking Regulation Act, 1949.

4. On the commencement of this Ordinance, the undertaking of every existing bank shall be transferred to, and shall vest in, the corresponding new bank.

5. (1) The undertaking of each existing bank shall be deemed to include all assets, rights, powers, authorities and privileges and all property, movable and immovable, cash balances, reserve funds, investments and all other rights and interests arising out of such property as were immediately before the commencement of this Ordinance in the ownership, possession, power or control of the existing bank in relation to the undertaking, whether within or without India, and all books of accounts, registers, records and all other documents of whatever nature relating thereto and shall also be deemed to include all borrowings, liabilities (including contingent liabilities) and obligations of whatever kind then subsisting of the existing bank in relation to the undertaking.

(2) If, according to the laws of any country outside India, the provisions of this Ordinance by themselves are not effective to transfer or vest any asset or liability situated in that country which forms part of the undertaking of an existing bank to, or in, the corresponding new bank, the affairs of the existing bank in relation to such asset or liability shall, on and from the commencement of this Ordinance, stand entrusted to the chief executive officer for the time being of the corresponding new bank, and the chief executive officer may exercise all powers and do all such acts and things as may be exercised or done by the existing bank for the purpose of effectively transferring such assets and discharging such liabilities.

(3) The chief executive officer of the corresponding new bank shall, in exercise of the powers conferred on him by sub-section (2), take all such steps as may be required by the laws of any such country outside India for the purpose of effecting such transfer or vesting, and may either himself or through any person authorized by him in this behalf realize any asset and discharge any liability of the existing bank.

(4) Notwithstanding anything contained in sub-section (2), on the commencement of this Ordinance, no person shall make any claim or demand or take any proceeding in India against any existing bank or any person acting in its name or on its behalf except in so far as may be necessary for enforcing the provisions of this section or except in so far as it relates to any offence committed by such person.

(5) Unless otherwise expressly provided by this Ordinance, all contracts, deeds, bonds, agreements, powers of attorney, grants of legal representation and other instruments of whatever nature subsisting or having effect immediately before the commencement of this Ordinance and to which the existing bank is party or which are in favour of the existing bank shall be of as full force and effect against or in favour of the corresponding new bank, and may be enforced or acted upon as fully and effectually as if in the place of the existing bank the corresponding new bank had been a party thereto or as if they had been issued in favour of the corresponding new bank.

(6) If, on the date of commencement of this Ordinance, any suit, appeal or other proceeding or whatever nature is pending by or against the existing bank, the same shall not abate, be discontinued or be, in any way, prejudicially affected by reason of the transfer of the undertaking of the existing bank or of anything contained in this Ordinance but the suit, appeal or other proceedings may be continued, prosecuted and enforced by or against the corresponding new bank.

(7) Nothing in this Ordinance shall be construed as applying to the assets, rights, powers, authorities, privileges and property, movable and immovable, cash balances and investments in any country outside India (and other rights and interests arising out of such property) of any existing bank operating in that country if, under the laws in force in that country, it is not permissible for a banking company, owned or controlled by Government, to carry on the business of banking there.

Chapter III
Payment of Compensation

6. (1) Every existing bank shall be given by the Central Government such

compensation in respect of the transfer under section 4, to the corresponding new bank of the undertaking of the existing bank as is specified against each such bank in the Second Schedule.

(2) The amount of compensation referred to in sub-section (1) shall be given to every existing bank, at its option:

(a) in cash (to be paid by cheque drawn on the Reserve Bank) in three equal annual instalments, the amount of each instalment carrying interest at the rate of 4 per cent per annum from the commencement of this Ordinance, or

(b) in saleable or otherwise transferable promissory notes or stock certificates of the Central Government issued and repayable at par, and maturing at the end of:

(i) ten years from the commencement of this Ordinance and carrying interest from such commencement at the rate of 4.5 per cent per annum, or

(ii) thirty years from the commencement of this Ordinance and carrying interest from such commencement at the rate of 5.5 per cent per annum, or

(c) party in cash (to be paid by cheque drawn on the Reserve Bank) and partly in such number of securities specified in item (i) or item (ii) or both, of clause (b), as may be required by the existing bank, or

(d) partly in such number of securities specified in item (i) of clause (b) and partly in such number of securities specified in item (ii) of that clause, as may be required by the existing bank.

(3) The first of the three equal annual instalments referred to in clause (a) of sub-section (2) shall be paid, and the securities referred to in clause (b) of that sub-section shall be issued, within sixty days from the date of receipt by the Central Government of the option referred to in that sub-section, or where no such option has been exercised, from the latest date before which such option ought to have been exercised.

(4) The option referred to in sub-section (2) shall be exercised by every existing bank before the expiry of a period of three months from the appointed day (or within such further time), not exceeding three months, as the Central Government may, on the application of the existing bank, allow and the option so exercised shall be final and shall not be altered or rescinded after it has been exercised.

(5) Any existing bank which omits or fails to exercise the option referred to in sub-section (2), within the time specified in sub-section (4), shall be deemed to have opted for payment in securities, specified in item (i) of clause (b) of sub-section (2).

(6) Notwithstanding anything contained in this section, any existing bank may, before the expiry of three months from the appointed day or within such further time, not exceeding three months, as the Central Government may, on the application of the existing bank, allow make an application in writing to the Central Government for an interim payment of an amount equal to 75 per cent of the amount of the paid-up capital of such bank, as on the commencement of this Ordinance, indicating therein whether the payment is desired in cash or in securities specified in sub-section (2) or in both.

(7) The Central Government shall, within sixty days from the receipt of the application referred to in sub-section (6), make the interim payment to the existing bank in accordance with the option specified in such application.

(8) The interim payment made under sub-section (7) shall be set off against the total amount of the compensation payable to such existing bank under this Ordinance and the balance of the compensation remaining outstanding after such payment shall be given to the existing bank in accordance with the option exercised, or deemed to have been exercised, under sub-section (4) of sub-section (5), as the case may be:

Provided that where any part of the interim payment is obtained by an existing bank in cash, the payment so obtained shall be set off, in the first instance, against the first instalment of the cash payment referred to in sub-section (2), and in case the payment so obtained exceeds the amount of the first instalment, the excess amount shall be adjusted against the second instalment and the balance of such excess amount, if any, against the third instalment of the cash payment.

(9) Any payment purported to have been made to an existing bank under sub-section (3) of section 15 of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969, shall be deducted by the Central Government from the amount of the compensation due to such existing bank and the amount so deducted shall be paid by the Central Government to the corresponding new bank.

Chapter IV
Management of Corresponding New Banks

7 (1) The head office of each corresponding new bank shall be at such place as the Central Government may, by notification in the Official Gazette, specify in this behalf, and, until any such place is so specified, shall be at such place at which the head office of the existing bank, in relation to which it is the corresponding new bank, is on the commencement of this Ordinance, located.

(2) The general superintendence, direction and management of the affairs and business of a corresponding new bank shall vest in a Board of Directors which shall be entitled to exercise all such powers and do all such acts and things as the corresponding new bank is authorized to exercise and do.

(3) (a) As soon as may be after the appointed day, the Central Government shall, in consultation with the Reserve Bank, constitute the first Board of Directors of a corresponding new bank consisting of not more than seven persons, to be appointed by the Central Government, and every Director so appointed shall hold office until the Board of Directors is constituted in accordance with the scheme made under section 9;

Provided that the Central Government may, if it is of opinion that it is necessary in the interests of the corresponding new bank so to do, remove a person from the membership of the first Board of Directors and appoint any other person in his place.

(b) Every member of the first Board of Directors (not being an officer of the Central Government or of the Reserve Bank) shall receive such remuneration as is equal to the remuneration which a member of the Board of Directors of the existing bank was entitled to receive immediately before the commencement of this Ordinance.

(4) Until the first Board of Directors is appointed by the Central Government under sub-section (3), the general superintendence, direction and management of the affairs and business of a corresponding new bank shall vest in a Custodian, who shall be the chief executive officer of that bank and may exercise all power and do all acts and things as may be exercised or done by that bank.

(5) The Chairman of an existing bank holding office as such immediately before the commencement of this Ordinance, shall be the Custodian of the corresponding new bank and shall receive the same emoluments as he was receiving immediately before such commencement:

Provided that the Central Government may, if the Chairman of an existing bank declines to become, or to continue to function as, a Custodian of the corresponding new bank, or, if it is of opinion that it is necessary in the interests of the corresponding new bank so to do, appoint any other person as the Custodian of a corresponding new bank and the Custodian so appointed shall receive such emoluments as the Central Government may specifiy in this behalf.

(6) The Custodian shall hold office during the pleasure of the Central Government.

8. Every corresponding new bank shall, in the discharge of its functions, be guided by such directions in regard to matters of policy involving public interest as the Central Government may, after consultation with the Governor of the Reserve Bank, give.

9. (1) The Central Government may, after consultation with the Reserve Bank, make a scheme for carrying out the provisions of this Ordinance.

(2) In particular, and without prejudice to the generality of the foregoing power, the said scheme may provide for all or any of the following matters, namely:

(a) the capital structure of the corresponding new bank, so however that the paid-up capital of any such bank shall not be in excess of rupees fifteen crores;

(b) the constitution of the Board of Directors, by whatever name called, of the corresponding new bank and all such matters in connection therewith or incidental thereto as the Central Government may consider to be necessary or expedient;

(c) the reconstitution of any corresponding new bank into two or more corporations, the amalgamation of any corresponding new bank with any other corresponding new bank or with another banking institution, the transfer of the whole or any part of the undertaking of a corresponding new bank to any other banking institution or the transfer of the whole or any part of the undertaking of any other banking institution to a corresponding new bank;

(d) such incidental, consequential and supplemental matters as may be necessary to carry out the provisions of this Ordinance.

(3) Every Board of Directors of a corresponding new bank, constituted under any scheme made under sub-section (1), shall include:

(a) representatives of the employees and depositors of such bank, and

(b) such other persons as may represent the interests of farmers, workers and artisans, to be elected or nominated in such manner as may be specified in the scheme.

(4) The Central Government may, after consultation with the Reserve Bank, make a scheme to amend or vary any scheme made under sub-section (1).

(5) Every scheme made by the Central Government under this Ordinance shall be laid, as soon as may be after it is made, before each House of Parliament while it is in session for a total period of thirty days which may be comprised in one session or in two successive sessions, and if, before the expiry of the session in which it is so laid or the session immediately following, both Houses agree in making any modification in the scheme or both Houses agree that the scheme should not be made, the scheme shall thereafter have effect only in such modified form or be of no effect, as the case may be so, however, that any such modification or annulment shall be without prejudice to the validity of anything previously done under that scheme.

Chapter V
Miscellaneous

10. (1) Every corresponding new bank shall cause its books to be closed and balanced on the 31st day of December of each year and shall appoint, with the previous approval of the Reserve Bank, auditors for the audit of its accounts.

(2) Every auditor of a corresponding new bank shall be a person who is qualified to act as an auditor of a company under section 226 of the Companies Act, 1956, and shall receive such remuneration as the Reserve Bank may fix in consultation with the Central Government.

(3) Every auditor shall be supplied with a copy of the annual balance sheet and profit and loss account and a list of all books kept by the corresponding new bank, and it shall be the duty of the auditor to examine the balance sheet of and profit and loss account with the accounts and vouchers relating thereto, and in the performance of his duties, the auditor:

(a) shall have, at all reasonable times, access to the books, accounts and other documents of the corresponding new bank,

(b) may, at the expense of the corresponding new bank, employ accountants or other persons to assist him in investigating such accounts, and

(c) may, in relation to such accounts, examine the custodian or any officer or employee of the corresponding new bank.

(4) Every auditor of a corresponding new bank shall make a report to the Central Government upon the annual balance sheet and accounts and in every such report shall state:

(a) whether, in his opinion, the balance sheet is a full and fair balance sheet containing all the necessary particulars and is properly drawn up so as to exhibit a true and fair view of the affairs of the corresponding new bank, and in case he had called for any explanation or information, whether it has been given and whether it is satisfactory;

(b) whether or not the transactions of the corresponding new bank, which have come to his notice, have been within the powers of that bank;

(c) whether or not the returns received from the offices and branches of the corresponding new bank have been found adequate for the purpose of his audit;

(d) whether the profit and loss account shows a true balance of profit or loss for the period covered by such account; and

(e) any other matter which he considers should be brought to the notice of the Central Government.

(5) The report of the auditor shall be verified, signed and transmitted to the Central Government in such manner as may be prescribed.

(6) The auditor shall also forward a copy of the audit report to the corresponding new bank and to the Reserve Bank.

(7) After making provision for bad and doubtful debts, depreciation in assets, contributions to staff and superannuation funds and all other matters for which provision is necessary under any law, or which are usually provided for by banking companies, a corresponding new bank shall transfer the balance of profits to the Central Government.

11. For the purpose of the Income Tax Act, 1961, every corresponding new bank shall be deemed to be an Indian company and a company in which the public are substantially interested.

12. (1) Every person holding office, immediately before the commencement of this Ordinance, as Chairman of an existing bank shall, if he becomes Custodian of the corresponding new bank, be deemed, on such commencement, to have vacated office as such Chairman.

(2) Save as otherwise provided in sub-section (1), all officers and other employees of an existing bank shall become, on the commencement of this Ordinance, officers and employees of the corresponding new bank and shall hold their offices or services in that bank on the same terms and conditions and with the same rights to pension, gratuity and other matters as would have been admissible to them if the undertaking of the existing bank had not been transferred to and vested in the corresponding new bank and continue to do so unless and until their employment in the corresponding new bank is terminated or until their remuneration, terms or conditions are duly altered by the corresponding new bank.

(3) For the persons who immediately before the commencement of this Ordinance were the trustees for any pension, provident, gratuity or other like fund constituted for the officers or other employees of an existing bank, there shall be substituted as trustees such persons as the Central Government may, by general or special order, specify.

(4) Notwithstanding anything contained in the Industrial Disputes Act, 1947, or in any other law for the time being in force, the transfer of the services of any officer or other employee from an existing bank to a corresponding new bank shall not entitle such officer or other employee to any compensation under this Ordinance or any other law for the time being in force and no such claim shall be entertained by any court, tribunal or other authority.

13. (1) Every corresponding new bank shall observe, except as otherwise required

by law, the practices and usages customary among bankers, and, in particular, it shall not divulge any information relating to or to the affairs of its constituents except in circumstances in which it is, in accordance with law or practices and usages customary among bankers, necessary or appropriate for the corresponding new bank to divulge such information.

(2) Every director, member of a local board or a committee, or auditor, adviser, officer or other employee of a corresponding new bank shall, before entering upon his duties, make a declaration of fidelity and secrecy in the form set out in the Third Schedule.

(3) Every Custodian of a corresponding new bank shall, as soon as possible, make a declaration of fidelity and secrecy in the form set out in the Third Schedule.

14. Every Custodian of a corresponding new bank shall be deemed to be a public servant for the purposes of Chapter IX of the Indian Penal Code.

15. (1) All acts done by the Custodian, acting in good faith, shall, notwithstanding any defect in his appointment or in the procedure, be valid.

(2) No act or proceeding of any Board of Directors or a local board or committee of a corresponding new bank shall be invalid merely on the ground of the existence of any vacancy in, or defect in the constitution of, such board or committee, as the case may be.

(3) All acts done by a person acting in good faith as a director or member of a local board or committee of a corresponding new bank shall be valid, notwithstanding that it may afterwards be discovered that this appointment was invalid by reason of any defect or disqualification or had terminated by virtue of any provision contained in any law for the time being in force:

Provided that nothing in this section shall be deemed to give validity to any act by a director or member of a local board or committee of a corresponding new bank after his appointment has been shown to the corresponding new bank to be invalid or to have terminated.

16. (1) Every Custodian of a corresponding new bank and every officer of the Central Government and of the Reserve Bank and every officer or other employee of a corresponding new bank, shall be indemnified by such bank against all losses and expenses incurred by him in or in relation to the discharge of his duties except such as have been caused by his own wilful act or default.

(2) A director or member of a local board or committee of a corresponding new bank shall not be responsible for any loss or expense caused to such bank by the insufficiency or deficiency of the value of, or title to, any property or security acquired or taken on behalf of the corresponding new bank, or by the insolvency or wrongful act of any customer or debtor, or by anything done in or in relation to the execution of the duties of his office, unless such loss, expense, insufficiency or deficiency was due to any wilful act or default on the part of such director or member.

17. Any reference to any existing bank in any law other than this Ordinance, or in any contract or other instrument shall, in so far as it relates to its undertaking which has been transferred by section 4, be construed as a reference to the corresponding new bank.

18. No provision of law relating to winding up of corporations shall apply to a

corresponding new bank and no corresponding new bank shall be placed in liquidation, save by order of the Central Government and in such manner as it may direct.

19. (1) The Board of Directors of a corresponding new bank may, after consultation with the Reserve Bank and with the previous sanction of the Central Government, make regulations, not inconsistent with the provisions of this Ordinance and any scheme made thereunder, to provide for all matters for which provision is expedient for the purpose of giving effect to the provisions of this Ordinance.

(2) In particular, and without prejudice to the generality of the foregoing power, the regulations may provide for all or any of the following matters, namely:

(a) the powers, functions and duties of local boards and restrictions, conditions or limitations, if any, subject to which they may be exercised or performed, the formation and constitution of local committees and committees of local board including the number of members of any such committees, the powers, functions and duties of such committees, the holding of meetings of local committees and committees of local boards and conduct of business there at;

(b) the manner in which the business of the local boards shall be transacted and the procedure in connection therewith;

(c) the delegation of powers and functions of the board of directors of a corresponding new bank to the general manager, director, officer or other employee of that bank;

(d) the conditions or limitations subject to which the corresponding new bank may appoint officers, advisers and other employees and fix their remuneration and other terms and conditions of service;

(e) the duties and conduct of officers, advisers and other employees of the corresponding new bank;

(f) the establishment and maintenance of superannuation, pension, provident or other funds for the benefit of officers or employees of the corresponding new bank or of the dependants of such officers or employees and the granting of superannuation allowances, annuities and pensions payable out of such funds;

(g) the conduct and defence of legal proceedings by or against the corresponding new bank and the manner of signing pleadings;

(h) the provision of a seal for the corresponding new bank and the manner and effect of its use;

(i) the form and manner in which contracts binding on the corresponding new bank may be executed;

(j) the conditions and the requirements subject to which loans or advances may be made or bills may be discounted or purchased by the corresponding new bank;

(k) the persons or authorities who shall administer any pension, provident or other fund constituted for the benefit of officers or employees of the corresponding new bank or their dependants;

(l) the preparation and submission of statements of programmes of activities and financial statements of the corresponding new bank and the period for which and the time within which such statements and estimates are to be prepared and submitted; and

(m) generally for the efficient conduct of the affairs of the corresponding new bank.

(3) Until any regulation is made under sub-section (1), the articles of association of the existing bank and every regulation, rule, bye-law or order made by the existing bank shall, if in force at the commencement of this Ordinance, be deemed to be the regulations made under sub-section (1) and shall have effect accordingly and any reference therein to any authority of the existing bank shall be deemed to be a reference to the corresponding authority of the corresponding new bank and until any such corresponding authority is constituted under this Ordinance, shall be deemed to refer to the Custodian.

20. (1) In the Banking Regulation Act, 1949:

(a) in section 34A, in sub-section (3), for the words 'and any subsidiary bank', the words, figures and brackets 'a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1970, and any subsidiary bank' shall be substituted;

(b) in section 36AD, in sub-section (3), for the words 'and any subsidiary bank', the words, figures and brackets 'a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1970, and any subsidiary bank' shall be substituted;

(c) in section 51, for the words 'or any other banking institution, notified by the Central Government in this behalf, the words, figures and brackets 'or any corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1970, or any other banking institution notified by the Central Government in this behalf' shall be substituted;

(d) in the Fifth Schedule, in Part I of paragraph 1, in clause (e), the Explanations shall be deemed never to have been inserted.

(2) In the Industrial Disputes Act, 1947, in section 2, in clause (bb), for the words 'and any subsidiary bank', the words, figures and brackets 'a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1970, and any subsidiary bank' shall be substituted.

(3) In the Banking Companies (Legal Practitioners Clients Accounts) Act, 1949, in section 2, in clause (a) for the words 'and any subsidiary bank', the words, figures and brackets 'a corresponding new bank constituted under section 3 of the (Banking Companies Acquisition and Transfer of Undertakings) Ordinance, 1970, and any subsidiary bank' shall be substituted.

(4) In the Deposit Insurance Corporation Act, 1961,

(a) in section 2,

(i) after clause (e), the following clause shall be inserted, namely:

'(ee) 'corresponding new bank' means a corresponding new bank constituted

under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1970;
(ii) in clause (g),
(e) for the words 'or a banking a company', the words 'a corresponding new bank or a banking company', and
(b) for the words 'with a banking company' the words "with a corresponding new bank or with a banking company"'.
shall be substituted;
(iii) in clause (i), after the words 'banking company', the words 'or a corresponding new bank' shall be inserted:
(c) section 13 shall be renumbered as sub-section (1) thereof and after sub-section (1) as so renumbered, the following sub-section shall be inserted, namely:
'(2) The provisions of clauses (a), (b), (c), (d) and (h) of sub-section (1) shall apply to a corresponding new bank as they apply to a banking company.'
(5) In the State Agricultural Credit Corporations Act, 1968,
(a) in section 2, after clause (i), the following clause shall be inserted, namely –
'(ii) "corresponding new bank" means a corresponding new bank constituted under section 3 of the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1970',
(b) after the words 'subsidiary banks' or 'subsidiary bank', as the case may be, occurring in clause (d) of sub-section (3) of section 5, in clause (b) of section 9 and in the proviso to section 18, the words 'corresponding new banks' or 'corresponding new bank', as the case may be, shall be inserted.
21. (1) Notwithstanding any judgement, decree or order of any court or tribunal,
(a) any action taken, or purported to have been taken, or anything done, or purported to have been done, between the 19th day of July 1969, and the 10th day of February 1970, by any corresponding new bank purported to have been constituted under the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969, or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969, or by any person purporting to act on behalf of such bank and any right, obligation or liability acquired or incurred, between the said dates, by or on behalf of such corresponding new bank shall be deemed to have been taken, done, acquired or incurred under the provisions of this Ordinance by or on behalf of the corresponding new bank constituted thereunder;
(b) any action taken, or purported to have been taken, or anything done, or purported to have been done, between the 10th day of February 1970, and the appointed day, by an existing bank or by any person acting on behalf of such bank, and any right, obligation or liability acquired or incurred, between the said dates, by or on behalf of such existing bank shall be deemed to have been taken, done, acquired or incurred under the provisions of this Ordinance by or on behalf of the corresponding new bank constituted thereunder.

(2) Any suit, appeal or other proceeding of whatever nature instituted on or after the 19th day of July 1969, by or against a corresponding new bank purported

to have been constituted by the Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969, or the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969, shall not abate, be discontinued, or be, in any way, prejudicially affected by reason of the expiry of the said Ordinance or the invalidation of the said Act, as the case may be, but such suit, appeal or other proceeding may be continued, prosecuted and enforced by or against the corresponding new bank as if such suit, appeal or other proceeding had been instituted by or against the corresponding new bank constituted under this Ordinance.

THE FIRST SCHEDULE
(See sections 2, 3 and 4)

Existing bank *Column 1*	*Corresponding new bank* *Column 2*
The Central Bank of India Limited	Central Bank of India
The Bank of India Limited	Bank of India
The Punjab National Bank Limited	Punjab National Bank
The Bank of Baroda Limited	Bank of Baroda
The United Commercial Bank Limited	United Commercial Bank
Canara Bank Limited	Canara Bank
United Bank of India Limited	United Bank of India
Dena Bank Limited	Dena Bank
Syndicate Bank Limited	Syndicate Bank
The Union Bank of India Limited	Union Bank of India
Allahabad Bank Limited	Allahabad Bank
The Indian Bank Limited	Indian Bank
The Bank of Maharashtra Limited	Bank of Maharashtra
The Indian Overseas Bank Limited	Indian Overseas Bank

THE SECOND SCHEDULE
(See section 6)

Name of existing bank	*Amount of compensation (in lakhs of rupees)*
The Central Bank of India Limited	1750
The Bank of India Limited	1470
The Punjab National Bank Limited	1020
The Bank of Baroda Limited	840
The United Commercial Bank Limited	830
Canara Bank Limited	360
United Bank of India Limited	420
Dena Bank Limited	360
Syndicate Bank Limited	360

The Union Bank of India Limited	310
Allahabad Bank Limited	310
The Indian Bank Limited	230
The Bank of Maharashtra Limited	230
The Indian Overseas Bank Limited	250

THE THIRD SCHEDULE
(See sub-sections (2) and (3) of section 13)
DECLARATION OF FIDELITY AND SECRECY

I, do hereby declare that I will faithfully, truly and to the best of my skill and ability execute and perform the duties required of me as Custodian, Director, member of Local Board, member of Local Committee, auditor, adviser, officer or other employee (as the case may be) of the* and which property relate to the office or position in the said* held by me.

I further declare that I will not communicate or allow to be communicated to any person not legally entitled thereto any information relating to the affairs of the* or to the affairs of any person having any dealing with the* ; nor will I allow any such person to inspect or have access to any books or documents belonging to or in the possession of the*and relating to the business of the* or to the business of any person having any dealing with the*

V.V. GIRI
PRESIDENT
14.2.1970

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Eastern Economist April 3, 1970
FROM THE PRESS GALLERY

RENATIONALIZATION OF BANKS BILL ADOPTED
Our Parliamentary Correspondent

New Delhi,
Saturday
With the Rajya Sabha's current session scheduled to end next week, the two Houses of Parliament this week rushed through the Banking Companies (Acquisition and Transfer of Undertakings) Bill which sought to renationalize the 14 major banks in the country. These banks with Rs 50 crores deposits or more had been first nationalized on 19 July last through an ordinance. This ordinance was replaced by an Act during the monsoon session of Parliament. But this Act could not stand the challenge in the Supreme Court. Following the judgement of the Supreme Court, striking down this legislation on 10 February, a new ordinance was issued on 14

*Name of corresponding new bank to be filled in.

February, in the light of the court's observations. The bill adopted this week replaced this second ordinance.

Politically Motivated

The discussion on the bill in both the Houses, which sat for late hours to adopt it, was quite lively. As could be expected, both the Swatantra Party and the Jana Sangh opposed the bill tooth and nail, alleging that the nationalization of banks was politically motivated. The other major points of criticism were: (*i*) keeping the foreign banks as well as Indian banks with deposits less than Rs 50 crores outside the purview of the bill; (*ii*) the compensation to be paid to the nationalized banking companies; and (iii) bank loans to political parties.

The keeping of the foreign and the smaller Indian banks outside the purview of the bill was strongly objected to, among others, by the members belonging to Congress-Opposition and the leftist groups. The Communists and the SSP members were prominent among those who wanted the compensation payable to the nationalized banking companies to be lowered. Banking loans to political parties were taken serious exception to primarily by the SSP and Congress-Opposition parties. While stressing the need for scaling down the quantum of compensation, several members urged that the right to property should be taken out of the fundamental rights by amending the Constitution. The spokesman of the DMK in the Lok Sabha, Mr Dandapani, pleaded that besides providing representation to employees, two nominees of state governments should be included in the Board of Directors of each of the nationalized banks. He also wanted freedom for state governments to launch and run regional banks.

Defending the bill stoutly, the Union Minister for Law, Mr P. Govinda Menon, who piloted it, did not accept any of the suggestions of the opposition members. The various amendments moved from the opposition benches were all rejected.

The foreign banks, Mr Menon said, had not been included in the purview of the bill solely because they provided specialized services for our external trade; he cited, in this connection, the services of the Bank of Netherlands in the diamond trade and those of the Japanese banks in the export of cotton. Further, the foreign banks, Mr Menon pointed out, assisted in raising foreign currency loans; they also helped Indian entrepreneurs in contacting parties overseas with a view to entering into technical collaboration arrangements. A third reason for not nationalizing them was the principle of reciprocity in international affairs. The Law Minister clarified that it was not the fear of any complication of an international character which had prompted the government to keep the foreign banks outside the scope of the bill.

Discrimination

Countering the plea for the nationalization of Indian banks with deposits below Rs 50 crores, Mr Menon stressed that first the present nationalization of 14 banks had to be stabilized. With the nationalization of these banks, nearly 87 per cent of the deposits with the banking system of the country would be controlled by the state banking institutions. The nationalization of the Indian banks left outside the scope of the bill, Mr Menon further observed, however, could not be ruled out at some future day.

The plea of the opposition members that political parties should not be allowed to get loans from banks was turned down by the Law Minister on the ground that these loans did not amount to donations.

In regard to the compensation being paid to the nationalized banking companies—about Rs 87.18 crores—Mr Menon said that his amount was reasonable. All factors had been taken into account in fixing this compensation. These included the profits made by each bank, the profits a bank was expected to make if continued on the private sector and the net surplus it had.

In reply to a question whether the nationalized banking companies would be allowed to restart the banking business, if they wished, the Law Minister said that this was a matter to be taken up with the Reserve Bank.

Mr Menon gave an assurance that an integrated scheme of the measures to be taken by the Government following the adoption of the bill would be placed before Parliament for approval within six months.

Towards Social Justice

As a concession to the leftist supporters of the measure, the Law Minister announced that the government had decided to delete section 36A(d) from the Banking Regulation Act which curbed trade union activities inside the banking premises.

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25th January, 1967

My dear Panesh,

I am enclosing herewith a clipping from the *London Times* of the 23rd regarding: 'Canadian Rejection of US Protest on Bank'. From this, you will see even economically developed independent countries refuse to facilitate banking expansion in their territories. Contrary to that, for peculiar reasons, foreign banking and other service organizations claim it as their birthright to expand in developing countries like ours. Also, I am afraid, our authorities without deeper consideration and thought facilitate that. Anyway I thought I should bring this to your notice, particularly in the light of pressures that are exerted on you for permitting more branches of foreign banking companies in India.

More when we meet and with kindest regards and best wishes.

Yours sincerely,
C.H. Bhabha

Shri P.C. Bhattacharya
Governor
Reserve Bank of India
Bombay

Enclo:

Canadian Rejection of US Protest on Bank

From our own Correspondent, Ottawa, January 22

The Canadian Government has sent a carefully worded but firm reply to the State Department in Washington rejecting a stiff protest over Canada's refusal to allow the Mercantile Bank of Canada, a United States owned subsidiary, to expand its activities in this country.

The Americans claim that Ottawa has not played fair, and that the proposed restrictions on activities here are discriminating and retroactive. Ottawa does not agree.

Mr Mitchell Sharp, the Finance Minister, said in Vancouver that there was nothing unreasonable about what the Canadians had done. Furthermore, he did not think there would be any occasion for the United States to retaliate.

'The Government position', he said, 'was simply that it did not want anybody—foreigner or Canadian—to hold a dominating position in charter banking here. All we ask the Mercantile Bank to do is to operate as any Canadian bank is requested to do. And I consider this policy quite reasonable, considering Canadian conditions.'

US Suspicions

'The Government', he added, 'was not opposed to foreign investment in Canada. On the contrary, it was recognized that if Canada was to continue its rapid expansion it was going to need foreign capital.'

Already rumblings are being heard from the direction of Congress and Wall Street. What the Americans appear to be suspicious about is the sudden return of Mr Walter Gordon, the former Minister of Finance, to the Pearson Administration, particularly at this time. Mr Gordon, who is the high priest of economic nationalism, had been rejected by the Liberal Party convention last October when he put forward his theories.

'What is Gordon going to do?' the Americans ask. At the moment Mr Pearson has given his old friend only a Ministership without portfolio, but has hinted at better things to come and referred to him as a senior colleague.

Mr Gordon's first task, some observers believe, will be to prepare a White Paper on the extent of foreign ownership in this country. On the other hand, there is feeling that perhaps the Prime Minister would rather have him at his side than not knowing what his former Minister of Finance was up to.

There may well be a confrontation with the Americans on Tuesday when the Commons banking committee meets to look at the legislation which led to the protest by the State Department.

At the committee hearings, the Mercantile Bank will be represented by Mr James S. Rockefeller, chairman of the First National City Bank of New York, the parent company, and by Mr R.P. Macfadden, president of Mercantile.

Medical Supplies

Other sensitive areas of Canadian-American relations will be explored this week in the Commons and outside Parliament, particularly in respect of some aspects of America's Trading with the Enemy Act. There has been trouble in this field before over United States legislation which in effect says that parent firms in the United States should be responsible for the conduct of foreign subsidiaries, and the observance of American laws. There are stiff penalties for infringements.

Questions have now been raised in the Commons over the refusal of American drug companies to allow Canadian subsidiaries to dispatch to Vietnam drugs and medical equipment paid for by American Quakers. Both the State Department and the Treasury in Washington have denied issuing any special directives to these parent drug houses. However, North Vietnam is regarded in American eyes as a prohibited area and the drugs, according to the Toronto Quakers who are organizing their dispatch through Canadian ports, are going to both sides in the war.

The New Democrats in the Commons have asked Mr Winters, the Trade Minister, if he was prepared to make representations to Washington that American corporations in this country were expected to act in accordance with Canadian laws and not in accordance with the laws of a foreign country.

Mr Winters said Washington was well aware of Ottawa's attitude and this matter of sovereignty was brought up in a 'forceful way' when Canadian Ministers met their Washington counterparts last year.

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Opening of Bank Branches

In the recent past, the practice has been to allow banks to open two offices at places where banks are in existence provided they open one office in a place which has no banks at all. I believe that it is in the interests of everybody to encourage more banks being opened in smaller places and to slow down somewhat the expansion in urban areas. My reasons are the following:

(a) It is only by opening banks in rural areas and areas where there are no banks at present that the banking habit can be really widespread;

(b) With the large harvest in sight there will be much more money in the rural areas and it is only if the banks can attract this money that they can start financing agriculture in a big way;

(c) The tendency for banks to open branches in a competitive spirit in urban centres have gone so far as to create a heavy concentration in cities like Bombay, Calcutta and Delhi. This is an expensive business. It means hiring or buying costly premises, paying high wages to employees and also encourages a certain amount of indiscipline which the bankers complain about.

In a recent speech to the bankers' club, I had suggested that there should be some slowing down of branch expansion in urban areas. Privately the bankers told me that they would welcome this so long as their competitors as well as foreign banks are also kept in check. So far as foreign banks are concerned, they are obliged to confine themselves to port towns only (including Delhi). Although this was meant to be a restrictive measure, it is for them something of a blessing because they operate only in the more profitable areas. My thinking at present is that so far as port towns are concerned, we should stop all new branches except of banks which do not have a branch in a particular port town. This will enable smaller banks to get a foothold if they want to have one. Furthermore, in respect of foreign banks, while all of them will be under restraint, those few—Japanese, French and Dutch—which have only one or two branches in the country will be able to open one or two additional branches in ports where they do not have any branch.

At the same time we should encourage banks to go to smaller towns as well as the rural area and ensure that those who do the pioneering work in any area are not confronted with too much competition too soon.

I hope this will have D.P.M.'s broad approval. He may also wish to talk over this idea with the bankers when he meets them in Bombay.

L.K. Jha
25.8.1967

D.P.M.
Copy to D.G. (An.)

14

No. B 9/1968

Memorandum to the Central Board
Policy Regarding the Licensing of Branches of Commercial Banks
by the Reserve Bank of India

I. *Introduction*

The branch licensing policy of the Reserve Bank of India is based on the provisions of section 23 of the Banking Regulation Act, 1949, which lays down the criteria to be followed by the Bank for dealing with the requests of commercial banks to open new places of business (vide Annexure I). A procedure has been evolved within the framework of the aforesaid section for dealing with applications from banks for opening offices, with emphasis on development of banking facilities in the country in a well-regulated manner, in accordance with the decisions of the Central Board. The policy is being reviewed and modified by the Bank from time to time to meet the requirements of the changing conditions in the economy.

II. *Evolution of Branch Licensing Policy*

2. In order to accelerate the pace of deposit mobilization in keeping with the tempo of economic growth, a liberalized policy was adopted by the Reserve Bank towards the close of 1956 when it was decided that licensed banks may ordinarily be permitted to open branches unless there were adequate reasons against granting permission in individual cases. The policy was further liberalized in July 1959 when the Central Board decided that more latitude should be allowed to financially sound smaller banks (licensed and unlicensed) having a restricted area of operation to open offices in adjoining areas. Although, as a result of liberalization of the policy, the pace of branch expansion was accelerated, one of the main objectives of the policy, namely,

the extension of banking facilities to rural and semi-urban areas, was not fully achieved as the choice of centres for opening new offices was left entirely to the discretion of banks which were inclined to open branches in developed centres only and were reluctant to go to unbanked areas for fear of making losses.

3. With a view to extending banking facilities in a planned and systematic manner to areas which were deficient in or devoid of such facilities, the branch licensing policy was reviewed and modified in terms of the proposals approved by the Central Board in June 1962. Under the revised procedure, the banks were classified under three categories, viz., (i) all-India banks, (ii) large regional banks and (iii) small regional banks. In order to ensure that all these banks expanded their activities in a regulated manner and in the process of expansion of bigger banks, the financially sound smaller banks were not crowded out of existence, the geographical spheres of operation of each of the above three categories of banks were demarcated. A coordinated programme of branch expansion was initiated for the first time and all the Indian banks excluding the State Bank of India and its subsidiaries (which have their own programmes) were advised to formulate a programme for opening offices for a period of three years ended July 1965 and to secure the Bank's approval in advance. Each bank was encouraged to implement a balanced programme of expansion embracing areas devoid of banking facilities and suburban areas of urban centres, besides towns of commercial and industrial importance.

4. The policy was again reviewed in April 1965 and certain modifications were approved by the Central Board at their meeting held in May 1965; a copy of the Memorandum approved by the Board at that meeting was placed on the table for the information of the members. The same policy was broadly reiterated by the Central Board at their meeting held in June 1967.

III. *Expansion Programmes of Commercial Banks in the Private Sector*

5. The first expansion programme was followed by two more programmes of two years each, the latest of which is to end on the 31st July 1969. Under the current programme, emphasis has been laid on the opening of offices in rural and semi-urban areas with the main objective of mobilizing deposits in such areas. Accordingly, banks were urged to open more number of offices in these areas instead of concentrating in urban centres.

6. A statement showing the progress made by the banks in opening offices under the impetus of these expansion programmes is given in Annexure II. It will be seen therefrom that under the first expansion programme for three years ended in July 1965, 606 offices were opened by the participating banks of which 224 were at unbanked places, while under the second expansion programme for the two years ended in July 1967, 544 offices including 197 in unbanked centres were opened. Under the third expansion programme, 32 eligible banks have been allowed in all 547 offices in 424 centres of which 327 are at rural and semi-urban centres; of the offices at rural and semi-urban centres allowed, 243 are at unbanked places. Of these, the banks have so far opened 42 offices of which 39 are in rural and semi-urban areas.

IV. *Modifications Proposed in the Existing Procedure*

7. The present branch licensing policy came up for discussion at the first meeting of the National Credit Council following which certain proposals for revision were formulated and discussed at the meetings of the Ad Hoc Advisory Committee of Bankers and the Standing Committee of the National Credit Council. At these discussions, the consensus was in favour of simplifying the existing policy, particularly by discontinuing the present procedure whereby banks are required to indicate centres where they propose to open branches, two years in advance and such centres are initially approved or rejected by the Reserve Bank on a simple population criterion. There was also general agreement on the desirability of doing away with any reservation of areas for small banks except where there is evidence of readiness on the part of such banks to open branches in areas reserved for them.

8. It is proposed that, in future, the branch expansion policy may be guided by the following principles:

(1) Banks should arrange for a continuous study of the banking needs and potential of the various regions where they wish to extend their operations, and their branch expansion programmes should be based on such studies. Each bank should select particular areas for development after a careful consideration of all the relevant factors, and its expansion programme should indicate the reasons for such selection. Developed or developing areas where economic activity is already in full swing should not be the only areas which are considered suitable for opening of new branches. Other areas where banks can encourage local enterprise or development of local resources by actively offering their services should also be selected. Branch expansion should aim, not only at mobilization of deposits, but also at expansion of credit facilities. The larger all-India banks which, at present, have a low credit–deposit ratio in their rural and semi-urban operations should endeavour to improve the ratio by making larger credit available at their rural and semi-urban branches.

(2) The two-year programmes to be submitted by eligible banks to the Reserve Bank need not be in terms of particular centres selected in advance, but only in terms of the total number of branches to be opened by each bank, showing the distribution of the total number between different States, and between rural areas, semi-urban areas, urban areas, cities with a population of 1 million or more and port towns.

(3) During the current expansion programme, each eligible bank should aim at opening a number of branches which is at least one-third larger than the actual number of branches opened by it during the period of the second branch expansion programme.

(4) All-India banks and the large regional banks should include in their programme a reasonable number of branches (not less than 10 per cent of the total) to be opened in underdeveloped areas.

(5) At least 50 per cent of the total number of branches to be opened should be in rural and semi-urban areas.

(6) For the purpose of (5) above, places with a population up to 10,000 may be

regarded as ‘rural’ and those with a population between 10,000 and 100,000 as ‘semi-urban’.

(7) At least 50 per cent of branches to be opened should be at unbanked centres.

(8) The present criterion of judging the adequacy or otherwise of the banking facilities available at a centre, viz., one branch for a population of 10,000, may continue.

(9) Within the overall programmes approved for individual banks on the basis of the principles set out in (1) to (7) above, eligible banks may apply to the Reserve Bank for allotment of individual centres, keeping in view the proportions to be observed by them between underdeveloped areas and other areas, between banked and unbanked centres and between rural and semi-urban areas on the one hand and urban areas on the other. To ensure steady progress, banks will be expected to indicate the number of centres which they propose to apply for in each quarter. On the basis of information available from the Reserve Bank and other sources regarding population and existing banking facilities, banks will be free to select centres of their choice where they find that there is scope for establishing additional banking facilities.

(10) Applications from eligible banks will be considered on ‘first come, first served’ basis in so far as they relate to centres with a population of more than 5,000 (excluding cities with a population of 1 million or more and port towns), where there is scope for establishment of additional banking facilities on the basis of one branch for every 10,000 of population.

(11) An allotment made on this basis will be subject to the condition that within a period of six months, the bank to whom a centre is allotted will take effective steps for the opening of a branch at that centre, including acquisition of land or the premises. If the bank fails to do so, the allotment will be cancelled and the centre will be available for allotment to another bank.

(12) A bank which fails to conform to the principles regarding the distribution of branches between the rural/semi-urban and urban areas and between banked and unbanked centres will be treated as ineligible for the benefits of the ‘first come, first served’ procedure.

(13) Applications with respect to the following categories of places will need detailed consideration and will, therefore, not be granted by the ‘first come, first served’ procedure.

(a) Centres with a population of 5,000 or less, (These are regarded as suitable for cooperative banks and applications with respect to such centres will need examination in consultation with the Agricultural Credit Department.)

(b) Cities with a population of 1 million or more and port towns, and

(c) Centres where additional branches are proposed to be opened in spite of sufficient banking facilities being already available on the basis of one branch for every 10,000 of population. In considering such applications, due regard will be had to the commercial and industrial importance and potentialities of the places concerned.

(14) Information regarding centres allotted from time to time will be made available to banks at monthly intervals.

(15) Commercial banks will be expected not to apply for centres adequately served by cooperative banks, but to endeavour, wherever possible to utilize the services of cooperative banks as their agents.

(16) The existing policy of permitting foreign banks to open branches at port towns on a restricted scale will continue.

(17) Applications from the State Bank of India and its subsidiaries for opening branches on commercial considerations outside their branch expansion programmes will continue to be dealt with on the same basis as applications from other commercial banks.

9. Under the present procedure, applications from commercial banks except those from the State Bank of India, for opening offices in India are referred to the Local Boards for advice before permitting the banks to open new places of business. As this procedure entails some delay, it is proposed to refer to the Local Boards only applications for opening offices at centres now reserved for detailed consideration. The remaining cases will be disposed of without reference to the Local Boards, but subsequently reported to them and the Central Board. Applications for opening offices outside the country will continue to be referred to the Committee of the Central Board as at present. Once a centre is allotted in accordance with the revised policy and the bank has completed its preparations for the opening of a branch at that centre, the necessary license will be issued upon application without reference to the Local Board.

10. The above principles will be applied to the current branch expansion programme. The principles will be applied with due flexibility. They will be brought to the notice of banks for their guidance.

11. The Board is requested to pass the following resolution:

'Resolved
That the proposals contained in the Deputy Governor's Memorandum dated the 27th April 1968 on the policy regarding the licensing of branches of commercial banks be and are hereby approved.'

Reserve Bank of India
Central Office
Department of Banking Operations and Development
Bombay

Dated 27th April 1968
Vaisakha 7, 1890 (Saka)

DEPUTY GOVERNOR

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D.O. No. DBOD. EFS. 2372/C.452–68

August 24, 1968

My dear Shiralkar,

Will you please refer to your D.O. Letter No. 3805–AS/68 dated 22 July 1968 asking for my comments on C.H. Bhabha's note on operations of foreign banks in India?

2. The note raises a number of specific issues, but there also seems to be underlying it a somewhat general point relating to our whole attitude towards foreign banks in India. It seems desirable to me that we should have a clear sense of direction in regard to our attitude towards foreign banks, and it is only within the framework of a long-term policy that decisions on specific issues have to be taken.

3. It is, I think, quite possible to argue, and I am not sure that Shri Bhabha would not argue, that foreign banks are not necessary for our economy. Certainly if there had been no foreign banks in India today, we would not have felt it necessary to have them. However, there are foreign banks in India and, what is often overlooked, many Indian banks have branches abroad; we are also opening new branches overseas. On every previous occasion when policy in respect of foreign banks has been considered, we have come to the conclusion that while there is need to ensure a proper discipline in respect of their activities, we should not adopt a policy of squeezing them out. Even recently when the entire future of the banking system was in a sense being considered afresh, the view we took in respect of foreign banks was not that they should be told to pack up, but that they should bring in foreign exchange on a long-term basis to represent their capital contribution as it were. We also asked them to set up advisory boards and to otherwise gear themselves to comply with social control. The assessment we made on that occasion also brought out that one of the useful things these banks have been doing is to help raise foreign exchange for Indian enterprises, the most important being of course our national airline.

4. If we accept the policy of allowing foreign banks to operate in the country, then clearly we cannot freeze their operations. As the economy grows and as the banking system develops, they must increase their activities and participations though clearly not to the extent of the Indian banking system.

5. One of the restrictions on them is that they are allowed to open branches only in port towns. Shri Bhabha has argued that as accounts in port towns are more lucrative, this is in fact a blessing on foreign banks. I am not sure whether he would feel happier if foreign banks were asked like Indian banks to open branches in unbanked areas pari passu with branches in port towns: foreign banks may well welcome it. However, there are good reasons, some of them political, against a change in the status quo. Shri Bhabha's impression that licenses to foreign banks to open new branches are being given liberally and without adequate scrutiny is not borne out by the facts. Since 1962, against 91 applications submitted by 9 foreign banks out of 13, we have permitted only 43 offices; during the same period, the number of new branches opened by Indian banks runs to 2367.

6. I am glad that you have already referred to the Centre Board of Direct Taxes the points regarding the revaluation of fixed assets and the increase in the depreciation cost. I hope you will forward their comments on these points to us in due course. Shri Bhabha's points about Head Office expenses are being looked into by the Department of Banking Operations and Development and the Exchange Control Department, and we shall write to you as soon as the necessary data have been collected.

7. Meanwhile, it will help us to know whether the basic assumption of our long-

term policy towards foreign banks as outlined above has the approval of Government. Once this is clear, then we would continue to maintain steady pressure on foreign banks to fall in line with our policies and expectations regarding their credit policies and the policy of Indianization, and see to it that they do not get any kind of an unfair advantage because of their foreign ownership.

Yours sincerely,
L.K. Jha

Shri S.S. Shiralkar
Additional Secretary
Ministry of Finance
Department of Economic Affairs
Government of India
New Delhi

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D.O.No.F.4 (58)–BC/68

Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi
23 October 1968

My Dear Jha,

Please refer to your letter No. DBOD.EFS.2372/C.452–68 dated 24 August 1968 regarding your comments on C.H. Bhabha's note on operations of foreign banks in India. I am enclosing a copy of the reply which has been sent to Shri C.H. Bhabha by the Deputy Prime Minister.

2. We have taken this opportunity of reviewing our policy regarding operations of foreign banks in the light of Shri Bhabha's note and the observations which you have made thereon. On the whole, we feel that our policy of confining foreign banks to port towns would continue but even in port towns a more restrictive policy appears to be indicated. We find that, during the three years from 1965–67, 169 branches were opened by foreign and Indian banks out of which 22 were by foreign banks. It is true that Indian banks cannot complain that they have not got their due share of new branches in port towns, though on a branch-to-branch basis, the performance of foreign banks has been substantially better. We find, however, that, in a number of places, foreign banks have been allowed to open branches in residential localities. In Calcutta during 1966–67 as many as eight branches were allowed to be opened by foreign banks in areas which are mainly middle class residential localities. These areas are well served by Indian banks and we would perhaps have been justified in rejecting applications for the opening of branches by foreign banks in those areas. We consider that foreign banks should be authorized expansion in port towns in those cases where we are satisfied that their global affiliations would be of distinct advantage to our export–import trade or in the matter of availability of foreign exchange loans to Indian concerns. In other words,

our present policy will be further tightened and the opening of branches by foreign banks in residential areas, even in port towns would be restrictive.

3. Since our policy is to restrict the business of foreign banks, we should ensure that the direction issued by the Reserve Bank in April 1968 in respect of their credit–deposit ratios is complied with as speedily as possible. It appears that steps taken by the foreign banks to reduce the credit–deposit ratio have not, so far, been satisfactory. We hope that the Reserve Bank would pursue vigorously the policy of restricting their credit–deposit ratios within the overall direction issued in April 1968.

4. Arising out of Bhabha's note, there are two directions in which a close scrutiny by the Reserve Bank might be necessary. In the first place, the head office supervision charges will need to be carefully scrutinized. I am sure, as you have mentioned in paragraph 6 of your letter, the Reserve Bank is looking into this aspect and certain points which have occurred to us have also been communicated to the Reserve Bank separately. Secondly, it appears to us that it might be fruitful if a detailed study is made by the Reserve Bank regarding the level of profitability of different foreign banks. Some of the net profit figures for 1966 are interesting. The First National City Bank with a deposit of about Rs 48.8 crores earned a net profit of Rs 67.07 lakhs as against virtually the same amount of net profit earned by the National and Grindlays with deposits of Rs 175.94 crores. Bank of Tokyo with deposits of about Rs 7 crores earned a net profit of Rs 13.26 lakhs as against the Chartered Bank which earned virtually the same amount as net profit with deposits which are eight times as high. Some explanation, of course, can be readily suggested and part of the profits might come down with the decline in credit–deposit ratio. Nevertheless, it appears to us that a detailed study could profitably be made with a view to finding out whether any positive steps can be taken to reduce the volume of their repatriable profits.

5. In the end, I would make a special mention of the three American banks. We are inclined to think that transfers of US Government funds to the three banks, if they cannot be avoided, should preferably take the form of Cooley loans to these banks rather than general purpose deposits. These will come up for discussion separately with the Americans and we would be writing to you about this at the appropriate time.

Yours sincerely,
S.S. Shiralkar

Shri L.K. Jha
Governor
Reserve Bank
Bombay – 1

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3796–DPM/68 New Delhi
19th October, 1968

My dear Bhabha,

You would recall that some time back you sent me a note on the operations of foreign banks in India. The points you raised were important and I had them carefully examined in my Ministry.

You have referred in the first place to the branch licensing policy of the Reserve Bank in respect of foreign banks and seem to have an impression that licenses to foreign banks for opening new branches are not so meticulously reviewed as in the case of Indian banks. While we are allowing the foreign banks to function in India, we have restricted their operations to port towns, and, even within port towns, no undue bias was shown to foreign banks in the matter of opening new branches. I find that, during the three years 1965–67, the total number of branches opened in port towns by Indian and foreign banks were 169 out of which foreign banks opened 22 branches. I would assure you that the branch licensing policy in regard to foreign banks has been restrictive and will continue to be so.

You have referred in your note to the revaluation of fixed assets which has been carried out by some foreign banks in recent months and have expressed the fear that this revaluation has been done with the object of getting the benefit of additional non-taxable deduction through extra depreciation on the revalued assets. This apprehension is not correct. Depreciation under the Indian Income Tax is allowed on the written down value of assets (namely, the actual cost of the assets to the assessee less depreciation actually allowed in previous years). Thus, even after the revaluation of assets, the banks will not be able to claim any advantage in the matter of depreciation admissible under the Income Tax Act. Also I had it further examined whether revaluation would give the banks any advantage in the matter of Surtax. Here again I find that the position has been fully protected under the rules and the reserves brought into existence by increasing, by revaluation or otherwise, the book value of assets would not be taken as capital for the purpose of Surtax Act.

You have rightly pointed out that the amount of head office supervision charges by the foreign banks should merit a close scrutiny. I have asked the Reserve Bank to look into all aspects regarding the appropriateness of the scale of such head office supervision charges and I am sure that whatever action is considered appropriate will be taken by the Reserve Bank.

As regards the operating losses by the foreign banks, it appears that three foreign banks incurred losses during 1967 but the loss cannot be stated to have resulted from higher debits on account of head office administrative charges. The losses are transferred to the head office and are not carried forward in the balance sheet. If any foreign bank chooses to carry forward the loss in any year without transferring them to their head offices, we have to think of necessary action at that stage but, as I have mentioned, no foreign bank has done it so far and, for the present, I would prefer to leave it at that. I also had it examined whether the loss can be adjusted by a foreign bank by utilizing the balance in the capital reserve account on account of revaluation of assets. This will not be allowed and the Reserve Bank would be advising the foreign banks to that effect.

I hope I have broadly covered the main issues you have mentioned in your letter. I must say that I greatly appreciate the trouble you have taken in bringing to my notice such important issues regarding the operations of foreign banks in this country.

Yours sincerely,
MORARJI DESAI

Shri C.H. Bhabha
Central Bank Building
Fort
Bombay – 1

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BRANCH LICENSING POLICY AND POPULATION CRITERION

D.G.(A) in his note dated the 28th September has raised a number of important questions relating to the use of the existing population criterion for branch licensing. To answer them adequately would require a considerable amount of work. However, even looking at the available data regarding the recent experience of growth of deposits at population centres of various size, certain useful indications can be obtained. I thought it would be useful at this stage to describe these:

(i) In the Annual Survey of Debits to Deposit Accounts we get annual averages of month-end deposits for each scheduled bank branch as for the calendar year. The branches are classified according to seven population groups, namely, (a) population below 10,000, (b) between 10,000 and 30,000, (c) 30,000 and 50,000, (d) 50,000 and 1 lakh (e) 1 lakh and 5 lakhs (f) 5 lakhs and 10 lakhs and (g) 10 lakhs and over. In the case of the last group, figures are also available for the four major cities such as Bombay, Calcutta, Delhi and Madras. The population, it may be noted, is according to the last Census. This, of course, introduces some error in the classification. The coverage of the Survey has varied somewhat from year to year. However, from 1963 onwards the number of reporting offices are between 97 and 99 per cent of the total.

(ii) The number of branches have increased in all the population groups during the period 1963–66 (for which data are available). Despite this, the average amount of deposits per office has also increased in all the groups. The following tables show this. There are, of course, variations in the rates of growth of the average deposit per office in the different groups. But the fact that the average has increased is significant. For if branch licensing were too liberal in any particular population group resulting in competition for the deposits, the average deposits per office should have declined in that group. This has not happened.

(iii) This raises the question of what should be the criterion to distinguish wasteful competition from healthy competition for branch opening in any particular area. Of course, the criterion cannot be a simple one such as average deposit per office. It will have to be based on some assumptions regarding what is a reasonable period for a branch to obtain that level of deposits which can be considered as a break-even point in the light of the cost of running an office in that locality. This suggests that the figures need to be studied further on an areawise basis. We have actually started a sample study of new branches opened in Calcutta and Bombay in the different areas of these two cities to find out what kind of impact they had on the nearby branches of other banks. Similar studies can be undertaken for either centres in the different population groups or areas in the different population groups. But I would not suggest that action should be held up pending results of these studies because even the available data are sufficient in my view to suggest that a liberalization of the present population criterion within some limits is quite safe. Under several population groups, the rate of increase of average deposit per office per year is more than 10 per cent. In the population group 10,000–30,000 for instance, increase in average deposit per office in 1966 over 1963 was as much as 57 per cent. In the next higher population group 30,000–50,000, we get an increase of nearly 50 per cent in the average deposit per office over the same period. In the population group 50,000 to 1 lakh, it was 77 per cent. Beyond this group, as one moves on to the larger cities, the rate of growth of average deposit per office itself comes down but one must remember that the average itself goes on increasing with the size of the cities. It is only in the population group below 10,000 that the rate has been very low—only 8 per cent in four years.

(iv) It seems to me, therefore, that no great harm will come to the banking system by relaxing the population limit to 5,000 per office. So long as we ensure that the banks do open a sufficient number of branches in the unbanked areas, we could allow them to open branches on the basis of a population of 5,000 per bank office. Of course, we must be very strict about observance of this condition.

(v) As far as the profitability of the branches is concerned, I think we could leave this to the banks themselves. If a bank does not expect to make profit in a particular locality in a city, it is not likely to open a branch there.

For consideration.
D.G.(A)

3.10.1968

In the course of the Meeting of the Bankers' Ad Hoc Committee held on 4 October 1968, D.G.(A) referred to one aspect of the Bank's branch licensing policy, namely, the Bank's sanction which at present is given for opening of 50 per cent of the new offices in banked areas if the other 50 per cent are opened in non-banked areas. A reference was made to the feeling expressed by the banks that enough scope was not given to them for branch expansion. It was, therefore, thought desirable to give more flexibility to the policy. The present norm was one office for 10,000 population. It was proposed to reduce it to one office for every 5,000. D.G.(A) wanted bankers

Average Deposits of Scheduled Commercial Banks
(in centres grouped according to population)

(Deposits in lakhs of Rs)

Population	1963		1964		1965		1966	
	Number of offices	Average deposit per office	Number of offices	Average deposit per office	Number of offices	Average deposit per office	Number of offices	Average deposit per office
1. Below10,000	695	9.7	767	9.5	890	9.9	1034	10.5
2. Between 10,000 to 30,000	1153	11.9	1334	13.0	1428	14.9	1426	18.7
3. Between 30,000 and 50,000	537	21.7	577	25.2	582	28.8	591	32.5
4. Between 50,000 and 1 lakh	581	28.4	629	32.0	636	32.6	641	50.2
5. Between 1 lakh and 5 lakhs	879	44.4	977	46.7	1009	50.9	1046	61.0
6. Between 5 lakhs and 10 lakhs	238	63.0	272	63.3	280	70.8	289	72.0
7. 10 lakhs and over	781	128.9	878	134.9	924	140.0	950	146.7

NOTE: Deposit figures are averages of month-end outstandings.
SOURCE: Survey of Debits to Deposit accounts.

Average Deposits of Scheduled Commercial Banks in the Major Cities

(Deposits in lakhs of Rs)

	1963		1964		1965		1966	
	Number of offices	Average deposit per office	Number of offices	Average deposit per office	Number of offices	Average deposit per office	Number of offices	Average deposit per office
Bombay	266	168.9	299	177.9	321	190.3	327	203.2
Calcutta	145	198.8	168	191.4	173	196.5	177	190.1
Delhi	173	97.1	195	111.9	199	107.4	205	122.3
Madras	134	44.7	143	43.6	148	52.6	150	53.9

NOTE: Deposit figures are averages of month-end outstandings.
SOURCE: Survey of Debits to Deposit accounts.

to consider whether it would be practicable for them to open offices in smaller centres.

There were two views expressed on this point. One view (expressed by Sarvashree Choksi, Pai and Laxminarayanan) was that the banks would welcome such a move. It was for them to choose areas which would be profitable for them. They thought that some competition was healthy for the growth of banking. The other view (expressed by Shri Gandhi) was that this would not be fair for the banks who had gone earlier in a particular region in that the fruits of the pioneering effort of their work would be reaped by other banks which came late in the field. Shri Ramanand Rao also strongly opposed the proposal to reduce the population criterion. On this, D.G.(A) referred to the study prepared by E.A. on 'Branch Licensing Policy and Population Criterion'.

Shri B.K. Dutt desired that further licensing should be stopped in particular areas which were overbanked. On this, there was some discussion on the criteria to be adopted for determining what could be considered as an overbanked area.

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Branch Licensing Policy—Relaxation of the Population Criterion from 10,000 to 5,000 per Bank Office

According to the existing procedure, in order to judge whether the banking facilities available at a place are adequate or not, the criterion of one bank office for every 10,000 of the population of the place is being followed. This criterion was adopted by the Reserve Bank as a rough guide soon after the passing of the Banking Regulation Act, 1949 and has been reiterated in the Deputy Governor's Memorandum No. B.9 which was approved by the Central Board at its meeting held on the 6th May 1968. It is, however, applied in practice with flexibility since the banking potential of a place is only partly dependent on the size of the population, and there are several other factors such as the economic development, the pattern of trade and industry, etc. of the place which also have to be taken into account. Moreover, in order to ensure that commercial and industrial centres are not deprived of adequate banking facilities, the above population criterion is relaxed and more bank offices are permitted wherever considered justifiable. Relaxations are also made in the case of the smaller banks which want to open branches in adjoining areas.

2. In the context of the present need for mobilization of deposits and the extension of banking facilities to all urban and semi-urban areas in the country which are devoid of or deficient in banking facilities, it is for consideration whether there should be a general relaxation of the population criterion from 10,000 to 5,000 per bank office. When the question was recently discussed in the Ad Hoc Committee of Bankers on the 4th October 1968, certain banks like the Central Bank of India, the Bank of India and the Bank of Baroda welcomed the proposal, whereas the State Bank of India and the Dena Bank opposed it as they felt that such liberalization might result in increasing the losses at their branches working in the smaller towns. In view of this and having regard to the general tendency of banks to open branches

in the bigger cities to the neglect of the smaller centres, it appears desirable to relax the population criterion on a selective basis, but not generally. A general relaxation, it is felt, may lead to further concentration of bank offices in the bigger cities and it would be difficult for us to resist requests of banks based on the new criterion, for opening offices in such centres. This may also lead to unhealthy competition between banks and may even result in diversion of business from existing banks. Further, there are about 500 places which are still underbanked even on the basis of the present population criterion and, if it is relaxed, the banks may not open offices at such centres in view of their general preference for bigger cities and other commercial centres. On the other hand, a policy of selective liberalization will enable us to allow suitable application of banks for opening branches even in the bigger cities, where there is ample scope for new deposits.

In view of the foregoing, it is suggested that the relaxation of the population criterion may be made on a selective basis as indicated below:

(i) In centres with a population of over 5,000 but not exceeding 10,000 and served by an office of the State Bank of India or its subsidiaries, another bank office of a commercial bank in the private sector may be permitted where considered justifiable. Several complaints have been received that the services rendered by the State Bank of India and its subsidiaries are not adequate. Permitting an additional office of a commercial bank is likely to promote greater mobilization of deposits in such places.

(ii) In places having a population exceeding 10,000 but below 5,00,000, the population criterion may be waived on a selective basis provided the banks do not locate their offices within a distance of 400 metres from the existing bank office. At present, the distance stipulation is insisted only in regard to the establishment of offices in residential and suburban areas of bigger cities.

(iii) In regard to places with a population exceeding 5 lakhs and port towns, we may not generally relax the existing population criterion but allow, on merits, and on a larger scale than at present, applications of banks to open offices in newly developing localities depending upon their potentialities and the availability of banking facilities there or in the vicinity.

3. If the above proposal for selective liberalization of the population criterion is approved, a draft memorandum to the Board will be prepared accordingly. If, however, a general relaxation of the criterion is considered essential to mobilize deposits, a suitable draft memorandum will be put up recommending the necessary liberalization.

(C.O.)
17.10.1968

D.G. (Ad)

The proposal to reduce the population norm from 10,000 to 5,000 was warmly welcomed by all major banks except Dena and SBI. SBI's opposition is understandable, because the proposal would bring in a commercial bank at a place with 10,000 population where SBI has an office. But SBI would benefit by some competition. I think the modification suggested by CO(O) would substantially achieve the purpose: we may relax the norm only at places below 5 lakhs. If approved, the proposal can be placed before the board.

BRANCH LICENSING POLICY—RELAXATION OF THE POPULATION CRITERION
FROM 10,000 TO 5,000 PER BANK OFFICE

Draft Memorandum to the Central Board is submitted for approval.

21.10.1968

C.O.(O)
D.G. (Ad)
Fair Memorandum to the Central Board is placed below for signature.

D.G.(Ad) 23.10.1968

110 copies of the Memorandum (45 copies on one side) are sent herewith.

20

No. B. 31

MEMORANDUM TO THE CENTRAL BOARD
Policy Regarding the Licensing of Branches of Commercial Banks
by the Reserve Bank of India

The policy regarding the licensing of the branches of commercial banks by the Reserve Bank of India under section 23 of the Banking Regulation Act, 1949, was last reviewed by the Central Board at their meeting held on the 6th May 1968, when it was liberalized with a view to assisting banks to fulfil the targets set for them in the Third Branch Expansion Programme. It is proposed to consider in the present memorandum in what directions the policy could be further modified in the context of the current need for mobilizing more deposits and the extension of banking facilities to the urban and semi-urban areas in the country to the maximum extent possible.

2. One of the important criteria which is being followed by the Reserve Bank at present in granting licenses to open branches is the population basis of allowing one bank office for every 10,000 of the population. This criterion was adopted by the Reserve Bank in 1949 soon after the passing of the Banking Regulation Act. Since then, owing to the rise in the purchasing power of the people, there are many places having a population of about 10,000 which offer scope for more than one bank office. The present policy of not allowing more than one office in such places, except when a special case is made out by a bank, is probably having an inhibiting effect on the pace of branch expansion, since banks generally tend to avoid the trouble of exploring the banking potential of a place where an additional office would be permitted only if a special case could be made out. In order to encourage banks to open more branches, it is necessary to remove all formal impediments which may inhibit their efforts to mobilize deposits wherever such possibilities exist. Banks themselves, in their own interest, may be expected to avoid going to areas

which offer no scope for additional offices. In many places with a population up to 10,000 where the State Bank of India, or another commercial bank already has an office, the present policy is not to allow the branch of another bank to be opened. However, at many such centres, the opening of one more office may help more deposits to be mobilized through inter-bank competition which may lead to improvement in customer service as well.

3. Having regard to the foregoing considerations, it is proposed that the population norm per bank office be reduced from 10,000 to 5,000 in the case of centres with a population of below 5 lakhs, as indicated below.

(a) In centres with a population of 5,000 but not exceeding 10,000 and served by an office of the State Bank of India, its subsidiary, or of a bank in the private sector, another office of a commercial bank may be permitted.

(b) In places having a population exceeding 10,000 but below 5,00,000, the population criterion may also be reduced to 5,000 per bank office, provided the banks do not locate their new offices within a distance of 400 metres from an existing bank office. At present, the stipulation as regards the distance between bank offices is insisted upon only in respect of offices in residential and suburban areas of bigger cities. The existing practice of permitting opening of offices in banked centres in the ratio of one office in a banked centre to one office in an unbanked centre will continue to be in force, and this will check any tendency towards concentration in the banked centres.

4. The above modifications will be applied to the current branch expansion programme and will be brought to the notice of the banks for their guidance. The other criteria set out in memorandum No. B.9 dated the 27th April 1968 will continue to hold good.

5. The Board is requested to pass the following resolution:

'Resolved
That the proposals contained in the Deputy Governor's Memorandum dated the 23rd October 1968 regarding modification in the policy relating to the licensing of the branches of commercial banks be and are hereby approved.'

B.N. Adarkar
Deputy Governor

Reserve Bank of India
Central Office
Department of Banking Operations and Development
Bombay, Dated 23rd October, 1968
Kartika 1, 1890 (Saka)

21

I have had more than one discussion with Shri Baksi regarding the procedure to be adopted for dealing with applications for licenses under Section 23 of the Banking Regulation Act, 1949.

2. Shri Baksi's general feeling seems to be that:

(i) the branch expansion programmes, judging by the evidence of the actual applications, is still heavily urban-oriented, particularly as the norms of 1:1 for urban and rural areas and 10 per cent for the opening of branches in centres with a population of less than 1,00,000 in the 7 underbanked States may not any longer be relevant, in view of the much greater emphasis on the opening of branches in rural areas and in these neglected States (if, as is likely, we are going to specify in future the actual places at which branches are to be opened in the light of the Nariman Committee's report after it is finalized, the ratios will, in any event, be meaningless);

(ii) in view of the difficulties arising out of language barriers, long distances from the head offices, lack of familiarity on the part of senior officers at the head offices with local problems in remote areas and inadequate or unsuitable arrangements for transfers and postings to and from remote areas, the opening of branches by any nationalized bank other than the State Bank of India or its subsidiary, in a State or Union Territory in which it does not already have a fair concentration of offices should be discouraged (this will mean that the emphasis in future will be on branch expansion in three or four States, other than the State in which the bank has its head office or has the predominant number of offices);

(iii) in the opening of branches, the claims of the smaller banks should not be overlooked, merely because they are not nationalized;

(iv) the theory that a lead bank has to be given some preference, as compared with other banks, in the opening of branches, may easily lead to a monopoly of business for the lead bank in the allotted district and cannot, therefore, be accepted; and

(v) subject to the above and subject to satisfactory performance in the opening of an adequate number of rural offices, in all the cities which have a cosmopolitan character, that is those with a population of 1 million and above or those which are otherwise known to be cosmopolitan, every bank should have an opportunity of opening an office on commercial consideration.

3. The Nariman Committee will shortly be finalizing its report. It will do so, after taking into consideration the 650 and odd treasury and sub-treasury centres which still remain to be covered under the proposals which have recently been made at the meeting of the ad-hoc committee of bankers and also the possibility of opening branches or sub or pay offices or satellite or mobile offices in schools, colleges, and factories. After the list of places to be covered has been finalized by the Nariman Committee, licences can automatically be given to every bank in respect of any place allotted to it according to the list.

4. The question of licensing will, thereafter, be relevant only for the opening of branches on purely commercial considerations outside the list as finalized by the Nariman Committee. Our licensing policy may be modified at this stage, so as to eliminate the present free for all system, which has led to a number of complaints, and some criteria for licensing can be drawn up, based on the considerations set out in paragraph 2 above.

5. The formal revision of our licensing policy may take some time. This matter will, in any case, have to be considered more fully at a later stage, after we have had some more experience of the working of the nationalized banks and before a clear and definite policy for the future is formulated. In the meantime, I have tried to point out the need (a) to clear pending and future applications as quickly as possible and (b) the need to allow complete freedom to the Reserve Bank to dispose of applications individually. Although we have consulted Government in regard to individual applications in one batch at their instance, in order to fix our ideas, it will not be practicable to continue this procedure as a standing arrangement, and it is not the intention that there should be individual consultations in future.

6. If Governor agrees, I shall follow this up with a letter to Shri Shiralkar explaining the position.

(The Nariman Committee's report cannot be deemed to be formal at this stage. Some details of the centres and districts involved are indicated in the folder below.)

R.K. Seshadri
17.10.1969

22

This was handed to me by Governor. My comments are as follows:
Para 2(i): When Nariman Committees plan is approved and it is agreed to license all centres to banks as shown in that plan, no question arises of any '1:1' or '1:10' ratios being observed. (ii) When the Committee's work is completed, all 327 districts of India will have been allotted to banks by consent, subject to (as has been agreed) the interest evinced by small banks and then special position in particulars districts (e.g. Andhra Bank in Guntur for which Union Bank was, in the absence of that knowledge, mentioned as the Lead Bank) being taken into account. (iii) covered by comments on (ii); (iv) The concept of a district-wise credit plan, with the responsibility for formulation of such a plan being initially taken by a commercial bank, involving RBI, SBI, subsidiaries, other commercial and cooperative banks, etc. (i.e., to ensure that 'lead' does not mean dominance or 'monopoly') is the very core of the credit scheme presented in Prof. Godgil's Group's Report. The categorical statement in (iv) that this theory cannot be accepted will mean throwing this whole approach overboard. (v) The conclusion that every bank which fulfils its rural quota should be allowed 'on commercial consideration' to open an office in cities having a population of 1 m. or more, is a hasty one; it is here that there is overcrowding; it is this area which is reserved, under the present policy, for detailed examination; it is here that much tighter restrictions are needed to prevent (and even to rectify) glaring duplication. It is wrong to turn policies upside down in this way.

Para 4–5: Please see margin. The main advantage of 'the freedom' that is complained of lies in the tempo it generates; it is easy to put a 'damper; more difficult to generate momentum.

There seems nothing in writing from Delhi. If policy is to be modified, this should be preceded by some written comments from Delhi, besides oral advice.

18.10.1969
DG (A)

Governor

23

When I was in Delhi, I had the occasion to discuss with Shri Baksi the question of branch licensing policy. The views which he expressed are not quite the same as summarized in para 2 of E.D.(S)'s note of 17.10.69. In fact, his thinking and mine were not dissimilar and I set out below the salient points.

The responsibility for branch licensing must continue to be that of the Reserve Bank as in the past.

While it is obviously desirable that nationalized banks should, among themselves, agree upon a coordinated programme of branch opening, we shall have to look at their proposals to take into account certain factors which may not have been prominent in the minds of the Group considering the allocations among themselves.

We have to take into account the interests of the State Bank on the one hand and the non-nationalized banks on the other.

We have to see that in an attempt to share out the responsibility for opening branches in rural areas, there is not merely an arithmetical allocation under which all banks carry a pro-rata responsibility in all backward areas, but that the pattern is one which will enable banks to concentrate and feel specially responsible for certain areas.

Towards this end, certain things will have to be watched. If, for example, a Bombay bank is to open say a dozen branches in Bihar, it would be preferable to allow these branches to be concentrated in a certain area in Bihar on which they could focus and for which they could provide one or two senior officers for overall supervision rather than scatter the branches all over the State. Factors such as language and distance are, no doubt, relevant in this context but cannot be given too much weight. Thus, to take another example, if the Bank of Canara with its specialized knowledge of helping small-scale industries wanted to go to the rural areas of Kashmir we should welcome it, but in that event it won't do for it to have just one or two branches. When a bank wants to have a very few branches in a particular State, it can better remain in the cities; entry into the rural areas has to be in a somewhat concentrated form.

After D.G. (A) and E.D. (S) have seen this note, I should like to have a word with them.

L.K. Jha
27.10.1969

1. Discussed with D.G. (A) and also with Governor. Governor referred to some of these points at the meeting of the Standing Committee of bankers on the 1st November 1969, and subsequently, Shri Nariman also mentioned to him the need for allocating the burden of responsibility for opening branches in the underbanked states and for the intensive development of particular districts under the lead bank scheme, in such a manner that banks like the Canara and Syndicate Banks and the Bank of Baroda and the Bank of India will be able to accept a fair share of the responsibility—particularly in Uttar Pradesh, Madhya Pradesh and other underbanked states.

2. We may await the final report of the Nariman Committee.

R.K. Seshadri
15.11.1969

24

I have been looking at the Report of the Nariman Committee. I know its recommendations are under examination. While I shall await the comments that might be offered, there are one or two points on which I am not quite clear about the nationale of the Committee's approach and would welcome any elucidation that Shri Mangesh Nadkarni might offer.

My doubts arise not so much on the principles and recommendations in the Report of the Committee but in regard to the actual allocations recommended. When the people concerned themselves agreed that a certain pattern is fair and equitable among them, my first reaction is to accept what has been recommended. However, my doubts remain and as they pertain to efficient working of the system rather than equity in the matter of apportionment of responsibilities and opportunities, I thought I would set them down.

In the matter of allocation of districts to lead banks, I do, in certain cases, entertain a doubt whether the chosen bank can, in fact, deliver the goods in the districts allocated to it. I notice, for example, that the Dena Bank has one district in Uttar Pradesh, three in Madhya Pradesh and one Union Territory—Dadra and Nagar Haveli. The last makes sense because it is close enough to the areas where the Dena Bank is strong and well placed to serve. I am not sure how effective we can reasonably expect it to be in a solitary district in Uttar Pradesh and further whether in Madhya Pradesh it would not have fared better in Mandsaur and Ratlam which are much nearer to Bombay and have been allotted to the United Commercial Bank rather than in Raipur, Bastar and Durg which are nearer to headquarters of the United Commercial Bank. This is only by way of illustration, but a further scrutiny of the proposed list from this angle may be worthwhile.

The second thing about which I have a doubt is that in the allotment of towns for the branch licensing programme, the choice does not seem to take into account the allocation of districts for lead bank purposes. Would it not make better sense for the lead bank to assume, as an initial part of its responsibility, the opening of branches in the unbanked towns in that district?

As I have said, I would welcome Shri Mangesh Nadkarni's comments on both these points. Further, it might help consideration to have the recommendations translated into a bankwise statement in which, in respect of each bank, would be shown the number of existing or licensed branches in each State together with the number of districts and towns now proposed to be entrusted to it, again on a datewise basis.

21.11.1969

(Notes have been submitted to Governor. Some adjustments have been made in the allocations of districts under the 'draw bank' scheme/allotments of unbanked towns. Circulars have been issued on the 23rd December 1969 to banks.)

25

Syndicate Bank Ltd.
Manipal
Mysore State
India

Camp: P.B. 196
BOMBAY
1 December 1969

Dear Shri Jha,

Standing Committee meeting on 12th December Report of the Committee on Branch Expansion Programme for the Public Sector Banks

On going through the report, I felt like raising a few issues for consideration by the Committee. May I request that the points I have raised are got examined?

Has the lead bank any definite commitment for opening a definite number of branches in the district assigned to it within a specified time? If a commitment of this nature is not there, how do we expect the country to be covered by the required number of branches within a reasonable time?

Will the lead bank enjoy any priority in opening the branches in the district assigned to it?

The manpower planning and training up of personnel required for assuming the role of development is possible only when each bank is prepared to take up the responsibility for a specific area, and not otherwise.

Involvement of a bank in agricultural finance, filling up of the credit gap and mobilization of deposits is possible only by a network of branches in an area.

Geographical accessibility of a branch is a must for this purpose. Unless each bank knows its areas of operation definitely, it will be unable to make any commitment for manpower assessment and training.

It would not be possible for it to build up the necessary infrastructure for developmental activities unless it is willing to establish a fairly large number of branches itself. In view of this, the recommendations in para 6.3 on page 17 will not make for effective functioning of a lead bank.

While I agree that no monopoly need be created, it would be worthwhile for each bank to fulfil its own commitments in the district where it has assumed leadership and then only think of venturing into other fields. Otherwise, large areas of the country will remain unbanked.

Unless the branches of banks are evenly spread out throughout the country, the pattern of credit distribution will not be uniform, credit being extended in only those areas where there are banks and the areas without a sufficient number of banks being unable to get their requirements of credit. It would thus widen the disparity that exists today. In the light of this, I am not clear what role the other lead bank to which the district of Nellore has been assigned will have to fulfil there, where we had at the instance and with the help of the Reserve Bank had made an exhaustive survey and subsequently applied for a network of branches there. If in future the other lead banks have to get priority for other branches in that district, it would be worthwhile for us to withdraw our applications in respect of Nellore as it would be uneconomical for us to work up this area by building up personnel for agricultural operations. In the absence of a clear-cut idea on branch banking, we fear we might be denied a chance to open branches where we would find it necessary to carry out these operations.

We had surveyed the Mandya district along with the Reserve Bank of India and the survey indicated that there are no places worth opening a branch by a commercial bank in view of the cooperative institutions in existence. I now find that the State Bank of India has been allotted (please see Annexure I Statement VI under Mysore) three branches in the important centres while the Syndicate Bank has been made the lead bank. Obviously, if the State Bank will have a larger number of branches in the area, what role can Syndicate Bank be expected to play in this district?

Before its nationalization, the Syndicate Bank had thought of developing Bellary District intensively and also of covering it up with a large number of branches, after undertaking a survey of the district jointly with the Reserve Bank of India. We have, since then, in fact, opened a number of branches in unbanked centres in this area. Now this district has been allotted to the State Bank as the lead bank. Though we have no objection to this, it is felt that the bank which had surveyed the district ought to have been chosen as the lead bank.

For the reasons mentioned above (please refer Annexure I Statement VI page 9 under Tamil Tadu), the Syndicate Bank will be willing to surrender the five places in Chingleput to the lead bank of the district. We had applied for Laccadive Islands where there is not even a single bank at present. We have been told we would not be granted that as the lead bank in the area is the State Bank, whereas in Krishna district for a village that we had applied for, we have been informed that the State Bank has been issued a license and it may not be worthwhile for us to open a branch there. This has created a lot of confusion in our own mind and a definite policy might save a lot of work for us as well as for the Reserve Bank in the matter of branch licensing.

Annexure I Statement III Puzhathi in Cannanore district is the same as Chirrakal where we have already opened a branch. This place has a population of 5,000 only and now I find it has been allotted to State Bank of Travancore, vide Annexure I Statement III.

Please refer to Annexure I Statement III Naregal in Dharwar district, has been

classified under Maharashtra—it should be in Mysore. This may kindly be corrected.
With regards,

Yours sincerely,
T.A. Pai

Shri L.K. Jha
Governor
Reserve Bank of India
Bombay

c.c. Dr R.K. Hazari
Deputy Governor
Reserve Bank of India
Bombay

c.c. Shri M. Narasimham
Secretary
Reserve Bank of India
Bombay

26

Report of the Nariman Committee

The note recorded by Governor in connection with the above report is placed below. As desired therein, elucidation is furnished in the following paragraphs in regard to the allocation of districts and the allotment of centres. This note is submitted in advance for explaining the issues generally, pending a detailed examination of the allocation as also the preparation of a bankwise statement which is in progress.

Allocation of the Districts

2. The Nariman Committee appointed a Sub-Committee consisting of the operational heads of all the nationalized banks to go into the question of allocating districts for 'lead bank' purposes as also the allotment of unbanked centres and to make its recommendations to the Committee. The State Bank of India also participated in the deliberations of the Sub-Committee in its second and third meetings. In the light of the discussions held in the second and third meetings, the State Bank of India was given by the Sub-Committee a fair number of districts as well as centres. As regards the allocation of the districts among the other public sector banks, the broad principle adopted was the contiguity of the districts to the main area of operation of each of the banks. Certain exceptions were made having regard to the fact that some of the districts had already been surveyed by one or the other nationalized banks either on its own or in association with the survey teams formed by the Reserve Bank. In these cases, it was generally felt desirable to allocate the district to the bank which had surveyed it. In a few such cases, the concerned bank had already gone ahead with the preliminaries for undertaking intensive

agricultural credit operations with a view to reaching the targets fixed for it.

3. On an analysis of the proposals made by the Sub-Committee regarding the allocation of the districts in the seven underbanked states, viz. Assam, Bihar, Jammu and Kashmir, Madhya Pradesh, Orissa, Uttar Pradesh and West Bengal, it was found that the allocation had become somewhat unbalanced in the sense that some of the banks with their main areas of operation in the eastern and northern India had to take up a disproportionately large number of districts in the above underbanked states by virtue of the contiguity of the districts to their main areas of operation. It may be observed in this connection that with the exception of Madhya Pradesh, the underbanked states are located in the eastern and northern India. Thus, for example, the United Commercial Bank and Allahabad Bank had, as their share in the allocation, as many as twenty-five and eighteen districts respectively, whereas some of the bigger Bombay banks, viz. Central Bank of India, Bank of India and Bank of Baroda had been allotted only nine, ten and six districts in the above states. The consensus among the members of the Committee in its last meeting held on the 12th November 1969 was that the banks in the eastern and northern regions which had a rather large number of districts for 'lead bank' purposes might find it difficult to effectively play their role in respect of so many districts. The Committee, therefore, decided to make adjustments in the allocation of the districts so as to rectify, to the extent possible, the above imbalances. Accordingly, some more districts, particularly from Uttar Pradesh and Madhya Pradesh, were allocated to the above three Bombay banks, although the latter two of these do not have any appreciable network of branches in those states. In allocating the districts thus in comparatively distant areas, the Committee has also held the view that in cases where, on the basis of the resources and manpower, any of the nationalized banks could be expected to deliver the goods, the contiguity of the districts to its main area of operation need not be the sole criterion and the distance need not necessarily stand in the way of the district being allocated to such a bank. Certain subsequent adjustments were accordingly made in the allocation of the districts in the underbanked states on the lines broadly indicated by the Committee in its meeting referred to above. On a closer look at the allocation, it, however, appears necessary to judge the ability of the 'lead bank', especially the smaller ones, to effectively play its 'lead bank' role in regard to some of the districts. A detailed study of these instances has been undertaken and the suggestions for remedial action, if any, will be put up later.

4. As regards the specific instances cited in the note placed below, viz. the allocation of Rae Bareilly district in Uttar Pradesh and Raipur, Bastar and Durg districts in Madhya Pradesh to the Dena Bank, it may be clarified that that bank had already undertaken intensive agricultural credit operations in the Raipur district (notwithstanding its being distantly situated). That bank, therefore, desired that it should be permitted to retain the district for the 'lead bank' role purposes. The Bastar and Durg districts are contiguous to the Raipur district, and hence those two districts were also allotted to it by the Sub-Committee, partly with a view to relieving

excessive burden on the other banks given the 'lead bank' role in Madhya Pradesh. As regards the allotment of the Rae Bareilly district in Uttar Pradesh to the Dena Bank, it may be stated that the Dena Bank requested the Sub-Committee for assigning the district to it in view of the fact that it had already extended financial assistance to a sizeable extent to the priority sectors operating in the district from its existing office at Lalganj. It had also already undertaken a detailed survey of the district on its own and had selected about ten centres for opening its offices there. In view of the above, the Sub-Committee agreed to allot the district to the Dena Bank.

Allotment of Centres

5. In allotting the unallotted centres out of the 580 unbanked centres, the Committee has not been necessarily guided by the allocation of the districts for 'lead bank' role purposes. The first list of 106 centres, each having a population of 10,000 and over, was circulated by the Reserve Bank in April 1969. The second list of 197 centres was also circulated by the Reserve Bank soon thereafter. The banks were then requested to make their selection of these centres and indicate their choice. In regard to the centres covered by these two lists, the banks tried to assess the suitability of each of the centres from their own angle. While some of these centres had already been allotted by the Reserve Bank on the basis of the choice indicated by the banks, the remaining centres were considered for allotment by the Committee. However, in making the allotment of the remaining centres out of the two lists as also the third list of 277 centres, the Committee felt it desirable to request each of the nationalized banks to indicate its choice in the light of its own assessment made after the receipt of the first two lists from the Reserve Bank or subsequently. The allotment has accordingly been made by the Sub-Committee, mainly in accordance with the choice indicated by each of the banks on the basis of the latter's own assessment of suitability to it. The existence of the allottee bank's offices in one or more towns in the vicinity, has also been taken into consideration by the Sub-Committee in making the allotment.

6. As will be seen from the Committee's report (vide paragraph 6.3 on page 17), the Committee has expressed a view against the 'lead bank' scheme giving rise to a monopoly in the matter of branch expansion in favour of the 'lead bank'. With a view to ensuring a fair allotment of centres for opening of bank offices in the district, it has been suggested by the Committee in the above paragraph that the 'lead bank' should follow a process of mutual selection of centres in the district in consultation with the other banks already operating in the area, so that the 'lead 'bank' does not take for itself only high potential centres in the district leaving the low potential centres to the associate banks. It is in the context of the above approach that the Committee has not linked the allotment of the 580 unbanked centres to the allocation of the districts for 'lead bank' purposes.

Sh. Nadkarni
Addl. C.O.
3.12.1969

Submitted.

C.C.(O)
A further note on the subject with detailed appendices showing the number of towns allotted and the number of districts taken up by each bank under the 'lead bank' scheme is also placed below.
D.G. (H)
Governor

27

Ref. DBOD. No. B.D. 4327/C.168–69 December 23, 1969
Pausa 2, 1891 (Saka)

State Bank of India and its Subsidiaries
14 Nationalized Banks
Andhra Bank Ltd.
Bank of Rajasthan Ltd.

Dear Sirs,

Branch Expansion Programme—Allocations of Districts under the 'Lead Bank' Scheme

As you are aware, the Governor of the Reserve Bank of India had appointed a committee under the chairmanship of Shri F.K.F. Nariman to evolve a coordinated programme for ensuring the setting up of adequate banking facilities in the underbanked districts of the country. The committee, in its report submitted to the Reserve Bank on 15 November 1969, has made recommendations for setting up 'lead' banks for each underbanked district, on the lines suggested in the report of the Group presided over by Professor Gadgil, as well as for opening bank branches to fulfil the target which had been adopted earlier of providing every place designated as a town in the last census report with a bank branch by the end of 1970. This letter relates to the lead bank scheme and a separate communication is being sent regarding branch expansion.

2. The recommendations of the Nariman Committee were discussed at a meeting of the Standing Committee of bankers on the 12th December 1969. The principle of the lead bank scheme was endorsed at that meeting. Certain comments were made in regard to the detailed allocation and Chairmen/Custodians were told to communicate their suggestions for change if any which they considered to be desirable in the allotments proposed by the Nariman Committee. Taking into account the comments which have since been received, the Reserve Bank has now made certain adjustments in the allocation of the districts. The following general considerations have also been kept in view by the Reserve Bank in making these adjustments:

(i) There should be a broad correspondence between allocation of responsibility (in terms of number of districts) and the resource base of banks concerned. The resource base, in turn, should take into account the deposits of the bank and its existing branch network, both in number and location.

(ii) In allotting 'Lead Bank' districts, the factor of contiguity has been borne in mind. Contiguity has been broadly defined to include clusters of districts. Such clusters would go a long way towards ensuring viability of operations as well as providing control points for developmental work and branch supervision. They would also provide the basis for long-term growth of banks in the districts allotted to them.

(iii) As far as possible, the existing regional orientation of banks has been kept in mind. In addition, the claims of one or two regional banks, which are not nationalized, have been taken into account.

(iv) The re-allocation has provided that in each state, barring certain exceptions, there would be at least two or more Lead Banks. Similarly, as far as possible, each bank has been allotted districts in more than one state.

(v) Metropolitan centres as well as some Union Territories have not been allotted under the Scheme.

3. The Annexure to this letter gives the details of allotments of the various districts under the Lead Bank Scheme. A map setting out the allotment of lead districts will be forwarded to you in due course.

4. With the designation of a particular bank as a Lead Bank in a district, the concerned bank will be responsible for taking the leading role in surveying the credit needs, in the development of branch banking and extension of credit facilities in the respective district. The more specific functions of a Lead Bank in a district may be spelt out in some detail as under:

(a) Surveying the resources and potential for banking development in its district;

(b) Surveying the number of industrial and commercial units and other establishments, and farms, which do not have banking accounts or depend mainly on moneylenders, and increasing their owned resources through the creation of surpluses from additional production financed from the banking system;

(c) Examining the facilities for the marketing of agricultural produce and industrial production, storage and warehousing space, and the linking of credit with marketing in the district;

(d) Surveying the facilities for the stocking of fertilizers and other agricultural inputs and the repairing and servicing of equipment;

(e) Recruitment and training of staff, for offering advice to small borrowers and farmers, in the priority sectors, which may be covered by the proposed credit insurance schemes and for the follow-up and inspection of the end-use loans;

(f) Assisting other primary lending agencies; and

(g) Maintaining contacts and liaison residually with Government and quasi-Government agencies.

5. The Lead Bank will be expected to assume the major role in the development of banking and credit in the allocated districts. At the same time, there is clearly no intention that the lead bank should have a monopoly of banking business in a district. The bank assigned the lead role is thus expected to act as the consortium leader and after identifying through survey, areas requiring branch expansion and areas suffering from credit gaps, it should invoke the cooperation of other banks

operating in the district for opening branches as well as for meeting credit needs.

6. The Reserve Bank of India will be in close touch with the banks concerned in the operation of the scheme and would appreciate banks bringing to its notice any problems they may be having in this regard. It would be useful if banks were to submit a quarterly progress report on the working of the Lead Bank Scheme for our information and any necessary action. We also trust that banks will exchange information of their experience in the operation of the Lead Bank Scheme with other banks.

7. Please acknowledge receipt.

Yours faithfully,
R.K. Hazari
Deputy Governor

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From Narasimham to D.N. Ghosh
Reference your telex of yesterday stop material for reply to Parliament Question is furnished below:
The National Credit Council at its meeting held in Delhi on 24th July 1968 adopted the report of its Standing Committee on the subject of guidelines in respect of credit allocations in 1968–69. The Standing Committee had addressed itself as a matter of immediate urgency to the question of increasing the participation of commercial banks in the financing of agriculture and small-scale industries. In regard to agriculture, the finance from commercial banks is likely to amount to rupees three hundred to four hundred crores by the end of 1968–69. Of this, a very large proportion would be deployed in food procurement and allied operations. At the same time, commercial banks would be expected to continue their finance for plantations and the marketing of produce other than food grains and in addition provide additional credit facilities for input distribution, medium-term credit for capital investment purposes such as tractors, pumpsets, etc. as well as for equipment and other facilities required for fisheries, dairying, poultry farming, etc. Further, commercial banks are expected to increase their subscription to land mortgage banks' debentures as compared with 1967–68 when their subscription amounted to about rupees eighteen crores excluding the subscriptions by the State Bank. Cooperative banks also are expected in the coming year to increase the quantum of their finance substantially by about rupees three hundred crores on the assumption of normal Kharif and Rabi rains in respect of production, marketing and capital investment. Altogether, the area of institutional finance for agriculture is expected to be considerably enlarged in the coming year. The council has also indicated to banks, in the nature K+ of a guideline an expansion of their credit to the small-scale industrial sector by rupees sixty to seventy crores as against an estimated expansion of rupees thirty to thirty-five crores in 1967–68.

As regards credit requirements of medium- and large-scale industries, the council felt that every effort should be made through appropriate credit policies to secure the highest possible rate of growth of industrial production in accordance with the plan priorities.

The Reserve Bank will follow these recommendations in formulating its own credit policies and will also take appropriate steps to ensure that the credit extended by the banking system is in conformity with these guidelines.

30.7.1968

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No.B.29

Memorandum to the Central Board
Commercial Banks' Assistance to Agriculture and Small-Scale Industries: 1968–69

I

1. *Targets set by the National Credit Council*

At the second meeting of the National Credit Council held at New Delhi on 24 July 1968, it was emphasized that the commercial banks should increase their involvement in the financing of the two priority sectors, viz., agriculture and small-scale industries, as a matter of urgency. The Standing Committee of the National Credit Council had estimated that deposits of commercial banks would increase by about Rs 400 crores during 1968–69, out of which, after allowing for statutory liquidity requirements, roughly Rs 290 crores would be available for credit expansion. The Council indicated that during 1968–69, commercial banks should increase their assistance to the agricultural sector to the extent of Rs 35–40 crores for financing the distribution of fertilizers and other inputs and the direct needs of the farmers (short- and medium-term) that is, production loans for purchasing seeds, inputs, implements, machinery, power tillers, tractors, pumpsets, etc. and also loans for fisheries, dairy farming, etc. This would, however, exclude finance provided to plantations and marketing of agricultural produce (including food procurement finance) as well as subscriptions to debentures of the land mortgage banks. The Council also recommended that commercial banks should enhance their credit to small-scale industries by Rs 60–70 crores. These were indicated as the minimum targets to be kept in view by the banks. Thus, banks would be required to divert between 33 and 38 per cent of the free portion of the estimated fresh accretion to deposits for financing the needs of the two priority sectors. In addition, the Council suggested that commercial banks' investment in debentures of lend mortgage banks should be at least 25 per cent higher in 1968–69 compared to 1967–68. Commercial banks other than the State Bank put in Rs 18.35 crores in such debentures last year and on the basis of the Council's recommendation are expected to invest about Rs 23 crores this year.* The amounts to be invested by each bank

*The State Bank's subscriptions to the Land Mortgage Bank debentures during 1967–68 were of the order of Rs 3.79 crores, and on this basis the bank should normally subscribe an additional amount of Rs 4.74 crores during 1968–69 in terms of the Council's is recommendations.

will similarly be related to its contribution last year. Commercial banks have also agreed that though such debentures would be 'approved securities' for purposes of statutory liquidity requirements, such investments would not be wholly at the expense of other investments in approved securities. They have informally agreed to count only three-fifths of such investment for liquidity cover purposes.

2. *Follow-Up Action to implement the National Credit Council's Targets*
The Ad-hoc Committee of Bankers which met on the 16th August 1968, discussed the follow-up action to be taken by banks to implement the decisions taken by the National Credit Council at its second meeting. The general consensus among the bankers present at this meeting was in favour of individual meetings between the Reserve Bank and each one of the major commercial banks for this purpose. Accordingly, discussions were held between 23 August 1968 and 25 September 1968 with twenty major banks (which accounted for 86.3 per cent of the deposits of the banking system as of end June 1968). At the meetings, banks' views were sought on the following aspects:

(a) their expectations about the likely amount of deposits in the coming year, and the amount of additional lending to the two priority sectors, and
(b) follow-up action taken by banks to increase deposit mobilization and to ensure the dispensation of credit to priority sectors as proposed, with particular reference to any practical difficulties likely to be experienced by them in realizing the targets.

3. *Bank's Estimates as indicated by Bankers*
Bank-wise details of the targets in respect of deposit growth and lending to the two priority sectors (viz. agriculture and small-scale industries) during these discussions are given in tables 1 and 2. It was decided at these meetings that the targets would be for the period July 1968–June 1969 (although the National Credit Council had in mind the period April 1968–March 1969). This was done in view of the fact that at the time the discussions started, about one half of the financial year was already over. A July–June basis was considered, therefore, to be more meaningful from the point of view of action by banks to achieve the targets.

4. *Deposits*
The expectation of these twenty major banks is that in 1968–69 their deposits will increase by about Rs 414 crores, as against Rs 402 crores in 1967–68 and Rs 335 crores in 1966–67. These twenty banks account for about 86 per cent of the total deposits of the banking system. The growth in deposits of banks other than these twenty banks is estimated to be around Rs 50 crores in 1968–69, or about the same as in 1967–68. On this basis, the estimates of deposit growth for the banking system as a whole would work out to Rs 464 crores as against Rs 452 crores in 1967–68. On a April–March basis, the Standing Committee of National Credit Council had estimated the annual deposit growth at about Rs 400 crores for 1968–69. Since these estimates were made, conditions have turned out to be somewhat more encouraging; the annual order of deposit growth of Rs 464 crores in 1968–69 on a July–June basis may be viewed in this context.

5. *Lending to the Priority Sectors*
The twenty major banks have indicated that their direct credit to agriculture would increase by Rs 44 crores and their lending to small-scale industries by Rs 93 crores in 1968–69 (Table 2). These twenty banks account for about 86 per cent of the total scheduled bank deposits and on this basis, the estimates of additional credit to agriculture and small industries for the banking system as a whole would work out to Rs 51 crores and Rs 108 crores, respectively. But considering the fact that some of the smaller banks are known to two priority sectors, could be somewhat larger than indicated above.

6. These figures imply that banks would deploy about 47 per cent of their available additional deposits (that is, after providing for statutory liquidity ratio) for financing of agriculture and small-scale industries as against the National Credit Council's expectation of 33–38 per cent. As between agriculture and small-scale industries, the former is expected to get a share of 15 per cent and the latter 32 per cent. Banks have indicated that on the basis of their individual past experience about the utilization of credit limits sanctioned, they would endeavour to sanction appropriate credit limits in order to achieve the actual increase in lending indicated by them.

7. *Overall Picture of Sources and Uses*
It may be noted that the targets indicated by the banks are somewhat in excess of the norms laid down by the National Credit Council, in respect of lendings to the two priority sectors. This is so not only in absolute amounts but also relatively to deposits. This raises the question whether these targets would result in starving other sectors of bank finance needed by them. However, although banks have naturally sought to aim at higher targets, it is somewhat doubtful whether the actual utilization of credit would turn out to be as expected. Success in this matter depends on the progress they make with the organizational and other arrangements under consideration. The higher targets aimed at by banks should, therefore, be regarded as what the banks are aiming at in order to ensure that at least the targets set by the

Table: Banking system: Overall budget for 1968–69 (in Rs crores)

	Deposit growth	Available deposits (after providing for 28% liquidity)	Credit to small-scale industries	Credit to agriculture	Subscription to land mortgage banks (over & above liquidity requirement)	Total 3+ 4+ 5+	Resources available for other sectors
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. As estimated by the Standing Committee at the time of the Second NCC meeting	400	288	70	40	10	120	168
2. As now estimated on the basis of banks' targets	464	334	108	51	12	171	163

Council will be fulfilled. Bearing this in mind and taking into account the improved prospects for deposit mobilization, the availability of resources to meet the requirements of other sectors should not pose any serious problem, as will be seen in the following table. In any event, the facilities of refinance from the Reserve Bank both for general purposes and in respect of special sectors such as food procurement, exports, etc. would be available to ease seasonal pressures on the position of individual banks.

8. *Deposit Growth—Individual Banks*
As regards the magnitude of the deposit growth in respect of individual banks, it may be stated that out of the estimated total deposit growth for the share of six other major banks, viz. the Allahabad Bank, the Bank of Boarda, the Bank of India, the Central Bank of India, the Punjab National Bank and the United Commercial Bank, is expected to be between 5 to 10 per cent of the total deposit accretion. These six banks together would account for 41 per cent (or Rs 192 crores) of the total deposit growth. Another six banks (the Bank of Maharashtra, the Canara Bank, the Syndicate Bank, the Union Bank of India, the United Bank of India and the National & Grindlays Bank) would account for between 2 and 4 per cent of the total deposit accretion individually, and their share in the total deposit accretion works out to be 16 per cent (Rs 75 crores). The individual share of the remaining seven banks would be below 2 per cent and the concerned banks are the Andhra Bank, the Dena Bank, the Indian Bank, the Indian Oversees Bank, the Chartered Bank, the First National City Bank and the Mercantile Bank.

9. *Total Allocation to the Two Priority Sectors by Individual Banks*
The twenty major banks taken together are expected to allocate 15 per cent and 31 per cent of their additional available deposits to agriculture and small-scale industries, respectively. It may be observed from Table 2 that as many as four banks, viz, the State Bank of India, the Bank of India, the Canara Bank and the United Bank of India expect to divert more than 50 per cent of their individual additional available deposits (after providing for statutory liquidity ratio) to financing of agriculture small-scale industries in 1968–69. It is worth noting that the Bank of India expects to channelize as much as 77 per cent of its additional available deposits to finance the two priority sectors. Another five banks, viz. the Bank of Baroda, the Bank of Maharashtra, the Union Bank of India, the United Commercial Bank and the Chartered Bank expect to divert between 40 and 48 per cent of their individual additional available deposits to financing of agriculture and small-scale industries. The banks which are expected to allocate 35 to 38 per cent of their additional available deposits numbered six, and these are the Andhra Bank, the Central Bank, the Indian Bank, the Dena Bank, the Indian Oversees Bank and the Allahabad Bank. The remaining banks numbering five will divert 27 to 29 per cent of their additional available deposits to the two sectors and the banks coming under this category are the Punjab National Bank, the Syndicate Bank, the First National City Bank, the National and Grindlays Bank and the Mercantile Bank. The twenty banks taken together are expected to allocate 46 per cent of their additional available deposits in 1968–69 for financing of agriculture and small-scale industries.

10. *Agriculture—Individual Banks' Position*
Of the estimated increase of Rs 51 crores in agricultural advances for the banking system as a whole, the share of the State Bank of India will be Rs 10 crores or a little under one-fifth of the target for all banks. Five banks, viz. the Allahabad Bank, the Bank of India, the Central Bank, the Canara Bank and the Punjab National Bank have an individual share between five per cent and 10 per cent. Another five banks whose individual share in the total target is between 3 to 4.9 per cent, together would contribute 22 per cent to the target and these banks are the Bank of Baroda, the United Commercial Bank, the Syndicate Bank, the Union Bank of India and the United Bank of India. Of the remaining nine banks, the four foreign banks* (viz. the Chartered Bank, the First National City Bank, the National & Grindlays Bank and the Mercantile Bank) do not expect to contribute anything while the individual share of others would be below 3 per cent.

11. *Small-Scale Industries—Individual Bank's Position*
As regards the share of individual banks in the target of lending to small-scale industries, it may be seen from Table 2 that as much as 33 per cent is accounted for by the State Bank of India. The individual share of all other banks would account for less than 10 per cent of the total target. The individual share of four banks, viz. the Bank of Baroda, the Bank of India, the Central Bank of India and the United Commercial Bank is ranging between 5 and 10 per cent of the target and their total contribution works out to be 26 per cent. Three banks, viz. the Allahabad Bank, the Punjab National Bank and the United Bank of India are expected to meet between 3 and 4.2 per cent of the target individually, and they together would account for 11 per cent of the target. The individual share of other banks which include the Andhra Bank, the Bank of Maharashtra, the Canara Bank, the Dena Bank, the Indian Bank, the Indian Oversees Bank, the Syndicate Bank, the Union Bank of India, the Chartered Bank, the First National City Bank, the National and Grindlays Bank and the Mercantile Bank would be less than 3 per cent of the target.

12. *Subscriptions to Debentures of Land Mortgage Banks*
As regards the targets for subscriptions to debentures of land mortgage banks, all the banks indicated during the discussions that they would subscribe 25 per cent more than what they did in 1967–68. Some of the banks indicated the likely quantum of subscriptions during the discussions. In the case of other banks which did not readily provide a figure, we have estimated the subscription on the basis of the formula agreed. On this basis, the targets for subscription to debentures of land mortgage banks in 1968–69 in respect of twenty banks would amount to Rs 27.48 crores and the estimate for all banks could be placed at Rs 31 crores. The bulk of the contribution is expected to be made by six major banks, viz. the State Bank (Rs 8 crores), the Central Bank (Rs 3.23 crores), the Punjab National Bank (Rs 3 crores), the Bank of India (Rs 2.5 crores), the Bank of Baroda (Rs 2.29 crores) and the

*Some of the foreign banks like the Chartered Bank indicated that they have some proposals to finance fertilizer distribution under consideration.

United Commercial Bank (Rs 1.45 crores) which together would account for 66 per cent of the target.

13. By and large, the consensus among bankers with whom discussions were held was that there should be recessionary conditions in certain pockets of the economy, some of the banks seemed to be pessimistic about realizing their targets, but, on the whole, the general consensus was that without compromising on the banking principles, it should be possible to increase their involvement. The Reserve Bank has indicated that there will be another round of discussions with individual banks to have a mid-term evaluation of the banks' performance.

II

14. *Organizational and Other Measures to Mobilize Deposits and to Enlarge Assistance to Priority Sectors*

Banks' efforts towards deposit mobilization consist of (a) spreading the network of their branches in new and untried areas and (b) formulating new schemes for popularizing the banking habit among the people by offering better services, several facilities, incentives and innovations. For example, several banks have undertaken either on their own or jointly with other banks, special surveys for assessing the banking potentialities of new regions or centres in the rural areas. They have also arranged for extensive propaganda in the rural areas through various means such as distribution of pamphlets, setting out the facilities and help offered by banks, holding of meetings at marketplaces and small towns, etc.

Deposit Mobilization: Some banks have also introduced novel schemes for attracting the attention of the rural populace (for example, the State Bank of India has arranged for photographs to be taken of individual depositors and distributed the same to their families along with the literature on the bank). Special schemes for issuing different types of deposits have also been evolved by several banks. These include, for instance, the In-Plant banking programme introduced by the First National City Bank through which the bank seeks to enlist the cooperation of the employers (company or firm) to get deposits from the employees of these institutions, introduction of schemes for investment deposits or deposit-passports, collection of deposits through coupons and launching of the programme for a house-to-house canvassing for deposits. A scheme for seeking a direct approach to the white-collar workers in cities has also been started by one of the leading foreign banks while several banks have taken action to improve the quality of the bank's services to the customers. Some banks have also formulated plans for extending advances in new areas in order to attract, at a later stage, deposits from these borrowers.

15. *Measures to Enlarge Assistance to Small-Scale Industries*

In order to enable them to increase their lending to the two priority sectors, namely, small-scale industries and agriculture, banks have, in recent months, taken several organizational and other measures. With a view to ensuring that the targets set by the National Credit Council in respect of lending to small-scale industries and agriculture are realized, commercial banks propose not only to strengthen the existing arrangements but also take further measures; generally speaking, banks' efforts are being generally directed to strengthen both the agriculturists and the small-scale industries. In the course of the discussions with the individual banks, the Reserve Bank also stressed the areas where action could be taken with advantage.

16. *Administrative and Organizational Measures*
In order to help evolve an approach to the problem of financing the priority sectors, formulate policies and programmes, review the work done, and to provide the much-needed sense of urgency to the task of lending to the priority sectors and generally for overseeing the needs of the priority sectors, some of the banks have already set up special sub-committees of their Boards of Directors consisting, among others, of the directors representing the interests of agriculture and small-scale industries. The Reserve Bank has, in fact, advised all banks to constitute such sub-committees of Boards of Directors without delay. The Bank has also advised that adequate use should be made of the directors representing the interests of agriculture and small-scale industries.

17. With a view to giving special attention to the expeditious processing of the applications of small-scale industries and also to generally undertake developmental work relating to small-scale industries, banks have already set up or are in the process of setting up special cells or departments to deal exclusively with the financing of small-scale industries. Qualified personnel are being recruited to speed up technical formalities in the processing of applications. While some banks have engaged the services of consulting engineers, others are considering the constitution of a panel of consultants to help them in the evaluation of technical feasibility of the projects. Some banks indicated that, apart from assisting the department concerned in scrutinizing the applications and making proper assessment of the technical feasibility of the proposals received from small-scale units, the services of their technical personnel would be made available to guide and assist the small-scale units in the technical aspects of the project. Banks will also be strengthening their liaison with the offices of the Development Commissioner for small-scale industries, offices of the Directorates of Industries of different states, the National Small Industries Corporation, the Small Industries Service Institute, etc., for keeping themselves posted with all the necessary information on small industries. Wider discretionary powers to the agents of the local branches in the matter of sanctioning credit limits of small-scale industries are also being given. Some of the banks have constituted small committees consisting of the local agent and two representatives of the area who contact small industrialists in the locality; they also seek information from big industries about their suppliers. Banks have also been giving particular attention to the opening of branches in industrial estate areas and have also engaged field officers for touring the areas, particularly in the Industrial Estates to assess the potentialities of increasing the scope of bank leading to smell industries.

18. One of the difficulties mentioned by the banks to them and that this denied them the facilities of techno-economic appraisal of credit prospects. The Reserve Bank has indicated to banks that in consultation with IDBI, it was proposed to set up technical advisory service to provide guidance to banks on technical, marketing and managerial aspects of small industries. The IDBI is to set up in the initial stages

a small nucleus of technical personnel at each of the regional offices of the IFD of the RBI at Bombay, Calcutta, Madras and New Delhi, so that they can assist the banks to provide technical appraisal reports of new projects as well as on other for modernization and expansion of small industries. These technical cells can usefully maintain close liaison with State Directorates of Industries, with Small Industries Service Institute and the regional offices of the National Small Industries Corporation for exchange of technical and other information. The data collected through contacts with these various institutions should prove invaluable in the assessment of projects and should in turn help the banks for taking more active interest in small industries. The technical staff will also be entrusted with other items of work. The regional cells would undertake active follow-up and periodical inspection of industrial concerns which are assisted by the IDBI. They may also undertake, in collaboration with State and Central Government agencies, special studies of small industries which actually face, or are likely to face, difficulties as a result of factors like obsolete technology, overproduction of particular items, and lack of quality control, and offer suggestions.

19. *Orientation of Lending Policies Banks*
Banks have generally agreed to bring all their new advances under the Credit Guarantee Scheme. In respect of the existing loans also, efforts will be made by them to bring as many as possible within the Credit Guarantee Scheme. The increased availment of the guarantee facilities is expected to result in commercial banks taking larger interest in financing small-scale industries. As a further inducement to the credit institutions to render more assistance to small-scale industries and to provide some relief to them, the fee for guarantee cover under the Credit Guarantee Scheme for small-scale industries has been reduced from one-quarter of 1 per cent per annum to one-tenth of 1 per cent per annum. The concessional rate will, however, be available only to those credit institutions which decide to seek guarantee in respect of all their eligible advances to small industries sanctioned or renewed on or after 1 October 1968. Some of the procedures relating to obtaining guarantee cover, particularly those relating to the filling of forms, have been considerably simplified. Banks have also been advised to give as much assistance as possible to their borrowers in filling in the necessary forms related to their borrowing from the banks.

20. During the discussions, the bankers also stressed that they were now placing greater emphasis on the feasibility of the scheme, capabilities and technical skill of the people behind the project, the marketability of products and the overall efficiency deserving cases, particularly in the case of educated entrepreneurs and qualified technologists, several conventional lending standards relating to security, margin, etc. were considerably relaxed. Many commercial banks usually charge a preferential rate of 8.25 per cent on their advances to small industries.

21. During the discussions, the Reserve Bank stressed in particular that the Head Offices of banks should keep continuous track of credit refusals by branch agents and analyse the experience of such refusals in order to explore ways and means of being of greater assistance to the small-scale industries.

22. *Publicity and Public Relations*
Banks have also been advised to strengthen their publicity and public relations arrangements and many of them have already brought out or are bringing out useful literature in regional languages explaining the facilities available for lending to priority sectors like small-scale industries and agriculture and the various lending procedures that are in operation. Some of the banks have already started conducting at the bank's regional centres' seminars, in which local industrialists are also invited to participate, for educating branch agents in the procedures and practices of providing finance for small industries.

23. *Measures to help Agricultural Sector*
As regards financing of agriculture, which is a relatively new field for the commercial banks, efforts are being made by banks to improve the organizational and other arrangements in order to be of greater assistance to the agricultural sector. There are serious limitations of personnel, but arrangements are being made to recruit staff with practical experience in agriculture. In the training courses offered in the training colleges of banks, courses on farm finances are being introduced. Bank officers are being deputed to agricultural universities for training in farm techniques. Banks have also been developing contacts with agricultural colleges and universities on various problems of agricultural development. During the discussions, the Reserve Bank stressed the need for strengthening the liaison with State Governments for identification of projects and priorities. In particular, it has been stressed that the regional representatives of banks should be in touch with district officials of the State Government concerned with agriculture, and try to get an idea of projects for development and the total financial needs of the projects. Several of the banks have also selected areas for intensive development and have also proposals to undertake surveys to identify promising areas and projects which can be provided with necessary financing. Some of the banks are also sending officers to Agricultural Refinance Corporation to get practical training of appraisal of projects. Some banks have already held seminars and addressed meetings at certain agricultural universities which have been found extremely useful in bringing the bankers in close contact with the farmers and agriculturists. Some of the banks send their staff experienced in agriculture to visit rural areas, coordinate the bank's credit operations with other agencies, make surveys of soil and credit requirements.

III

24. *Difficulties Encountered by Banks*
In the course of the discussions, some of the difficulties encountered by banks in the speedy implementation of the targets for credit for the two priority sectors were mentioned by the representatives of banks. Some of the more commonly felt difficulties were as follows:

(i) the difficulties in persuading the borrowers to fill in the various forms relating to financial accounts with particulars as required by the Credit Guarantee Organization;
(ii) the question of banks lending against equitable mortgage and the

arrangements for recording the land claims in respect of loans to farmers. In this connection, the banks wanted to know whether the Government would be in a position to give protection to commercial banks by way of relief from Stamp Duty and an assurance for recovery in cases of default;

(iii) the reluctance on the part of big industrialists who are customers for goods manufactured by the small-scale industries to have the bills drawn against them by small industrialists for goods sold to them. This prevents the small industrialists to borrow from banks against receivables making them borrow only against stocks of goods. If such bills get accepted by the purchasers (that is, the bigger industries), the banks said, they could lend even to the extent of 100 per cent of the value of stocks;

(iv) the Reserve Bank generally advises banks not to lend against imported goods which are over six-month old. This affects the small-scale industries adversely since they usually have to keep over one-year-old goods as they can get the import licence only once a year; and

(v) difficulties arising from staff indiscipline and problems of direct recruitment in the context of growing requirements.

25. In recent months, the Reserve Bank has made several liberalization in the procedure for obtaining guarantee cover for advances to small industries. Thus, in respect of applications for guarantee against advances below Rs 50,000, banks are not required to forward financial statements from their borrowers. Regional offices of the Industrial Finance Department of the Bank which operates the Credit Guarantee Scheme, have been opened to expedite the work relating to guarantees. The other difficulties mentioned by the bankers are being examined.

IV

26. *Credit Policy to Assist Lending to Priority Sectors*

This section outlines the measures taken in recent months by the Reserve Bank and its affiliated institutions to facilitate a larger flow of commercial bank credit to agriculture and small-scale industries. Thus, in November 1967, the Reserve Bank informed the banks that refinance would be available at Bank Rate (irrespective of their net liquidity ratios) for their advances for the sales and distribution operations in respect of chemical fertilizers and pesticides. In February 1968, the Bank announced that the total increase in bank advances to the three priority sectors, viz. agriculture (defined as sales and distribution operations in respect of chemical fertilizers and pesticides), small-scale industries covered by the Credit Guarantee Organization and exports, over the average of such advances during the base period (that is, July–October 1966 for slack season and November 1966–April 1967 for busy season) is eligible for refinance at a concessional rate of 4.5 per cent, irrespective of the net liquidity of banks. The Bank has also given a relief in the computation of banks' net liquidity ratio system, so long as this ratio is at or above 30 per cent a bank can borrow at Bank Rate, and that any fall in this ratio beyond 30 per cent would attract a penal rate (on the excess borrowings which is stepped up progressively with fall in the ratio). The relief in the computation of net liquidity ratio was given in the shape of treating the increases in the lending to the three priority sectors, viz. agriculture defined as sales and distribution of chemical fertilizers and pesticides, small-scale industries covered by the Credit Guarantee Organization and exports over the prescribed base period as part of the liquid assets. This measure would enhance the liquidity ratio and thus reduce the cost of borrowing from the Reserve Bank.

27. The Reserve Bank has also announced certain relaxations from the norms prescribed for banks in the conduct of their banking business in favour of bank advances to agricultural sector and small-scale industries. Thus, unsecured advances to finance sales on hire purchase or deferred payment terms, of machinery and equipment for agriculture, dairy farming and fishing are exempted from the norm stipulated for banks' unsecured advances and guarantees in terms of the Bank's letter of 3 May 1967. Advances to small-scale industries covered by the Credit Guarantee Organization and performances guarantees executed on behalf of small-scale industries are also exempted from the above norm. Further, term loans granted for agricultural development, which are either refinanced by the Agricultural Refinance Corporation or not and to small-scale industries covered by the Credit Guarantee Organization are excluded from the total term loans which are generally expected not to exceed 5 per cent of the total deposits. Recently, the Bank decided to extend the refinance facilities under its Bill Market Scheme to bank advances to cooperative banks for the purpose of enabling the latter to make advances to small-scale industries.

28. The IDBI is providing refinance to banks in respect of medium-term loans to small-scale industries covered under the Credit Guarantee Scheme at a concessional rate of 4.5 per cent (as against its normal lending rate of 6 per cent), provided the effective interest rate of the lending institutions is not more than 8 per cent. The minimum amount of loan refinanced and the extent of refinance was also liberalized in April 1968. Thus, the minimum amount of loan to a small-scale unit covered under the Credit Guarantee Scheme for refinance was reduced from Rs 1 lakh to Rs 20,000 and the amount of refinance was raised from 80 per cent to 100 per cent. The IDBI has also extended its refinance facilities to bills covering sales of agricultural machinery and agricultural implements, as an experimental measure up to the end of June 1969.

29. The Agricultural Refinance Corporation normally provides medium- and long-term credit by way of refinance or otherwise for development of agriculture and other allied industries. Recently, the Corporation has relaxed its policy of refinance facilities to banks and mention may be made in this connection about the Corporation's decision to make where the cultivators come under the area of operation of a sugar factory and the factory is prepared to assist the bank in supervision, technical guidance, recovery of loans, etc. The Corporation has also decided to entertain proposals from banks for financing the purchase of power tillers, tractors, pumpsets, etc. and provide refinance for the purpose, provided

Table 1: Deposit accretion during 1968–69 (July–June)

Name of the Bank	Actual level of deposits as at the end of June 1968 (1)	Percentage share of the bank in the total deposits (2)	Expected growth of deposits during 1968–69 (July–June) (3)	Deposits available after providing for 28% liquidity requirements during 1968–69 (July–June) (4)	Percentage share of the bank in the expected growth of deposits (Rs 464.4 crores) (5)
1. State Bank of India	838	21.1	110.0	79.3	23.7
2. Central Bank of India	384	9.7	35.0	25.2	7.5
3. Punjab National Bank	321	8.1	45.0	32.4	9.7
4. Bank of India	302	7.6	27.0	19.4	5.8
5. Bank of Baroda	232	5.8	30.0	21.6	6.5
6. United Commercial Bank	164	4.1	25.0	18.0	5.4
7. United Bank of India	121	3.0	11.0	7.9	2.4
8. Canara Bank	118	3.0	15.0	10.8	3.2
9. Dena Bank	104	2.6	8.0	5.8	1.7
10. Allahabad Bank	99	2.5	30.0	21.6	6.4
11. Union Bank of India	107	2.7	12.0	8.6	2.6
12. Syndicate Bank	81	2.0	15.0	10.8	3.2
13. Indian Bank	66	1.7	8.4	6.0	1.8
14. Bank of Maharashtra	65	1.6	10.0	7.2	2.2
15. Indian Overseas Bank	54	1.4	8.0	5.8	1.7
16. Andhra Bank	37	0.9	5.5	4.0	1.2
17. National & Grindlays Bank	192	4.8	12.0	8.6	2.6
18. First National City Bank	59	1.5	5.0	3.6	1.1
19. Chartered Bank	52	1.3	1.5	1.1	0.3
20. Mercantile Bank	29	0.7	1.0	0.7	0.2
Total of 20 banks	3425	86.3	414.4	298.4	89.2
Other Scheduled Commercial Banks	544	13.7	50.0*	36.0	10.8
All Scheduled Commercial Banks	3969	100.0	464.4	334.4	100.0

*Assumed to be the same as the growth of deposits for these banks during 1967–68.

Deposits Growth (Rs Crores)

	Major Banks	Other Banks	Total
1966–67	335	59	394
1967–68	402	50	452
1968–69 (Estimated)	414	50	464

Table 2: Targets for lending to agriculture and small-scale industries July–June 1968–69

Name of the Bank	Actual level of advances as at the end of June 1968	Percentage share of the bank in total advances	Advances to agriculture (excluding Plantations) as of end June 1968	Col. (3) as % of Col. (1)	Advances to small-scale industries as of end June 1968	Col. (5) as % of Col. (1)	Deposits available after providing for 28% liquidity requirements during 1968–69	Targets of 1968–69: Increase in advances to agriculture	Targets of 1968–69: Increase in advances to small-scale industries	Targets of 1968–69: Total of Col. (8) and Col. (9)	Col. (8) as % of Col. (7)	Col. (9) as % of Col. (7)	Col. (10) as % of Col. (7)	Contribution of the bank to the total targets (Percentages): Agriculture (Rs 51 crores)	Contribution of the bank to the total targets (Percentages): Small-scale industries (Rs 108 crores)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)
1. State Bank of India	776	25.0	3.39*	0.6*	63.00	8.1	79.3	10.00	35.00	45.00	12.6	44.2	56.8	19.6	32.5
2. Central Bank of India	302	9.7	0.12*	..*	20.57	6.8	25.2	3.00	6.10	9.10	11.9	24.2	36.1	5.9	5.7
3. Punjab National Bank	224	7.2	12.87	5.7	10.19*	5.3*	32.4	5.00	4.50	9.50	15.4	13.9	29.3	9.8	4.2
4. Bank of India	213	6.9	0.04*	. .*	6.00	2.8	19.4	5.00	10.00	15.00	25.8	51.5	77.3	9.8	9.3
5. Bank of Baroda	166	5.3	1.58	1.0	6.66	4.0	21.6	2.50	6.34	8.84	11.6	29.4	41.0	4.9	5.9
6. United Commercial Bank	127	4.1	0.28	0.2	7.64*	6.2*	18.0	2.50	6.00	8.50	13.9	33.3	47.2	4.9	5.6
7. United Bank of India	91	2.9	0.14*	0.2	4.52*	5.2*	7.9	2.00@@	3.22	5.22	25.3	40.8	66.1	3.9	3.0
8. Canara Bank	85	2.7	0.88	1.0	10.04*	13.6*	10.8	3.00	3.00	6.00	27.8	27.8	55.6	5.9	2.8
9. Dena Bank	69	2.2	0.95	1.4	7.81	11.3	5.8	1.08	1.15@	2.23	18.6	19.8	38.4	2.1	1.1
10. Allahabad Bank	66	2.1	–*	–*	3.24*	4.8*	21.6	3.00	4.50	7.50	13.9	20.8	34.7	5.9	4.2
11. Union Bank of India	70	2.3	3.83	5.5	2.55	3.6	8.6	2.00	1.50	3.50	23.3	17.4	40.7	3.9	1.4
12. Syndicate Bank	59	1.9	1.65	2.8	6.99	11.8	10.8	2.00	1.00	3.00	18.5	9.3	27.8	3.9	0.9
13. Indian Bank	54	1.7	0.70	1.3	8.32	15.4	6.0	0.85	1.30	2.15	14.2	21.7	35.9	1.7	1.2
14. Bank of Maharashtra	44	1.4	1.43	3.3	6.34*	16.1*	7.2	0.95	2.50	3.45	13.2	34.7	47.9	1.9	2.3
15. Indian Overseas Bank	39	1.3	0.13*	0.4*	7.29*	20.4*	5.8	0.58	1.50	2.08	10.0	25.9	35.9	1.1	1.4

16. Andhra Bank	27	0.9	1.39	5.1	2.40	8.9	4.0	0.50	1.00	1.50	12.5	25.0	37.5	1.0	0.9
17. National & Grindlays Bank	163	5.3	–*	–*	3.49	2.1	8.6	–	2.50	2.50	–	29.1	29.1	–	2.3
18. First National City Bank	38	1.2	–	–	0.83	2.2	3.6	–	1.00	1.00	–	27.8	27.8	–	0.9
19. Chartered Bank	42	1.4	–	–	1.78	4.2	1.1	–	0.50	0.50	–	45.5	45.5	–	0.5
20. Mercantile Bank	28	0.9	–	–	1.67	6.0	0.7	–	0.20	0.20	–	28.6	28.6	–	0.2
Total of 20 banks	2683	86.5	29.38	1.1	181.33	6.8	298.4	43.96	92.81	136.77	14.7	31.1	45.8	86.3	86.3
Other Scheduled Commercial Banks	420	13.5	4.66++	1.1	28.79	6.9	36.0+	7.04++	14.73++	21.77++	19.6	40.9	60.5	13.7	13.7
All Scheduled Commercial Banks	3103	100.0	34.04	1.1	210.12	6.8	334.4	51.00	107.54	158.54	15.2	32.2	47.4	100.0	100.0

Note: @ Rs 2 crores suggested by us.
@@ Rs 95 lakhs suggested by the bank.
* Relate to 31 March 1967—Purpose-wise survey of Bank Advances.
+ Estimated on the basis of Rs 50 crores deposit growth for these banks.
++ Estimated on the basis of the share of the banks to total deposits as of end June 1968.
. . Negligible.

Table 3: Budget for additional deposits during 1968–69 (July–June)

Name of the Bank	Growth of deposits during 1968–69 (July–June)	Deposits available after providing for 28% liquidity requirements	Lending to priority sectors (targets for 1968–69) Agriculture	Small-scale industries	Exports @ 40% of the additional (targetted)	Subscription to debentures of L.M.B.	Total of Col. (3)+ Col. (4)+ Col. (5)+ Col. (6)	Balance available for meeting other requirements Col. (2)–Col. (7)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1. State Bank of India	110.00	79.30	10.00	35.00	4.10	3.20	52.30	27.00
2. Central Bank of India	35.00	25.20	3.00	6.10	1.40	1.29	11.79	13.41
3. Punjab National Bank	45.00	32.40	5.00	4.50	0.40	1.20	11.10	21.30
4. Bank of India	27.00	19.40	5.00	10.00	1.30	1.00	17.30	2.10
5. Bank of Baroda	30.00	21.60	2.50	6.34	1.20	0.92	10.96	10.64
6. United Commercial Bank	25.00	18.00	2.50	6.00	1.20	0.58	10.28	7.72
7. United Bank of India	11.00	7.90	2.00**	3.22	0.20	0.16	5.58	2.32
8. Canara Bank	15.00	10.80	3.00	3.00	0.90	0.40	7.30	3.50
9. Dena Bank	8.00	5.80	1.08	1.15*	0.20	0.39	2.82	2.98
10. Allahabad Bank	30.00	21.60	3.00	4.50	0.40	0.41	8.31	13.29
11. Union Bank of India	12.00	8.60	2.00	1.50	2.30	0.31	6.11	2.49
12. Syndicate Bank	15.00	10.80	2.00	1.00	0.40	0.24	3.64	7.16
13. Indian Bank	8.40	6.00	0.85	1.30	1.10	0.12	3.37	2.63
14. Bank of Maharashtra	10.00	7.20	0.95	2.50	0.20	0.22	3.87	3.33
15. Indian Overseas Bank	8.00	5.80	0.58	1.50	1.70	0.18	3.96	1.84
16. Andhra Bank	5.50	4.00	0.50	1.00	0.20	0.06	1.76	2.24
17. National & Grindlays Bank	12.00	8.60	–	2.50	1.20	0.20	3.90	4.70
18. First National City Bank	5.00	3.60	–	1.00	0.10	–	1.10	2.50

19. Chartered Bank	1.50	1.10	–	0.50	0.20	0.10	0.80	0.30
20. Mercantile Bank	1.00	0.70	–	0.20	0.10	0.02	0.32	0.38
Total of 20 banks	414.40	298.40	43.96	92.81	18.80	11.00	166.57	131.83
		(100.0)	(14.7)	(31.1)	(6.3)	(3.7)	(35.8)	(44.2)
Other Scheduled Commercial Banks	50.00	36.00	7.04	14.73	4.90	1.40	28.07	7.93
		(100.0)	(19.6)	(40.9)	(13.6)	(3.9)	(78.0)	(22.0)
All Scheduled Commercial Banks	464.40	334.40	51.00	107.54	23.70	12.40	194.64	139.76
		(100.0)	(15.3)	(32.1)	(7.1)	(3.7)	(58.2)	(41.8)

NOTE: Rs 2 crores suggested by us.

** Rs 95 lakhs suggested by the bank.

* Estimated on the basis of percentage share of advances to export sector (as reported under section 42) to total deposits as of end May 1968.

Figures in brackets refer to percentages to total available deposits in the respective bank group.

that the schemes are drawn up keeping in view the area development aspect.

B.N. ADARKAR
DEPUTY GOVERNOR
Dated October 21, 1968
Asvina 29, 1890 (Saka)

Reserve Bank of India
Economic Department
Central Office
Bombay

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Internal Note April 1969

There are a few points on which some active thinking is necessary since we shall have to take a final view on them fairly soon.

One question relates to the policy for the slack season. D.G. (An) has been expressing some concern over price trends and suggesting the introduction of some measures of restraints on expansion of bank credit. The extent to which and the manner in which this could be done requires discussion and consideration.

Another issue is the determination of priority sectors and targets, if any, for them for the period July 1969 to June 1970. Since the National Credit Council has left it to us to take the initiative and to have a discussion in the Standing Committee, it will take us quite a few weeks to reach finality and to advise the banks, and therefore, we ought to give some thought to this question also.

It seems to me that merely to step up the targets for small-scale industries and agriculture will not be the right answer, for one thing we ought to evaluate is whether after the sizable increase of bank credit to small-scale industries, there would still be large scale additional needs for working capital in this area. The position regarding agriculture would be different because this is a much vaster field. However, we have brought into the field of agricultural credit quite a variety of operations, some extremely easy such as lending to a Government or a Government's sponsored body against stocks of food and fertilizers. Unless, therefore, we attempt some kind of sub-quotas, the really difficult areas of lending may remain neglected.

However, do these two areas really exhaust the possibilities? There is, of course, the export sector, but there is not target in this case. Can anything else be done to ensure that banks are on the lookout for export business rather than merely deal with such requests as come to them? As the return to banks is not high when they finance exports, the danger of their not being overactive is there.

Another thought comes to my mind. One of the things which has been causing concern is regional imbalance, and this manifests itself quite prominently in operations of banks. Not only are many States underbanked but there is evidence to show that the banking system sometimes transfers resources from poorer areas to richer areas. Is it possible for us to think of any ways in which this imbalance can be corrected? Can we have any objective, non-political criterion, on the strength of which we can ask banks to increase their lending in particular States, and possibly set targets for it? Of course, in any such targets due credit will have to be given for their contribution to State loans, etc. In this context we have also to consider whether the area approach can be woven into the scheme. For example, in getting an underbanked State better banked, should we discuss and settle with banks the names of those which will take particular responsibility for individual States?

In formulating our ideas on all these subjects, we shall have to bear in mind D.G. (An)'s point about the need for some monetary restraints.

I hope that after we return from Bangalore, there will be some concrete ideas at least to discuss among us.

D.G.(A) L.K. JHA
D.G.(An) 29.4.1969
Secretary

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NOTE ON NCC BOMBAY
D.O. No. July 18, 1968

Dear Prof. Gadgil,

In the light of our correspondence and discussions, I am circulating a paper to the National Credit Council drawing attention to the points you had made in your written statement which was circulated to the Council at its opening session, as well as in your letter to me.

The paper which we have circulated does not put forward any solution and confines itself to a somewhat colourless account of the present position and past developments. I hope that at the Council meeting you will yourself take a lead in suggesting what the answer to the problem would be.

I confess that I myself see no satisfactory answer even though I fully understand the problem you have posed. The difficulty, I think, lies in the following factors:

(a) Even though the small man may not easily be able to borrow from a big bank, when it comes to depositing his money he prefers the big bank to a small bank;
(b) Without adequate deposit resources, smaller banks may be willing, but are unable to help the small man;
(c) All too often the board of management of small banks lends itself to local influences and pressures in its lending operations so that in course of time it causes to be as sound and viable as one would like it to be.

In other words, smaller banks seem to suffer from all the weaknesses of cooperative banks in certain States.

How can this situation be remedied? One is tempted to suggest that perhaps this is a problem more for the Banking Commission than for the Credit Council because it relates to the structure and organization of the banking industry. Whatever the view about the agency to explore the problem, one still has to think in terms of possible solutions.

One way is to get the larger banks themselves involved in financing small business. This is, in fact, what in a sense the National Credit Council is trying to do. There are obvious difficulties in doing so. Can greater decentralization of authority and delegation of powers from the central offices to the field officers help to make things a bit easier?

An alternative which one banker has been canvassing is that large all-India banks should have small subsidiaries which will be more localized and also oriented towards meeting the needs of smaller people. Incidentally, and this I believe is his main consideration, such a body would not have to observe the same standards regarding wages and employment which all-India banks have to do because it would be a separate and small entity.

One of the ways in which smaller banks can mobilize more despite it, is by offering a somewhat higher interest. One consequence of this, of course, would be that their lending rates would be higher. Speaking for myself, I have always felt that one should be laying greater emphasis in the adequacy of the credit available than on cheapening the cost of it, but this is not an widely accepted view. Indeed, in an industrial estate in Hyderabad, a point was made that because they have to borrow from the State Bank of Hyderabad and not from the State Bank of India, the interest rates are somewhat higher.

None of what I have said is new to you, but I thought if I indulged in a certain amount of loud thinking, it would enable you to deal with this question when it comes before the National Credit Council.

Yours sincerely,
L.K. Jha

Prof. D.R. Gadgil
Vice Chairman
National Credit Council
New Delhi

No. of date

Copy to Dr I.G. Patel, Special Secretary, Department of Economic Affairs, Ministry of Finance, Government of India, New Delhi.

L.K. Jha
Governor

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D.R. Gadgil's Note for the National Credit Council

It is expected that the National Credit Council will play an important part in meeting the objectives which Government had in mind when it accepted social control of the banking system. The existing regulatory provisions in relation to banking are used by the Reserve Bank of India for certain limited aims such as security of deposits and regulation of the total volume of credit and direction of its flow. Broader social aims could not be easily fitted in this scheme of regulation and the ordinary devices available to the Reserve Bank may not necessarily serve the purpose of these broader aims. It is necessary, in the first instance, to define the broader aims that a banking system can serve and the structural reorganization and the attitudes and policies needed to fulfil the aims. It is highly desirable that discussions at the highest level precede action in this regard and that for the larger part action follows through voluntary acceptance of the articulated objectives and not through a set of externally imposed regulatory measures. The National Credit Council ought to be visualized as essentially serving these ends. It follows that the first task before the Council is to evolve a set of directions in which the banking system should move so that social purposes are fulfilled through its operation.

The purpose of this note is maldistributed to highlight a few aspects of this problem. It is hallmark of an unequal society that not only is the ownership of the resources of production very badly distributed within it, but also that operational and other facilities are equally maldistributed. In case of the banking and credit system, as it operated twenty years ago, this inequality was glaringly evident. Those commanding the largest resources not only could get their credit requirements satisfied in the fullest measure but also obtained credit at specially favourable rates. At the other extreme, large masses of small business and households had no access to any institutional credit facilities. Developments during the past twenty years have, in part, changed the picture. The successful carrying out by the State Bank of India of its programme of branch expansion, bringing together the State Bank and the older Indian State Banks into one structure covering the whole country, and a number of experiments undertaken by the State Bank of India in financing small industry and cooperative organizations have contributed towards this. Developments in the cooperative credit structure have made fuller and more widespread institutional credit available to much greater numbers than before and special schemes in finance of small industry have slightly improved the position of categories of artisans and small industrialists. Even so, the basic inequality is still large and the main objective of social control of banking and credit would appear to be that of more evenly spreading available credit over different areas and categories, relatively lowering the cost of credit to small operators.

It is necessary in framing a programme for meeting social objectives through the credit system to take an integrated view of commercial and cooperative banking. Cooperative banking is now under regulation of the Reserve Bank of India. It covers a progressively wider field and because of its organizational structure and approach is specially fitted to deal with problems of the smaller men and the weaker sections. It is not generally realized that in terms of numbers served, the cooperative credit system is today the largest system of institutional credit. The following extracts from a statement made by me some years ago brings this out statistically. The data of today will be even more striking than the data cited in the quotation.

'As on 30th June 1963, there were 211 thousand primary agricultural credit societies in India with a membership of 217 lakhs. Of the total membership, more than 104 lakh members made borrowings from their societies during the previous year and the average loans advanced per borrowing member was Rs 246. The non-agricultural societies consist chiefly of employees credit societies and urban banks. These together cater to the credit requirements of small traders, government servants and other wage and salary earners and other similar categories of urban and semi-urban residents. The number of non-agricultural credit societies on 30th June 1963 was 12,850 and their membership was 55 lakhs. They had deposits of over Rs 115 crores and the loans advanced by these societies to members during 1962–63 amounted to Rs 166 crores.'

'The cooperative credit system is the only well-nigh universal institutional credit system in rural India. It caters through a larger number of organizations to larger numbers of people than any other institutional system, even in urban India. This dispersed and wide coverage of the cooperative credit system is reflected in the locational distribution of the offices of cooperative banks. In 1963, commercial banks in India had 5,495 offices located at 1,860 places; the corresponding figures for cooperative banks were 2,360 offices at 1,864 places. The number of places served by cooperative banks was larger even though their number of offices was almost half than that of commercial banks. The feature is emphasized by the distribution of offices of the two classes among places with differing population. The all-India figures do not bring out the contrast fully as cooperative banking has not developed equally in all states. The figures for Maharashtra in which both commercial banking and cooperative banking may be taken to be well-developed are more instructive. In 1963, commercial banks had 691 offices at 169 places in Maharashtra and the cooperative banks had 673 offices at 483 places; and while the commercial banks had offices at 115 places with a population of less than 25,000, the corresponding number of places with cooperative banks was 385.'

There are two or three aspects of this problem of spreading widely institutional facilities and keeping low the cost of credit to small man. It has to be realized that appropriate instruments must be fashioned before given purposes can be fulfilled. For example, it is the experience in every branch of economic activity that meeting the needs of small man is essentially a dispersed, highly local and small-scale operation which can best be carried out by local institutions which operate on the basis of personal knowledge of local circumstances. It is obvious that some types of large institutions cannot satisfy this requirement easily. In the same way, supplying credit for agricultural production is not only a dispersed and small unit activity but is subject to many risks which are to be fully incorporated in the organization and methods of the credit system. Encouraging and mobilizing savings of small and dispersed establishments is a function which can be performed only by the institutions which distribute credit appropriately. One of the first problems to be studied by the National Credit Council would be the appropriate division of labour among existing categories of credit institutions and the need, if any, for creating special types of institutions for fulfilling certain needs.

Development of commercial banking, for example, in India, has almost entirely gone on lines of the British system. Growth of smaller single unit local banks or district banks with branches concentrated in small areas of operation has not been encouraged. It is for consideration whether in certain areas and for certain aspects smaller units even in the commercial banking field may not be allowed to be established and to grow. The cooperative credit structure being essentially federal has considerable elasticity and is specially meant at the primary level to fulfil the needs of small men. Primary urban cooperative banking, where it has developed, has given credit facilities to small business in a manner that could never have been otherwise available to them and the salary earners' societies have in a very large measure financed the consumption requirements of very large numbers of salary earners of specific categories very satisfactorily.

It is true that development of cooperative activity has been very uneven and that this is specially so with urban primary cooperative banks. However, I consider it part of the task of the National Credit Council to look into causes of uneven developments of this type and to encourage by special measures the spread in all areas of institutions appropriate for meeting specific ends. There is another aspect of this problem with which Reserve Bank is intimately connected. Furnishing adequate credit to the small man is somewhat difficult in ordinary commercial banking practice because of the lack of security offered and the uncertainty that surrounds the business. The costs of each unit of business also tend to be high. The cooperative approach gets over this, in part, because it brings together groups of persons largely known to each other and, therefore, can operate on the security of knowledge of character and other non-bankable features. However, whether in cooperative banking or in commercial banking where a small local unit adopts practices and procedures appropriate to the situation, it is apt to run up against norms laid down by Reserve Bank or other inspecting authority. The security for credit offered, the margins insisted upon, the number of instalments, the method or frequency of granting extensions and other features of any supervisory system would have to be specially adapted to the needs of financing the smaller men and the weaker sections. The local bank or the cooperative bank can keep down the cost of credit to the small man only because the overheads are smaller or because there is some voluntary work and lower pay scales. Expectations of the regulating authority would have taken account of all such features of the business.

While the cooperative institutions or single unit or small area banks can fulfil certain purposes of social control more effectively than other members of the system, the resources they could command for the purpose may not be a adequate. Therefore, the units with command of larger resources could be looked upon as, in part, supplying resources to this other part of the system. The recent practice of commercial banks of buying debentures of Land Development Banks is a step in this direction. It should, therefore, be clear that it is not necessary for each unit in the banking system to try to perform all functions. It should, in fact, be accepted that it is not possible for this to happen and, that to make it happen artificially may involve unnecessary costs.

The newly established National Credit Council will have to review initially the present operations of the various constituents of the credit and banking systems taking an integrated view of the commercial and cooperative systems. Such a review should indicate the reorganizations and the new developments in structures, policies and procedures needed to make the credit system serve objectives of social control and the appropriate part to be played in the future by each category and type. In this manner, the Council could play the part of a nuclear organization where forward looking thinking is continuously done, from which operations of Government, the Reserve Bank and the Planning Commission could all profit.

D.R. GADGIL

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Syndicate Bank Limited
T.A. Pai
Managing Director & Chairman

MANIPAL
MYSORE STATE (INDIA)
Camp: P.B. 196
BOMBAY-1
19th May, 1969

My dear Shri Adarkar,

Further to my personal discussion with you, I will submit a separate application for availing of credit from the Reserve Bank of India, under the Bill Market Scheme. But at the same time I would like to suggest that we be permitted also to offer inland usance bills up to 90 days for rediscount.

Banks have been financing manufactures' and wholesalers' accounts receivables and the most convenient way of doing it has been found to be to draw a bill against acceptance to be discounted by the Bank. Creation of such bills is bound to help monetary management and impart flexibility to credit mechanism if they are made eligible for rediscount by the Reserve Bank of India. The Reserve Bank of India Section 17 2(b) has a provision for accommodation against such bills. It is only a question of invoking that provision to enable a bill market to come into existence.

For many years, we have been discussing about the creation of bill market in this country. Unless creation of bills is actively encouraged by the Central Banking Authority by more positive steps like free discounting facility being made available when the banks want to borrow from the Reserve Bank of India, it may as well take many more years to take a shape. The present bill market scheme of the Reserve Bank of India does not take into account the genuine trade bills.

When norms were laid down recently for clean credit and bills drawn for genuine trade transactions covering the needs, by the manufactures on their wholesalers or the wholesalers on the retailers, we have, in fact, given an opportunity for the creation of such bills and banks have started actively encouraging this business. In order to properly canalize credit with the manufactures, wholesalers and retailers, if the Reserve Bank makes it possible for the banks to lodge these bills with them for temporary borrowings, it would go a long way in giving further fillip to this practice becoming popular. When these bills satisfy the conditions laid down under the Reserve Bank of India Act 17(2) (b), as eligible paper since they bear the signature of a bank, the creditworthiness of the manufacturer or wholesaler can be easily ascertained and there should be no problem to handle the bills under the scheme.

Since IDBI bills already provide that the banks should retire those bills three days in advance of maturity, similar practice could be introduced in respect of these bill also. The Banks can arrange their portfolio of bills maturing date-wise in bunches, the smallest bill covering Rs 5,000, and these will be short-term advances of self-liquidating nature. The bills could be lodged with the RBI with the pronote and a stipulation that they should be retired by the bank three days before the date of maturity. May I suggest that the Reserve Bank introduce this scheme forthwith on the very merits of the scheme, without waiting for the recommendations of the Banking Commission, as it is likely to take some time, so that when the recommendations of the Commission come up, they might be of a more comprehensive nature to cover up other transactions also?

I hope you will kindly consider my suggestions to enable us to offer these bills in the manner that I have suggested or in any alternative manner that you might suggest.

With kindest regards,

Yours sincerely,
T.A. Pai

Shri B.N. Adarkar
Deputy Governor
Reserve Bank of India
Bombay

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Internal Note

REDISCOUNTING TRADE BILLS BY THE RESERVE BANK OF INDIA

Shri T.A. Pai of the Syndicate Bank Ltd. in his letter dated the 19th May 1969 to the Deputy Governor has stated that under the existing Bill Market Scheme, the Reserve Bank of India makes advances to banks against the security of manufactured or specially created bills, and that the Reserve Bank should now allow banks to offer inland bills with usance up to 90 days for rediscount. In this connection, Shri Pai has stated that banks have been financing manufactures' and wholesalers' accounts receivable and that the most convenient way of doing it has been found to be to draw a bill against acceptance to be discounted by the bank. According to him, creation of such bills is bound to help monetary management and impart flexibility to credit mechanism if they are made eligible for rediscount by the Reserve Bank. He has further stated that as one of the signatures on such bills will be that of a bank and goodness of the second signature of the manufacturer or wholesaler can be verified, these bills will satisfy the conditions laid down in section 17(2) (a) of the Reserve Bank of India Act, and that such bills can be retired by the banks availing of refinance from the Reserve Bank three days in advance of the date of their maturity as is done in the case of bills rediscounted by the Industrial Development Bank of India.

2. The question of substituting the 'manufactured' or specially 'created' bills which are now being lodged with the Reserve Bank as security for advances under the Bill Market Scheme by genuine trade bills was examined in detail in March 1964 at the instance of the then Governor. In this connection, the note dated the 20th March 1964 recorded by Shri Gulmohamed may please be seen. Paragraph 7 of the note gives a summary of the suggestions. To recapitulate, it was stated that

the arrangement of obtaining from the eligible banks 'manufactured' or specially 'created' bills as security for advances under the Bill Market Scheme had been working well and meeting the twin objects of reliving monetary stringency during the busy season, and at the same time enabling the Reserve Bank to exercise a qualitative control on the expansion of credit by commercial banks. It was, however, suggested that a beginning could be made by the banks undertaking acceptance business and creating bank bills so as to promote the development of a market in genuine trade bills. Such bills could be made eligible for rediscount with the Reserve Bank. It was felt that if the Reserve Bank were to offer rediscounting or refinance facilities in respect of trade bills, this might encourage banks to undertake acceptance business which, in turn, could form the basis for the creation of a supply of prime bank bills. However, the offer of rediscounting facilities in respect of such bills by the Reserve Bank would not, by itself, result in an open market for bills. For the development of an open market in bills, the establishment of an institution which would act as a dealer in bills and an intermediary between the banks appeared necessary. The advantage would be that the day-to-day surplus resources of the banks which they lent to each other through brokers on a clean basis could be employed in granting call loans to a discounting institution against the security of parcels of bills, thereby linking the call loan market to bills representing specific trade transactions. This might also enable the Reserve Bank to exercise greater influence in the call money market through its rediscount policy.

3. Shri Joshi, the then Executive Director was of the view that there was scope for development of bill business, especially with the establishment in increasing numbers of industrial and manufacturing concerns which had to give credit facilities to consumers of their goods. However, the various possibilities of developing the use of bills could not be exploited unless acceptance and discount houses were established. The question of offering rediscount facilities by the Reserve Bank would become material only when such bills were on offer. He had, therefore, suggested that it would be advisable if the representatives of the Indian Banks' Association and some prominent bankers interested in this field were called by the Governor for a preliminary talk so that a proper fillip could be given to the establishment of Acceptance and Discount houses, and the part the banks proposed to claim in this regard, considered.

4. Shri Narasimham (then Director of Banking), also touched on this question in his note dated the 21st May 1964. He was of the view that as the creation of the trade bill as a credit instrument would call for a change in commercial banking procedure, the initiative, in a sense, would have to come from the constituents of the banks. His conclusion, however, was that the existing Bill Market Scheme might be continued till the volume of genuine trade or institutional bills increased sufficiently. Shri Pendharkar was of the opinion that from the point of view of central banking control, it did not appear to be absolutely essential that there should be a genuine Bill Market. The control of short-term fluctuations in the supply of credit by the central bank could be effected in several ways. The use of a bill was only one of those methods. Further, in our conditions, the trade bill was not likely to assume significance, as a method of financing the borrower. As far as the part

played by a bill in facilitating inter-institutional finance is concerned, the inter-bank call money market performed this function. Whether its place could be taken by the bills or by bank acceptance, was doubtful. In any case, the bill in its traditional form or as a bank acceptance was not absolutely essential for central banking control. Dr Madan was also of the view that there were real difficulties in resuscitating the genuine Bill Market. The question was discussed by the Governor with the officers concerned but no particular decision was taken.

5. The question whether the Reserve Bank should provide rediscount facilities against trade bills is to be considered from two angles:

(i) whether the proposal would enable the Reserve Bank to have a better control over credit made available to the banking system; and

(ii) whether rediscounting of trade bills will be a better method of providing refinance to the scheduled commercial banks as against the present Bill Market Scheme.

From the point of view of Central Bank control, as pointed out by Shri Pendharkar in his note, it is not absolutely necessary that the Reserve Bank should rediscount trade bills. The control is adequately exercised even under the present system.

As regards (ii) above, the existing Bill Market Scheme has been working satisfactorily. While enabling the scheduled commercial banks to obtain the requisite refinance from the Reserve Bank, it enables the Bank to have qualitative control over the relative transaction. Under the Scheme, the Reserve Bank has an opportunity to assess the financial position of the parties whose bills are to be lodged with it and also to ensure that the bills have arisen out of bona fide trade/commercial transactions. These advantages will not be available if bills are to be rediscounted as we will not have an opportunity to ascertain whether the bills have arisen out of genuine trade and commercial transactions, and to assess the financial position of each of the numerous parties whose bills may be offered. Further, many of these bills may be for small amounts. At present, banks obtain refinance under the Bill Market Scheme by converting a few larger advances into bills. This keeps the administrative cost of refinance down both for the borrowing banks and the Reserve Bank. Once we start rediscounting trade bills, we may be confronted with a larger number of small bills. Even if we place a restriction as to the minimum amount for which we will rediscount a bill, at say, Rs 50,000, the administrative work involved in scrutiny of the bills, keeping a track of the due dates, etc. will involve as there is paucity of genuine trade bills which may be eligible for rediscount by the Reserve Bank, it will be necessary to continue the Bill Market Scheme even if we decide to introduce a Scheme of rediscounting trade bills. It is doubtful whether banks will offer trade bills to any appreciable extent when it is so much easier to obtain refinance under the Bill Market Scheme.

6. It may be added that we have in a separate note suggested that the Reserve Bank of India Act may be amended so as to enable the Reserve Bank to provide refinance against declarations of advances (which may also include discounted trade bills) of banks for trade and commercial purposes and to give the Reserve Bank a

first charge on the relative advances which are declared in the proposed declarations. If this is approved and the Reserve Bank of India Act is accordingly amended, the procedure for obtaining refinance from the Reserve Bank will be still more simplified and there would not be any need to have a separate Scheme for rediscounting of bills by the Reserve Bank.

7. In view of the foregoing, there is no need, at present, to provide facilities for rediscounting of trade bills. We may, however, discuss the question with a few bankers, if considered necessary.

24.07.1969

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No. 208–SDB/71

Secretary

Ministry of Finance
Department of Banking
New Delhi
June 19, 1971

My dear Jagannathan,

Yesterday in Lok Sabha, there was a question about the LIC's and the UTI's entry into the call money market. The texts of the question and the answer are enclosed. As you are aware, some of the banks have strong feelings on the subject and now it seems Parliament is becoming curious. Today, FM was recalling a brief discussion some time ago in his room with you on this matter. You appeared of the view that some ceiling on interest rates payable by the banks to the LIC and the UTI in the call money market could perhaps be imposed. It would be nice if you could give the matter your further consideration and indicate what the Reserve Bank proposes to do.

With kind regards,

Yours sincerely,
A. Baksi

Shri S. Jagannathan
Governor
Reserve Bank of India
Central Office
Bombay – 1
Enc: 1

Lok Sabha
Unstarred Question No. 2603
To be answered on the 18th June, 1971/ Jyaisth 28, 1893 (Saka)
Diversion of Deposits by Life Insurance Corporation (LIC) and Unit Trust of India (UTI) with Banks
2603. Shri C. Chittibabu:

Will the Minister of Finance be pleased to state:

(a) whether the Life Insurance Corporation of India and the Unit Trust of India have been diverting their deposits with the banks to inter-bank call money market;

(b) whether this withdrawal will affect the liquidity ratio to be maintained by the Banks;

(c) whether this action of the Life Insurance Corporation and the Unit Trust of India entering call money market and cornering huge profits, adversely affects the deposit mobilization by the Banks; and

(d) if so, the remedial action Government proposes to take in this regard?

Answer
The Minister of Finance
Shri Y.B. Chavan

(a) Prior to June 1970, the Reserve Bank did not permit payment of interest by scheduled commercial banks on call and short notice deposits to parties other than banking institutions and cooperative banks. From 3 June 1970, the Reserve Bank has permitted the LIC and the Unit Trust to receive interest on call and short notice deposits made by them with banks at rates ruling in the inter-bank call money market.

(b) No, Sir.

(c) & (d): As the Scheduled commercial banks can secure call and short notice deposits from the LIC and the UTI in the inter-bank call money market, the quantum of deposit with banks is not adversely affected. The banks, however, have to pay interest to the LIC and the UTI at inter-bank call money market rates which are generally higher than the rates admissible on savings and short-maturity deposits. Thus, the matter is one of adjustment in income and expenditure between two wings of financial bodies, viz. on one side the scheduled commercial banks and, on the other, two long-term financial institutions.

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State Bank of India
Central Office
Bombay
9th July, 1971

Dear Shri Jagannathan

Call Money Market
Participation Certificates
New Bill Market Scheme

I write briefly to record the gist of our discussions regarding the above items on Saturday, the 26th June:-

Call Money Market

The Reserve Bank of India have examined the position and find that, substantially, the funds placed in the call money market by the Life Insurance Corporation of India and the Unit Trust of India do not represent diversion of funds from bank deposits; in other words, the sum of Rs 35–40 crores so placed in the call money market is an addition to the resources of the market. The authorities have taken the view that these two institutions need not be debarred from operating in the call money market, provided it can be ensured that there is a reasonable maximum on the interest rate at which such funds can be placed. The Unit Trust of India have been consulted and they are agreeable to the imposition of such a maximum; the Reserve Bank will now consult the Life Insurance Corporation of India in this regard.

While reiterating my view that this would amount to the Life Insurance Corporation of India and the Unit Trust of India being treated as preferred depositors who can earn a higher rate of interest on surplus funds than is permissible to the general public under the Reserve Bank of India's directive on deposit rates, it was indicated that, if the authorities had made up their mind, we had nothing more to say. However, it remains to be seen what is the maximum rate of interest that comes to be fixed.

I suggest that we may discuss this matter again after this maximum rate has been tentatively determined, before finalizing the matter.

Participation Certificates
New Bill Market Scheme

In answer to my query whether the restriction applicable to the purchase of participation certificates, namely, that these can be purchased only by financial institutions, would apply equally to bills under the new bill market scheme, Dr Hazari indicated that there would be no such restriction.

The same considerations which weighted in favour of the Reserve Bank of India stipulating that transactions in participation certificates should be confined to financial institutions only should, in my humble opinion, apply in the case of bills as well. I am unable to subscribe to the view that the bill market, by itself, is going to add to the volume of funds in the banking system and I would most stoutly oppose any arrangement whereby parties with surplus funds in the 'specified centres' can divert deposits from banks to purchase bills from banks, and thereby earn a higher return than is permitted by the deposit rates directive of the Reserve Bank of India. In our social set-up, I would submit that it is the large body of small depositors that need the opportunity for a better return and not the large business houses or other wealthy parties with substantial idle funds.

Instances have come to light where parties have been able to buy bills from other banks (presently some of the foreign banks) at rates up to 7.5 per cent, or even higher, for bills with maturities of between 90 and 180 days. Apart from the fact that this does not, in any way, amount to adding to the resources of the banking system, it reduces the banking system's requirement for liquidity under the law or in terms of your directives.

I returned with the impression that you are going to have this aspect thoroughly examined in the Reserve Bank. I would request that this be done early.

With best regards,

Yours sincerely,
R.K. Talwar

Shri S. Jagannathan
Governor
Reserve Bank of India
Central Office
Bombay

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D.O.DBOD.No.CAS.502/C.446–72 May 25, 1972

Dear Dr Patel,

Credit Authorization Scheme

As Government are aware, the above Scheme was introduced by the Reserve Bank in November 1965 with the object of more closely aligning the growth of bank credit to the requirements of the Plan and as an additional measure of credit regulation. (You will recollect that conditions were then very difficult as would be brought out by various indicators including the fact that the Bank rate was put up twice in succession in September 1964 and February 1965; there were heavy drawings from the IMF in 1965 and again in 1966.) The cut-off point for the purposes of obtaining our prior authorization by scheduled commercial banks for granting additional credit limits was then fixed at Rs 1 crore. In fixing this cut-off point, the Bank took in view that there were then about 650 borrowers having credit limits of Rs 1 crore or more from the banking system as a whole, and it was felt that the purpose in view would, by and large, be served by regulating the flow of bank credit to this category of borrowers. As regards the scrutiny of the applications received for our prior authorization, it was then being done mainly with regard to the purpose for which the limits were sought, and in this connection the banks' statements were relied upon. During the course of the administration of the Scheme, it was observed that banks were not generally appraising the credit proposals with sufficient degree of rigour, nor were they always imposing the necessary financial discipline on the borrowers so as to obviate bank funds being diverted by borrowers for purposes other than their genuine requirements. The need was, therefore, felt for placing the appraisal procedures obtaining in banks on a more systematic basis so as to prevent the borrowers from misusing bank funds. Accordingly, we had, in June 1970, introduced a comprehensive set of forms which would help banks in credit appraisal and also make the regulatory system a more effective mechanism for ensuring the end-use of bank credit. We have, at present, left some discretion to banks for granting, without our prior authorization, certain categories of advance.

2. Since the time when the Scheme was introduced, there has been a considerable development of the economy. Further, with the rationalization of the credit appraisal procedures and the familiarity which banks now have with our present requirement of information regarding the borrowers, they can be expected to lend now on the basis of credit appraisal and the actual needs of the borrowers, and also impose financial discipline so as to prevent misuse of the funds made available to them. In the light of the need for stimulating industrial expansion and investment, and against the background of Government's recent measures to this end, we feel that any measures that we might take to expedite credit sanctions by banks would be useful. In view of the above, it is felt that the area of discretion within which banks could act, though still under our supervision but without our *prior* authorization, could be widened. We are, therefore, thinking of allowing further discretion to banks in the matter of granting credit limits, without our prior authorization, to the individual parties till their credit limits from the banking system as a whole reach Rs 2 crores (including those in the exempted categories), but the grant of such facilities would be subject to subsequent ratification by the Reserve Bank. The proposed cut-off point of Rs 2 cores in regard to the discretion to banks would appear to be reasonable in view also of the substantial expansion in scheduled commercial bank credit which now stands at Rs 5241 crores as against Rs 2020 crores as at the time of introduction of the Scheme, the increase in the number of parties covered by the Scheme from 650 to over 1000 and, more than these, having regard to the experience that the banks have of the Reserve Bank's credit appraisal and credit authorization procedures, and the experience that the Reserve Bank has acquired of the present standard of scrutiny by the banks. It is also felt that the above proposal would not be a 'carte blanche' to banks as we propose advising them that the grant of these facilities would be subject to the subsequent ratification by the Reserve Bank, and where the Bank feels that the enhancement in limits/additional limits are not warranted or are warranted only to a lower extent, the concerned banks will have to arrange for the cancellation of such limits or for suitable reduction therein. We would, thus, be able to watch the exercise of their discretion to ensure that it is in consonance with the present criteria of the Reserve Bank. The sanction of credit limits to the individual parties in excess of Rs 2 crores would, in any event, continue to be subject to our prior authorization except that, over and above this level, we propose to allow the banks to grant additional facilities up to 10 per cent of the authorized limits or Rs 20 lakhs, whichever is lower, for genuine productive/trade operations, provided the party is not already having such facilities from other bank(s).

3. As regards the grant of the term loans by banks, the instructions issued to them in terms of paragraph 9 of the guidelines enclosed with Government's letter No. F.1 (72)–Corp/69 dated the 9th June 1971 to the Vice-Chairman of the Industrial Development Bank of India would continue to be in force, and no change therein is contemplated.

4. We shall be glad to have Government's views on the proposals made above.
With kind regards,

Yours sincerely,
R.K. Hazari

Dr I.G. Patel
Secretary
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi – 1

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May 25, 1972

D.O.DBOD.No.CAS.501/C.446–72

Dear Shri Bhide,

Credit Authorization Scheme

As Government are aware, the above Scheme was introduced by the Reserve Bank in November 1965 with the object of more closely aligning the growth of bank credit to the requirements of the Plan, and as an additional measure of credit regulation. (You will recollect that conditions were then very difficult as would be brought out by various indicators including the fact that the Bank rate was put up twice in succession in September 1964 and February 1965; there were heavy drawings from the IMF in 1965 and again in 1966.) The cut-off point for the purposes of obtaining our prior authorization by scheduled commercial banks for granting additional credit limits was then fixed at Rs 1 crore. In fixing this cut-off point, the Bank took in view that there were then about 650 borrowers having credit limits of Rs 1 crore or more from the banking system as a whole, and it was felt that the purpose in view would, by and large, be served by regulating the flow of bank credit to this category of borrowers. As regards the scrutiny of the applications received for our prior authorization, it was then being done mainly with regard to the purpose for which the limits were sought, and in this connection the banks' statements were relied upon. During the course of the administration of the Scheme, it was observed that banks were not generally appraising the credit proposals with sufficient degree of rigour, nor were they always imposing the necessary financial discipline on the borrowers so as to obviate bank funds being diverted by borrowers for purposes other than their genuine requirements. The need was, therefore, felt for placing the appraisal procedures obtaining in banks on a more systematic basis so as to prevent the borrowers from misusing bank funds. Accordingly, we had, in June 1970, introduced a comprehensive set of forms which would help banks in credit appraisal and also make the regulatory system a more effective mechanism for ensuring the end-use of bank credit. We have, at present, left some discretion to banks for granting, without our prior authorization, certain categories of advances (vide list attached).

2. Since the time when the Scheme was introduced, there has been a considerable development of the economy. Further, with the rationalization of the credit appraisal procedures and the familiarity which banks now have with our present requirement of information regarding the borrowers, they can be expected to lend now on the basis of credit appraisal and the actual needs of the borrowers and also impose financial discipline so as to prevent misuse of the funds made available to them. In the light of the need for stimulating industrial expansion and investment, and against the background of Government's recent measures to this end, we feel that any measures that we might take to expedite credit sanctions by banks would be useful. In view of the above, it is felt that the area of discretion within which banks could act, though still under our supervision but without our *prior* authorization, could be widened. We are, therefore, thinking of allowing further discretion to banks in the matter of granting credit limits, without our prior authorization, to the individual parties till their credit limits from the banking system as a whole reach Rs 2 crores (including those in the exempted categories), but the grant of such facilities would be subject to subsequent ratification by the Reserve Bank. The proposed cut-off point of Rs 2 crores in regard to the discretion to banks would appear to be reasonable in view also of the substantial expansion in scheduled commercial bank credit which now stands at Rs 5241 crores as against Rs 2020 crores as at the time of introduction of the Scheme, the increase in the number of parties covered by the Scheme from 650 to over 1000 and, more than these, having regard to the experience that the banks have of the Reserve Bank's credit appraisal and credit authorization procedures and the experience that the Reserve Bank has acquired of the present standard of scrutiny by the banks. It is also felt that the above proposal would not be a 'carte blanche' to banks as we propose advising them that the grant of these facilities would be subject to the subsequent ratification by the Reserve Bank and where the Bank feels that the enhancement in limits/additional limits are not warranted or are warranted only to a lower extent, the concerned banks will have to arrange for the cancellation of such limits or for suitable reduction therein. We would, thus, be able to watch the exercise of their discretion to ensure that it is in consonance with the present criteria of the Reserve Bank. The sanction of credit limits to the individual parties in excess of Rs 2 crores would, in any event, continue to be subject to our prior authorization except that, over and above this level, we propose to allow the banks to grant additional facilities up to 10 per cent of the authorized limits or Rs 20 lakhs, whichever is lower, for genuine productive/trade operations, provided the party is not already having such facilities from other bank(s).

3. As regards the grant of the term loans by banks, the instructions issued to them in terms of paragraph 9 of the guidelines enclosed with Government's letter No. F.1 (72)–Corp/69 dated the 9th June 1971 to the Vice-Chairman of the Industrial Development Bank of India would continue to be in force, and no change therein is contemplated.

4. We shall be glad to have Government's views on the proposals made above.
5. We have also separately written to Dr I.G. Patel for his views in the matter.
With kind regards,

Yours sincerely,
R.K. Hazari

Shri V.M. Bhide
Additional Secretary
Government of India
Ministry of Finance
Department of Banking
New Delhi – 1

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V.M. Bhide
Additional Secretary

DD No: 17(46)/72–CP

Ministry of Finance
Department of Bank
'Jeevan Deep' Parliament Street
New Delhi
December 11, 1972

Dear Dr Hazari,
You are already aware of persistent demands of the Electricity Boards for funds from the nationalized banks. A study of the bank credit for State Electricity Boards has been attempted in the Department of Banking, a copy of which is enclosed. I shall be grateful for your comments and suggestions on the subject.
With kind regards,

Yours sincerely,
V.M. Bhide

Dr R.K. Hazari
Deputy Governor
Reserve Bank of India (Central Office)
Bombay – 1

Enclo: 1

Government of India
Ministry of Finance
Department of Banking
Development Division

Sub: Bank Credit for State Electricity Boards
This note seeks to examine the question of extending bank credit to the State Electricity Boards for financing their operations. While the various issues are examined in the first 6 sections, the conclusion that emerge in these sections are briefly summarized in section 7. The basic revenue account data of the 15 State'

Electricity Boards taken together for the years 1968–69 to 1972–73 are presented in Annexure I . . . The data has been culled out from different sources—resources statements of the State Electricity Boards, the report of the power economy committee, etc. Some of the data are not strictly comparable but the differences are not such as to vitiate the arguments.

Section I

1. At the commencement of the current year, the total block capital of the State Electricity Boards was Rs 3,851 crores. While exact figures of the capital in use are not readily available, it can be placed at about two-third of the block capital or roughly Rs 2,700 crores. The total energy anticipated to be generated during the year is 57,000 million KWH, of which line losses will account for about 10,000 million KWH. Thus, the energy likely to be sold (consumed) will be about 47,000 million KWH and the total revenue likely to be realized Rs 588.55 crores. The average receipt per unit will be 12.6 paise for the systems as a whole, the range for the individual boards extending from 7.7 paise for Mysore to 19.2 paise for Madhya Pradesh. It cannot, however, be inferred that a higher average automatically implies higher tariffs as the higher average could also be due to higher proportion of consumption in the domestic and commercial sectors, for which the rates of tariff are generally high and lower proportion of consumption in the agriculture and industries sector for which the tariffs are generally low.

2. The total expenditure on establishment charges, cost of fuel, cost of power purchase, etc. is placed at Rs 333.22 crores, this representing nearly 57 per cent of the total revenue receipts. Here again, considerable variation is noticed from board to board, the range being from 40 per cent in the case of Punjab to 68 per cent for Maharashtra.

3. For purposes of our analysis, the crucial figure is the balance of revenue receipts available after meeting the expenditure on establishment charges, fuel charges and cost of power purchase. This has been termed as the gross operating surplus and represents the amount available with the Electricity Boards for payment of interest charges as well as for being credited to depreciation and other reserve funds, as also for the sinking and loan resumption funds. Except for a small amount that is drawn upon for capital maintenance from the depreciation reserve fund, almost the entire balance in these funds is generally available as a capital resource for the Electricity Board; this amount can be utilized either for plan financing or for repayment of loans. Thus, the gross operating surplus really determines the capacity of a board to pay interest charges as well as pay installments on the loans that it may take from commercial banks.

4. As will be seen from Statement No. 1 the gross operating surplus expressed as a proportion of the block capital at the beginning of the year is likely to be a little less than 6.7 per cent in the current year. Since the percentage was somewhat higher in 1968–69 (7 per cent) and there has been a steady decline over the last few years, it is clear, given the present framework of functioning of these boards, that the proportion is not likely to improve substantially in the next two or three years. Since the interest arrears now is of the order of Rs 50 crores per annum and the

cumulative interest arrears work out to over Rs 350 crores, a substantial improvement in the gross operating surplus position is called for if the Boards are to meet the interest liability in full. It should be noted here that, at present, bulk of the borrowings of the Boards are at fairly low rates of interest of 7 per cent and less.

5. If in calculating this proportion works in progress are excluded, then the percentage of gross operating surplus to the capital base works out to little more than 10 per cent. The return in the margin, that is, on new project cannot normally exceed this figures as, because of the escalation in costs particularly after devaluation, the cost of new projects for a given installed capacity is likely to be very much higher now than in the past. Actually, the return in the margin is likely to be closer to 7 per cent as the proportion of the construction period to the total current currency of the loan that may be obtained for financing the new project may not be much different from the proportion of the works in progress to the total capital outlay. In other words, it can be assumed, that given the present working conditions of the boards, the rate of return on new projects, that is, the proportion of the gross operating surplus to the capital cost of the new project, may not be appreciably more than 7 per cent.

6. If banks are to extend credit facilities to the Electricity Boards, then having regard to the current borrowing rate as well as the need for liquidity, the interest rates will have to be at least 9 to 10 per cent and the period of repayment of the loan can be stretched to a maximum of about ten years, with a moratorium for the first three years. To comply with these conditions, the working of the Electricity Boards would have to be such as to generate a minimum gross operating surplus of about 23 per cent—to cover repayment liability, interest charges and also to meet a certain minimum expenditure on the revenue account itself on maintenance. Since, however, the gross operating surplus is not likely to be much is excess of about 7 per cent of the capital outlay, it is clear that Electricity Boards cannot be considered to be financially viable from the banks' point of view. No doubt, individual schemes of generation or transmission could be shown to work at better results, by ascribing to these schemes, the entire additional revenue likely to be realized as a result of those and other programmes. But then, this would result in a correspondingly lower rate of return on the other programmes, so long as the total profit and loss position for the board does not show any radical changes, and to this extent, the capacity of the Electricity Boards to pay interest on existing borrowings will get reduced. Thus no individual programme, either of generation or transmission and distribution or rural electrification of the Electricity Boards can be considered as a bankable proposition for which credit could be extended at the usual rates.

7. This conclusion which has been arrived at on the basis of certain overall figures holds good for most of the individual boards. As will be seen from the figures given in Annexure II, the gross operating surplus expressed as a percentage of the block capital is likely to vary in the current year from 3.14 per cent (Assam) to 13.01 per cent (Madhya Pradesh). Apart from Madhya Pradesh, the only other Electricity Boards which are likely to have a percentage substantially higher than the all-board average are Gujarat (9.58 per cent) and Andhra Pradesh (8.14 per cent). Even in

these cases, the return cannot be considered to be sufficiently high from a strictly bankers' point of view.

Section II

8. The present inefficient operation of the Electricity Boards is attributable to several factors. On the one hand, the tariff for industrial and agricultural uses continues to be very low and completely out of alignment with the present cost structures. At the time of the plan discussions, the Planning Commission makes suitable suggestions for upward revision of tariff and also sets targets for the achievement during the plan period. Experience has, however, shown that not many Electricity Boards generally achieve the targets. To the extent the Electricity Boards keep on adding to their capital base, while at the same time retaining the rates fixed on an earlier date without any substantial revision, their working will result in greater and greater losses. It is, therefore, very necessary that all efforts are taken to ensure that the Electricity Boards adhere to the targets for additional mobilization of resources.

9. On the other side, the unsatisfactory position can also be attributed to the low load factor and high line losses due the absence of grids and proper systems development. The Power Economy Committee which had examined these issues in great detail has made several recommendations in its report submitted in March 1971. The Committee had estimated that if full integrated operations of power systems throughout the country could be achieved by 1980–81, a net saving in capital expenditure of the order of Rs 300 crores can be achieved. If only integrated operations were available, the saving in fuel charges even in 1968–69 in the Southern Region alone would have been around Rs 8.27 crores. The Committee has also estimated that if adequate advance action, by way of necessary investigation of hydro stations and arrangement for fuel supplies and transport had been taken at appropriate times, it would have been possible to achieve the most economic mix of energy sources with the necessary hydro capacity, and if only this has been achieved, it would have been possible to generate additional revenue of the order of Rs 180 crores at the prevailing tariffs during the 4th Five Year Plan. The Committee has also pointed out that by adopting standardization of designs, specifications, materials and construction practices, a saving of about 15 per cent could have been effected in the capital cost of rural electrification. Further, through proper systems development, the line losses could be reduced substantially and at current tariffs and levels of generation each per cent saved in line losses would result in an additional revenue of Rs 7 crores per annum.

10. A determined effort will have to be made to achieve a balance between hydro stations on the one hand and thermal and nuclear stations on the other, so that the latter category of stations are used mainly as base load stations and hydel stations are used more as peaking stations. Considerable investment will also have to be made in transmission and distribution so as to bring about regional and national grids. Systems development would also have to be attended to on a priority basis so as to reduce line losses. The gap between peak and trough demands would have to

be reduced gradually by promoting more intensive use of power for night shifts in the industrial undertakings (if necessary through incentives by way of reduced tariff) and also for more intensive use of power in the rural areas, both for domestic and industrial purposes. Otherwise, with the present stress on connecting more and more pumpsets to power, the gap between peak and trough demands in the rural areas will become very wide as the pumpsets are operated only during certain periods, and even during these periods only during certain fixed hours of the day.

11. All those efforts for improving the operational efficiency of the Electricity Boards, if these are to be effective, would have to form part of a comprehensive plan which strikes a balance between investments in generation, transmission and distribution, systems development and Rural Electrification. Such an integrated plan might naturally call for much larger outlay and power schemes in the Vth and VIth plan periods than what could possibly be accommodated within the plan ceilings. In fact, it is to some extent due to paucity of funds and the perpetual pressure for new generating stations to meet the increasing pack demand, that the programmes of transmission, distribution and systems development has suffered in the past. The same problem is likely to be faced in the Vth and VIth plan periods as well. Since, at least, in the immediate future, the present comfortable deposit surplus position (not so very comfortable from the Banks' point of view) is likely to continue, it could be examined whether the power outlay could not be fixed at higher level taking credit for the flow of a larger quantum of Bank funds than in past. Whatever amount is finally decided upon could be treated as plan/resources, even as borrowings from the open market and LIC figure now. This way not only will a bigger power plan be possible but it could also be ensured that the flow of Bank credit for power programmes in different regions conforms to the national policy regarding disbursal of public sector investment and reduction of regional imbalances. It will, however, be advantageous, if bulk of the amount flows to the Electricity Boards not as subscriptions to debentures but as term loans for specific schemes, and also if the availability of such funds could be linked to certain targets for revision of tariff and improvement in efficiency. Apart from securing a larger return for the Banks, such an active association of the Banks in the implementation of individual schemes might introduce an element of discipline in the functioning of the Electricity Boards.

12. It is however doubtful, whether even with the implementation of such a comprehensive plan the working of the electricity boards would improve, in the short run, to such an extent so as to make their schemes fully financially viable. Some relaxation in the terms of lending by Banks would therefore be necessary, not so much in the rate of interest as in the period of repayment. The currency of the loan will have to be a long-term one, stretching over a ten-to-twelve-year period with a moratorium for the first three years. The resultant loss of liquidity will be more than offset by the increased interest rate (compared to what they would have got by subscribing to open market loans).

13. All power scheme involve large outlays and under the arrangements outlined in the earlier paragraphs, the question of taking those up for implementation outside the framework of the plan will not arise and consequently the flow of bank credit to

Electricity Boards for financing schemes outside the framework of the plan will stop completely. The Banks would, however, have to land adequate support to the Electricity Boards towards working capital requirements, ways and means, advance, making advance payments on equipment, bridging finance, etc., and this assistance would have to be outside the framework of the plan. Then there is also the question whether Banks should finance rural electrification programmes outside the framework of the plan. These issues are dealt with in the subsequent sections.

Section III

14. The rural electrification schemes pose some special problems and deserve to be examined separately. For one thing, with the increasing emphasis on energization of pumpsets, the State Governments are keen on the implementation of more and more of these schemes and because of the limitation of funds in the plan, quite naturally assistance is sought from the Rural Electricity Corporation and commercial banks. Again, compared to the other power programmes, these schemes have lesser gestation periods and what is more could be conceived, so to say, on the spot depending upon the availability of funds. As a result, over the last few years, a number of rural electrification schemes have been formulated outside the plan framework and taken up for implementation with assistance from the Rural Electricity Corporation or the commercial banks. As will be seen from Annexure IV in which the operation of the REC are briefly reviewed, so far the Corporation has sanctioned Rs 167 crores for 293 schemes, the amount actually disbursed being around Rs 67 crores. The public sector banks, on their part, have sanctioned limits aggregating to about Rs 65 crores for such schemes. Generally, the banks finance such schemes on a consortium basis after the scheme for an area as a whole is cleared from the technical angle by the Agricultural Finance Corporation. The terms of repayment offered by the Rural Electricity Corporation are very much more favourable than those offered by the banks, both in the rate of interest as well as period of repayment.

15. Several shortcomings are noticed in the present arrangements whereby banks extend finance for rural electrification schemes. Firstly, there is very little examination of the merits of the proposals and banks sanction the funds asked for on the basis of the clearance of the AFC on the technical side and the guarantee of the State Governments on the financial side. Local pressures, in some cases a genuine desire to lend more in lead districts, and surplus funds position are some of the factors that have contributed to the somewhat indiscriminate lending by the banks for these schemes and in the absence of a coordinating agency, differing patterns of financing have emerged and undercutting in interest rates is also not uncommon. If these borrowings had not been exempted from the credit authorization scheme, then at least the Reserve Bank of India would have been in the picture. There would not only have been greater scrutiny of the schemes—the mere filling up of the various forms prescribed under the credit authorization schemes would throw up several crucial pointers regarding the financial viability of the schemes—but there would also have been a certain uniformity in the procedures and practices followed by the commercial banks.

16. Secondly, in some cases the cost of 22 KV lines, transformers, etc. are also

included as part of the outlay on these rural electrification schemes, even though these items should legitimately form part of the plan programmes. Generally, only the cost of the lines which are to be borne by the farmer-customers and also to some extent, the feeder lines to the points from where farmers are to take the connection should be included under the schemes. Perhaps, this is one reason why many of the Electricity Boards seek more and more funds from commercial banks for their rural electrification programmes, rather than from the Rural Electricity Corporation which offers much more favourable terms.

17. Thirdly, the borrowal of such short-medium term funds at about 10 per cent interest rate from banks for financing rural electrification schemes could ruin the Electricity Boards financially. The working of the Boards is such that they default in the payment of interest to State Governments even when the loans taken from the State Governments carry comparatively lower interest rates. Such loans are also generally not repayable. To the extent the Electricity Boards seek to fulfil the terms of borrowings from the banks, they would be forced to default more in the payment of interest to the State Governments on the revenue account and also contribute less towards the financing of plan schemes on the capital account. The Planning Commission who were consulted for their views on the entire question of bank credit for power programmes are yet to give us their final views. But what they have said in the interim reply more than supports the points made above regarding financing of rural electrification programmes. The relevant sentences are extracted below:

'You would be aware that investment on rural electrification does not bring any significant return to the Electricity Boards, but on the other hand involves appreciable losses even on long-term basis. Therefore, financing rural electrification programmes through short-term loans at high interest rates would result in erosion of the resources of the State Electricity Boards and reduce their capabilities for financing their other capital programmes.'

18. Fourthly, to the extent a large number of rural electrification programmes aimed at energizing pumpsets are formulated outside the framework of the plan, it would become increasingly difficult to plan properly for striking a balance between the supply and demand for pumpsets.

19. Lastly, the laissez-faire conditions that now seem to govern these lendings by the banks have only tended to increase the regional imbalance in the investment of bank funds. Out of the Rs 150 crores sanctioned by the banks, so far, to the Electricity Boards for rural electrification and other purposes, Maharashtra state alone accounts for Rs 50 crores while the borrowings by Tamil Nadu exceeds Rs 20 crores.

20. The only way to avoid these unhealthy trends would be to stipulate that all rural electrification schemes should also figure as part of the plan programmes so that the Planning Commission is able to take an overall view. Banks should most certainly finance such schemes; but their lending should be within the framework of the plan policy as settled by the Planning Commission and should be governed by the principles set out in Section II. Since these new arrangements can possibly be introduced only as part of the 5th Five Year Plan, it could be considered, whether

in the meantime, such lendings should not be brought under the purview of the credit authorization scheme, with immediate effect so that, at least, the RBI could act as a coordinating agency and as a sobering influence.

Section IV

21. The Electricity Boards now seek assistance from banks for making advance payments for purchase of equipment, for tiding over ways and means problems, for bridging finance, for working capital, etc. To some extent, these demands are quite justified. Generally, the outlay on power programmes as proposed by the Electricity Boards and the State Governments far exceed the resources insights. These outlays are pruned considerably by the Planning Commission during the plan discussions and even for financing the outlays so pruned the resources of the Electricity Boards have to be stretched to the maximum. This arrangement does not leave any margin with the State Electricity Boards for working capital requirements or for meeting unforeseen expenses. The difficulties get accentuated, when, as usually happens, the investment exceeds the approved outlay and the generation of internal resources falls short of the targets, thus creating severe ways and means problems. In the circumstances, it is but natural that the Electricity Boards should look to the banks, who function as their bankers, for meeting these requirements. In fact, the banks have even now sanctioned limits aggregating to over Rs 80 crores to the Electricity Board for such purposes.

22. But the present arrangements for the sanctioning of such advances have led to the emergence of two unhealthy trends. The first, as earlier indicated, is the uneven geographical distribution of these facilities, with two or three States accounting for bulk of the advances. The second and perhaps the more important trend is the tendency on the part of some of the Electricity Boards to utilize such short-term borrowings for financing larger power outlays than what has been approved. In some cases, these borrowings are also utilized to cover up for the shortfall in the generation of internal resources. It will, therefore, be desirable to lay down some criteria to govern such advances and thereby guard against the misuses of these facilities. The following suggestions could be considered in this regard:

(a) For each Electricity Board, a limit should be fixed—say 5 per cent of the annual revenues—for the borrowing from the banking industry as a whole towards working capital, cash credit accommodation, ways and means advances, etc.

(b) Advance payment requirements as well as advance action outlays are usually provided for, as part of the plan outlay. In some cases, the demand may however arise before the finalizing of the plan outlays. In such cases, the banks can extend bridging finance to meet the requirement, provided there is a clear indication from the Electricity Boards and the Planning Commission that these requirements figure as part of the plan programmes and that the funds required will be provided in the next year's budget. Thus, in such cases, the currency of the bridging finance will extend up to the commencement of the next financial year only.

(c) Sometimes, the delay in the receipt of promised assistance from State

Governments, LIC, etc. puts the Electricity Boards in difficulty. In genuine cases of this type, the banks could give bridging finances for such periods, extending up to the time of realization of the promised assistance.

(d) These borrowings can also be brought within the ambit of the credit authorization scheme.

Section V

23. Another facility now enjoyed by the Electricity Boards is the IDBI's scheme of rediscounting of bills relating to purchase of equipments for which a limit of Rs 1 crore has been set for each Electricity Board. The utilization of this facility so far is rather poor because the effective rate of interest is rather high being 11 per cent or more. Actually, the rediscounting rate is only 6 per cent and the difference represents bank charges, stamp duty, etc. The Maharashtra State Electricity Board has, to some extent, got over this difficulty by insisting on suppliers discounting the bills with the Board's bankers who had quite naturally agreed to waive the commission in view of the large business transactions of the Board with them. The other Electricity Boards could also follow this example and thus obtain some financial relief. But steps should be taken to ensure that this facility of rediscounting does not amount to double financing in favour of the Electricity Boards.

Section VI

24. We then come to another important issue, the one relating to the payments for the supply of plant and equipment by the Bharat Heavy Electricals Ltd and Heavy Electricals (India) Ltd. Recently, the procedure for making such advance payments had been changed and whereas hitherto the Electricity Boards had to pay as much as 50 per cent as advance, they are now required to pay only 10 per cent. The change in the procedure, while providing considerable relief to the Electricity Boards would shift the burden on to the BHEL and HEIL and push up their working capital and cash credit requirements. As will be seen from the details furnished in Annexure V, this additional requirement of BHEL and HEIL is likely to be quite large and it will be appropriate if a consortium of banks rather than a single bank could meet this demand. Any assistance provided this way will ultimately go to help the Electricity Boards as, so long as these two public sector undertakings are able to obtain their working capital requirements in full, they are not likely to insist on larger advance payments from Electricity Boards. The detailed proposals which these two public sector undertakings might submit to the Planning Commission to the Ministry of Irrigation and Power regarding their requirement of additional working capital and cash credit requirements would have to be examined in our Department very carefully, if necessary, in consultation with select Custodians. Our approach should be one of cooperation to ensure that the banking industry meets, in full, the requirements of these two public sector undertakings.

Section VII

25. To sum up, the suggestions made in this note are:

(i) The outlay on all power schemes as well as funds required for making advance payments or for taking advance action should be provided as part of the annual and Five Year Plans. While the banking industry could definitely contribute to financing a part of the power plans, it will be desirable if bulk of their contribution takes the shape of medium- and long-term loans for financing specific programmes rather than as subscriptions to the open market debentures floated by the Electricity Boards. However, whether the banks should extend credit for meeting a part of the outlay on power programmes and if so, to what extent is a matter for the Planning Commission to take a decision in consultation with us. They have already been addressed for their views and now they could be requested to expedite their decision so that if the banks are to finance part of the plan outlay then this decision could form part of the 5th Five Year Plan strategy for financing power programmes.

(ii) The banks could provide bridging finance to meet advance payments as well as outlays on advance action; but such bridging finance should be extended only on the basis of a clear assurance from the Electricity Boards and the Planning Commission that the schemes for which the funds are sought form part of the plan programmes and also that the required amount will be provided in the budget for the next financial year. The currency of the loan given would extend up to the commencement of the next financial year. The banks could also extend bridging finance for short duration against promised assistance from the State Governments, LIC, etc. where there is delay in the realization of these amounts.

(iii) Banks operating as bankers for Electricity Boards may extend cash credit, working capital required, ways and means advances, etc. to the Boards. The banks should, however, scrutinize the proposals closely and satisfy themselves of the genuineness of the demand so as to guard against the possibility of such short-term advances being misutilized for financing larger plan outlay or for covering up the shortfall in generation of internal resources. A ceiling should also be prescribed on the borrowings by each Electricity Board from the banking sector as a whole. The limit could be 5 per cent of the total annual revenue of each Board.

(iv) All rural electrification programmes should be taken up for implementation as part of the annual and Five Year Plans only. Bank finances for such schemes should be within the framework of the plan programmes and governed by the considerations set out under suggestion (i). Till such time as a new arrangement is brought into force, advances for rural electrification schemes should be subject to the clearance of the RBI by being brought within the purview of the credit authorization scheme. This will also apply to the advances mentioned under (ii) and (iii).

(v) Steps should be taken to enable the Electricity Boards to take full advantage of the bill rediscounting scheme drawn up by the IDBI; it must also simultaneously be ensured that this does not result in double financing in favour of the Electricity Boards.

(vi) The additional working capital and cash credit requirement for BHEL and HEIL should be met in full by the banking industry, preferably on a consortium basis. This matter should be pursued with the Planning Commission and the two organizations concerned.

26. Incidentally, earlier this year we had called for the views of the public sector banks on these issues. In our letter, we had suggested that perhaps it would be better if commercial banks do not advance monies directly for financing schemes and that their assistance could be limited to subscription to debentures and to provision of short-term loans towards bridging finance, ways and means requirements, etc. The banks have, by and large, endorsed these views.

ANNEXURE **I**

State Electricity Boards Analysis of Revenue Accounts

(Rs in crores)

Item	1968–69 Accounts	1969–70 Accounts	1970–71 Estimates	1971–72 Estimates	1972–73 Estimates
1. Block capital at the beginning of the year	2206.46	2570.42	2994.52	3465.39	3851.63
2. Total Revenue Receipts	333.32	390.88	454.09	518.36	588.55
3. Working expenses	180.49	217.53	259.29	287.16	333.22
4. Ratio of working expenses	54.15%	55.65%	57.10%	55.40%	56.90%
5. Gross operating surplus (item 2 to item 3)	152.83	173.35	194.80	231.20	255.33
6. Rate of return on Block Capitals (Ratio of item 5 to item 1)	6.92%	6.75%	6.60%	6.67%	6.66%
7. Contribution to reserves	61.18	77.00	87.46	104.39	111.84
8. Interest liability	110.54	124.73	150.17	175.14	193.89
9. Interest arrears during the year, i.e. amount not paid for want of resources	18.89	29.38	42.83	48.73	50.00

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D.O.No.CPC. 777/212–72/73 29 January 1973

Dear Shri Bhide,

Further to my D.O. dated December 14, 1972, I enclose a brief note setting out our comments on the principal issues raised in the note of your department on bank credit for electricity boards. Rather than issue another set of guidelines to the banks, we would prefer an informal arrangement by which banks would consult us regarding the proposals received by them from State Electricity Boards before finalizing the terms and conditions.

With kind regards,

Yours sincerely,
R.K. Hazari

Encl:

Shri V.M. Bhide
Additional Secretary
Department of Banking
Ministry of Finance
Government of India
New Delhi

Bank Credit for State Electricity Boards

The Banking Department's note on Bank Credit for State Electricity Boards admits that programme for power transmission and distribution and systems development have suffered for lack of funds and are likely to so suffer in the future as well. It is also admitted that banks have excess liquidity. However, there is a certain reluctance to match these two phenomena. It is felt that Electricity Boards are not viable borrowers from the banks' point of view (para 6). Hence, if banks are to be permitted to lend to Electricity Boards at all, it should be subject to the following conditions:

(1) Loans for capital outlay should only be for schemes approved by the Planning Commission and included in the Plan.
(2) Credit for this purpose should be extended in the form of term loans only and not through subscription to debentures.
(3) Concessions in terms of lending should be in regard to the period of repayment rather than the rate of interest (para 12).
(4) Whether banks should, at all, extend term credit to Electricity Boards and if so to what extent, is a matter to be decided by the Department of Banking in consultation with the Planning Commission.
(5) Banks may extend bridging loan for advance payment requirements which could arise before plan outlays are finalized, but only if it is clear that the funds so lent will be reimbursed through budgetary provisions in the following year.
(6) Working capital required by the Boards could be financed by banks. But an overall ceiling of borrowing from banks is suggested at 5 per cent of the total annual revenue of each Board.
(7) Bank financing of rural electrification programmes is considered generally undesirable. The suggestion made is that all such programmes should form a part of the Plan with bank financing coming under its framework.
(8) The credit authorization scheme should be made applicable to lending for (a) rural electrification programme (pending the arrangement suggested); (b) working capital requirements of Electricity Boards; and (c) bridging loans given on an annual basis. This would imply that in respect of term lending to the Boards, the Reserve Bank would not be consulted.

The point is not adequately appreciated that the country now faces a power famine of serious dimensions, and that future development hinges on the build-up of this vital infrastructure. This situation happens to coincide with one of adequate liquidity in the banking system. Even if this were not so, there would seem to be a case for involving banks to a greater extent in the financing of electricity projects. In the present circumstances, it would be little short of gross negligence to allow power schemes to languish for want of finance while banks are unable to find outlets for their resources. The alternative left for putting through the schemes would be through provision of governmental finance—which could mean, ultimately, recourse to the Reserve Bank. It would obviously make more economic sense to allow the turnover of existing liquidity than permit further deficit financing. It would be argued that power projects could be financed through new markers borrowings of State and Central Governments. Banks would certainly be called upon to subscribe to them, but it is clearly unnecessary to adopt this roundabout method of financing to the exclusion of direct lending to the Electricity Boards.

Nor does it seem necessary to obtain the Planning Commission's approval for such proposal made by a State Electricity Board. The Resources Working Group has estimated an addition to bank deposit of Rs 9,130 crores during the 5th Plan period. Of this, about 18 per cent is expected to be pre-empted for subscription to the market borrowings of the Central and State Government, and a further 7 per cent by way of subscription to the bonds of non-financial enterprises (into which category State Electricity Boards would fall). An amount of Rs 1,500 crores (or 16.4 per cent of the increase of deposits) is expected to be provided for the working capital requirements of public sector enterprises. The total contribution of banks to the public sector in the 5th Plan would amount to 42 per cent of the anticipated increase in deposits. There would thus be scope for bank financing of non-plan projects even in the public sector.

The suggestion made that banks' involvement in power programmes should be through term loans rather than exclusively through subscription to bonds, would seem acceptable. For one thing, the direct contact of banks with State Electricity Boards would be beneficial in that it might promote financial discipline and improve their working. Also, this would be a means of improving the credit–deposit ratio in some less-developed States which offer little scope for other lending. At the same time, it has to be recognized that the investment in the bonds of Electricity Boards is not very high, forming only 6.5 per cent of total bank investments in March 1972. As a proportion of investments in State Government securities and securities of State associated/approved bodies, this was 13.3 per cent for the country as a whole, though among individual states it ranged between 6.5 per cent in Maharashtra and 20.1 per cent in Haryana (vide Statement appended).

The distinction drawn in the note between term loans to State Electricity Boards (which would require clearance from the Banking Department and the Planning Commission) and working capital and bridging loans (which would require Reserve

Bank clearance) is somewhat ambivalent. A good portion of the so-called working capital, now being provided, is in actuality utilized to meet medium- and long-term requirements. If it be conceded that lending to State Electricity Boards is desirable in the present context, then what is necessary is an evaluation of each proposal taking into account not only the financial prospects but the overall portfolio of the lending bank and the position of the concerned Board and the power requirements of the State as well. This could be done in an integrated manner in the Reserve Bank, not just under the Credit Authorization Scheme but from the angle of overall credit planning. In the conditions prevailing at present, it should be possible for banks to enter into fairly large scale commitments for financing State Electricity Boards over at least the next two to three years. Thereafter, the share of total credit that could be allocated for electricity projects would have to be decided taking account of the requirements of other sectors and the overall resource position. It might be desirable to set up a consortium arrangement for the distinction of this type of results between banks with the Reserve Bank as coordinator. This would be the best arrangement to take an overall view of the resources of the banking system and then to decide on the size of funds available for electricity boards. This would also eliminate the scope for individual State Electricity Boards to obtain credit in excess of requirements and at concessional terms by playing up the 'competition' between banks.

While it is conceded that lending to State Electricity Boards should not run out of proportion, either in regard to an individual bank's involvement or to an individual Board's reliance on the banking sector, an overall ceiling on bank borrowing as proposed, would be undesirable. The position would clearly vary from Board to Board and a flexible approach is very necessary.

The proposed conditions under which bridging loans may be made appear rather impracticable. At any rate, if the idea of bank lending to State Electricity Boards under Reserve Bank supervision is accepted in principle, individual cases could be examined on merits, without any blanket regulation. The same would apply to loans for rural electrification. Here, a liaison with the Rural Electrification Corporation would be helpful in judging requirements.

The suggestion that concessions in lending should be done in the form of adjustment of repayment schedule rather than in lower rate of interest may not be feasible. While a realistic schedule of repayment, with a maximum 'holiday' is important, State Electricity Boards would also require some concessions in interest rate, which could be around 9 to 9.5 per cent for the present.

The note also includes a reference to the financial requirements of the Bharat Heavy Electricals Ltd. and Heavy Electricals (India) Ltd. A recent change in the procedures relating to the advance payment by Electricity Boards to these industries have enhanced the working capital needs of these undertakings. It is said that their additional working capital requirements would have to be examined in the Banking Department 'very carefully, if necessary in consultation with select custodians'. It is true that advances to public sector projects are exempt from scrutiny under the Credit Authorization Scheme, but that is no reason why the expert machinery available in Reserve Bank cannot be used for this purpose.

Credit Planning Cell
Reserve Bank of India
Bombay

Bank Investments in Bonds of State Electricity Boards

(Rs lakhs)

	March 1972		(2) as % of (1)
	Investments in State Government securities and securities of State associated approved bodies	Investments in bonds of State Electricity Boards	
	(1)	(2)	(3)
1. Andhra Pradesh	9809	832	8.5
2. Assam	1196	300	25.1
3. Bihar	3238	727	22.5
4. Gujarat	11493	1321	11.5
5. Haryana	2347	706	30.1
6. Kerala	3964	942	23.8
7. Madhya Pradesh	3364	534	15.9
8. Maharashtra	21337	1381	6.5
9. Mysore	9364	1730	18.5
10. Orissa	2314	592	21.0
11. Punjab	4333	753	17.4
12. Rajasthan	4082	630	15.4
13. Tamil Nadu	13115	1742	13.3
14. Uttar Pradesh	7950	1129	14.2
15. West Bengal	5649	701	12.4
Total	104075	14020	13.5
All India	105249@	14020	13.3

@There are no investments in bonds of State Electricity Board in Himachal Pradesh, Jammu & Kashmir, Nagaland, Delhi and other Union Territories.

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J.S. Raj
Chairman

UNIT TRUST OF INDIA
POST BOX NO. 2000
BOMBAY 1

D.O.No.UT.5773–5774/NP.8–74

23rd January 1974

Dear Shri Jagannathan,

AMENDMENTS TO THE UNIT TRUST OF INDIA ACT, 1963

You will please recall the discussion I had with you in June 1972 about the difficulties which the Trust is facing in investing its surplus funds in view of the statutory provisions which, at present, restrict the Trust from investing its monies except in shares, securities or keeping it deposited with scheduled banks or with other approved institutions. While agreeing to promote a suitable amendment to the Act to enable the Trust to invest its surplus funds in loans and other instruments such as participation certificates, bill discounts, etc. approved by the Reserve Bank, you had in your letter dated 14 June 1972 desired that I should put up self-contained proposals to enable you to make a reference to the Government.

2. We have considered various suggestions to amend the Act from time to time in consultation with the Legal Department and had the suggestions also approved by the Board of Trustees. I am now sending you a draft Bill (in triplicate) prepared by the Legal Department on our instructions, containing our proposals for amending the Act. We are also enclosing a statement of objects and notes on clauses of the Bill explaining the various provisions thereof. The matters in respect of which amendments have been suggested are broadly explained below:

(i) *Enlarging the Scope of the Trust's Investments*

At present, the investments of the Trust are statutorily restricted to shares and securities or keeping money on deposit with scheduled banks, etc. It has been the experience of the Trust in recent years that securities of first class companies are not available in sufficient quantities with the result that it is becoming extremely difficult to employ the Trust's funds in profitable outlets. Pending investments of the funds on long-term basis, the Trust takes recourse to Government securities and Call and Short Notice deposits with banks. The rate of return on Government securities is low and they are not, therefore, suitable for investment in view of the obligation of the Trust to pay reasonable dividends to unit holders. Call and Short Notice deposits with banks being by their nature very short-term investments do not generally yield a high return except in unusual times like the present. It is, therefore, necessary to consider some other fields where the Trust can employ its funds, on short-term or long-term basis, more remuneratively. In this connection, I may add that it will be necessary for amendments to the act.

If the Trust can invest in participation certificates or rediscounting of bills, it will be able to earn better yield on its funds. Unlike other term lending institutions, like the Industrial Development Bank of India, Industrial Finance Corporation, Industrial Credit and Investment Corporation of India and Life Insurance

Corporation of India, the Trust is precluded from giving direct loans. In view of this, we have to take recourse to the tortuous procedure of subscribing to privately placed debentures which is time consuming as well as expensive. We, therefore, feel that the Trust should be permitted to give loans directly in addition to subscribing to debentures. Clause 3 of the enclosed draft Bill deals with these amendments.

(ii) *Eligibility for Reappointment of Chairman and Executive Trustee*
A doubt has been raised whether, in the absence of a specific provision in this regard in the Act, an outgoing Chairman or Executive Trustee will be eligible for reappointment. Legal Department have suggested that it will be preferable to amend the Act to place the matter beyond doubt. We are, therefore, suggesting amending Section 14(2) (a) of the Act retrospectively. This is dealt with in clause 2 of the Bill.

(iii) *Restriction on the Use of Words "Unit", "Units" or "Unit Trust" by Persons other than the Trust*
It has been brought to our notice that certain institutions and persons, for example, New Bharat Savings Unit (P) Ltd., Calcutta, Nav Bharat Investments Ltd., Bombay and Gujarat Savings Unit Pvt. Ltd., Bombay are offering investment schemes to the public using the words 'Unit' or 'Units' as part of their names or in their advertisements. As the use of the words 'Unit' and 'Units' is likely to be confused by the public with the units of the Unit Trust of India, we feel it will be desirable to prohibit on the lines of corresponding Section 7 of the Banking Regulation Act, 1949, the use of words 'Unit', 'Units' and 'Unit Trust' by persons offering investment Schemes. Clause 4 of the enclosed Bill proposes insertion of a new section in the Act for this purpose.

(iv) *Provision of Nomination by Unitholders and Agents*
At present, there is no provision in the Act enabling a unitholder to make nomination in respect of the units held by him. This has been a great handicap and a deterrent factor to some extent to investment in units by persons who do not want to take advantage of the provisions for joint holding but would like only to make a nomination. We, therefore, feel that the Act should be amended to permit the Board to include a clause in the Unit Schemes for nomination by unitholders.

It is also felt necessary to have an enabling provision for nomination by sales agents of the Trust in respect of the commission, etc. payable to them on sales of units procured by them. Such a provision is necessary as in the case of Unit-Linked Insurance Plan, commission would be payable over a period of ten years. The facility of nomination would be an additional incentive for the agents. Life Insurance Corporation of India extends a similar benefit to its agents and Section 44(2) of the Insurance Act, 1938, as applicable to Life Insurance Corporation has been modified for this purpose.

The first part of clause 5 of the Bill sets out the amendments.

(v) *Investment on Behalf of Minors*
We have had the position examined by the Legal Department and also by the Solicitors. The legal position that emerges is that the investment on behalf of a minor is governed by his personal law. In the case of Hindus, the natural guardian is the father and, in the absence of the father, the mother. The mother cannot act as natural guardian so long as the father is alive and is able to act as natural guardian. As regards Muslims, the natural guardian of a minor is the father, the executors appointed by a will by the father, the father's father and executors appointed by his father's father. The mother is not competent to act as natural guardian under any circumstances. Persons who are neither Hindus nor Muslims (for example, Christians and Parsis) are governed by the English Law under which the natural guardian is the father and after the father's death, the mother is the natural guardian only for the purpose of nurturing the child. We have received several applications by working mothers for investment in units on behalf of their minor children which we were unable to accept having regard to the legal position stated above. Therefore, it will be necessary to amend the Act to enable investments in units on behalf of a minor by either parent. The second part of clause 5 of the Bill seeks to insert a new section in the Act for the purpose.

3. We feel that the amendments suggested by us are necessary for the future growth of the unit trust movement in India. We shall, therefore, be glad if the proposed amendments are taken up with the Government for necessary action at a very early date.

With best regards,

Yours sincerely,
J.S. Raj

Shri S. Jagannathan
Governor
Reserve Bank of India
Bombay – 1

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D.N. Ghosh
Joint Secretary

Department of Banking
Banking Vibhag
'Jeevan Deep'
Parliament Street
New Delhi
April 6, 1974

Dear Dr Hazari,

This is with regard to certain developments in the money market about which Shri Talwar has made references in the Annual General Meeting of Shareholders at Madras on 29th March, 1974. First, he has referred to the practice of rediscounting of bills, which are not eligible for refinance by the Reserve Bank of India, by approved financial institutions such as LIC and General Insurance Corporation and has taken the view that this practice militates 'against the spirit of credit curbs', for even when such bills cover the sale and purchase of sensitive commodities, banks can offer such bills to financial institutions with impunity. Further, this helps one set of large depositors to obtain higher return on short-term surpluses.

Secondly, he has questioned the propriety of issuing participation certificates. He mentions that funds obtained by the bank from financial institutions through the medium of participation certificates 'steer clear of the discipline imposed on regular bank deposits. While a bank may lend not more than 60 out of every 100 rupee of its deposits, it remains unhampered in lending the entire amount of Rs 100 derived through participation certificates'. While on this, we would invite a reference to certain other aspects regarding participation certificates which were brought out in our letter of 8th May 1973.

Thirdly, Shri Talwar refers to certain adverse impact on the banking system arising out of the participation of LIC and Unit Trust in the call money market. As the funds of the LIC and Unit Trust would have normally accrued to the banking system in the shape of deposits at the normal rates of interest, there would appear to be little justification, in Shri Talwar's opinion, of getting the funds in a 'roundabout and expensive' way through call money market. The 'gains' as Shri Talwar puts it, 'accruing to Life Insurance Corporation and Unit Trust from the call money market are in the nature of a windfall from a special concession at the expense of the banks'.

We are not offering at this stage any comments on the merits or otherwise of the points raised by Shri Talwar. As Parliament is in session and the Consultative Committee of the Ministry of Finance is also scheduled to meet on 2nd of May 1974, it is not unlikely that the points raised by Shri Talwar may come up for discussion. We shall be grateful if we could have, at your convenience, a detailed brief from the Reserve Bank on the points raised by Shri Talwar and also your advise, in case the points are raised, on the lines on which Finance Minister could deal with them.

Regards,

Yours sincerely,
D.N. Ghosh

Dr R.K. Hazari
Deputy Governor
Reserve Bank of India
Central Office
Bombay
KBP:

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TELEX MESSAGE
For: M.B. Usgaonkar, Under Secretary, FINBANK, New Delhi
From: S.V. Raghavan, DCO, DBOD, RBI, Co, Bombay

Refer your Telex MSG. No. 710 dated 30th April 1974. Our views on Shri R.K. Talwar's observations on Participation Certificates and on the question of participation of LIC and UTI, in the Call Money Market are given below:

Participation Certificates Scheme
Shri Talwar contends that the funds raised by issue of P' Certificates are equivalent to deposits accepted by banks. This contention is not correct. If such funds are treated as deposits they will, no doubt, be subject to our directive on deposit rates. On the other hand, P' Certificates Scheme envisages loan participation and as such, funds derived through issue of P' Certificates are in the nature of refinance obtained from sources other than Reserve Bank of India by the issuing bank up to the extent of 100% of the relative advances. The cumbersome legal formalities adopted by banks in connection with the issue of P'Certificates will themselves testify that these transactions are only loan participations and do not represent another mode of acceptance of deposits. In any case, we have not been treating Participation Certificates as deposits. As already advised in our D.O. letter GCS. No. 142/C. 475–7 dated 7th February 1974, P' Certificates Scheme is on an experimental basis up to the end of June 1974.

Participation of LIC and UTI in the Call Money Market
We do not accept Shri Talwar's view that Money Market should be the exclusive preserve of banks, and that it is not desirable for the LIC and UTI to participate in the Call Money Market. Our reasons are as under:

i) The LIC and UTI command very large quantum of surplus funds which represent savings of the people. These funds have been collected by the institutions with their own efforts and at their own cost.
ii) It is not correct to assume that all these surplus funds will necessarily be kept with banks in the form of deposits. The tendency for these institutions would be to secure maximum return on such funds, and as such they may be inclined to keep them even outside the banking system or in other investments.
iii) The availability of their surplus funds in the Call Money Market tends to reduce banks' resort to the Reserve Bank.
iv) The Reserve Bank is continuously trying to foster the growth of an active

money market, and in this context it cannot keep outside the market, institutions like LIC and UTI which command very large resources. Their active operation outside the sphere of Money Market might even affect the credit situation in the country and may ultimately prove detrimental to the interests of banks themselves.

v) These institutions cannot be treated on a par with ordinary depositors.

The above thoughts have also been echoed to some extent in the speech delivered by Shri J.N. Saxena, Chairman, Indian Banks' Association at the Annual Meeting of the Association held on 19th April 1974 as under:

'Some criticism has been voiced in this respect with regard to the facility afforded to the Life Insurance Corporation of India and the Unit Trust of India to operate in the money market. . . . True, the two institutions are enabled to reap the benefit of the high rates, but the remedy is a ceiling of the nature afore-referred. Also, it would not really be correct to assume that the money that they place with banks at call through the call market would, in any case, be placed by them in current accounts with banks, as they could not possibly afford to keep the funds idle and would naturally look to alternative investment in Treasury Bills.'

S.V. RAGHAVAN
30-04-1974

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TELEX DBOD.GCS.No. July 13, 1976
D.O.No. DBOD. TEP.4/C.517–76 Asadha 22, 1986 (Saka)

Dear Shri Sen Gupta,

You will remember that while at Bhopal on 19th June 1976, I had told you that Government had recently issued certain instructions to public sector banks directly and we were not even informed about the issue of such instructions, as copies of the relative letters were not endorsed to us. Some of the letters I had in mind are:

1. D.O.No. 20(I)/76-KSA dated the 24th January 1976
2. D.O.No. 2-18/76-AC dated the 15th/19th April 1976
3. D.O.No. 20(1)/76-KSA dated the 17th May 1976
4. No. F. 9/14/76-AC dated the 17th May 1976
5. D.O.No. 4/1/16/75-IR dated the 24th June 1976

We feel that normally instructions to banks should issue from the Reserve Bank. This will not only avoid confusion at the banks, but would also lead to better coordination. In case of any urgency, while Government may write to backs directly, copies of these letters should invariably be endorsed to us. In case Government ask the banks to submit any information/statements to them directly, the banks should also be advised to forward copies of such statements, etc. to us to avoid our writing to them again on the same subject. It is also necessary that copies of all important communications addressed by Government to any bank are endorsed to Reserve Bank.

2. We shall be glad if you will please issue suitable instructions to all concerned and we are advised in the matter.

With kind regards,

Yours sincerely,
K.S. Krishnaswamy

Shri N.C. Sen Gupta
Secretary
Department of Revenue and Banking
(Banking Wing)
Government of India
New Delhi

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/C.517–76

Dear Shri Menon,

Please refer to my D.O. letter DBOD. No. TEP. 4/C. 517–76 dated 13th July 1976 addressed to Shri N.C. Sen Gupta, the then Secretary in the Department of Revenue & Banking, regarding communications addressed by Government to public sector banks on matters of importance. While copies of a few letters addressed to such banks direct by Government have been endorsed to us, it has come to our notice that instructions still continue to be issued directly to banks, without consulting us or even informing us about them. For instance, D.O. letter No. 9(1)/73-DEV dated 9th August 1976 was issued by the Department of Revenue and Banking to the Chairman of the lead banks in Bihar State on such an important matter as the strategy of branch banking in the State, and we were not kept informed by the Department notwithstanding the fact that branch banking is regulated by the Reserve Bank under the provisions of the Banking Regulation Act. Another letter bearing No. F. No. 9(7)–76 ESA was issued on 4th September 1976 to the Chairman of the State Bank of India and the nationalized banks on the question of stepping up their lendings to the priority sectors to 33.33 per cent of their total advances by the end of the 5th Five Year Plan. This important communication was also not endorsed to us. We would once again request Government to ensure that there is no communication gap between the Reserve Bank and the Department of Revenue and Banking on such vital matters of policy, and also in other matters and to instruct all the officials concerned suitably in the matter.

With kind regards,

Yours sincerely,
K.S.K

Shri K.P.A. Menon
Addl. Secretary
Deptt. Of Revenue & Banking
(Banking Wing)
Government of India
New Delhi

DIRECTIVES SECTION

PARTICIPATION CERTIFICATES SCHEME—THE LAKSHMI VILAS BANK LTD.

We have, so far, permitted 43 banks (34 Indian and 9 foreign) to issue participation certificates under the above Scheme. The Scheme, which was started on an experimental basis, is being extended from time to time and the present extension is for a further period of one year, that is, up to 30th June 1977. In this connection, it may be stated that the Lakshmi Vilas Bank Ltd., a licensed scheduled bank, is not on the list of approved banks for issue of these certificates. During the course of the inspection of the bank carried out recently, it was observed that it had issued participation certificates to the United India Fire & General Insurance Co. Ltd. without obtaining our approval for entering into such an arrangement. We had, therefore, taken up the matter with the bank, and in reply it has now sought our approval for inclusion of its name under the above Scheme.

The Lakshmi Vilas Bank Ltd. started functioning in the year 1926. Its paid-up capital as on 31.12.1975 stood at Rs 22.88 lakhs as against Rs 20.11 lakhs as at the end of the previous year. It is observed from the last report on the inspection of the bank conducted with reference to its position as on 28th September 1973 that its financial position is sound and its affairs are not being conducted in a manner detrimental to the interests of its present or future depositors. Certain financial data pertaining to the applicant bank is placed below. Its deposits as on 31st December 1975 stood at Rs 18.96 crores as against Rs 17.11 crores at the end of previous year. Its deposits for the week ended on 25th June 1976 amounted to Rs 19.95 crores showing an increase of about Rs 1 crore during the current half-year. Its advances as on date, stood at Rs 11.77 crores.

The bank has stated that due to tight resources position it becomes necessary for it to borrow from approved financial institutions by issuing participation certificates against the working capital advances made by it to industrial concerns. It has explained that it was under such circumstances, that it had to take recourse to the Participation Certificates Scheme by issuing participation certificates to the United Fire & General Insurance Co. Ltd., which had surplus funds available with it, although it had no approval to participate under the scheme. The bank has added that so far it has issued certificates of the order of Rs 20 lakhs to the said company.

Due to the reasons stated above, it may not be possible for the bank to meet the increasing demand of the borrowers from its own resources. If the bank is allowed to enter into participation arrangement with other financial institutions like banks, LIC, UTI, etc., it would help the bank in augmenting its resources and would, in turn, widen the scope of its assistance to the industrial sector. In view of this, we may allow the bank to issue participation certificates to other approved institutions on the usual terms of the Scheme. If approved, the bank will be advised suitably on the usual lines.

29.07.76

Directive Section

Participation Certificate Scheme —Lakshmi Vilas Bank Ltd., Madras

Ref: Letter dated 20th August 1976

The Lakshmi Vilas Bank Ltd., a licensed scheduled commercial bank had, in June 1976, sought our permission for inclusion of its name in the list of approved banks, for the purpose of entering into participation arrangements, with the other approved financial institutions. The bank's request was, however, declined. In this connection, our office note dated 2nd August 1976 and the E.D.(L)'s remarks thereon may please be seen at flag 'K'.

2. The bank has again approached us with a request to reconsider the application. In this connection, it has stated that it is now diversifying the advances to industrial units to a sizable extent from that of traditional business of advancing amounts against pledge of gold and jewels. Further, in order to make rapid strides in the matter of diversification of advances, it is making endeavours to build up necessary infrastructure. This requires extension of its branch network at metropolitan centres like Bombay, Calcutta, Hyderabad, etc. In addition to this, it has stated that the industrial units which are enjoying facilities with it, pay large insurance premium to the general insurance companies. These associations could be distinctively advantageous to the bank provided it is permitted to enter into participation arrangements and thereby afford it an opportunity to augment its resources position. This would also facilitate it, in extending larger credit, inter alia, to the industrial sector. If the bank's request to enter in the participation arrangement is declined, it may suffer loss of interest. It also fears that it would not be in a position to compete effectively with the banks which are placed in the approved list and will face genuine hardship in strengthening its resources particularly when it is short of funds. The financial position of the bank is as under:

(in lakhs)

	1974	1975
1. Paid-up capital	20.11	22.87
2. Reserve fund	18.00	23.65
	(as on 6-8-76	13-8-76)
3. Deposits	2048.27	2083.07
4. Advances	1304.00	1318.00

Accordingly, there seems to be some force in the bank's above argument. It is a small-sized bank and it may not be possible for it to meet suitably the increasing demand of its borrowers from its own resources. In the circumstances, it is for consideration whether we may grant necessary permission to the bank to enter into participation arrangements with other approved institutions on the terms and conditions set out in our current circular letter dated 17th May 1976.

O (Gon)
31.08.1976
D (Apte)
31.08.1976

For the purpose of the Participation Certificates Scheme, we have, so far, approved thirteen banks in the private sector. The smallest among these is the Karur Vysya Bank Ltd. other than Bharat Overseas Bank whose deposits stand around Rs 27 crores at the end of August 1976. Even compared to these banks, the operations of the Lakshmi Vilas Bank Ltd. are smaller. When we consider the request of the Lakshmi Vilas Bank Ltd., we may have to consider whether it is necessary for us to stipulate some minimum limit, say Rs 25 crores' deposits . . . it may not be advisable for smaller banks to enter into the business of Participation Certificates with a view to granting advances to industrial concerns. It is important to note that once an advance is granted even on a cash credit basis, it is generally anticipated that it will continue to be allowed, and it is really difficult to withdraw the funds from a going concern. In the above context, it is in the interests of the Lakshmi Vilas Bank Ltd., to increase its deposits, to expand its business and earn more profits. Apparently, the bank is keen to make quick profits by accepting monies from insurance companies, when available. One point which is favourable to the bank, however, is that another bank in Karur itself, viz., Karur Vysya Bank Ltd. has been approved by us for the purpose. On this score, the Karur Vysya Bank Ltd. is favourably positioned, while the Lakshmi Vilas Bank Ltd. is at a disadvantage, although both are licensed scheduled banks. But we have to fix some minimum requirements for approving a bank under the Participation Certificates Scheme and it is desirable that we reject the request of the Lakshmi Vilas Bank Ltd. for reconsideration.

01.09.1976

The bank is faced with the problem of augmenting its resources in order to meet the emerging demands consequent to diversification of its advances portfolio. There is, therefore, some force in the bank's argument and its request for being included in the approved list of banks for the participation certificate scheme merits examination de novo.

As the issue relates to the question of adequacy or otherwise of the bank's resources and their uses, Credit Planning Cell may please throw more light on it.

02.09.1976
Adviser (Shri Raman)
A note recorded by Dco (B) is attached.

06.09.1976
Addl.Co. DBOD
E.D.(L)

The Participation Certificate Scheme has not always been used with sufficient care by the smaller banks, with the result that they are able to get into a resource jam.

On balance, we may say no to Lakshmi Vilas Bank and also . . . the Karur Vysya Bank should remain in the list.

Participation Certificates Scheme
Lakshmi Vilas Bank Limited

As regards suggestion made by D.G. (K) on pre-payers, regarding reviewing the case of Karur Vysya Bank Ltd., . . . to remain in the list of approved banks for the purpose of entering into Participation Certificates Scheme. We may examine it separately.

Draft reply to Lakshmi Vilas Bank Ltd., may please be approved.

O (Gons)
22.09.1976
D (Haj)
22.09.1976

Note: Fair Letter to the Chairman, Lakshmi Vilas Bank Ltd. is placed below for signature please.

Credit Planning Cell
Participation Certificates Scheme
Lakshmi Vilas Ltd., Madras

Kindly see the note from DBOD placed below.

2. The question of granting permission to a bank for inclusion in the list of approved banks for the purpose of entering into participation arrangements with other approved, financial institutions has to be viewed in the wider context of enabling the bank to mobilize the surplus resources within the financial system and the scope for utilizing these for productive purposes. This, in fact, is the basic objective of the Participation Scheme.

3. Lakshmi Vilas Bank has stated that it is in a position to mobilize surplus resources from the General Insurance companies and employ these resources for diversification of its advances particularly to industrial units. It is observed that the Karur Vysya Bank was granted permission to enter into participation arrangements precisely on these considerations. It would, therefore, be difficult for us to deny similar facilities to Lakshmi Vilas Bank. The size of the bank in terms of its deposits need not be a very material factor in taking a decision on this issue, provided the affairs of the bank are being conduced in a satisfactory manner.

In view of what is stated above, Lakshmi Vilas Bank may be granted permission to enter into participation arrangements with other approved financial institutions, subject to the usual conditions.

D.G. Borkar
6/9/1976

I agree with DCO(B).
Addl. Co. DBOD

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BANKERS' COMMITTEE FOR EACH STATE—20-POINT ECONOMIC PROGRAMME

Please see the news item appeared in *The Economic Times* dated 29th October 1976 on the above subject. The Union Ministry of Revenue & Banking is stated to have allotted the task of coordinating efforts for implementation of schemes prepared under 20-Point Economic Programme in the states to nine public sector banks as shown below:

Name of the bank	Names of States of which it will hold charge
1) State Bank of India	1) Andhra Pradesh 2) Jammu & Kashmir 3) Meghalaya 4) Nagaland 5) Orissa
2) Central Bank of India	1) Bihar 2) Madhya Pradesh
3) Bank of Maharashtra	1) Maharashtra
4) Bank of Baroda	1) Gujarat 2) Rajasthan 3) Uttar Pradesh
5) United Bank of India	1) Assam 2) Manipur 3) Tripura 4) West Bengal
6) Punjab National Bank	1) Haryana 2) Himachal Pradesh 3) Punjab
7) Canara Bank	1) Kerala
8) Indian Overseas Bank	1) Tamil Nadu
9) Syndicate Bank	1) Karnataka

The functions of the Committee are stated to be: (i) to consider problems requiring inter-bank coordination such as area demarcation for implementation of different schemes, (ii) allocation of schemes being implemented at the district level, and (iii) bringing uniformity in the terms and conditions of credit under specific schemes.

The participants in the Committee will include, besides the banks concerned, Chairman of regional rural banks, representatives of commercial banks, Government agencies, representatives of state cooperative banks and land development bank. The Chief Minister have also been requested to associate representatives of the Central and State legislatures with the Committee.

2. We have neither been consulted in the matter nor a copy of the instructions

issued by Government has been received by us. In this connection, our D.O. letter dated 13th July 1976 to Government may please be seen. The basis on which the allotments of states have been made are not known to us. It is proposed to write to Government as in the draft letter placed below for approval please.

4.11.76

Setting Up of State-Level Bankers' Committees

As desired by D.G. (K), the C.O. had written to Shri Menon for the details of instructions issued in the matter by Government to banks. A copy of the instructions issued by Government to banks has since been received and is placed below. The functions of the Committee and the responsibility of convening the meetings of the Committee in each State are as indicated on pages 1 & 2 of the note. The basis of allocation of States to banks are their lead responsibility and also the spread of their branch network is rural areas. The meetings of the Committee are expected to be held at least once in a quarter. It has also been suggested that these meetings should be held before each meeting of the State Level Coordination Committees which are being strengthened by State Governments through association of the members of Parliament and State legislatures.

It is not known whether a representative of the Reserve Bank of India would be associated with the Bankers' Committee. As regards State Level Coordination Committee, we had recently received a request from the Government of West Bengal for nomination of RBI's representative on such a Committee and we have nominated our Joint Chief Officer, Calcutta on the Committee.

24.11.76
D (Krishnan) It would appear that on receipt of C.O.'s D.O. letter to Shri Menon, the Government have merely endorsed a copy of circular addressed by them to SBI and the 14 Nationalized banks and 31 grameen banks. Detailed instructions from Government to us on the subject will help us to activate our regional offices, which, in turn, will have greater involvement so as to hasten the process of implementation of the 20 Point Economic Programme by the commercial banks.
C.O.
25.11.76
Governor may like to see their office notes as also the circular issued by the Dept. of Banking. This is yet another instance of by-party of the RBI by the Dept. Governor had told me sometime back that he had suggested to HRD a clear demarcation of the functions of the RBI to the Dept. Would it be convinient for the Governor to take up this matter in his next visit to Delhi?

25.11.76
Governor

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Kum. Kusum Lata Mital
Joint Secretary

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
(BANKING DIVISION)
'JEEVAN DEEP' PARLIAMENT STREET
NEW DELHI

D.O. No. 8(17)/77–CPT

30th December 1978

Dear Shri Singh,

It will be recalled that your bank had suo moto requested for being allowed to operate the Differential Rate of Interest Scheme in your lead districts. We understand from the Reserve Bank of India that all the private sector banks which were entrusted with lead responsibility and were implementing the Differential Rate of Interest Scheme have not been filing quarterly returns. Consequently, the progress of implementation by your bank cannot be monitored.

2. It will be recalled that at the meeting convened by the Prime Minister with the Chief Executives of banks and term lending institutions in October 1978, both the Prime Minister and the Finance Minister had laid considerable stress on the private sector banks falling in line with the working patterns of the public sector banks so as to achieve the social obligations expected from the banking system. This issue has also been stressed by the Governor, Reserve Bank of India in his recent address to all banks. Some private banks have also agreed to implement the DBI Scheme in its enlarged form.

3. It is regretted that uptil now the performance of your bank under the DRI Scheme has been very unsatisfactory.

4. In view of the importance now being attached by the Government for providing credit at concessional terms to the weaker sections of the community, you are requested to chalk out a time-bound programme for enlarging the lending by your bank under the DRI Scheme so as to achieve the minimum stipulation envisaged therein.

5. A copy of this letter is being endorsed to the Reserve Bank. You are requested to keep this Department advised regarding the progress in this direction.

Yours sincerely,
KUM. KUSUM LATA MITAL

Shri Inderjit Singh
Chairman
Punjab & Sind Bank Ltd
H-Block, Connaught Circus
New Delhi

Copy to the Chief Officer, DBOD, Reserve Bank of India.
N.B. Government issued similar letters to the Chairman of Andhra Bank Ltd. and Bank of Rajasthan Ltd.

Y.P. SETHI
UNDER SECRETARY TO THE GOVT. OF INDIA

Remarks recorded by the D.G.(K) and C.O. have been circulated among B.P. and B.L. sections. Only for information, no action necessarily appears.

ACO (H)
02.02.1979
DCO (R)
02.02.1979

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V.K. Dikshit
Joint Secretary

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
(BANKING DIVISION)
'JEEVAN DEEP'
PARLIAMENT STREET
NEW DELHI - 1
3.3.81

D.O. NO.8(26)/77–CPT

Dear Shri Tambe,
One of the recommendations of Dr K.S. Krishnaswamy Working Group as contained in para 3.7 of the report which has been accepted by the Government, deals with assistance through intermediary organizations. This recommendation covers all advances to priority sector and 20-point programme and would seem to apply to advances under the Differential Rate of Interest Scheme as well.

2. We have been approached by some State Governments and State Sponsored Corporations with requests that they should be recognized as approved intermediaries for channelizing credit under Differential Rate of Interest to Scheduled Castes, Scheduled Tribes and other weaker sections of society. We have, so far, not agreed to such requests. However, in the light of the above referred recommendations of the Working Group headed by Dr Krishnaswamy, such requests have to be examined afresh.

3. I shall, therefore, be grateful to be apprised of your reaction to the requests for routing of the Differential Rate of Interest credit through State sponsored

corporations. As you are aware, at present, the Differential Rate of Interest credit is being routed only through State Corporations for the welfare of SCs/STs and the Cooperatives/LAMPS in identified tribal areas.

With regards,

Yours sincerely,
V.K. DIKSHIT

Shri W.S. Tambe
Executive Director
Reserve Bank of India
Central Office
Bombay

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Joint Chief Officer

9th May 1981

B.P. 377/C. 453(a)–81

Dear Shri Dikshit,

DRI ADVANCES THROUGH STATE SPONSORED CORPORATIONS

Please refer to your D.O. letter No. 8(26)/77-CPT dated 3rd March 1981 addressed to Shri W.S. Tambe, our Executive Director. The Working Group on Priority Sector Lending and the 20-Point Economic Programme has, inter alia, recommended that banks, while continuing to provide direct assistance, may also route credit to individual beneficiaries through State sponsored corporations/agencies besides functional cooperatives. On the basis of the recommendations of the Working Group, we have advised the State Governments that they may set up corporations/agencies exclusively for the benefit of weaker sections so that the banks may also route credit to individual beneficiaries through them.

2. Government have permitted banks since May 1977 to route advances under the DRI Scheme through State Corporations for the welfare of scheduled castes and scheduled tribes. Banks have also been permitted by Government since December 1978, to route credit under the Scheme through RRBs on an agency basis and cooperative societies/LAMPS organized specifically for the benefit of the tribal population in areas identified by the Government. Further, Government have recently permitted the sponsoring banks to lend under the Scheme through RRBs on a refinance basis.

3. One of the main reasons which weighed with the Working Group on 20-Point Programme in suggesting assistance through intermediaries is that it may not be possible for commercial banks to directly cater to the credit requirements of a large number of beneficiaries. Banks' advances to priority sector at the end of December 1979 under 110 lakhs borrowal accounts aggregated Rs 6011.47 crores constituting around 34 per cent of the total advances. Banks have to ensure that this proportion goes up to 40 per cent by 1985. It is expected that by 1985 the

volume of priority sector advances would be more than double the present level while the number of beneficiaries would be about three times the present number. However, under the DRI Scheme banks have to lend a minimum of 1 per cent of their aggregate advances. The advances granted under the Scheme at the end of March 1980 under 22 lakhs borrowal accounts amounted to Rs 150 crores constituting 0.9 per cent of the total advances of the banks. Banks have thus almost reached the target and the additional funds that will be available for lending under the Scheme are limited. Besides, the RRBs which operate mainly in rural areas have also been recently permitted to lend under the Scheme on a refinance basis. We, therefore, believe that no useful purpose may be served by allowing State sponsored corporations as intermediaries to lend under the Scheme. Permission to lend under the DRI Scheme through them may also bring about anomaly in the interest rate charged to the borrowers as the corporations are also expected to finance under other schemes at normal rate of interest.

With kind regards,

Yours sincerely,
M.L. Inasu

Shri V.K. Dikshit
Joint Secretary
Ministry of Finance
Deptt. of Economic Affairs
(Banking Division)
'Jeevan Deep'
Parliament Street
New Delhi – 110 001.

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Managing Director

State Bank of India
Central Office
Bombay, No. 1
4th January 1969
No. OP–285

Dear Shri Adarkar,

Proposed Asian–American Bank

Our New York representative has written to say that the Bangkok Bank Limited are interested in setting up an Asian–American bank as a joint venture of five banks operating in south-east Asia. The *raison d'être* for such a venture has been stated to be the absence of branches of Asian banks in New York except Japan, Pakistan and the Philippines, and the proposal proceeds on the footing that as it may not be profitable for a south-east Asian bank to open a branch all on its own, a joint venture would be the answer. The idea is still in a preliminary stage, but we have been sounded whether we would like to participate along with four other banks—

Bank of New South Wales, Australia

Overseas Union Bank Limited, Singapore
Prudential Trust, Manila, and
Bangkok Bank Limited, Thailand

2. Brief details of the proposal are as follows:-

(a) Share capital of US $20 million presumably to be contributed equally.

(b) The scheme envisages that Governments of each participating bank would designate the Asian–American Bank Limited as one of their depository banks for the placement of foreign exchange funds; the bank will also handle official transactions along with the other agencies of the Governments concerned. Besides this, it is envisaged that each Government would leave a permanent deposit of US $10 million on which interest would be paid.

(c) The proposed bank would be the main New York correspondent of the participating banks.

(d) The bank will offer complete trade financing facilities, including letters of credit, discounts, acceptances, foreign exchange facilities, etc., and it is hoped that, with the wide network of offices of the participants, the new bank should be able to cash in on their knowledge of customers, regulations, legal requirements, etc. and thereby have an edge over American banks doing business with the participant countries.

(e) Total funds employed have been assumed at US $60 million (presumably after meeting start-up expenses, liquidity requirements, etc.) and an initial gross profit of US $11,28,000 has been estimated.

3. We have given consideration to the proposal on the basis of the brief data supplied. While several questions require answer, our preliminary reaction is that it would be difficult and that it may not be worthwhile for us to participate. Firstly, there is the question of a sizeable capital contribution (US $4 million; Rs 3 crores) from us. The surplus resources of our London office are not sufficient for a diversion of this order, and we would necessarily have to arrange for a remittance from India which the Reserve Bank of India, in line with their present policy, would not allow. Secondly, we are not too sure whether the Government of India would be agreeable to lodge a sizeable deposit of US $10 million (Rs 7.5 crores) with the proposed bank at an interest of 6 per cent per annum on a permanent basis. The third question is what the proposed bank is expected to achieve. With working funds of US $60 million (prospects of US nationals placing deposits may be discounted), the bank can finance the large transactions we have with USA only to a marginal extent; besides ourselves, there would be four other countries involved. We have, at present, a wide network of correspondents in the USA operating as an efficient machinery for routing transactions between the USA and India. The proposed bank cannot be a substitute for this, besides which the impact of our participation on our correspondents, with whom our relations are cordial precisely because we do not compete in the USA, would possibly be unfavourable. Lastly, by participating in

the venture, we will be ruling out our ever-opening a full-fledged office if circumstances should become propitious.

4. All told, our preliminary reaction is unfavourable. A representative of the Bank of Bangkok may possibly visit India in the near future to sound us, and I thought it would be useful if I apprised you of the proposal and had the benefit of the views of the Reserve Bank of India. I am sending a copy of this letter to Ghosh of the Finance Ministry with a request to let me know Government's reaction.

Yours sincerely,
N. RAMANAND RAO

Shri B.N. Adarkar
Deputy Governor
Reserve Bank of India
Central Office
Bombay – 1

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D.O.No.DBOD, B.L.471/C, 212–69 February 7, 1969

Dear Shri Ramanand Rao,

PROPOSED ASIAN–AMERICAN BANK

Please refer to your D.O. letter No. O.P. 285 dated 4th January 1969 on the above subject. We generally agree with your approach to the proposal as set out in paragraphs 3 and 4 of your letter. We, however, consider that as a long-term policy, it is desirable that an Indian bank should open a branch in the United States. We shall be glad to have the State Bank's views on this suggestion in due course.

Yours sincerely,
B.N. ADARKAR

Shri N. Ramanand Rao
Managing Director
State Bank of India
Central Office
Bombay – 1

DBOD. No. B.L. 472/C. 212–69 dated 7th February 1969

Copy forwarded to Shri D.N. Ghosh, Deputy Secretary to the Government of India, Ministry of Finance, Department of Economic Affairs, New Delhi, with reference to his D.O. letter No. F.8/2/21/69-SB dated 30th January 1969 to Shri Nadkarni.

CHIEF OFFICER
BANKING OPERATIONS

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C 212/Vol. 9 April 1969

INTERNAL NOTE

I do not think that it will be possible either for Government or for the Reserve Bank to deposit a sum of US $10 millions or, for that matter, any other sum with the proposed Asian–American Bank in New York.

2. The rate on negotiable certificates of deposits, which is what we are offered, is lower than that on commercial paper and banker's acceptances and the rates quoted by the B.I.S., which are fractionally higher than even these rates. The extra yield on deposits with the new bank, as compared with the yield on treasury bills, is also so marginal that it can be ignored.

3. This, however, is a minor point. It will not be appropriate for the Reserve Bank to open an account with a private bank, especially when it has no international standing. Although there is no legal obstacle, we cannot recognize and entrust our funds to a new institution like this, when in spite of the higher yields which could have been obtained, we have not been anxious to divert our funds to any of the leading American banks in the past.

4. As far as Government is concerned, on the advice of the First Boston Corporation, who are the fiscal agents for the Government of India in the United States, they keep their I.S.M. balances with about fourteen leading commercial banks in the United States. The criterion on which these banks have been chosen is the extent of their direct or indirect investments in India, in the form of loans to enterprises in which the Government of India is interested or participation by the banks in the I.B.R.D. issues for financing loans to India. The banks with which deposits are now held are able to provide letter of credit and other facilities to the Government of India, on terms which the new institution will obviously not be able to command. The Government of India cannot also depart from its criteria. Although the Ambassador (Economic) and Financial Adviser of our Embassy in Washington are authorized to approve of ad hoc additions to the list of local bankers for the I.S.M., they cannot ignore liquidity and safety, which they are required to take into account under the memorandum of instructions drawn up and issued in February 1963.

5. In view of the above, the State Bank's preliminary view, namely, that this proposal cannot be pursued further appears to be justified and may be supported.

R.K. SESHADRI
25.4.1969

(D.G. (A) I think we should advise Shri Ramanand Rao that it would be possible to take a view about the disability of placing a deposit of US $ 10 million with the new bank in a permanent basis only after the State Bank of India has assessed the merits of the proposition. As ED(S) has observed in para 3 above, there is no difficulty in law in RBI making the deposit; if so, the other considerations mentioned by ED(S) have to be weighed against the advantages, if any, which SBI may find in the scheme.)

28.04.1969

I agree with D.G. (A) that it is necessary for the State Bank to make an assessment as an institution of the advantages that it may derive from participating in the proposed scheme. At the same time, sooner or later, a view on a wider plane will also have to be taken by the Reserve Bank and Government. I see some advantages in bringing the Government into the picture even while the SBI is examining the scheme strictly on merits.

I recall that at one time both the Economic Secretary and myself had felt that it might be worthwhile for the State Bank to have a branch in New York not so much on the consideration of what the SBI could earn but on wider considerations. On the one hand, there would be the point about reciprocity: if American banks have branches here, our leading bank should also have a branch in the USA. Then again, on many matters, the State Bank could be generally helpful to the Indian economy in the conduct of Government business as well as the country's export trade, if there was a branch in a place like New York. Shri Dehejia, however, was firmly of the view that a branch would be so much of a losing proposition that it would not be worth the State Bank's while to open a branch.

The present proposal has one more angle to it which is of interest to us and to the Government. We very often talk of regional cooperation. The support we have had in this is not too significant. There are trends to indicate that South-East Asian countries in some matters tend to leave India out of the picture. Thus, when South-East Asian Governors meet, Governors from India and Pakistan are not invited though the Governor from Nepal is. On the other hand, there is also a tendency that if India comes into the picture, Japan might also be roped in.

The present proposals have a different orientation. We are asked to join in the scheme; if we do not, there is the possibility of further widening of the gulf between India and a number of Asian countries.

I am not for a moment suggesting that these considerations tilt the scale very heavily in favour of the decision. On the contrary, the pros and cons would need to be weighed very carefully. I would suggest, therefore, that simultaneously with writing to Shri Ramanand Rao, D.G., might also address a letter to Dr Patel.

29.4.1969

D.G.(A)

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D.O.No. DBOD.B.L. 1620/C.212–69 April 29, 1969

My dear I.G.,

I enclose a copy of a letter received from Shri Ramanand Rao about the proposed Asian–American Bank. State Bank of India are examining the proposal, but have enquired, in the meanwhile, whether the Government of India or the Reserve Bank would be agreeable to place a deposit of US $10 million with the proposed bank on a permanent basis. After consulting the Governor, we have advised Ramanand Rao that it would be possible to take a view on this matter only after the State Bank, as an institution, has made an assessment of the advantages it may derive from participating in the proposed scheme.

2. You will recall that at one stage both the Governor and you had felt that it might be worthwhile for the State Bank to have a branch in New York, partly as a matter of reciprocity and partly for its possible benefits to the country's export trade. Shri Dehejia, however, was of the view that the branch in New York would be so much of a losing proposition that the matter was not worth pursuing.

3. The present proposal, however, has certain aspects which are of interest to the Government as well as the Reserve Bank. The Bangkok Bank has sponsored this proposal as a means of furthering regional cooperation and our participation in it may materially influence the attitude of countries like Japan. From our own standpoint also, the implications of our keeping out of a scheme of regional cooperation have to be borne in mind. The present proposals have thus a different orientation. We have been invited to join in the scheme; if we do not respond, there is some risk of widening the gulf between India and some of the South-East Asian countries.

4. While we would like the above considerations to be given due weight, we would not suggest that they tilt the scale very heavily in favour of the decision. On the contrary, the pros and cons need to be weighed very carefully. The Governor has, therefore, asked me to bring this matter to your personal attention while simultaneously requesting Ramanand Rao to examine the proposition from his own angle.

Yours sincerely,
B.N. Adarkar

Dr I.G. Patel
Special Secretary
Ministry of Finance
Department of Economic Affairs
Government of India
New Delhi.

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D.O.No.F.15(20)–BO.III/72

Ministry of Finance
Department of Banking
'Jeevan Deep' Parliament Street
New Delhi
November 23, 1972

D.N. Ghosh
Jt. Secretary

Dear Dr Hazari,

Please refer to the correspondence resting with Shri Chakrapani's D.O. letter No. DBOD. B.D. 3015/C. 10 (A)–72 dated 15th June 1972, addressed to Shri Balasubramanian, regarding the opening of a representative office by the Bank of

India at Djakarta. In another similar case, we have received a D.O. letter No. DBOD. B.D. 4654/C. 353 (A)–72 dated 30th August 1972, from Shri Ambani, informing that the Reserve Bank have approved the proposal of the State Bank of India to open a branch at London—West End (United Kingdom).

2. The opening of a branch or a representative office by an Indian Bank in a foreign country has political overtones. Government will have to keep in view the mutual relations between India and the country concerned and also the future prospects. We would, therefore, suggest that whenever any application for any bank is received for opening a branch or a representative office in a foreign country, whether for the first time or not, a reference may be made to us; we would, in turn, consult the Ministry of External Affairs and Department of Economic Affairs and communicate the views of the government to the Reserve Bank. We would greatly appreciate if this is followed as a convention in future. This has the approval of the Finance Minister.

Yours sincerely,
D.N. Ghosh

Dr R.K. Hazari
Deputy Governor
Reserve Bank of India
Central Office
Bombay – 1

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Opening of Offices of Indian Banks in Foreign Countries

Ref: Shri D.N. Ghosh's D.O. letter No. F 15(20) BO. III/72 dated 23rd November 1972 and the Governor's remarks therein.

1. *United Kingdom*

A statement showing the particulars of offices of Indian banks functioning in UK indicating therein the dates of their opening as also of the licences/allotments pending with banks for opening offices, is attached. So far as State Bank of India is concerned, the approval of its Executive Committee was obtained by the bank for its proposed office at London—West End at the meeting held on 30th August 1972 and the minutes of the meeting were subsequently placed before the bank's Board at the meeting held on 14th November 1972.

2. *Indonesia*

In August 1967, a reference was received from Government of India calling for our comments on the suggestion made by the then Indian Ambassador in Indonesia, to open an office of Indian bank in Djakarta. As the proposal involved remittance of funds to the extent of US $1 million and as the State Bank of India, which was asked to examine the feasibility of opening an office in Indonesia by providing the requisite funds from its overseas branches, expressed its inability, Government of India was advised that it might not be worthwhile to pursue the matter.

Later during the discussion our Deputy Governor (Dr Hazari) had with Shri A.

Baksi, the then Secretary, Banking Department, in New Delhi on 14th February 1971 (when Shri V.M. Bhide and other officers of the Banking Department were also present) was given to understand that there was no objection from the Government's side to the Bank of India opening a branch in Djakarta.

Governor may like to see the note on pre-page. Re: The substansive point in Shri Ghosh's letter I would prefer that we have a discussion on the general future spread of Indian banks' branches abroad with External Affairs, Economic Affairs and Banking Deptt. rather than accept a procedure as suggested of consulting Government formally on each proposal. As Government would appreciate, the latter would be time consuming, ad hoc and in terms of perspective unsatisfactory.

DG (H)
7/12

Governor on return
11/12
Please see Governor's note dated the 29.12.72

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These papers below are of interest. Government, in the Department of Banking, have requested that we may consult them if there are any proposals for further opening of branches of Indian banks in foreign countries. It has been stated that in appropriate cases, the Ministry of External Affairs would have to be consulted.

D.G. (H) and I agreed that it would be best to have such discussions in advance, in principle, regarding the countries in which it would be advantageous to have the opening of further branches.

I had discussions with Shri N.C. Sen Gupta on this basis. I believe I mentioned to him our ideas that it would be advantageous to have branches opened: (1) in Germany, with whom we have such a volume of trade and (2) in France (having regard to the fact that the French have a bank in India and could be expected to reciprocate). In addition to the branches that we expect to open in West Asia (including the 'Gulf'), it would be perhaps advantageous to have one further bank (State Bank) to open a branch in Tokyo and that it would be highly desirable to have a branch or branches opened in Indonesia as soon as we are permitted. The existing branch in Thailand will have to be reconstructed. The question of opening branches in Africa will have to be separately considered. (I wonder if D.G. (H) would care to give me a draft letter or write himself to Secretary, Banking covering the above ideas with such modification or expansion as may be called for.)

S. Jagannathan
29.12.1972

D.G. (H)
02.01.1973

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Summary record of the discussions at the Deputy Governor's (Dr R.K. Hazari) meeting with the Chairman of certain selected commercial banks held at the Reserve Bank of India at 4 p.m. on 18th April 1974 regarding opening of offices in foreign countries.

The question of opening branches by Indian banks abroad in the context of growing international trade emanating from India and other relevant factors has been engaging the attention of the Reserve Bank of India for some time. So far, individual banks have been opening offices abroad after making their own individual assessment of business potential at various centres. Recently, the need was felt for making a concerted effort to determine the needs and priorities and explore the possibilities of rapid expansion of Indian banks in foreign countries in a planned and coordinated manner so as to derive the optimum benefit for the country from such expansion. As a first step in this direction, a meeting of the Chairman of certain selected commercial banks was convened by the Reserve Bank of India on 18th April 1974, for the purpose of considering the various issues involved in the functioning as well as opening of new offices in foreign countries. Deputy Governor, Dr R.K. Hazari, presided over the meeting. The names of the representatives who participated in the meeting are furnished in Annexure I.

2. At the outset, the Deputy Governor stressed the urgent need for expansion of Indian commercial banks in foreign countries and invited the bankers to set out the various handicaps and constraints they were experiencing or were likely to experience in opening offices, the types of business that could be handled by them as also the areas which could be profitably covered within a period of next two to three years. He explained that the main objectives of expansion of Indian banks abroad should be the earning of foreign exchange and expansion of their sphere of activities and influence so as to prove to be a catalyst for growth of Indian trade and business. They could also play a crucial role in helping to promote and setting up of joint ventures and financing investment of Indian industries which are operating either singly or jointly with foreign industrial concerns in foreign countries. The representative of the Government of India (Shri D.N. Ghosh) explained that Government expected banks to go in a big way in some of the foreign countries, particularly the West Asian region, and assured the bankers of full support in their efforts in this regard from the Government. Thereafter, there was a detailed discussion on the various issues raised by the bankers. The points that emerged out of the discussions are enumerated below:-

(i) Some of the bankers expressed that the present restriction while permitting banks to open offices outside India, that no overdraft arrangements would be allowed from Head Office, needed modification. According to them, since the volume of business at the overseas branches was increasing considerably, these offices did experience difficulty, at times, in finding resources for financing of their business out of lines of credit obtained from foreign banks, and therefore standby country-wise/centre-wise arrangements from the Head Office would be necessary. It was agreed that the feasibility of the above proposal would be considered by the Exchange Control Department of the Reserve Bank.

(ii) In countries where the laws of the Government are not in favour of foreign banks opening branches or where business considerations so required, it may be necessary to register the presence of Indian banks by capital participation either with local banks or with other foreign banks already operating there. This would entail clearance of the principal of financial participation and remittance of funds. The extent to which such remittance would be allowed by Government would have to be made clear, if any dialogue had to be started by the concerned banks for such joint participation. In cases where full-fledged branches are to be established, apart from remittances towards capital for meeting statutory requirements, it would be necessary to remit funds towards initial expenses for setting up of the branch as also for meeting the working capital needs till such time as the branch becomes viable, which may extend to say a period of three to five years. It would be helpful if Government could lay down broad guidelines in this regard.

(iii) It was also represented that there should not be any objection to Indian banks' branches abroad dealing with nationals of other countries, irrespective of our relationship with those countries.

(iv) By virtue of the powers vested in it, the Enforcement Directorate calls for information in respect of banks' constituents abroad also. Apart from the fact that it is not clear whether the banks would get protection against any action taken by the parties concerned, particularly when such protection is not available under the laws of the relative countries, this has the effect, to some extent, of inhibiting the growth of business of Indian offices abroad. It was mentioned that while it was not the intention of banks to shield parties who might be guilty of violation of law, it would be necessary for the Government to amend the law in such a way as to ensure that it did not inhibit growth of business.

It was agreed that the issues raised in items (ii), (iii) and (iv) above would be examined by the Government.

3. It was represented that, at present, there was no incentive for non-residents to keep their funds with banks in India in the form of either foreign exchange or Indian rupees, and that apart from the fact that a number of formalities had to be gone through for repatriation of such funds, there was likelihood of an adverse effect on the investment itself on account of variations in the rates of exchange at the time of repatriation. The bankers, therefore, stressed the need for permitting banks to maintain foreign currency accounts in India. It was mentioned that if such permission were granted, the parties would be protected from any loss on account of fluctuations in rates of exchange and the country would have substantial

foreign exchange which could be used for its benefit. Banks assured that the utilization of such funds in India would be only for such projects as were approved by the Government. It was also represented that the Exchange Control Department should be less restrictive in so far as maintenance of foreign currency position is concerned, and that they should be permitted to maintain suitably longer positions. It was decided that the Exchange Control Department of the Reserve Bank of India should examine the above issues in detail.

4. Thereafter, the discussions centred around allocations among banks. The countries/centres considered for opening of offices are listed in Annexure II. Deputy Governor indicated that, while selecting centres for opening offices abroad, due considerations should be given to the magnitude of the existing as well as potential trade of the country in general, and with India in particular, the interest of the population of Indian origin that is likely to be served, the commercial viability of the proposal in relation to the environment of international money markets and the remittances that will be involved on account of capital and working expenses. He mentioned that it would be necessary to fix priorities while selecting countries/centres for opening offices, having regard to the present magnitude of trade and payment transactions, financing of investment of Indian industries which are operating either on their own or jointly with foreign industrial concerns in foreign countries, and the need to build up an efficient structural base in the world's financial centres for operations in the international money markets and multi-currency transactions. In this context, it was considered necessary to give priority to opening offices in the West Asian region. This region is in a buoyant state of economic and financial growth with large foreign currency surpluses on account of hike in oil prices. The countries in the region have ambitious plans for development and there is a high potential absorbing capital goods, consumer goods and technical know-how. Against this background, Indian banks have an important role to play in not only furthering India's exports to these countries but also in developing closer economic relations with them. It should also be possible for Indian banks to employ the surplus resources available at these centres gainfully through their other offices abroad. Priority may also have to be given for opening offices in the international financial centres which will enable the banks to operate in the financial markets, and will also serve as a reservoir of funds for its other branches. It was also made clear that reciprocity had been accepted by Government of India in principle and that banks would have to be guided not only by profitability but also by the broader aspect of the prospects of generating trade, setting up of industries, etc. Having regard to the above factors, it was decided that UK, particularly London, should be kept open for entry by Indian banks, each application being decided on merits. Tentative decisions taken in regard to allotment of other countries or centres are given below:-

Name of country (1)	Name of centre (2)	Name of allottee bank (3)	Remarks (4)
1. USA	San Francisco	Bank of India	1. The bank's request for a possible extension at Los Angeles will be sympathetically considered. 2. The claims of other banks for centres in USA will be kept in mind.
2. Canada	Toronto/ Vancouver	State Bank of India	To try for a Representative Office.
3. Panama	Panama	Bank of Baroda	The bank will conduct a survey of the area.
4. Jamaica	–	Syndicate Bank	The proposal should be given low priority and a survey should be conducted by the bank for prospecting for a future date.
5. Suriname	Paramaribo	Bank of Baroda	–
6. UK	London	Syndicate Bank Punjab National Bank	Being their first entry abroad, it would be advantageous for them to establish offices first in London.
	Channel Islands	Bank of India	The bank has proposed to consider opening office in the place after sufficient potential has developed.
7. Netherlands Luxembourg Belgium	Amsterdam Luxembourg Brussels/ Antwerp	Bank of Baroda	As the bank was not sure at which of these places it would be in a position to obtain permission of the authorities of the countries concerned, it was decided to give the bank time up to six months to finalize the position and approach Reserve Bank in the matter. The question of allotting the remaining centres to any other bank/s will be considered thereafter.
8. Italy	Milan	Punjab National Bank	The bank has to conduct a survey to assess the potentialities.
9. USSR	Moscow	State Bank of India	The bank will consider the feasibility of shifting one of its existing Representative Offices at Frankfurt to Moscow.
10. Countries in West Africa	–	–	Bank of India has been asked to scout the region to ascertain the potentialities.
11. Lebanon	Beirut	State Bank of India	The bank has been asked to explore the possibility of establishing a full-fledged office in the form of joint participation subsidiary, etc.

12. Iran	Tehran	–	State Bank's report to be studied. Action will be taken shortly.
13. Kuwait	Kuwait	Bank of India	The bank will have to conduct a survey and explore the possibility of registering its presence in the country. The bank will also consider the prospects of having exclusively merchant banking in the area.
14. Bahrein	Manama	-do-	-do-
15. Oman	Muscat	Bank of Baroda	The bank has been given time for six months to obtain clearance of the authorities of the country so as to establish an office at the centre pursuant to the licence already granted to it. The interest of State Bank of India in opening an office at the centre will be kept in view.
16. Qatar	Doha	Bank of Baroda	The bank has also suggested another centre in the Persian Gulf area viz., Sarjan and it will be carrying out necessary survey for the purpose.
17. Bangladesh	Dacca	State Bank of India	–
18. Indonesia	Djakarta	Bank of India	The bank will explore the possibility of establishing a local bank with equity participation. Other Indian banks who may be interested will also be considered for participation.
19. Philippiness	Manila	State Bank of India	The bank will prospect the area to consider the feasibility of establishing an office. Any other Indian bank operating in the region may be associated in the proposal.
20. Australia	Sydney	Bank of Baroda	The bank will explore the region for considering the feasibility of opening an office at the centre.
21. Laos	Vientiane	Bharat Overseas Bank Ltd.	The prospects of opening an office at the centre may be considered at a later stage.
22. Papua & New Guinea	Pt. Moresby	Bank of India	The feasibility of opening an office at the centre will be considered at a later stage.

It was decided that the question of considering the remaining countries/centres shown in Annexure II may be deferred for the present.

Finally, the Deputy Governor impressed upon the bankers the need to take early measures for establishing/exploring the possibilities of opening offices in the countries/centres allotted to them.

He also stressed the importance of the role that our foreign branches have to play in the promotion of exports from India and exhorted the banks to make out all efforts in this direction. He suggested that among other things, banks may consider while extending credit facilities at their foreign branches the feasibility of linking credit to imports from and exports to India.

Annexure I

Names of persons who participated in the meeting held on 18th April 1974 in connection with opening of offices abroad by Indian banks and presided over by Deputy Governor (Dr R.K. Hazari).

Reserve Bank of India	
1. Dr K.S. Krishnaswamy	Executive Director
2. Shri M.L. Gogtay	Chief Officer, Department of Banking Operations and Development
3. Shri C.L. Thareja	Controller, Exchange Control Department.
4. Shri P.N. Khanna	Joint Chief Officer, Department of Banking Operations and Development
5. Shri A.K. Bhuchar	Joint Chief Officer, Department of Banking Operations and Development
6. Kum. N. Ambegaokar	Director, Division of Trade, Economic Department
7. Shri S.H. Khan	Manager, Exports, Industrial Development Bank of India
Government of India	
1. Shri D.N. Ghosh	Joint Secretary, Department of Banking
Banks	
1. Shri R.K. Talwar	Chairman, State Bank of India
2. Shri P.L. Tandon	Chairman, Punjab National Bank
3. Shri J.N. Saxena	Chairman, Bank of India
4. Shri V.D. Thakkar	Chairman, Bank of Baroda
5. Shri V.R. Desai	Chairman, United Commercial Bank
6. Shri A.M. Kadhiresan	Chairman, Indian Overseas Bank
7. Shri G. Lakshminarayanan	Chairman, Indian Bank
8. Shri P.V. Seshagiri	Chairman, Bharat Overseas Bank Ltd
9. Shri Miles Francis	Manager, Foreign Exchange, Syndicate Bank

Annexure II

Countries/Centres suggested for consideration at the meeting for opening offices of Indian banks.

Region	Country	Centre
A. *North America*	1. USA	i) New York
		ii) San Francisco
		iii) Chicago
		iv) Los Angeles
		v) Miami
	2. Canada	Toronto/Vancouver
B. *Central American Countries*	1. Panama	Panama
	2. Trinidad & Tobago	Port of Spain
	3. Jamaica	–
C *South America*	1. Brazil	Rio de Janeiro/São Paulo
	2. Argentina	Buenos Aires
	3. Guyana	–
	4. Venezuela	–
	5. Surinam	Paramaribo
D. *UK*	1. UK	London and other places
	2. Channel Islands	–
E. *Western Europe*	1. France	Paris
	2. West Germany	i) Frankfurt
		ii) Hamburg
	3. Netherlands	Amsterdam
	4. Italy	Milan
	5. Luxembourg	Luxembourg
	6. Belgium	i) Brussels
		ii) Antwerp
	7. Switzerland	Zurich
F. *East European Countries*	1. Austria	Vienna
	2. Czechoslovakia	Prague
	3. USSR	Moscow
G. *Africa, etc.*	1. Nigeria	Lagos
	2. Ghana	Accra
	3. Sudan	Khartoum
	4. Ethiopia	Adis Ababa
	5. Zambia	–
	6. Gambia	Bathhurst
	7. Sierra/Leone	Free Town
	8. Liberia	Monrovia
	9. Canary Islands	Las Palmas/Tenerife
	10. Mauritius	Port Louis
H. *West Asia*	1. Lebanon	Beirut
	2. Kuwait	Kuwait
	3. South Yemen	Aden
	4. Yemen Arab Republic	–

	5. Abu Dhabi	Abu Dhabi
	6. Oman	Muscat
	7. Bahrain	–
	8. Saudi Arabia	Riyadh
	9. Iran	Tehran
	10. Iraq	Baghdad
	11. Afghanistan	Kabul
	12. Qatar	Doha
I. *East and Far East*	1. Bangladesh	i) Dacca
		ii) Chittagong
	2. Indonesia	Djakarta
	3. Philippines	Manila
	4. Hongkong	Hongkong
	5. Japan	i) Tokyo
		ii) Nagasaki
		iii) Osaka
		iv) Kobe
	6. Australia	Sydney
	7. Singapore	Singapore
	8. Fiji Islands	Raki Raki
	9. Papua and New Guinea	Pt. Moresby

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D.O.No. DGH/2–360 May 17, 1974

Dear Shri Sen Gupta,

Thank you for your D.O. letter No. 25(5)/73-BO. III dated 13 May 1974. I note that you are convening a meeting at 11 a.m. on May 25 to discuss the question of opening of offices of Indian commercial banks abroad. I am requesting Shri A.K. Bhuchar to make it convenient to attend the meeting on behalf of Department of Banking Operations and Development. Shri Shiralkar is writing to you separately.

2. I do think that on balance it would be worthwhile from the country's point of view to allow banks which do not have branches abroad just now to open such branches and for this purpose to carry out surveys, where necessary, for the following reasons:

(i) Unless a bank undertakes such activity it is never likely to have the necessary competence.

(ii) A branch in UK, particularly in London, is a necessary first step towards entry in the field of international finance.

(iii) Getting of a licence or its equivalent from a foreign monetary authority depends not so much upon a bank having or not having a foreign branch already, but upon its credit standing, size and management.

(iv) Each bank has a certain ethnic image and I am sure you would agree that

Punjab National Bank and Syndicate Bank do have close ethnic affiliations with certain sections of the Indian community. In view of these reasons, I feel that Punjab National Bank and Syndicate Bank should be encouraged to have foreign branches, each starting with a branch in London.

3. As you might be aware, the major issues involved in adopting a strategy for Indian banks' branches abroad relate to remittance of foreign exchange and permission, where required, for capital participation on majority or minority basis in existing banks or in new banking ventures including merchant banks. I hope that your meeting on the 25th would come to a decision on these matters.

With kind regards,

Yours sincerely,
R.K. Hazari

Shri N.C. Sen Gupta
Secretary to the Government of India
Ministry of Finance
Department of Banking
'Jeevan Deep'
Parliament Street
New Delhi

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D.O.No.25(22)–BO.III/74
Secretary

Ministry of Finance
Department of Banking
'Jeevan Deep' Parliament Street
New Delhi
December 10, 1974

My dear Jagannathan,

As regards opening of foreign branches of Indian banks, FM has minuted as follows:-

> In the matter of opening branches in foreign countries, we should be generally guided by the RBI, who should have the expertise with them to advise Government in this matter. Let me discuss this with the Governor of the Reserve Bank before we take a final decision. The Governor may be requested to come prepared and speak to me when he comes to Delhi next.

It will be appreciated if you will kindly keep us informed about your next visit to Delhi so that the matter can be examined by FM.

Yours sincerely
N.C. Sen Gupta

Shri S. Jagannathan
Governor
Reserve Bank of India
Central Office
Bombay – 1

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D.O.No.G/8/DBOD/33 April 21, 1975

My dear Sen Gupta,

Please refer to your letter No. 25 (22)-BO.III/74 dated 10th December 1974 regarding the opening of foreign branches of Indian banks in London. As you are aware, it has been possible to discuss this matter in FM's room when all Secretaries of the Ministry of Finance were present.

2. In amplification of what he has already recorded in the minute which has been reproduced in your letter, FM has indicated, as you will recall, that it will be desirable for Government as a normal rule to accept and act on the considered recommendations of the Reserve Bank of India, that as part of this approach, any facts or information which any Government department may have and any suggestions from Government departments, may be passed on to the Reserve Bank, so that they may be taken into consideration, before the Bank's views are finalized. FM's decision/approval will be sought wherever necessary. I think this arrangement will be quite satisfactory.

3. The above two paragraphs are only by way of preliminary remarks. As you are aware, this whole question of bank branches abroad was considered in a systematic way during 1974, first at a meeting of the RBI with the principal banks and as a second step, at a meeting within the Government, convened by the Department of Banking and attended by representatives of the Ministry of External Affairs, of the Reserve Bank, etc. The principles of the approach have been duly settled. We are now concerned only with certain particular cases.

4. As far as the United Kingdom is concerned, it has been our view, as was recorded after the RBI meeting that it should be free and open to any Indian bank which finds it convenient and possible to open a branch within that country. As the question of reciprocity does not arise in the case of the United Kingdom, entry into the UK being free (so far as the British authorities and their regulations are concerned), the only questions which we have to consider are whether it will be in the interests of our own banks to open any new branches in London or elsewhere in the UK.

5. I am enclosing herewith for your information two statements showing the growth in the deposits of the Indian commercial banks in the United Kingdom and the profits remitted to India by the Indian banks from the UK. (The figures are for the years inclusive of 1973. By all accounts, 1974 has been a better year than ever before, for Indian banks' operations abroad.) It will be noticed that the growth in deposits and the profits which have been remitted to India in recent years has been quite substantial. (So far as the State Bank of India is concerned, the increase in profits is, if anything, understated, as that bank has recently made some arrangements for remitting portion of the profits to India in the form of head office expenses, for supervision of the branches in the UK, and the effect of this arrangement is not reflected in the profits, which have been remitted in the past.)

6. London is a growing financial centre and is the most natural and convenient

place for the turnover of funds in various currencies in the Euro-market. In view of the investment of a substantial portion of oil funds in the Euro-market or local in sterling deposits in London, the volume of banking business in London has considerably increased in the last two years or so, and the opportunities for banks to open branches and to run them profitably have also been increased correspondingly.

7. Apart from the above, the London branch of an Indian bank generally caters not only to the requirements of its own constituents in London or within the UK, but also to the needs of the other foreign branches of the Indian banks where there are any. With a branch in London, an Indian bank will be able to utilize the wide range of facilities available in London and get their personnel trained in foreign exchange. The transaction of foreign exchange business through a correspondent will not be an adequate substitute for the opening of a bank's own branch in London. In fact, there will be a saving in the commission, which is now payable to the foreign correspondents, which may be equal to or even greater than the cost of running a London branch. We should, therefore, encourage Indian banks to establish a few more offices in London before the position for some reason, which cannot now be anticipated, becomes difficult.

8. There seems to be no reason from our own experience so far, or on other grounds, to expect that the opening of a few more branches as suggested, will result in a reduction of the deposits or profits of our banks, which are already represented in London or have opened branches elsewhere within the UK. (As conveyed indirectly above, the public sector banks which do not have, as yet, branches in the UK necessarily pay commissions on their foreign transactions, to *foreign* corresponding banks in the UK, and this can be saved when the bank has its own branch in London.)

9. So far as the Reserve Bank of India is concerned, the opening of a few more branches of Indian banks in London may be useful, as we now find it necessary, from time to time, to put out funds in the Euro-market through our banks and it will be desirable if we can deal with a larger number of Indian banks for this purpose, with a view to avoiding a concentration of funds in any one bank. As the possibility that our shipping companies and perhaps at a later stage, a few other concerns may have to borrow larger amounts in the Euro-market, cannot be ruled out, the opening of a larger number of branches of Indian banks within the UK will also facilitate such borrowing, if necessary on competitive terms.

10. It was against this background and after specific consideration that we supported the case of two particular banks.

11. In the circumstances indicated, I suggest that we may permit both the Punjab National Bank and the Syndicate Bank, which have already applied to us, to proceed further with the arrangements for the opening of their London branches. The preliminary expenses in the case of these two banks will be of the order of £31,000 and £30,000 respectively. (The figures of profits actually remitted each year by Indian banks already operating in the UK will show that these non-recurring amounts required as preliminary expenses are quite small, in relation to the benefits expected year after year.)

While the relatively small sums required as preliminary expenses may be sanctioned immediately, the question of granting them permission to remit up to £200,000 in each case towards working capital requirements may be considered after the banks have examined the matter further, have made more precise estimates of the amounts which may be required, and have made these available to us for scrutiny. I would mention that these proposals regarding the United Kingdom will, in no way, interfere with or be allowed to affect our efforts to open banks/branches in the Middle East/West Asia, in countries such as Iran, Lebanon (where there are legal restrictions) or in other countries. Also, in view of the very large amounts in foreign currency that we are already asking our public sector banks to hold abroad on our behalf (see reference to this in para 9), it should be possible to find any small sums required to get the new branches going, without making any real dent on our reserves.

12. I shall be glad if you could kindly confirm that in the light of what I have said we may now grant licences to these two banks to open their London offices.

Yours sincerely,
S. JAGANNATHAN

Shri N.C. Sen Gupta
Secretary
Government of India
Ministry of Finance
Department of Banking
New Delhi

Profits of Indian Banks in UK

(in Rs lakhs)

	1970	1971	1972	1973
Bank of India	17.26	9.75	20.00	46.63
	(1.86)	(1.38)	(2.21)	(2.59)
Bank of Baroda	8.44	15.54	12.23	18.17
	(0.64)	(0.74)	(0.85)	(0.98)
UCO Bank	–1.12	2.40	3.42	11.76
State Bank of India	8.09	8.51	15.49	31.59
Central Bank	–5.12	–5.82	–28.61	–10.72
				About Rs 1 crore

Deposit Growth of Indian Commercial Banks in the UK

(in Rs crores)

1969	–	62.46
1970	–	73.76
1971	–	76.77
1972	–	105.05
1973	–	111.43
Sept. 1974	–	121.58

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D.O.No.26(4)–B.O.III/78
Baldev Singh
Joint Secretary

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
(BANKING DIVISION)
'JEEVAN DEEP', PARLIAMENT STREET
NEW DELHI - 1
2.2.1978

Dear Dr Patel,

Under the Banking Regulation Act, 1949, grant or refusal of a licence for banking business for a bank, including a foreign bank, is a function exclusively assigned to the Reserve Bank of India. A convention has, however, developed over the years for the Reserve Bank to consult the Ministry of Finance and for the Ministry of Finance to consult the Ministry of External Affairs before any decision is taken either to give or to refuse a licence to a foreign bank for conduct of banking business, mainly due to the political angle involved in such a decision. Of late, both the Government and the Reserve Bank have received a number of requests from the foreign banks operating in India for expansion of their branch network in India and from other foreign banks for their entry into India. Some canvassing by the banks concerned in support of their applications has also been noticed.

2. There is already a Committee existing for consideration of proposals by Indian Banks wanting to open branches abroad. This Committee consists of Secretary (Economic Affairs), Additional Secretary (Banking), a representative of the Reserve Bank (usually Deputy Governor) and a representative (Secretary or other senior officer) of the Ministry of External Affairs. It is our view that applications received from foreign banks for establishing representative offices or branches in India may be placed for consideration before the same Committee. If you agree, the applications received so far will be placed before the next meeting of the Committee.

With regards,

Yours sincerely,
BALDEV SINGH

Dr I.G. Patel
Governor
Reserve Bank of India
Bombay

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Section 23 of the Banking Regulation Act, 1949
D.O. letter No. 26(4)–B.O. III/78

GOVERNMENT OF INDIA
2nd February 1978

In the D.O. letter under reference, it has been stated that it is the Government's view that applications received from foreign banks either for their entry into our country or for expansion of their existing branch network in our country, may be placed for consideration before the Committee already set up by it for considering applications received from Indian banks for opening branches abroad. This Committee consists of Secretary (Economic Affairs), Additional Secretary (Banking), representative of the Reserve Bank of India (usually Deputy Governor) and a representative (Secretary or other senior officer) of the Ministry of External Affairs.

2. By virtue of the provisions of sections 22 and 23 of the Banking Regulation Act, 1949, the authority for granting permission to a foreign banking company to establish itself in India or to expand its existing branch network in India or to an Indian banking company to open offices in or outside India vests in the Reserve Bank of India. The Bank is required by law to satisfy itself on certain aspects in this regard before granting the necessary permission. In view of the political implications involved in cases of applications of Indian banks for opening branches abroad and of foreign banks for entry into India or expansion of their branch network in India, we were, in the past, consulting Government before granting such permission by making formal references to them. These formal references used to set out the merits and demerits of the proposals involved and in the light of the views received from Government, the Reserve Bank of India used to take decisions for allowing or disallowing a proposal. In the case of applications of Indian banks for opening offices abroad, it is the Committee of the Central Board of Directors of the Reserve Bank of India which takes the decision.

3. Till April 1974, banks were opening offices abroad after making their own individual assessment of business potential at various centres, after obtaining our permission. In April 1974, the need was felt for making a concerted effort to determine the priorities and explore the possibilities of rapid expansion of individual Indian banks in various countries in a planned and coordinated manner so as to derive the optimum benefit for the country from such expansion. As a first step in this direction, a meeting of the Chairmen of certain selected commercial banks was convened by us on 18th April 1974 for the purpose of considering the various issues involved in the functioning as well as opening of new offices in various countries. At this meeting, a representative of the Government of India was also present. After a detailed discussion on the various issues raised by the bankers, certain tentative decisions were taken in regard to the allotment of countries to various banks. It was decided that in opening branches abroad, banks should be guided not only by profitability but also by the broader aspect of the prospects of generating trade, setting up of joint ventures, etc. The Reserve Bank of India accordingly wrote to the allottee banks to initiate action on the decisions taken at the said meeting.

4. Soon after the above meeting, the Department of Banking convened another meeting at which practically the same issues, which were considered at the meeting convened by Reserve Bank of India, were gone into. At this meeting, a question was raised as to whether it was advisable for banks like Punjab National Bank and Syndicate Bank which had no branches abroad, to consider having branches abroad. It may be relevant to mention that at the meeting convened by the Reserve Bank of India, these banks were considered for expansion abroad. After some discussion, it was decided at that meeting that there was no particular harm in asking these two banks to formulate concrete proposals for consideration of the Reserve Bank of

India and the Economic Affairs Department. After this meeting, the Secretary, Department of Banking issued letters to Chairmen of State Bank of India, Bank of India and Bank of Baroda advising them to send reports periodically to Government of the progress made in undertaking surveys of the places, etc. allotted to them in the meeting convened by the Reserve Bank. The Secretary also stated that he would be holding periodical meetings of the concerned banks to review the progress made in undertaking surveys, opening of new foreign branches, etc., a field which by statute falls within the jurisdiction of Reserve Bank of India. The purport of this letter was not clear to us.

5. The Punjab National Bank and Syndicate Bank, in accordance with the tentative decisions taken at the meeting held by the Reserve Bank of India in April 1974, after survey, submitted to us applications for opening a branch each in London. The Reserve Bank of India supported these applications. When these proposals were put up to the then Finance Minister by Government, he commented as follows: (Vide Government's letter dated 10.12.1974)

> In the matter of opening branches in foreign countries we should be generally guided by the Reserve Bank of India, who should have the expertise with them to advise Government in this matter. Let me discuss this with the Governor of the Reserve Bank before we take a final decision. Governor may be requested to come prepared to speak to me when he comes to Delhi next.

Subsequently, the Governor met the Finance Minister. Following the discussion with the then Finance Minister, the Governor wrote on 21st April 1975 to the Secretary (Banking) as under:

> In amplification of what he has already recorded in the minute which has been reproduced in your letter, Finance Minister has indicated as you will recall, that it will be desirable for Government as a normal rule to accept and act on the considered recommendations of the Reserve Bank of India, that as part of this approach, any facts or information which any Government department may have and any suggestions from Government departments, may be passed on to the Reserve Bank, so that they may be taken into consideration, before the Bank's views are finalized. Finance Minister's decision/approval will be sought wherever necessary. I think this arrangement will be quite satisfactory.

6. Notwithstanding the above, in August 1975, the Banking Department, without even consulting the Reserve Bank of India, advised all the public sector banks that applications for opening branches abroad, which were, till then, being considered by the Reserve Bank of India, were to be considered by a Committee and that, therefore, all applications for opening branches abroad were required to be submitted to Government directly, and only a copy was to be sent to the Reserve Bank of India. This naturally had the effect of eroding the authority of the Reserve Bank of India. Since then, these proposals are being considered by the above Committee. The former Department of Banking (now Banking Division of Department of Economic Affairs) has been providing secretarial service to the committee, and has also been advising

the banks *directly* of the decisions taken by the Committee. The formal licences are issued thereafter by the Reserve Bank of India.

7. The sequence of events as stated above has already had the effect of lowering the image of the Reserve Bank in the eyes of the banks. A note was recorded in the DBOD on 12th September 1975 expressing unhappiness over the above decision of the Government. In view, however, of the then prevailing circumstances, the Reserve Bank of India did not pursue the matter with the then Government.

8. The present suggestion of the Government, viz., that the above Committee would also consider applications of foreign banks either for their entry into our country or for their expansion of their existing branch network in our country, would indirectly have the effect of further eroding the powers of the Reserve Bank and also, in our view, would lower its image.

9. Another aspect which needs consideration is that under the law, it is the Reserve Bank of India which has been granted the power to grant permission in these cases. In taking a decision, the Reserve Bank can take into account the views of others, viz., Government and this is why in the earlier years, it was consulting Government mainly because of the political implications, involved as Government may have in its possession material which it could pass on to Reserve Bank of India. But by the present procedure, which was unilaterally decided by Government, it has executively abrogated powers which are lawfully vested in the Reserve Bank of India.

10. Yet another aspect is the need for keeping the records straight of both Government and Reserve Bank of India so that at a future date, one will be able to correctly interpret the circumstances and factors taken into account while taking a particular decision. The absence of formal communications between the Reserve Bank and the Government wherein the grounds on which a particular view is supported or otherwise are clearly spelt out in the notes or letters exchanged, may lead to possible suspicion or view that the decisions were taken arbitrarily. Whenever Reserve Bank of India consults the Ministry of Finance on any application received by it, it would be open to the Ministry to have the views of the Ministry of External Affairs or any other Ministry before communicating their views to the Reserve Bank of India. Any facts or information which any Government Department may have or any suggestion from Government could also be passed on to the Reserve Bank so that it may take them into consideration before finalizing its view.

11. In view of the foregoing, we are not in favour of the Committee considering such applications of foreign banks for opening offices in our country. It is also our view that applications of Indian banks for opening branches abroad should be considered by the Reserve Bank of India and the position that obtained prior to August 1975 should be restored, so that the autonomy of the Reserve Bank of India is preserved.

12. If Governor approves, we may send a copy of this note to Government as in the draft forwarding letter below.

P. Venkateswaran
24.02.1978

(In my view, this is a matter on which the present position is quite unsatisfactory. Every time we put up a memorandum to the Board regarding opening of foreign branches by Indian banks, we are merely asking the Central Board to endorse a Government decision. This is not right for either the RBI or the Government. Since under the statute, RBI is the authority to grant the licences, the processes should in both form and substance, conform to the statutory provisions. Hence, we shall take up the matter with Government and set right the machinery. To do so does not clearly imply any reduction in RBI having to consult with, and generally respect the views of Government.)

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D.O.No.25(6)–BO.III/78
Baldev Singh
Joint Secretary

Ministry of Finance
Department of Economic Affairs
(Banking Division)
'Jeevan Deep' Parliament Street
New Delhi - 1
31.3.1978

Dear Dr Krishnaswamy,

Kindly refer to Dr Manmohan Singh's D.O. letter No. 1795-SEA/78 dated the 28th March 1978 regarding the next meeting of the Inter-Departmental Committee to consider the proposals submitted by various public sector banks for opening of branches, etc. abroad. This is to clarify that the agenda for the above meeting will be confined only to proposals of Indian banks for opening branches/representative offices abroad. A revised list of agenda items is enclosed in supersession of the earlier list of items enclosed with the Economic Secretary's letter.

With regards,

Yours sincerely,
Baldev Singh

Dr K.S. Krishnaswamy
Deputy Governor
Reserve Bank of India
Central Office
Bombay

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D.O.DBOD.No.BL.930/C553(A)–79 February 7, 1979

My dear Manmohan,

You will recall that last week we had discussed with the Dy. Prime Minister and Finance Minister the policy with regard to foreign banks opening branches in India. It was confirmed that we continue to adopt a restrictive policy in allowing foreign banks to open branches in India, and within this restrictive policy, we aim at diversifying the presence of the international banking community in India, and not enlarging that part of the international banking community which is already represented in the country. Accordingly, the UK and the USA banks will not be encouraged to enlarge their presence in India and we would prefer opening of new branches in India by banks from countries not already represented in India but where Indian banks have branches. The principle of reciprocity will be a major consideration in dealing with these cases, although it would not be desirable to try and quantify how exactly 'reciprocity' is to be defined. This will naturally vary from region to region.

2. Although the question of foreign banks opening representative offices in India was not discussed, we may take a fairly liberal view making it absolutely clear to the banks concerned that our agreeing to the opening of the representative office does not, in any way, confer a claim or privilege for setting up a branch office later.

3. With regard to Indian banks opening offices abroad, it is our opinion that not every bank need go abroad, but only the bigger ones which have developed the necessary expertise need be permitted to go. Wherever feasible, we should encourage joint efforts by a few nationalized banks rather than encourage them to compete with each other for the sake of so-called 'prestige'. This approach implies that instead of taking ad hoc decisions in responses to pressure or persuasion from individual banks, we should prepare a perspective plan for the next few years for Indian banks opening branches abroad. It is in this light that we had invited proposals from selected nationalized banks and had planned to call a meeting of these banks to discuss the matter within the broad framework of the policy outlined above. However, as you have convened the Inter-Departmental Committee meeting on the 8th instant, I have deputed Shri Bhuchar to attend the same (in the absence of Dr Krishnaswamy) with the instruction that if the consideration of some of the doubtful cases cannot be deferred, he should take, on behalf of the RBI, the stand that may be consistent with the general approach I have outlined above. The private sector banks need not be allowed to open branches outside the country, at least for the present.

4. I would be grateful if you could let me know whether the general approach in this letter is also acceptable to the Ministry of Finance so that we may not act at cross purposes—and, what is more important, do not encourage our own banks to play us one against the other. Between the Ministry of Finance and the RBI there should, in fact, be informal discussion and agreement on individual cases before we discuss them at a general meeting, as otherwise the danger I apprehend would be difficult to avoid. That is why we had earlier suggested a reconsideration of the present procedure which, to say the least, puts the RBI in an awkward position; and I hope that it would be still possible for us to evolve something better than the present procedure which puts us more in the role of, at best, a public prosecutor rather than at least a member of the judiciary.

With best regards,

Yours sincerely,
I.G. Patel

Dr Manmohan Singh
Secretary, Ministry of Finance
Department of Economic Affairs
Government of India, New Delhi

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D.O.No.1011–SEA/79

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
February 15, 1979

Dear Dr Patel,

Kindly refer to your D.O.No. DBOD No. BL.930/C 553(A)-79 dated 7th February 1979. We are in full agreement with you concerning the policy with regard to foreign banks opening branches in India. With regard to the Indian banks opening offices abroad, we were awaiting the results of the meeting which RBI had proposed of the nationalized banks to discuss the matter. Meanwhile, however, we were informed by the Chief Officer, DBOD, that since a large number of applications for opening offices abroad were pending, it might be worthwhile convening a meeting of the inter-departmental committee. It was in the light of the suggestion which was made by him at Poona that we took the decision to call a meeting without awaiting the results of the discussion which RBI was proposing to have with the nationalized banks.

2. There is, of course, no question of the general policy approach outlined by you not being accepted by us, and if you wish that the existing procedures for the clearing of the proposals of Indian banks for opening offices abroad needs to be changed, we could certainly do so. The fact of the matter is that, as you know, our proposals require consultation with the Ministry of External Affairs; also the bank concerned has to apply for permission to remit funds abroad. We ourselves in the Department of Economic Affairs may have views about the desirability or otherwise of individual nationalized banks deploying their resources in opening of offices abroad. It was in the light of these considerations that, in the past, an inter-departmental committee was set up for expeditious clearing of proposals, and it is a matter of record that RBI's advice has been a major guiding principle in deciding such proposals. We believe that the inter-departmental committee (which consists only of representatives of DEA—banking and foreign exchange wings, RBI and MEA) expedites the process. We are not, however, wedded to any particular procedure. Should you think that the Committee be disbanded and an alternative procedure evolved, we can jointly consider this.

With kind regards,

Yours sincerely,
MANMOHAN SINGH

Dr I.G. Patel
Governor, RBI
Bombay

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March 1, 1979

My dear Manmohan,

Kindly refer to your D.O. letter No. 1011-SEA/79 dated 15th February 1979. I am sorry that I was not aware that the meeting was called at our instance. Somehow, I also had the feeling that the banks concerned are also present at such meetings. In the light of the position as you have stated in your letter, I see no reason for making change in the present practice. However, as already arranged, Dr Krishnaswamy will take a meeting with the banks soon where their plans for the next two or three years could be discussed to avoid ad hoc decisions. It would be an advantage if someone from the Banking Division is also present at that meeting.

With best regards,

Yours sincerely,
I.G. PATEL

Dr Manmohan Singh
Secretary
Government of India
Ministry of Finance
Dept. of Economic Affairs
New Delhi

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D.O.No.25/11/80–BO.III
R.K. Kaul
Additional Secretary

MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
(BANKING DIVISION)
'JEEVAN DEEP' PARLIAMENT STREET
NEW DELHI - 1
August 12, 1981

Dear Dr Patel,

Kindly refer to Dr Krishnaswamy's D.O. letter No. DBOD/BL/3090/C 212 (A) 3–80 of April 16, 1980, forwarding a draft of the policy guidelines to be followed in the matter of permitting Indian banks to open branches, representative offices, subsidiaries, joint ventures abroad, etc.

2. Government have considered the matter in detail. The view taken is that, having regard to the political, foreign exchange and other factors involved in opening offices of Indian banks abroad, it would be desirable to obtain Government's approval 'in principle' for opening branches/offices, etc. of our banks abroad as well as for participation in the equity capital of foreign banks or institutions. The inter-departmental committee, which is already in existence, will continue to carefully examine the proposals and make suitable recommendations to the Government. Government's approval, with or without modifications, will be communicated to the RBI. The Indian banking companies should, however, not normally submit formal applications for licences to the central banking authorities

of other countries without first obtaining approval of the RBI/Government of India.

3. The minutes of the inter-departmental committee meeting held on 11th June 1980, as approved, are sent herewith. It may be desirable to have a further meeting of the inter-departmental committee as soon as it may be convenient so that, having regard to the existing circumstances, specific proposals, if any, for opening offices abroad by different banks could be considered further.

With kind regards,

Yours sincerely,
R.K. KAUL

Dr I.G. Patel
Governor
Reserve Bank of India
Central office
Bombay – 400 001
Encl.: as above.

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No. 228–SDB/70

MINISTRY OF FINANCE
DEPARTMENT OF BANKING
NEW DELHI
May 20, 1970

My dear Adarkar,

I mentioned to you over the telephone yesterday the fact of discussions in Lok Sabha and Rajya Sabha on the sensational, and somewhat enigmatic, happenings in the London branch of Central Bank of India. Enclosed are a copy each of the 'uncorrected' versions of the two discussions, the brief and the note for pad which had been put up to the Ministers the previous day. You would also have noticed various newspaper reports in the country and in UK. The two debates, as you can see, have given many persons rather unpleasant impressions.

Shri V.C. Patel was with us here yesterday at our request. He will, no doubt, see you and Dr Hazari.

There are many strands in the unpleasantness as the papers referred to in the first paragraph above will bear out. In particular, serious misgivings have arisen as to why branches abroad of Indian banks appear to be left on their own and are not subjected to anything like adequate supervision and surveillance from India, particularly from the headquarters of the bank concerned and the Reserve Bank. It appears difficult to avoid altogether the impression that the internal audit of branches abroad by the headquarters of the bank is very weak, if it exists at all; also, that the auditors in the countries abroad where the branches are located may not have been selected carefully and are not seen to be doing their jobs effectively and with some degree of care which the Indian public may expect (personally, I have in mind the question whether these foreign auditors should not have gone into the quality and strength of the links between the London office and the headquarters of the bank in Bombay); furthermore, how much responsibility the Reserve Bank has assumed so far and is able to assume now in the matter of checking that the branches abroad of Indian banks function properly is not clearly known. To take the last point, for instance, we ourselves are not sure why the London branch could not be visited by Reserve Bank Inspectors for so many years.

Suspicions will continue to linger that if a sensational fraud can have occurred in the London branch of Central Bank, frauds of a similar kind or other kinds may have occurred, or can occur in branches abroad of other Indian banks.

The subject, though a difficult one, merits very early and thorough attention. We shall be grateful if the Reserve Bank examines all the facets of the problem and lets the Government have a full report with indications of what it proposes to get done through the banks, what it itself intends to do and what, if anything, it would like the Government to do.

With kind regards,

Yours sincerely,
A. Baksi

Shri B.N. Adarkar
Governor, Reserve Bank of India, Central Office, Bombay – 1

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D.O. No. 1 May 26, 1970

My dear Baksi,

I have received your letters of 20th and 22nd May 1970 regarding the Central Bank case. As you have rightly observed, the case raises so many issues requiring early and thorough investigation. We should take them up one by one. In this letter, I propose to deal briefly with only one aspect, viz., the Reserve Bank's inspections.

2. An inspection of foreign branches of Indian banks was carried out in 1960–62. During the discussion on the subject at the Central Board meeting in October 1961, a decision was taken at the instance of the then Governor, Shri H.V.R. Iengar that such inspections need not be carried out more often than once in three years. The reasons given were (1) that they were expensive and (2) that by and large the foreign branches were found to be working on the right lines. In February 1965, this question was taken up again and the then Deputy Governor, Shri C.S. Divakar, and Executive Director, Shri D.R. Joshi, decided that the matter be deferred for some time. In November 1967, the position was reconsidered and in February 1968 a decision was taken to resume the inspections of foreign branches. I was then in charge of DBOD and was concerned with this decision.

3. In resuming the inspections of foreign branches, we gave priority to the branches in Asia and Africa. In view of the obvious importance of London and UK, it was assumed that the branches there would be in charge of senior and responsible officials and could, therefore, be taken up after the inspection of Asian and African branches was over. The last Reserve Bank inspection of the affairs of the Central Bank, as a whole, took place in 1968 and a report of that inspection showed that the London branch, unlike many other branches of the Central Bank, was earning

profits. The 1968 report, however, referred for the first time to the irregularities in the accounts of Montex, C. Raman and the Trevor Group of accounts; this Report was finalized in May 1970 only.

4. The various functions of the Reserve Bank assume different priorities according to the needs and exigencies of the time. For a number of years up to 1960–66, the Reserve Bank's main preoccupation was to bring about the elimination or mergers of a number of small banks which were then tottering or in a semi-solvent state. The inspection staff which is naturally drawn from the more senior and experienced personnel had to be deployed for that purpose. It was this consideration which must have weighed with the Board in agreeing to inspection of foreign branches at long intervals. From 1967 onwards, the accent of Reserve Bank's policy has been on reorganization and development which also require the services of the Bank's senior and experienced personnel. Under the scheme of Social Control, the reorganization of the Boards had to be carried out within a time limit. It was also incumbent on the Reserve Bank to generate a tempo of development work in order that Social Control may show results, within a reasonable period of time, in terms of branch expansion and increases in lending to agriculture and small-scale industries. A big effort had to be mounted to achieve an increase in the number of new branches from the neighbourhood of 350 or so to 700 and later 900 or 1000 per year, and to bring about the necessary adaptation in the commercial banks' personnel and policies for increased lending to priority sectors. This shift in emphasis resulted in lower priority being accorded for some time to mere policing work. It should not be assumed that such work was neglected, but the more expensive types of action (like inspection of foreign branches) where experienced personnel had to be deployed for long periods and at considerable expense were undertaken on a smaller scale. After all, no amount of policing by the Reserve Bank, which, in any case, has to be carried out on a selective, sampling basis, can be an effective substitute for the bank's internal management especially when the bank concerned is one like the Central Bank with a vast network of branches. This bank has been found to be seriously deficient in the matter of internal checks and balances, and its practices in regard to the selection and posting of personnel are deplorable. Under the Banking Regulation Act, the Reserve Bank's control over personnel was limited to the Chief Executive Officer, and through him, to such other members of staff as were really found to be indulging in malpractices or lacking in efficiency. The degree of control which we shall exercise hereafter in the matter of personnel was not exercised prior to nationalization.

5. The internal working of commercial banks in India has so many deficiencies that it is a matter of surprise that the number of frauds actually occurring is so small. Over the last few years, we have been trying to improve the working in many respects, but this is a task which will take some years to be fully accomplished. My four years of hard work in the DBOD were not enough. There are a number of areas where it is essential to improve our inspection procedures and also bring about radical changes in the internal working of banks. I shall write another letter to draw attention to those areas. While doing so, I would ask you to appreciate that given the limitations of personnel and the importance and urgency of developing

the social aspects of banking, the Reserve Bank could not possibly do all it wished by way of cleaning up the internal working of banks. In fact, it was the Reserve Bank's excessive preoccupation with mere policing that had led to the development work being somewhat neglected, prior to the introduction of social control. I recognize, however, that both development and improvement of personnel and procedures must now be pursued simultaneously and with equal vigour.

6. I am personally investigating the Central Bank case and shall write more in subsequent letters.

Yours sincerely,
B.N. Adarkar

Shri A. Baksi
Secretary
Department of Banking
Ministry of Finance
Government of India
New Delhi

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D.O. No. 2 May 26, 1970

My dear Baksi,

Following certain internal discussions and a discussion with Shri V.C. Patel and his two colleagues, I am sending you this further report about the Central Bank case. I hope my observation in the other letter sent today that the Reserve Bank was not able to accomplish all that it wished in the matter of improving the internal working of commercial banks does not give you the impression that the Reserve Bank neglected this aspect. What I wish to convey is that the internal working of some of the banks is so defective that the effort required to set it right has to be much greater than what the Reserve Bank has been able to put in with its limited personnel and the demands of other equally important matters. I am giving below a list of the points on which the Central Bank has been asked to furnish its explanations, and my observations on some of them will help to illustrate the state of affairs in its internal working.

1. The bank has been asked to prepare a responsible and authentic account of the developments relating to the fraud at the London Office and to submit it not later than the close of business tomorrow. DBOD has been asked to undertake a special scrutiny of all proceedings at the Head Office of the bank in relation to its fraud. It has started the work this afternoon.

2. Shri Patel has confirmed that apart from half-yearly audits conducted by the bank's external auditors, viz., Messrs Fergusson, Rolland & Davis, the bank has not carried out any periodical inspections of the London Office so far. Three ad hoc inspections were carried out in 1966, 1968 and in October 1969. The Inspector who carried out the October 1969 inspection has not submitted a comprehensive report but has sent various letters. The bank has been asked to let us have copies of

the 1966 and 1968 reports and also the letters from the Inspector who visited London in October 1969. The half-yearly audit reports are sent to the Head Office as well as to the bank's statutory auditors, Billimoria & Fergussons. It will be examined how far the statutory auditors as well as the auditors in London have done their duty.

3. The bank has been asked to explain whether the audit reports caused any concern to the Head Office, especially in regard to the advances referred to in Shri Mewawala's report, what action was taken by the Head Office, and whether these irregular accounts were reported at any time to the Board. It is our intention to ascertain how far the Board acquiesced in the irregularities brought to their notice. Montex and G. Ramon & Co. have been allowed an advance of over £360,000 whereas the limit sanctioned by the Head Office for Montex was only £100,000. This irregularity has been going on for a long time and it needs to be ascertained whether there was any failure on the part of the management to bring it to the notice of the Board or whether the Board also connived at it.

4. It is understood that the external auditors have been auditing the London office ever since it was opened on 14th August 1953.

5. DBOD will examine the entire proceedings leading to the acceptance of Shri Sami Patel's resignation. Shri Patel offered to resign on the 9th and Shri Mewawala accepted his resignation on the 26th after consulting the Head Office. The bank had sufficient time to consult Government in the matter but did not do so. Shri Sami Patel continued to work in the bank from 9th March to 26th March and, according to press reports, he put through some more irregular transactions. The development between 9th March and 26th March will be studied.

6. DBOD will also study the returns received from the London Office regarding advances, securities and guarantees, in order to ascertain how far the Head Office was aware of the irregularities and what action was taken by them to check them. It is understood that the returns are processed by a section in the Branch Inspection Department which is headed by one Mrs Peston Janasp. She has remained in this position for the last five or six years. An Assistant General Manager, Shri Premahi, was supervising her work, and since he retired in October 1969 she has been reporting directly to Shri Mewawala, General Manager.

7. DBOD will examine the bank's records regarding: (a) the sanctioning by the Head Office of the advances, bill limits, guarantees, etc. which have been referred to in the inspection reports and Shri Mewawala's Report, (b) the system of obtaining credit reports on the parties, (c) the extent to which powers had been delegated to the London Manager and the Adviser, and (d) the borrowing powers delegated to the London office. Shri Patel said that when the branch was opened special discretionary powers were given to the London Manager, and these were exceeded by him. It needs to be examined what kind of powers had been delegated by the Head Office to the London office. The advances at the London Office exceeded the deposits which meant that the London office was allowed to borrow in London or that the Head Office provided additional resources. The factual position is to be ascertained.

8. Shri Sami Patel was continuously in London for over fourteen years. The bank has been asked to explain whether his transfer to India was considered at any

time and, if so, who opposed it. It is a regular feature of all bank frauds that the person concerned is found to have remained at the same post for a number of years. This was the feature of the fraud involving Rs 41 lakhs at the Central Bank's Relief Road Branch at Ahmedabad. The bank is being asked to report to us all cases in which the Chief Managers, Managers and Accountants have remained at the same post for more than five years.

9. It is also being ascertained whether any payments have been made against the bills in question, whether by the London office or by anybody else.

10. The bank has been asked to find out whether Shri Patel, his wife or any concern with which they were associated had accounts with the London office and they were allowed to withdraw the balance in these accounts. The bank has also been asked what action, if any, they are taking about the operations on any accounts which Montex or G. Ramon & Co. have with the Head Office or other offices of the Central Bank.

11. We shall have to take stricter action in respect of this bank in regard to the following matters:

(a) Responsible positions being held by the same individuals for too long a time.
(b) Internal inspections, particularly in regard to the tendency of individual officers to defeat internal checks by performing functions or exercising powers normally assigned to other officers.
(c) The processing of returns from branches and reporting irregularities to the Board.
(d) The manner in which certain records are maintained. (After the fraud at Ahmedabad, Billimorias, at our request, had formulated certain suggestions in regard to the maintenance of bill registers, etc. and since a similar fraud has subsequently occurred at Calcutta, we have to satisfy ourselves that those suggestions were actually implemented by the bank.) At Calcutta, an instance has occurred of the bank discounting bills for Rs 9 lakhs on behalf of parties which are non-existent but in respect of which its Cash Department had earlier produced a favourable credit report.
(e) The bank's instructions to London regarding the procedure to be followed in issuing guarantees, etc. will also be studied.

12. The above is only an illustrative list intended to stimulate inquiry. If you have any additional points, to suggest, kindly do so.

Yours sincerely,
B.N. Adarkar

Shri A. Baksi
Secretary
Department of Banking
Ministry of Finance
Government of India
New Delhi

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Reserve Bank of India
Agricultural Credit Department
Central Office
Garment House, P.B. No. 16575
Bombay 400 018
23 May 1975
2 Jyaistha 1897(S)
Ref. No.ACD.Plan.3720/PR.428(1)–74/5

The Registrar
Cooperative Societies

Dear Sir,

Linking Borrowings from the Reserve Bank with Efforts at Deposit Mobilization by Central Cooperative Banks—Modifications in the Scheme

Please refer to our circular letter No. ACD.Plan 467/PR 428(1)-72/3 dated 17 August 1972, communicating the main features of the scheme for linking of borrowings from the Reserve Bank with efforts at deposit mobilization by central cooperative banks. Under the scheme, which was introduced with effect from the year 1973–74, the rate of interest charged by the Reserve Bank on short-term agricultural advances to state cooperative banks on behalf of central cooperative banks was raised from 2 per cent below the 'Bank Rate' to ½ per cent below the 'Bank Rate'. The central cooperative banks were, however, allowed a rebate of 1½ per cent (a) on their borrowings from the Reserve Bank equal to the 'base level' and (b) on borrowings over and above the 'base level' up to twice the increase in their involvement in short-term agricultural loans out of their own resources or to the full extent of the loans granted by them to small/marginal farmers, whichever is higher. In terms of the recently introduced provisions of the Interest Tax Act, 1974, scheduled state cooperative banks are liable to pay tax at the rate of 7 per cent in respect of their chargeable interest. From the legal position as it stands at present, it appears that the state cooperative banks would be liable to pay interest tax on the higher rate of interest intially charged by them to the central cooperatives banks, even when rebate admissible under the deposit mobilization scheme is passed on to the latter banks. The state cooperative banks would thus have to suffer a double disadvantage, first by granting rebate to district central cooperative banks at 1½ per cent, and then paying interest tax on the amount of interest collected without taking into account the rebate.

2. The above problem was considered by the Standing Committee on Linking Borrowings with Deposit Mobilization, as its second meeting held at Bombay on 4 April 1975. In view of the fact that, if the scheme is continued in the present form, the scheduled state cooperative banks might have to face considerable losses, the committee decided to modify the scheme in a manner which will involve charging a lower rate of interest earlier and granting rebate later. The revised scheme, as proposed by the Committee, is as under:

The Reserve Bank's rate of interest on loans and advances to state cooperative banks on behalf of all central cooperative banks for seasonal agricultural operations will be fixed at 2 per cent below the 'Bank Rate' with effect from 1 July 1975 on (a) that part of the borrowings of the state cooperative banks which represents the 'base level' up to twice the increase in the involvement of the central cooperative banks out of their own resources in agricultural loans, or to the full extent of increase in the loans granted by it to the small/marginal farmers, whichever is higher. The borrowings of a central cooperative bank in excess of the above amount, if any, will be charged interest at ½ per cent below the 'Bank Rate'. An agreement between the Reserve Bank and state cooperative banks on the one hand, and between the latter and the central cooperative banks on the other, will authorize the recovery of interest at the higher rate on a part of the borrowings of the state cooperative bank, as the case may be.

The interest charged by state cooperative banks to central cooperative banks will also be on the same pattern.

3. The recommendations of the Committee in this regard have since been accepted by the Reserve Bank of India, and it has been decided to introduce the scheme modified as above, with effect from 1 July 1975. Detailed instructions regarding operational procedures to be followed under the modified scheme, as also the revised agreements, etc., will be sent to you shortly.

4. We shall be glad if the contents of this circular are brought to the notice of state and central cooperative banks in your state.

Yours faithfully,
M.V. Hate
Jt. Chief Officer

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Ref.No.ACD.Plan.5591/PR.484/75/6 — 23 September 1976
1 Asvina 1898 (Saka)

The Secretary
Cooperation Department
Government of India

Guidelines for the Implementation of the Recommendations of the Expert Committee on Consumption Credit

As you are aware, the Government of India had appointed in March 1976, an Expert Committee on Consumption Credit under the chairmanship of Shri B. Sivaraman, Member, Planning Commission, to suggest measures for meeting the consumption credit needs of small farmers, landless labourers, etc. consequent on the steps taken by the state governments for moratorium and in charge and scaling down of debts from non-institutional sources. The recommendations of the Committee were discussed at a conference of the Chief Ministers of small states convened by the Finance Minister at Bangalore on 16 June 1976 and were generally endorsed.

2. One of the recommendations made by the Committee was that the Reserve Bank of India should issue necessary guidelines to the cooperative and commercial

banks for expeditiously implementing its recommendations. Accordingly, we have prepared guidelines keeping in view the recommendations of the Committee and the decisions thereon taken at the Bangalore conference. A copy of the guidelines is enclosed for immediate implementation.

3. The guidelines contain the details of the steps to be taken for the reorganization of primary agricultural credit societies into variable units, each having a full-time paid secretary and the procedure for amalgamation of the societies. Details of the steps required to be taken by the cooperative banks and the societies in the matter of recovery of overdues, deposit mobilization, nature and scope of consumption loans that may be issued by them, etc. are also indicated in the guidelines. The institutions may be suitably advised in the matter immediately.

4. Your attention is invited, particularly to paragraphs 6 and 17 of the guidelines wherein we have suggested the amendments to the Cooperative Societies Act with a view to expediting the amalgamation of non-viable societies, and also providing for the right of prior claim of the society over the crops of the members even in respect of the consumption loans issued to them. Steps may be taken to amend the Cooperative Societies Act with such modifications as may be necessary in the light of the existing provisions in the Act, if necessary, by issue of an Ordinance for this purpose.

5. Item VII of the guidelines relates to the terms and conditions governing loans from the Bank's long-term Operations Fund to the state governments for contribution to the state governments' share capital of reorganized primary societies. It may be seen that the terms and conditions have been further liberalized by us.

6. We are endorsing a copy of this letter to the Registrar of Cooperative Societies and to the state cooperative bank of your state for their information and immediate action.

7. We shall be glad if you kindly advise us as soon as possible of the action taken in the matter.

I. Guidelines for the Implementation of the Recommendations of the Expert Committee on Consumption Credit

1. *Reorganization of Primary Agricultural Credit Societies*

The Committee had recommended that only such of those reorganized societies including FSS and LAMPS which are having full-time paid secretaries or managers should undertake the issue of consumption loans to their members. In this connection, the Committee had emphasized the need for expeditious completion of the reorganization programmes which have already been taken up on hand by most of the states, and which will have to be implemented vigorously in pursuance of the decisions taken at the meeting of some of the Chief Ministers held at Bangalore on 16 June 1976. It is expected that in the next few months, a large number of primary societies will be reorganized and have full-time paid secretaries.

2. The problems connected with the reorganization of the societies as also those of merger or liquidation of the non-viable societies were discussed recently at a meeting convened by the Reserve Bank of India in Bombay on 4 May 1976.

According to the decisions taken at the meeting, the following steps should be taken by the state governments to expedite the programmes:

(i) For the purpose of viability, account should be taken of the short-term agricultural credit business only. The other business, viz., medium-term, long-term agricultural credit and consumption credit should be taken as additional potential.

(ii) Normally, a gross cropped area of 2,000 hectares (5,000 acres), whether irrigated or not, might be taken as adequate to provide a minimum short-term credit potential of Rs 2 lakhs for the reorganized society.

(iii) In cases where more than 2,000 hectares were to be covered, the area of operation of the organized society should be confined to a radius of 10 kms only, excepting in hill or tribal or desert areas, so however that the jurisdiction of a society did not cut across the village boundaries.

(iv) Where a village was big and had more than 2,000 hectares, a detailed exercise with reference to actual scales of finance might have to be done to ensure a minimum short-term credit business of Rs 2 lakhs on the assumption that the society would be able to meet only about 40 per cent of the potential calculated on the above basis.

(v) In the proposed area of less than 2,000 hectares, a detailed exercise with reference to actual scales of finance might have to be done to ensure a minimum short-term credit business of Rs 2 lakhs on the assumption that the society would be able to meet only about 40 per cent of the potential calculated on the above basis.

(vi) If one administrative unit like gram panchayat or patwar circle did not have in its jurisdiction 2,000 hectares of gross cropped area, two or more such administrative units might be covered by the reorganized society wholly, in which case the territorial limit of 10 kms radius might not be applied. Preferably, in such cases, farmers' service societies of the smaller model might be organized, instead of a viable primary agricultural credit society. However, the society should not be again reorganized if on a subsequent date, the area of the gram panchayat is altered.

(vii) Where a society had already attained a short-term loan business of Rs 2 lakhs, it might not be normally disturbed but could be made the nucleus of a farmers' service society (FSS), a large-sized multi-purpose society (LAMPS) or a reorganized primary agricultural credit society.

(viii) If once the area is decided, good working societies might be merged with the nucleus society selected for retention and the non-viable ones liquidated.

3. The above guidelines do not require any fresh survey. In some of the states, the programme of the organization may have reached an advanced stage of implementation. However, the state governments should have a second but quick look at the area of operations of the reorganized societies with a view to ensuring that ordinarily each such society covers a gross cropped area of not less than 2,000 hectares and not more than a radius of 10 kms. Certain marginal adjustments would be necessary only in cases where these conditions are not satisfied. In this connection, reference may be made to the detailed guidelines issued under cover of the

Agricultural Credit Department's circular letter No.ACD.Plan 5115/PR.55(1)–75/6 dated 28 May 1976 addressed to all the state governments on this subject. As suggested therein and as urged by the Expert Committee on Consumption Credit, vigorous steps have to be taken by the state governments to reorganize as many primary credit societies as possible into viable societies immediately. All the reorganized societies should be provided with full-time paid managers/secretaries. The cost of these managers may have to be subsidized initially by the state governments for which purpose they may make adequate provision in their budgets for the year 1976–77.

II. Merger or Liquidation of Non-viable Societies

4. Having identified the area appropriate for a viable society and also selected a good working society which could be retained and reorganized, the position of the other existing societies in the area should be quickly decided. They may either be liquidated or amalgamated. In order to ensure that the reorganized viable society/FSS/LAMPS are not burdened from their very inception with the bad debts and overdues of the amalgamating society, it is necessary that those falling under any of the following categories may straightaway be taken into liquidation:

(i) A society whose estimated bad debts (as per the latest available audit report) exceeded its owned funds, that is, share capital plus all reserves.
(ii) A society which has been dormant for over three years.
(iii) A society which has been classified as 'D' in the latest available audit report.

2. Care will have to be taken to see that in merging the other societies with the viable society/FSS/LAMPS, the latter's financial position is not adversely affected. If the aggregate value of the bad debts of a society meant for merger exceeds its reserves but is within its owned funds, the bad debts should be set off against the reserves, and also against share capital to the extent necessary and the book value of the share capital should be brought down to its real value. The detailed procedure in this regard is indicated in the Agricultural Credit Department's circular letter No. ACD.Plan.5113/PR.55(1)–75/6 dated 28 May 1976 addressed to the state governments.

3. Amalgamation of two or more societies as per the procedure suggested in para 4 of the ACD circular letter No.ACD. Plan/5113/PR/55(12)–75/6 may not be feasible without the necessary statutory provision in the Cooperative Societies Act. Although presently, most State Cooperative Societies Acts provide for either voluntary or compulsory amalgamation of two or more societies, the provisions of these enactments are deficient in several respects, with the result that state governments experience considerable difficulty in pushing through the reorganization programme. Moreover, most of the State Cooperative Societies Acts do not empower the state governments to reduce the value of the share capital of the amalgamating societies. It would be necessary to vest such powers with the state government if the procedure for amalgamation outlined above is to be followed. The State Cooperative Societies Acts would, therefore, have to be suitably amended providing for compulsory amalgamation of societies and vesting the Registrar with adequate powers with a view to expediting the process of amalgamation. A draft of

the model section which could be incorporated in the Cooperative Societies Acts has since been communicated to the state governments vide circular letter No. ACD.Plan.5347/PR.(1)–75/6 dated 14 June 1976. The same may be adopted by them with such modifications as may be necessary in the context of the existing provisions in the State Cooperative Societies Acts.

4. Pending merger of the weak societies with the one identified for retention, the area of operations of the latter may be extended to cover the area of those marked for liquidation or amalgamation, and non-members may be admitted to the society marked for retention and financed by it. There may be no harm even in admitting a non-member to this society, provided care is taken to see that he does not receive accommodation from the old society. Such a person may hold only one share for the time being, of the new society, and for the purpose of borrowing from it, his shareholding in the old society may be reckoned as available for accommodation from the new society, for after merger he would be holding shares to a corresponding extent of the new society.

III. Recovery of Overdues of Cooperatives

8. The Expert Committee on Consumption Credit has emphasized that the cooperative institutions and the state governments should launch a vigorous drive for the collection of overdues of the cooperatives. Such recovery would release the owned funds of the institution, that is, the central banks and the primary societies, which are presently locked-up in overdues, for the purpose of issuing consumption loans. For achieving this end, the following steps, in particular already recommended by the Study Team on Overdues of Cooperative Credit Institutions have to be taken by the State governments, if not already done.

(i) Creation of favourable climate by the state governments themselves which may include denying credit to defaulters of societies and not granting blanket stay orders on the execution of the decrees obtained by cooperatives.

(ii) Strengthening of the existing machinery in the Cooperative or Revenue Departments for expediting the arbitration and execution cases against defaulters.

(iii) Denial of voting rights to the defaulters of societies and automatic supersession of the board of directors of central banks and managing committees of societies in the overdues exceeded a certain level for a specified period.

5. The recommendations of the Study Team on Overdues were communicated to the state governments in terms of the Agricultural Credit Department's Circular No.ACD.Plan.1239/PR.475–74/5 dated 15 July 1974 for implementation. The state governments should review the progress in the implementation of these recommendations and take further immediate steps to ensure complete compliance.

IV. Augmentation of Resources

6. Among the measures suggested by the Committee for augmenting the resources of the cooperative institutions for facilitating the issue of consumption loans, the most important steps relate to deposit mobilization. In this connection, the

Committee has cited the success achieved by cooperatives in Kerala in mopping up resources from the rural areas. The broad features of the scheme were as under:

(i) A decision was taken at a meeting convened by the Chief Minister in February 1976 for making intensive efforts for deposit mobilization in April 1976 by celebrating the month as a 'Deposit Mobilization Month'.

(ii) A target of Rs 20 crores was fixed to be reached during April 1976 as follows:

(iii) The Government set up committees consisting of officials and non-officials at the village level, taluka level, district level and state level for canvassing of deposits.

(iv) To pursue the campaign on a day-to-day basis and to review its progress on a weekly basis, a small steering committee consisting of the President, Kerala State Cooperative Bank Ltd.; Chairman, State Cooperative Union; Secretary to the Government, Planning Development; Registrar of Cooperative Societies and Secretary, Kerala State Cooperative Bank was also set up.

(v) The Chief Minister and other ministers held press conferences on the campaign. A minister was named for each district to supervise and guide the operations. The President of the State Cooperative Bank, Chairman of the State Cooperative Union and the Presidents of the Central Cooperative Banks also met the press on different dates to explain the significance of the campaign by issuing special supplements in important local newspapers. The Government had asked the Director of Public Relations to render the necessary publicity support to the scheme.

(vi) The state cooperative bank collected information relating to the position of deposits in each institution as on 31 March 1976 immediately after the close of the month which facilitated review of the progress in collecting deposits every week thereafter. Based on this weekly review, the state government and the banks issued suitable press releases regarding the progress of the campaign from time to time.

(vii) The state government and state cooperative bank had formulated suitable guidelines for the utilization of deposits, especially in granting loans to the weaker sections of the community. It is understood that although the target of Rs 20 crores had been exceeded by Rs 6 crores in April 1976 itself, the campaign would be continued.

7. Similar campaigns with active support of the state governments and involvement of the cooperative banks may be launched in other states also, which would help substantially to raise the deposit resources of cooperative banks. Further, state governments may remove the disabilities from which the cooperative banks may be suffering on account of administrative instructions or statutory provisions in receiving deposits from local authorities, public corporations and public bodies. It is needless to emphasize again the urgency for extending insurance cover to the deposits with the cooperative banks from the Deposit Insurance Corporation. States which have still not amended the Cooperative Societies Act to facilitate the extension of the Deposit Insurance Corporation Act may do so without any further delay.

V. Issue of Consumption Loans: Procedural and Other Aspects

8. As recommended by the Committee, all the primary agricultural credit societies which are having full-time paid managers/secretaries, the FSS and the LAMPS may issue consumption loans to their members, whether they are agriculturists or not, including agricultural labourers subject to the purpose-wise ceiling indicated by the Committee as under:

a) General consumption	Rs 75@
b) Medical expenses	Rs 250
c) Educational needs	Rs 100
d) Marriage ceremonies	Rs 250
e) Funerals, births, etc.	Rs 75
f) Certain religious ceremonies	Rs 75

Normally, only one person from a family becomes a member of a society. There are, however, cases where more than one person from the same family is a member. Since the by-laws of societies provide for admission of any individual above the age of eighteen, it is possible that husband, wife and adult sons may all become members, particularly when universal membership is stressed, and try to take advantage of the consumption credit facilities known to be envisaged for various purposes. Under the crop loan system, it is not possible for the different members of a family to take a production loan because the same is linked with a given survey number. In the case of agriculturists wishing to take a consumption loan, the society should insist upon their indicating the survey numbers of the lands in the application. In the case of non-agriculturists, the society should insist upon their indicating the number of the house which may have been given for the census purposes or by the gram panchayat. Failure to take these elementary precautions has been responsible for fictitious acreages and over financing under the crop loan system. The consumption credit recommended here is for a family, and proper identification thereof is absolutely necessary to avoid over financing land certain defaults.

(a) Maximum limit

13. It is not likely that member would require loans for all these purposes at one point of time. If, however, loans for more than one purpose mentioned above are required, the same may be issued subject to the repaying capacity of a borrower but based on his minimum needs, and also subject to the purpose-wise ceilings mentioned in para 12 above.

14. In terms of para 3 of the Agricultural Credit Department's circular No.ACD.Plan.4458/PR.17-75/6 dated 8 April 1976 loans for consumption purposes may be issued only to the agriculturist members of primary agricultural credit societies, not exceeding 10 per cent of the short-term borrowings or Rs 250/- per member, whichever is less. The Committee, however, felt that this constraint may cause hardship to borrowers whose needs may be genuine and who may have the

@Although this item does not specifically appear in the report of the Committee, yet it has been included here because the Committee has reckoned this item in estimating the credit needs for consumption at Rs 170 crores.

necessary repaying capacity. This has been agreed to by the Reserve Bank and as mentioned in paras 12 and 13 above, loans may be issued for consumption purposes to all members whether they are agriculturists or not, and for all purposes mentioned in para 12, subject to the purpose-wise ceiling recommended by the Committee. The Agricultural Credit Department's circular dated 8 April 1976 is being modified accordingly.

15. The purpose-wise ceiling will not apply to members of primary agricultural credit societies borrowing against the security of gold and silver ornaments. The individual limit in that case will be Rs 1,000/- as indicated in our circular dated 8 April 1976.

(b) Security

16. As for security, the societies may obtain the same type of security as is being provided by the agriculturist-members in respect of their short-term agricultural loans. Thus, if the short-term agricultural loan is issued to a member, either against a charge on land or mortgage of land or against personal security, that is, against promissory note signed by the borrower or one or two other members as sureties, similar security should be obtained for the consumption loans also. Most of the State Cooperative Societies Acts provide for the creation of a first charge on land or other immovable property in favour of a society by the borrowing members by means of a declaration, irrespective of the purpose of the loan. Hence, the society would be in a position to proceed against the land or immovable property for the recovery of the consumption loans also. In cases, however, where an agriculturist-member is issued a loan for the raising of crop or for the purchase of cattle, implements, etc. against personal security as a charge on land or interest in the land cannot be created for some other or the other, the society by virtue of the provisions in the Cooperative Societies Act, will have a prior claim on the crop raised or the cattle, etc. so acquired out the loan as, for example, Section 31 of the Madras Cooperative Societies Act, 1961 which reads as under:

First charge of society: (1) Subject to their prior claim, if any, of the Government in respect of land revenue or any money, recoverable as land revenue, any debt or outstanding demand due to a registered society from any member or past member or the estate of a deceased member shall be a first charge:

(i) upon the crop or other agricultural produce of such member for the raising of which the loan was taken from the registered society by such member, and

(ii) upon any cattle, fodder for cattle, agricultural or industrial implements or machinery, or raw materials for manufacture, supplied or purchased in whole or in part out of the loan of money given by the registered society or on any articles manufactured from raw materials so supplied or purchased or on any workshop, godown, or place of business constructed or purchased out of any such loan.

17. It may thus be seen that the society will have no prior claim over the crops or other movable properties if the loan issued to the member is for consumption purpose. It may, therefore, be necessary that the provisions in the Cooperative Societies Act which confer the right of first charge (prior claim) on the society may

be so amended as to cover the loans issued for consumption purposes also. In this connection the provisions of Section 40(1) of the Madhya Pradesh Cooperative Societies Act, 1960, which reads as under are commended for adoption by the state governments with such modifications as are considered necessary:

Notwithstanding anything contained in any law for the time being in force, but subject to any prior claim of the State Government in respect of land revenue or any money recoverable as arrears of land revenue, any debt or outstanding demand owing to a society by any member or past member or deceased member shall be a first charge upon the crops and other movable property belonging to such member, past member or forming part of the estate of the deceased member, as the case may be:

18. In the case of non-agriculturist-members, such as, for instance, agricultural labourers, it may be advisable to issue consumption loans against personal security with at least two if not more members as sureties. In fact, loans may, if possible, be advanced to a group of four or five individuals against their joint and several liability. No other security should be insisted upon in case of agricultural labourers and other weaker sections of the community.

(c) Shareholding

19. A member may be required to purchase shares to the extent of 5 per cent of the loans obtained by him for consumption purposes. In no case, however, the member need subscribe for more than Rs 10 towards share capital in respect of such loans. The deficit in the share capital of the society in raising adequate funds, if any, may be made good by contribution by the state governments out of borrowings from the Reserve Bank's long-term Operations Fund, if necessary.

(d) Rate of Interest

20. As recommended by the Committee, the rate of interest should be the same as charged by the society to its members in respect of its short-term agricultural loans. It is also not advisable to charge lower rates of interest for consumption loans. In cases where the society is charging lower rates of interest on agricultural loans issued to small and economically weak farmers, the normal rate should be charged for the consumption loans issued even to this category of borrowers.

(e) Repayments

21. The consumption loans issued to farmer-members with landholding exceeding 0.5 acre may be recovered along with the short-term agricultural loans, that is, the due dates will be the same and the period not exceeding one year if the quantum of consumption credit is less than 10 per cent of the short-term loan advanced to him. Where the quantum is higher than the above, a longer period up to three years may be allowed, so however that the annual instalment is not less than 10 per cent of his short-term loan. In the case of those with landholding of 0.5 acre or less and non-agriculturist members, it would be preferable to fix a monthly instalment of not less than Rs 10. Where the quantum of consumption credit exceeds Rs 120, for example, in the case of loans for marriages, the period of loan may have to be

longer, but not exceeding three years in any case keeping in view the monthly instalment of Rs 10. It has been recommended by the Committee that this category of borrowers may be covered by the Employment Guarantee Scheme of the state government or some such similar schemes. There should be a link up with the authorities of the scheme for facilitating recovery on a monthly basis.

VI. Refinance from the Higher Financing Agencies

22. The central cooperative banks may reimburse the loans issued by the primary agricultural credit societies for consumption purposes from out of their own resources or from out of the borrowings from the state cooperative bank to the extent possible.

23. The Reserve Bank will treat the finance so provided as a legitimate charge on the central bank's resources and sanction a higher credit limit for short-term agricultural purpose, subject, to, of course the eligibility of the bank for the same.

VII. Share Capital Loan from the Reserve Bank's long-term Operational Fund

24. In light of the recommendations of the Expert Committee on Consumption Credit for strengthening the equity base of primary agricultural credit societies, the following relaxations have been made to the existing terms and conditions governing the grant of loans to the state governments for share capital contribution of such societies.

(a) Normally, only a society already reorganized on the pattern indicated in the Agricultural Credit Department's letter No.ACD.Plan.5115/PR.55(1)-75/6 dated May 28, 1976 or a viable/potentially viable society having a full-time paid secretary/manager will be eligible for share capital contribution up to Rs 15,000 per society as against Rs 10,000 allowed at present. Loans in excess of Rs 15,000 but not exceeding Rs 50,000 will be considered on the merits of each case, depending on the consumption loans issued and consumers' business undertaken. Where reorganization involves amalgamation or liquidation of the non-viable or dormant societies and such reorganization cannot be brought about before applying to the Reserve Bank for long from the long-term Operations Fund, the Bank will consider applications in respect of the societies identified for retention, provided the societies conform to the pattern indicated in the above circular and the state government gives an undertaking in writing that the other societies within the area of operation of the societies on whose behalf an application has been made, would either be liquidated or amalgamated before the end of the cooperative year in which the loans for contribution to share capital have been availed of.

(b) Reorganized societies with overdues not exceeding 40 per cent of the outstandings will be eligible for share capital contribution (as against 30 per cent presently allowed). There is, at present, no stipulation regarding the level of overdues for reorganized societies in special programme areas like SFDA etc., for those financed by commercial banks, those organized or reorganized as FSS or LAMPS and those in the States grouped as 'C' by the

Working Group on Cooperation, viz., Assam, Bihar, Meghalaya, Orissa, Rajasthan, West Bengal, Manipur, Tripura and Nagaland.

Farmers Service Societies

25. The existing terms and conditions governing FSS would continue. They will be eligible for share capital contribution up to Rs 50,000 or Rs 1 lakh, each accordingly as the society covers about 10,000 population or the whole block. The contributions already made in respect of the existing societies in their areas would, however, be taken into account in determining the exact amount of the loan for contribution to the share capital of the FSS. The cost of the managing director would have to be met by the sponsoring bank, and of the technical personnel by the state government. The Government should also undertake to amalgamate/liquidate the existing societies in their area of operations within a period of two years. The loan for contribution will be sanctioned, irrespective of the overdues of the FSS.

Large-Sized Multi-Purpose Societies

26. LAMPS organized in tribal areas on the pattern recommended by the Bawa Committee and with a full-time paid manager and other complementary staff will be eligible as hitherto for a share capital loan up to Rs 1 lakh, irrespective of the overdues if the society covers the whole block and Rs 50,000 if it covers 10,000 population. Where the LAMPS has no technical staff of its own, it should be ensured that the services of the extension staff of tribal and other developmental departments of the state government are made available to its members. However, besides the full-time paid manager, the LAMPS should have adequate trained staff for undertaking service functions such as purchase and sale of essential commodities/running of fair price shops and for handling the forest produce of tribal members.

27. Societies in the tribal areas other than LAMPS will be eligible for share capital, irrespective of the level of their overdues on the same basis as in the case of the organized primary agricultural credit societies, viz., Rs 15,000 normally and up to Rs 50,000 on the merits of each case.

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D.O.No.G.8–68 CAMP DELHI

June 22, 1968

My dear I.G.,

You are aware that Shri Manubhai Shah has been thinking in terms of recommending through the Administrative Reforms Commission that certain specialized institutions for financing industry and agriculture, such as the IDBI and ARC should be completely separated from the Reserve Bank and function as wholly independent agencies directly under Government.

I have been giving thought to this proposal as objectively as I can even though I happen to be the Governor of the Reserve Bank, and in that capacity do oversee the working of these institutions.

While the case for such a change would be fully set out in Shri Manubhai Shah's report on the subject, I feel it desirable to set out very briefly the problems and difficulties which I see in such a course. These are:

(a) To a considerable extent, the resources at the disposal of these institutions are provided by the Reserve Bank. While we can do so in respect of institutions which function more or less as subsidiaries, if they were separated from the Reserve Bank then the channel through which any resources would flow from the RBI to these institutions would be the Central Budget. In other words, we would be making somewhat larger contributions to the Central Budget by way of RBI profits and it would be for the Central Government when presenting the Budget to decide whether and how much should be given to these institutions out of the totality of Centre's resources (including Reserve Bank's contribution) in the light of all other competing claims on them.

(b) To a considerable extent, these institutions draw upon or supplement the resources which for similar purposes are made available by the banking system. Functioning under the Reserve Bank, they can develop a more coordinated approach in their working and also obtain cooperation from the banks in a fuller measure than would perhaps be possible otherwise. Just at a time when we are gearing banks to do more for agriculture and small-scale industries, if the main agencies for providing finance to agriculture and industry were divorced from the Reserve Bank, the result may not be altogether satisfactory. A considerable proportion of the activities of these institutions relates to refinancing which means that the parties with whom they have their transactions are banks rather than the ultimate beneficiaries. Let me give one or two concrete examples. We are trying to get thousands of bank branches to help industry, particularly small-scale industry, by making term loans with facilities for guaranteeing and refinancing which we provide through the RBI and IDBI. Will this be possible for an independent institution to do so? Similarly, in the agricultural sector, the Agricultural Refinance Corporation has sanctioned over Rs 100 crores of refinance in favour of land mortgage banks. In doing so, the ARC has to form a judgement on the capacity of the land mortgage banks concerned to handle the business. Such a judgement means drawing upon the knowledge which the Reserve Bank through its Agricultural Credit Department has of the regular operations of the land mortgage banks, their managerial capacity and other relevant factors.

(c) Under the present arrangements, at least a part of the finance being made available to agriculture and industry comes out of credit creation. This can only be done so long as the Reserve Bank retains its present relationship with these institutions. If the IDBI were to become an independent institution, then like the IFC and ICICI, its operations would have to be limited to the real resources at its disposal and it should not undertake any activities which would be in the nature of credit creation.

(d) The IDBI, in its operations, acts as a leader and coordinator between all the institutions which provide long-term finance, such as the LIC, ICICI and IFC. Every month there are inter-institutional meetings at which, for larger projects, a consortium approach is adopted so that all the finance needed by way of equity and loans is provided by the different institutions after mutual discussion and agreement. When necessary and appropriate, the State Bank and the scheduled banks also participate in such financing. An institution like the LIC as well as the banks are prepared to accept the IDBI's lead primarily because the RBI has general supervisory role over all financial institutions. It is because the Vice Chairman of IDBI is also a Deputy Governor of the RBI that inter-institutional meetings on such occasions when I am not present are presided over by the Vice Chairman of the IDBI and banks cooperate with the RBI. An IDBI without RBI's backing may not be able to play such a role any more than the IFC was, before the creation of the IDBI.

(e) Developmental banking, whether in industry or agriculture, has to be aggressive rather than cautions. Yet it is essential that their operations should not disregard the safety of the loans made. Experience has shown that all too often financial institutions set up to help industry or agriculture find themselves in difficulties because they have made a large number of irrecoverable loans. So many cooperatives have run into difficulties because they have disregarded sound banking principles. The Reserve Bank being a non-political body is in a better position to apply restraint, where necessary, than an institution outside the banking field would be. This danger would be accentuated if it were to happen that such institutions were placed under the Ministries concerned with development rather than with Finance.

(f) Finally, there is the consideration that all these institutions are going concerns. They have made sizable loans and they are in the process of considering others. A major reorganization which would call for fresh legislation and involve transfer of staff, accounts, etc. would inevitably mean a temporary standstill in the process of making and recovering loans. I doubt whether the impact of such a change on the economy which is enough problem today, would be a healthy one.

As the issues relate to the scope of activities of the Reserve Bank itself, I feel that it would be better if you rather than I discussed the problem in all its aspects with D.P.M. and indicated to me the lines on which he feels we should proceed.

Yours sincerely,
L.K. Jha

Dr I.G. Patel
Special Secretary
Department of Economic Affairs
Ministry of Finance
Government of India
New Delhi

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D.O.No.G.8 BOMBAY
July 3, 1968

My dear Manubhai,

Thank you very much for sending me copies of your draft report. As already agreed, we shall meet and discuss on 9th July, and I suggest 11 in the morning for the purpose if it is convenient to you. You also told me that you would be here on Saturday, the 6th and would like to have some discussions on that day too. Damry will have returned from Hyderabad on the 5th evening; so I suggest you could meet him on the 6th morning—again at 11 a.m. if it suits you. Pendharkar will also be available for any discussions that you may wish to have with him. On Monday, the 8th you could meet Adarkar, Baksi and Anjaria. If points of detail have been covered in this manner, we could discuss the report as a whole on the 9th morning.

Meanwhile, I thought it might be useful if I wrote to you offering my comments on one basic issue, viz., whether the Reserve Bank should confine itself to the traditional central banking functions or whether it should continue with its developmental functions as well. It is only after one's sense of direction on this fundamental point is clear that the rest of the recommendations in the draft report can be considered and discussed.

In paragraphs 14 and 15 of the report, the view has been expressed that the Reserve Bank of India being entrusted with developmental work was a 'historical accident' and that this was partly due to 'the British Government not being interested in the development of the country'. Factually, it is only after independence and nationalization that the Reserve Bank of India began to be seriously involved in developmental work. No doubt, following the report of the Banking Commission which had recommended the setting up of the Reserve Bank of India, it had been entrusted with some special responsibilities in respect of cooperatives and agriculture from its very inception. But the Agricultural Refinance Corporation, the IDBI and indeed all that the RBI does for development are very much the result of deliberate policy decisions in the years after independence. The IDBI was set up as a subsidiary of RBI only four years ago, despite the fact that the IFC and the ICICI both had been in existence for many years before. The changes proposed in the draft report should, I suggest, be put forward, if they are to be put forward, not on the ground of rectifying a legacy of foreign rule or an inadvertent slip, but on the judgement that the previous decisions were unsound.

You have referred to the practice followed in a number of countries. Certainly in many of them, central banks do not undertake developmental activities. These are countries whose development has taken place over more than a century, who have not had to face the kind of problems which we are facing, and who have not had recourse to planning as an instrument of development. The example of England, USA, France and Japan is therefore not necessarily valid for us. However, I would point out that the Bank of England had the Bankers' Industrial Development Company which was set up after World War I as its subsidiary. The example of the Soviet Union or Hungary can hardly help us because they have no problem of providing finance for the private sector. On the other hand, if we look at Canada and Australia, we find a different picture. Not only was the I.D.B. in Canada set up as a subsidiary of the Bank of Canada—a model which we followed—but the Royal Commission on Banking a few years ago came out solidly in favour of continuing this arrangement. Canada, as you know, had been trying to industrialize its vast agricultural hinterland and to build up industries which, by American standards, fall into the group of small and medium industries. This is the main task of IDB in Canada. In Australia, the Commonwealth Bank initially undertook developmental functions as well. This position was changed in 1959 not because the system did not work well but because of political reasons. Even so, the Reserve Bank of Australia continues to deal with agriculture directly. In Brazil, central banking and agricultural and industrial credits are handled by the Banco de Brazil. In Italy, the IMI from 1931 to 1948 was very much under the Bank of Italy, the Governor of the latter being Chairman of the former. In fact, it would not be an exaggeration to say that the concept of the Central Bank keeping away from development is a nineteenth-century laissez-faire idea.

However, it is not by looking at what other countries are doing that we can really solve our problems. The main reasons why you seem to favour a change in our set-up seem to be the following:

a) Involvement in development distracts from the main functions of the RBI as a Central Bank which are therefore neglected.
b) As independent institutions, these agencies will be far more successful in fulfilling the tasks assigned to them.

So far as the first point is concerned, I should like to say quite categorically that whether the RBI discharges its functions well or poorly is in no way affected by the links which the RBI has with developmental work connected with IDBI or ARC. Both these institutions have their own staff and function as autonomous organizations. The people who look after management of the Public Debt or foreign exchange control do not have any occasion to devote any time to work connected with agricultural or industrial development. On the operational plane, the links between the developmental agencies under the RBI and the rest of the RBI staff boil down to only two things. Firstly, for filling their posts, they do frequently draw upon the RBI staff which has a good deal of experience of a kind which they need and which would not be available in the open market. Secondly, if and when occasions do arise for consultations, these can be done quickly and informally. For example, if the IDBI receives a request for financing an export on deferred payment, it can make a quick check from the Exchange Control Department whether deferred payment facilities have, in that case, been approved or would be approved. Similarly, when a commercial bank wants to open a branch in a rural area, the Department of Banking Operations and Development can make a quick informal check with the ACD to find out whether cooperative interests were likely to be adversely affected by it.

The point has been made (para 16.2) that the board of directors of a developmental organization should consist mainly of the representatives of interests it seeks to serve. So far as the ARC is concerned, it has an independent board of the type that you have described. It is only the IDBI which has the same board as the RBI. Now unless it is the intention to provide the IDBI with the kind of board which the ICICI has, viz., a board consisting of industrialists only, I doubt if the view could be sustained that the IDBI, on its own, would have a better board than it has today. On the RBI Board, there are always some of the foremost industrialists in the country as well as some of the smaller industrialists; in addition, there are persons of eminence in law, economics, accounting and public life. Then again, the IDBI in its actual operations and in examining new loan applications, does bring in other experts into the picture. I am not clear, therefore, as to what are the elements not represented on the RBI which should be on the IDBI, or which are on the RBI but should not be on the IDBI.

A point has been repeatedly made in the draft that it is desirable to sever the links between the RBI and developmental agencies so that what they do can be freely discussed and debated in public and in Parliament. I do not see any basis for the assumption that bodies like the IDBI and ARC are immune from criticism because they operate under the shelter of RBI. The credit policy followed by the RBI itself is a matter which is open to public debate, and in fact the Press makes frequent references to it. There have been references in Parliament also. Similarly, credit policy for agriculture and cooperatives has been discussed in various forums including meetings of State Chief Ministers presided over by the Union Minister for Food, Agriculture and Cooperation. If public criticism of the working of IDBI and ARC has not been vociferous, could it not be that this is because these institutions have followed sound objective criteria, and because it is recognized that they are not subject to political influence?

One of the major objections which I see to the pattern of reorganization outlined in the draft report is that not only does it mean a reversal of policy decisions taken four or five years ago, but it also means a reversal of certain major decisions taken in the last few months. We are just now engaged in making the entire banking system reorientate itself towards lending more on agriculture, to small-scale industries and exports. This lending incidentally has to be both short-term and medium-term. To achieve this, the boards of major banks have been reorganized, the National Credit Council has been created and the whole machinery of what is known as social control is being provided for, by the proposed amendments to the relevant acts. If now wholly new institutions are to be set up to look after agriculture, small-scale industries and exports respectively, then all this effort at reorganization will have been so much waste of time.

I am not one of those people who feel that if a mistake has been made, we should not own it up and rectify it. The crucial question to consider is whether the kind of reorganization which is being suggested will really help the people for whose benefit they are meant. I personally think it won't and I have set out below briefly the main reasons why I say so:

(a) Large-Scale Industry:

Experience has shown that for financing any large-scale project, it is necessary to secure the assistance not of one single institution but of a number of them. Thus, the IDBI works in close conjunction with the LIC, IFC and the ICICI as well as the commercial banks who also take a share in underwriting and in providing short- and medium-term finance.

The link between the IDBI and the RBI certainly helps in securing a coordinated approach among so many institutions, each fully independent of the other but each prepared to treat the Governor of the Reserve Bank as someone whose leadership they should accept. An independent IDBI will be no more effective in this than the IFC was before IDBI was created.

(b) Small-Scale Industry:
Their credit needs cannot be met by one central institution located in Delhi or even by branches in other State capitals. They need a decentralized approach. The banking system with thousands of branches all over the country including semi-urban areas is much more accessible to the genuine small-scale industrialists, and therefore the system that we have built up of involving the banking system in this task by giving them guarantees through our IFD and refinancing through IDBI is, to my mind, a better answer to the problem than the alternative now being put forward.

(c) Agriculture:
In regard to financing agriculture through cooperatives, one of the weaknesses today is that while the RBI deals with the apex body in each State, there are two other tiers between the apex body and the ultimate borrower. The result is that although the RBI gives money to the apex body for various purposes at 2 per cent below the bank rate, the ultimate rate which the borrower pays to a cooperative is higher than the maximum rates charged by commercial banks to their clients. This is because at each tier a margin has to be kept to take care of the cost of administration and the risk involved. If an all-India body were to be interposed so that there are 4 tiers instead of 3, then whatever else may happen, the lending rate to the ultimate borrower will go up by 1½ to 2 per cent, which will be the all-India body's margin. If you discuss the problem with someone like Prof. Gadgil who has direct experience of this, you will probably come to the conclusion that the alternative you have suggested will create more difficulties than it will solve.

In regard to the ARC, again its links with the ACD are vital and should not be disrupted. In fact, the real problem on the ARC front, as your report itself brings out, is that while large sums have been sanctioned, very little has been disbursed. This clearly calls for a study of the operational arrangements at the State level which hold up implementation of schemes and delay disbursements. If the ARC had been slow in sanctions, I would have been the first to concede the need to have a second look at it.

(d) Exports:
The financing of exports broadly has two aspects. On the one hand, there is the problem of credit to help manufacturers produce for exports, and on the other, to tide over the period which must elapse before they receive full payment from their buyers abroad. This, in my view, is best done by the banking system. The

manufacturer's bank would know its overall working, be providing it with finance for other purposes as well, and would have a lien on much of its assets. For another agency to be relied upon for this purpose would mean a fresh investigation of the manufacturer's affairs and financial position, conflict of claims in regard to lien and other similar problems. Countries which have got specialized agencies for financing exports like the Export–Import bank undertake, in the main, the responsibility for financing the buyer abroad. This is quite a different operation. The normal line of division is that for credits of a type which banks can provide, bank money continues to be deployed with appropriate guarantees to cover export risks. When, however, it is a question of making long-term credit available or of putting funds at the disposal of a buying country to buy whatever it wants, then another agency comes into play. This other agency can be the Government itself. This is our practice also when we make Government to Government loans available. On the other hand, in some countries there are special institutions which make such loans usually in addition to the loans at Government level. The question whether a separate Export bank is headed by India has to be considered in the light of whether we feel that the time has come when, in addition to Government to Government credits, we also need an institution to extend credits of this kind. However, to disturb the existing arrangements for financing the exporter to produce, pack and ship will, to my mind, do more harm than good.

I am sorry this letter has already become longer than I had intended it to be. Let me conclude. The economy is just beginning to emerge from a most disappointing and sterile phase. At this juncture, to think of radical changes in the very institutions that have sustained it in these difficult years may well have many adverse repercussions. These institutions, when they come into being, will probably spend a year or so in getting organized, finding office space, staff and other similar activities. One of the advantages of the present arrangement is that private savings as well as such credit as the Reserve Bank creates, do go to provide additional resources for the institutions and agencies under discussion. However, if wholly new institutions of the kind envisaged were brought into being and their main reliance for resources were through debentures, then all that would happen is that the money which certain institutions are required to invest in trustee securities will come to these bodies, and to that extent institutional support for Central and State loans will be undermined.

I hope you will think over what I have said above so that when we meet, we can jointly address ourselves to the basic issue of accelerating development in which I am as much interested as you are.

Yours sincerely,
L.K. Jha

Shri Manubhai Shah

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January 5, 1972

My dear I.G.,
I have been giving continuous thought to the question of the Unit Trust and the new Chairman that we have to find.

2. I appreciate that it is necessary to put forward several names, since some of them may not be acceptable to Government. I have, however, deliberately not eliminated any names (of which I was doubtful about their acceptability) since I wish to indicate the full range of possibles as *I* see them, and also explain the process of thinking that leads me to suggest these names.

3. The position of the Chairman, Unit Trust has, during the greater period of R.S. Bhatt's tenure been equated to a Deputy Governor of the Reserve Bank, carrying a salary of Rs 3,500/- (with no free house or house allowance). However, during R.S. Bhatt's first year he got something less. A starting pay of Rs 3,125 in the scale of Rs 3,000–125–3,250. We could consider this post as something approximating, from the point of view of pay only, to that of a Secretary to Government, but it could also be filled on the scale of Rs 3,000–100–3,500 or Rs 3,000–125–3,250 or Rs 3,250–125–3,500, if need be, to fit the selected person.

4. In addition to adequate standing, good general ability and, most important, complete integrity with a reputation for such, which are all obviously necessary qualities, I consider it highly desirable that the person selected should have professional expertise, or at least a degree of professional familiarity with the field in which he will have to function. Against this background, I cite four names below, with some comments.

(1) Shri J.S. Raj
My first name is/continues to be, J.S. Raj. He has been in Government service from about 1941 and until 1970. He has functioned in the public sector whenever he was not in direct Government service, in the Ministry of Agriculture, in the Stock Exchange wing of the Department of Economic Affairs (Additional Director, Stock Exchange) or working as our Director on the IMF. For long periods, he has held senior positions in what *I* call public institutions, that is, he was Director of the Asian Department of the IMF for many years, and more recently Vice-President of the International Finance Corporation, which, of course, is an affiliate of the World Bank. He is an economist with education in London and had done teaching in Rangoon University. He has acquired valuable acquaintance with Indian industry as Deputy General Manager of the ICICI (which is now owned for the major part by our financial institutions, LIC, banks, insurance companies that have been now taken over by Government, etc.). He was also, for some time, General Manager of the Nigerian Industrial Development Bank, as an employee of the World Bank.

In nationalized banks, in the nationalized LIC and in our recently taken over general insurance companies, we have been careful to retain men of professional standing and ability as the heads, and therefore we have kept on many of those who were Chairmen of large Indian banks before nationalization, and the senior executives of the life companies that merged and became the LIC, and more recently executives of the general insurance companies that have been taken over, when the men concerned are believed to be both able and honest. (I would like to cite Trikha, B.K. Dutt of banks and B.K. Shah of insurance.) I do feel that for our leading investment institution, the Unit Trust, it would not be incorrect in any way to apply similar criteria, that is we should value professional skill, experience and standing, and we should not count any period of service in a private company against the individual, especially if that has helped the individual in a unique way to acquire experience and skill in the particular field (banking, insurance or investment, as the case may be), and the person concerned has a good reputation. R.S. Bhatt was himself in the Oriental Life Insurance, in its Investment Department, a long time ago. This experience stood him in very good stead. J.S. Raj has been in the private sector, in the ordinary sense of the word, only after his return to India in the middle of 1970, when he became the head of a small investment corporation. Such experience as he has been acquiring in this is not only not misplaced but an addition to such acquaintance with Indian industry as he acquired in the ICICI and in the International Finance Corporation, as also during his period in the Finance Ministry's Stock Exchange wing.

(2) Shri A. Rajagopalan

The most obvious source to look for a person with the requisite experience would, after the Unit Trust itself (which cannot just yet provide a suitable chairman) be the LIC. There have been several Managing Directors of the LIC who have recently retired. Leaving out of account a possible name on the wrong side of 62, I would say, an eminently suitable person would be A. Rajagopalan, Additional Secretary in the Department of Insurance, who was the Managing Director of the LIC for a period and later in Ceylon advising the Ceylon Government on insurance, especially on problems of nationalization. He is a capable man well-known to you and to F.M. He is presently handling not only the LIC but also the general insurance companies that have been taken over by Government as a prelude to nationalization.

(3) Shri P.D. Kasbekar

I may briefly mention that while the Reserve Bank has a few people of ability and standing, it does not have any one (after Pendharkar) with any special proficiency or detailed acquaintance with the particular field (and none that I would suggest for being placed above the Executive Trustee from the Reserve Bank, Shri S.D. Deshmukh). I would like to pass on to discuss the possibilities from Government.

But first I would mention about P.D. Kasbekar. He is a senior Joint Secretary who handles not only capital issues but also matters relating to investment policies of the LIC and the Unit Trust. He has picked up a sound knowledge of Company Law and the working of the Company Law Department. He has the requisite personal qualities as well and would make a good choice.

(4) Shri K.S. Raghupathi
Apart from Kasbekar, I am not able to think of anyone whose work has directly touched on questions of investment. There are quite a few able senior officers in Government with a financial background, whom you will be able to think of. I shall be content with naming Raghupathi, now in the Ministry of Foreign Trade, a senior Joint Secretary (or possibly he has become Additional Secretary recently). He was in the Department of Iron and Steel when the first three public sector steel plants were erected and commissioned. He was our Economic Minister in London for quite a number of years and has fairly good general acquaintance with the field of banking, investment and company affairs. You may be able to think of one or two other suitable names.

(5) and (6)
There are two other names, viz. (5) Dr B.K. Madan, who was Deputy Governor, Reserve Bank of India and Vice-Chairman, IDBI and then retired as our Executive Director on the IMF; and (6) K.P. Mathrani who retired recently as Secretary, Ministry of Food and was previously not merely Secretary, Finance in undivided Bombay but also Additional Secretary in-charge of banking and 'internal finance' in the Department of Economic Affairs at Delhi and later Chairman, IFC. The last two are eminently suitable, and I put them last in my list only because I believe they have recently crossed their sixtieth birthday, being therefore only a couple of years or so younger than R.S. Bhatt.

I shall telephone you after you have had a chance to see this letter. I apologize for the length of this letter.

With kind regards,

Yours sincerely,
S. JAGANNATHAN

Dr I.G. Patel
Secretary
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

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JOINT COMMITTEE ON THE PUBLIC FINANCIAL INSTITUTIONS LAWS (AMENDMENT) BILL, 1973
COMPOSITION OF THE COMMITTEE

Shri B.N. Kureel, Chairman
Members
Lok Sabha
2. Shri Dinen Bhattacharya
3. Shri Chandulal Chandrakar
4. Shri K. Chikkalingiah
5. Chaudhry Dalip Singh

6. Shri Anadi Charan Das
†7. Shri B.K. Daschowdhury
8. Shri C.T. Dhandapani
9. Shri Jambuwant Dhote
10. Shri Jagdish Chandra Dixit
11. Shri Devinder Singh Garcha
12. Shri Indrajit Gupta
13. Shri Noorul Huda
14. Shri Ramachandran Kadannappalli
15. Shri Robin Kakoti
16. Shri N.S. Kamble
17. Shri Madhu Limaye
*18. Shri K.M. Madhukar
†19. Shri Vikram Mahajan
20. Shri Jagannath Mishra
21. Shri Shrikishan Modi
22. Shri Piloo Mody
23. Shri Surendra Mohanty
24. Shri Pratap Singh Negi
25. Shri Rajaram Dadasaheb Nimbalkar
26. Dr Laxminarayan Pandeya
27. Shri E.V. Vikhe Patil
28. Shri M.S. Purty
29. Ch. Ram Prakash
30. Shri Ram Swarup
31. Shri M.S. Sanjeevi Rao
32. Shri M.Ram Gopal Reddy
33. Dr Govind Das Richariya
34. Shri Babu Nath Singh
35. Shri Somchand Solanki
36. Shri K. Suryanarayana
37. Shri T.V. Chandrashekharappa Veerabasappa
38. Shri N.R. Vekaria
39. Shri Sukhdeo Prasad Verma
% 40. Shri C. Subramaniam

Rajya Sabha
41. Shri K.B. Chettri
42. Shri Babubhai M. Chinai
43. Shri Bhupesh Gupta
44. Shri Yashpal Kapur

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†Appointed w.e.f. 20.11.1974 vice Sarvashri K.R. Ganesh and A.K.M. Ishaque resigned.
*Appointed w.e.f. 30.8.1974 vice Shrimati Roza Vidyadhar Deshpande resigned.
%Appointed w.e.f. 20.11.1974 vice Y.B. Chavan resigned.

45. Shri M.S. Abdul Khader
46. Shri B.V. Abdulla Koya
47. Shri A.G. Kulkarni
48. Shrimati Sumitra G. Kulkari
49. Dr K. Mathew Kurian
50. Shri B.N. Mandal
51. Shri Rishi Kumar Mishra
52. Shri Lokanath Misra
53. Shri Deorao S. Patil
54. Shrimati Saraswati Pradhan
55. Shri S. Ranganathan
56. Shri R. Narasimha Reddy
57. Shri Kameshwar Singh
58. Shrimati Maimoona Sultan
59. Shri Subramanian Swamy
60. Shri Gian Chand Totu

Legislative Council

1. Shri S.K. Maitra, *Joint Secretary and Legislative Council*
2. Shri N.L. Vaidyanathan, *Additional Legislative Council*

Representatives of the Ministry of Finance (Department of Banking)

1. Shri M.G. Balasubramanian, *Additional Secretary*
2. Shri M.K. Venkatachalam, *Joint Secretary*
3. Shri V.K. Shunglu, *Deputy Secretary*
4. Shrimati Nalini M.K. Menon, *Deputy Secretary*

Secretariat

1. Shri P.K. Patnaik, *Additional Secretary*
2. Shri Y. Sahai, *Chief Legislative Committee Officer*

Report of the Joint Committee

I, the Chairman of the Joint Committee to which the Bill* further to amend the Industrial Development Bank of India Act, 1964, the Reserve Bank of India Act, 1934, the Industrial Finance Corporation Act, 1948, the State Financial Corporation Act, 1951, the Life Insurance Corporation Act, 1956 and the Unit Trust of India Act, 1963 was referred, having been authorized to submit the report on their behalf, present their report with the Bill, as amended by the Committee annexed thereto.

2. The Bill was introduced in Lok Sabha on 22nd December, 1973. A motion for suspension of the first proviso to Rule 74 of the Rules of Procedure and Conduct of

*Published in the Gazette of India, Extraordinary, Part II, Section 2, dated 22nd December, 1973.

Business in Lok Sabha in its application to the motion for reference of the Bill to a Joint Committee of the Houses was moved in Lok Sabha by Shri K.R. Ganesh, the then Minister of State in the Ministry of Finance on 25th March, 1974 and was adopted.

Thereafter, the motion for reference of the Bill to a Joint Committee of the Houses was moved in Lok Sabha by Shri K.R. Ganesh, the then Minister of State in the Ministry of Finance on the same day and was adopted (Appendix I).

3. Rajya Sabha concurred in the said motion on 11th May, 1974 (Appendex II).

4. The message from the Rajya Sabha was published in Lok Sabha Bulletin – Part II, dated 13th May, 1974.

5. The Committee held 23 sittings in all.

6. The first sitting of the Committee was held on 6th June, 1974 to draw up their programme of work. The Committee decided to invite memoranda from all State Governments, leading Chambers of Commerce and Industry, Public Financial Institutions, Employees Associations of Public Financial Institutions, eminent economists and cooperative organizations interested in the subject matter of the Bill and also decided to issue a Press Communiqué on its behalf fixing 10th July, 1974 as the last date for receipt of memoranda. The Committee also decided to take oral evidence of the representatives of some of the associations, individuals, etc.

7. 25 memoranda on the Bill were received by the Committee from various associations, organizations, etc. (Appendix III)

8. The Committee heard oral evidence given by the representatives of various associations, organizations, etc. at their sittings held from 15th to 17th July, 25th to 27th September, 21st to 23rd October 1974, and 5th to 7th February and 16th April 1975. (Appendix IV)

9. At their sitting held on 10th June 1975, the Committee decided that (i) the evidence tendered before them might be laid on the Table of both the Houses; and (ii) two copies each of memoranda received by the Committee from various associations, organizations, etc. might be placed in the Parliament Library after the report of the Committee was presented, for reference by the Members of the Parliament.

10. The Report of the Committee was to be presented by 26th July, 1974. The Committee were granted extension of time twice—the first extension on 23rd July, 1974 was up to 21st February, 1975, and the second extension on 19th February, 1975 was up to 28th July, 1975.

11. At their sittings held on 9th and 10th June, 1975 the Committee held general discussion on the various points raised in the memoranda submitted to the Committee, and also during the course of evidence tendered before the Committee.

12. The Committee considered the Bill clause-by-clause at their sittings held on 19th and 20th June and 11th July, 1975.

13. The Committee considered and adopted their Report on 19th July, 1975.

14. The observations of Committee with regard to the principal changes proposed in the Bill are detailed in the succeeding paragraphs.

15. *Clause* 2: The Committee are of the view that the Industrial Development

Bank of India which would be the principal financial institution in the country and the other financial institutions should deploy their resources in accordance with national priorities.

Clause 2 has been amended accordingly.

16. *Clauses* 5: 19: 20: 39: [*Original clause* 37]; 48: [*Original clause* 44]; 56 [*Original clause* 51]; and 58 [*Original clause* 53]. The amendments made are of a formal nature, being consequential to the change of the year.

17. *Clause* 7: (i) The amendment made in Paragraph (c) of sub-section (1) of proposed section 6 is of a consequential nature.

(ii) New section 6 (1) (c) (iii): The Committee are of the opinion that two directors of the Development Bank should be from amongst the employees of the Development Bank and the financial institutions. Out of these directors, one shall be selected from amongst the office employees, and the other shall be selected from amongst the workmen, and such selection shall be made in the manner prescribed by the Central Government.

New section 6 (1) (c) (iii) has been inserted accordingly.

(iii) Proposed new section 6(1) (c) (v): The Committee are of the view that for the words 'practical experience', the words 'professional experience' may be substituted.

The Committee are also of the view that special knowledge of, and the professional experience in, 'marketing' should also be one of the qualifications for eligibility for being nominated as members of the Board of Directors of the Development Bank.

Proposed new section 6(1) (c) (v) has been amended accordingly.

18. *Clause* 17: The amendments made are of a verbal nature.

19. *New Clause* 21: The Committee are of the view that the Industrial Finance Corporation Act, 1948 might also extend to Kohima and Mokokchung districts in the State of Nagaland from such date as the Central Government may, by notification in the Official Gazette, appoint.

New Clause 21 has been inserted accordingly.

20. *Clause* 22 (*Original clause* 21): The amendment made is of a drafting nature.

21. *New Clause* 23: The Committee on Subordinate Legislation of Lok Sabha have recommended that rules and regulations made under various enactments should statutorily be published in the official Gazette.

The Committee on Subordinate Legislation of both Houses of Parliament have also approved a revised model clause for the laying, before Parliament, of rules, etc. made by the Central Government under Central Acts.

New clause 23 has been inserted with a view to amending section 42 of the Institutional Finance Corporation Act, 1948 in order to give effect to the above recommendations of the Committee on Subordinate Legislation.

22. *New clauses* 41 *and* 53: New clauses 41 and 53 seek to insert new section 6A in the Life Insurance Corporation Act, 1956 and new section 19A in the Unit Trust of India Act, 1963, respectively. Both the sections seek to empower the Corporation or the Unit to impose conditions necessary to protect their interests, and for ensuring that the accommodations granted by them are put to the best use by the concerns

to which such accommodation had been granted. Further, they provide that where any arrangement is entered into by the Corporation or the Unit Trust with any assisted concern providing for the appointment by either of them, of one or more directors, the provisions of the Companies Act, 1956, or of any other law shall not apply to such director, and that such director shall hold office during the pleasure of the Corporation or the Unit Trust, as the case may be, nominating him and shall not incur any liability for anything done or omitted to be done in good faith in the discharge of his duties as a director and shall not also be liable to retire by rotation. Since the role of the nominated directors is quite different from that of the elected directors, it is necessary to extent the aforesaid legal protections to the nominated directors so that they may function properly as directors of the assisted concerns.

The Committee notes that provisions similar to these provisions already exist in the Industrial Development Bank of India Act, 1964, the Industrial Finance Corporation Act, 1948, and the State Financial Corporations Act, 1951, and as such, there is no objection, in principle, to the insertion of the proposed new sections.

Accordingly, new section 6A has been inserted in the Life Insurance Corporation Act, 1956, and new section 19A has been inserted in the Unit Trust of India Act, 1963.

23. *New clause* 43: The Committee on Subordinate Legislation of both Houses of Parliament have approved a revised model clause for the laying, before Parliament, of rules, etc. made by the Central Government under Central Acts. This clause has been inserted with a view to bring section 48 in line with the revised model clause approved by the above-mentioned Committees.

24. *Clause* 1 and *Enacting Formula*: The amendments made are of a formal nature.

25. The Committee recommend that the Bill, as amended, be passed.

B.N. Qureel
Chairman
Joint Committee

New Delhi
July 25, 1975
Sravana 3, 1897 (*Saka*)

Minutes of Dissent

I

The Public Financial Institutions Laws (Amendment) Bill 1973, as approved by the majority of the Joint Committee, is a retrograde piece of legislation. The proposal to delink Industrial Development Bank of India, Unit Trust of India, Industrial Finance Corporation of India and State Financial Corporations from the Reserve Bank of India, and to convert the Industrial Development Bank of India as an apex financial institution, separated from the Reserve Bank of India and functioning as a parallel institution under the administrative control of the Ministry of Finance, Department of Banking, will destroy the very foundations of the credit structure which has been built up during the last two decades.

The main objective of the Bill is to 'restructure the Industrial Development Bank of India in certain respects, so as to enlarge its role as the principal financial institution financing industry and for coordinating the working of other financial institutions engaged in the financing or promotion or development of industry.' It is our contention that the Bill, as amended and approved by the Joint Committee, will fail miserably in achieving the above objective. In fact, the contents of the Bill have very little relation to the actual provisions in the Bill. The statement of objectives, thus, remain as a statement of pious wishes, totally irrelevant to the actual provisions in the Bill. We are surprised to note that the Bill has been approved by the majority in the Committee, rejecting the very weighty and valuable arguments put forward by experts during the tendering of evidence before the Committee. The evidence before the Committee very clearly indicate that the Bill has been misconceived, and should therefore be scrapped. The evidence further indicates that there is no valid economic or administrative reason for delinking the Industrial Development Bank of India from the Reserve Bank of India.

The reconstitution of the Industrial Development Bank of India, as proposed in the Bill, will not improve operational efficiency of the Industrial Development Bank of India; nor will it create better machinery for developmental financing, better coordination of credit operation, etc. The Industrial Development Bank of India, from its very inception in 1964, was expected to function as 'The principal financial institution for coordinating the working of institutions engaged in financing, promoting or developing industry for assisting the development of such institutions.' This characterization of the functions of the Industrial Development Bank of India is nothing new. For, as stated by the then Finance Minister, the late Shri T.T. Krishnamachari, while moving the Industrial Development Bank of India Bill in 1964:

> 'We are envisaging the new Industrial Development Bank of India as the Central Coordinating Agency which ultimately will be concerned directly or indirectly with all the problems and questions relating to the long- and medium-term financing of industry.'

The organizational changes proposed in the Bill will introduce dichotomy in the credit structure, between long-term lending and short-term finance. At present, coordination between long-term lending and short-term credit is attempted to be brought about by the unified control exercised by the Reserve Bank of India, which is really the apex of all financial institutions, ensuring the desired integration in the credit structure.

It is generally accepted principle that, in a developing economy the Central Bank should perform not only the traditional role of banker to the bankers, but also perform the developmental and promotional role in the field of long-term lending. It is this principle which is being negatived by the present Bill.

The Reserve Bank of India has, during the last two decades, initiated steps in promoting both industrial and agricultural finance. The operations of the Reserve Bank are not without blemish. The point at issue, however, is that the decision to integrate short-term and long-term finance under guidance of the Central Bank, that is, the Reserve Bank of India, was a step in the right direction and consistent with the modern notion of Central banking in the context of a developing economy.

The protagonists of the present Bill seem to argue that, though the Reserve Bank of India performed a useful role in the promotion of industrial finance in the past, a stage has now come when industrial financing function should be separated from the Reserve Bank of India. This argument implies that developmental finance is not a core function of the Reserve Bank of India, and that they were given the extra responsibilities for nursing a child which has now become adult. The analogy is that industrial finance should now be left free to grow as an independent entity. As pointed out earlier, this argument is a distorted one and negates the fundamental principle that there should be no dichotomy between short-term credit and long-term lending and that the Central Bank, particularly of a developing country, should play the crucial role of integration and coordinating both these areas of financing.

The Industrial Development Bank of India was set up in 1964 as a wholly owned subsidiary of the Reserve Bank of India. The Industrial Development Bank of India was to function as the apex of an integrated structure of industrial finance, and to provide resources for industrial projects of large size which could not be catered to by the then existing agencies and institutions. Apart from extending medium- and long-term finance in the form of direct deployment of funds to industrial units, the Industrial Development Bank of India was also to give refinance facilities to the commercial banks and State Financial Corporations.

It is important to note that a number of institutions were set up during the last two decades of India for meeting the requirements of short-term credit for trade and commerce, medium- and long-term investment finance for industry, as well as short-, medium- and long-term finance for agricultural operations. In the creation of these specialized institutions and in guiding them, the Reserve Bank of India has played a vital role. The direct and indirect control, assistance and guidance of the Reserve Bank has been helpful in ensuring a certain degree of coordination and integration of the functions of these specialized institutions.

Even after the present Bill is passed, agricultural finance will continue to remain with the Reserve Bank. Thus, under the new dispensation, the Reserve Bank of India will continue to perform the developmental function in the field of agricultural finance, but will have very little role in the field of industrial finance. This will surely be disastrous to a proper development of the credit infrastructure in the country, apart from the fact that it implies an asymmetry which is irrational and illogical.

The present Bill will introduce a situation where the benefit of professional management under the control and guidance of the Reserve Bank of India will be denied to the IDBI. This will also be contrary to the intention of the farmers of the original IDBI Bill in 1964. To quote the Finance Minister who moved the Bill in the Rajya Sabha in 1964:

> 'In view of its close association with the Central Bank of the country, the IDBI will be able to draw on the knowledge and experience of that Bank and to obtain in its day-to-day operations, such guidance and assistance as may be necessary.'

The IDBI was constituted as a subsidiary of the Reserve Bank of India in consonance with the widely accepted principle that the Central Bank of a developing country should assume special responsibility for the promotion of a sound investment banking structure. Explaining the rationale for making IDBI a fully owned subsidiary of the Reserve Bank of India, the then Finance Minister, the late Shri T.T. Krishnamachari stated in the Lok Sabha thus:

> 'The House will appreciate that the responsibilities which are proposed to be entrusted to the institution will be onerous and heavy. It is, in a sense, a lender of the last resort for all periods other than purely short-term periods, and for all or practically all purposes, as far as industrial enterprises are concerned. We have considered it desirable in those circumstances, to provide for the ownership and management of the new institution being vested in the Reserve Bank of India.'

Apart from the above theoretical and fundamental considerations, there are several practical advantages in continuing the present arrangement, that is, the IDBI continuing as a fully owned subsidiary of the Reserve Bank. Mention has already been made to the availability of the fund of professional management and financial expertise which the Reserve Bank possesses and which will flow to the IDBI as a matter of course. Another distinct advantage arises from the financial dependence of the IDBI on the Reserve Bank. To quote the Annual Report of IDBI for the year 1971–72:

> 'As a result of the discontinuance by the Government of the flow of funds to the IDBI since 1969–70, the main sources of funds for the IDBI in the last three years have been (i) repayment of instalments by borrowers, (ii) borrowings from the Reserve Bank of India out of the National Industrial Credit (Long-Term Operations). Fund and increase in paid-up capital, which is wholly contributed by that Bank. Borrowings from the LTO Fund have been on an increasing scale during the last three years.'

Against these distinct advantages, the new Bill gives the definite impression of a futile institutional change. By delinking the IDBI from the Reserve Bank, neither the volume of credit to industry will increase nor will the cost of credit decrease. Thus, there is no economic rationale for the Bill.

The evidence given before the Joint Committee show that certain large industrial houses such as Tatas and Modis had taken interest in the proposal for delinking of IDBI from the Reserve Bank of India, and that Shri Palkhivala had also suggested such a proposal.

The implication is very clear. Some of the monopoly houses feel that the 'relative' independence of the Reserve Bank of India, and therefore of the IDBI, is an impediment in the free flow of financial resources to the coffers of these monopoly houses. Not that these houses have not benefited from the existing dispensation. Their expectations are that once the IDBI is delinked from the Reserve Bank of India, their ability to corner public funds to bolster their private profits and assets will be enhanced considerably.

It is logical to conclude that once the 'relative' independence of the Reserve Bank of India in directing long-term developmental finance through the IDBI mechanism is taken away and powers handed over to a holding company under the direct control of the Banking Department of the Government of India, it will further strengthen the stranglehold of the monopoly companies on developmental finance in particular and on the economy in general. Delinking of IDBI from the Reserve Bank of India will further encourage the disastrous tendencies of monopoly growth in the country and result in the misuse of resources for non-priority sectors.

In conclusion, it can be asserted that, while the Bill has no economic or administrative rationale behind it, it will have disastrous consequences to the Indian economy arising from the dichotomy between short-term credit and long-term finance, and the definite possibility of higher and easy control by monopoly houses on credit availability. The only logical inference we are able to draw from this otherwise irrational and hasty measure is that the higher officials of the Ministry of Finance, Department of Banking, and the economic power groups are interested in expanding their realm of financial management and control, irrespective of the accepted principles of credit policy and planning and economic rationale.

We totally oppose the Bill and reject the conclusions of the Joint Committee. In our opinion, the Bill should be withdrawn.

New Delhi K. MATHEW KURIAN
July 22, 1975 DINEN BHATTACHARYA

II

This Bill, in our opinion, being limited to the question of certain structural changes only in the relationship between the Industrial Development Bank of India and the Reserve Bank of India, begs the main question, viz. the credit policies of the public financial institutions, *vis-à-vis* various sectors of industry and areas of industrial development. The Bill does not, at all, venture into any reformulations or redefinitions of Government's basic policies in the matters of financing, promoting and developing industries. To that extent, the Bill is quite inadequate and will have little or no impact on the actual credit map as it has emerged over the years.

Evidence cited before the Joint Committee, more than amply confirmed that the dominant bias in the credit outlook of these financial institutions continues to be in favour of the big business houses. Thus, the five institutions (IDBI, IFCI, LIC, UTI and ICICI) have between them sanctioned loans of over Re 1 crore each to 253 private companies. The total of such loans amounted to no less than Rs 837.42 crores as on 31st December, 1974; out of the 253 companies concerned, 80 received loans of more than Rs 3 crores each. The bulk of the beneficiaries are undertakings attached to one or other of the monopoly houses.

Further, these five financial institutions are holding more than 25 per cent of the paid-up capital in each of 129 companies, representing a total investment of Rs 76.83 crores as on 31st December, 1974. Equity of the value of Rs 25 lakhs and over is held by these institutions in each of 70 companies of the monopoly sector. Even a giant like Tata Iron Steel & Company (TISCO) has 39 per cent of its equity shares held in this way.

It is this pro-monopoly bias in the credit fall-out from the public financial institutions which calls for review and assessment in the light of the declared national objectives and priorities, and for suitable correction through legislation. In our opinion, the small-scale cooperative, agricultural, marketing and similar sectors are being neglected by the public financial institutions, but all these matters do not come within the purview of the Bill at all.

We had pressed for inclusion of two elected representatives of the workmen employees of the restructured Industrial Development Bank of India to be included as Directors. Ultimately, it has been accepted that there should be one such, but the manner of his nomination/selection has been left to be prescribed. We consider this to be unsatisfactory. There is no reason why elected representatives of the employees should not be on the Directors' Board, as in the case of the nationalized banks, so that they can effectively contribute to the better functioning of the Industrial Development Bank of India in keeping with national priorities.

In the end, we would like to stress that the functioning of the institutions such as Industrial Development Bank of India in the interests of the national economy, and for the promotion of truly national-building economic and social objectives cannot be satisfactorily ensured without certain radical structural changes in the industrial sector.

New Delhi — INDRAJIT GUPTA
July 22, 1975 — BHUPESH GUPTA

77

INTERNAL NOTE
IFD
17.2.1976

INDUSTRIAL FINANCE DEPARTMENT

Transfer of functions and staff to Industrial Development Bank of India consequent upon Public Financial Institutions Laws (Amendment) Act, 1975

The Industrial Finance Department was set up in September 1957 to deal with all matters pertaining to industrial finance, including the activities of State Financial Corporations and the administration of Refinance Corporation for Industry. Later, the administration of the Credit Guarantee Scheme was also entrusted to it. With the establishment of the Industrial Development Bank of India in July 1964, the function of refinance was transferred from Industrial Finance Department to Industrial Development Bank of India. The major responsibilities of IFD are: (i) inspecting and financially assisting the SFCs and coordinating their procedures and policies, (ii) functions which relate to IDBI itself, viz., subscription to share capital of the IDBI by Reserve Bank of India, purchase by Reserve Bank of India of bonds and debentures issued by IDBI, making of loans to IDBI for purchase of or subscription to shares, bonds and debentures issued by Industrial Finance Corporation of India, SFCs and other notified financial institutions, making short-term loans to IDBI, etc., (iii) administration on behalf of the Government of India the Credit Guarantee Scheme, (iv) promotional work connected with the growth and expansion of small-scale industries, especially their credit needs. The Department opened regional offices at Bombay, Calcutta, Madras and New Delhi in early 1968 with a view to making closer contacts with State Financial Corporations, banks and other bodies, and to play more effectively a promotional role in ensuring an adequate framework of institutional credit for growth and expansion of industries, particularly in the small-scale sector. In view of the greater responsibilities devolving on the Chief Officer, IFD, the post was upgraded to that of Senior Officer Grade I with effect from 18th May 1968.

The Department has been divided into the following five Divisions:

1. Planning Division
2. Operations Division
3. Inspection Division
4. Guarantee Division
5. Administration Division

2. Section 16 of the captioned Act, provides that if, on the appointed day, or any time thereafter, any of the functions of the Reserve Bank is transferred to the Development Bank, that Bank may also take over the staff who were attending to these functions immediately before the appointed day, with the previous approval of the Reserve Bank. Such staff would also be entitled to exercise options within a period of eighteen months from the appointed day and so opting, they should be repatriated to Reserve Bank before the expiration of thirty months from the appointed day.

3. The question of transferring to IDBI the functions of IFD in relation to the affairs of SFCs was considered at length in Central IFD's note dated 15th September 1975, and it has been decided by Deputy Governor (Shri Chari) and D.G. (Se.) that the allocation of work of IFD as between the Reserve Bank and the IDBI consistent with the laws should be as follows:

(a) All items of work in relation to SFCs such as that relating to establishment of SFCs, raising of their share capital, appointment of Managing Director, approval of General Regulations, underwriting of shares, issue of directives, inspections, etc. will be attended to by IDBI;

(b) IDBI to scrutinize proposals for issue and sale of bonds and debentures so far as individual SFCs are concerned and to present a consolidated picture to RBI which will then send a reply to IDBI after consulting the Secretary's Department indicating the total amount of distribution and the terms (cf. Section 7 (1) of SFCs Act, as now amended);

(c) The IDBI to deal directly with the Department of Accounts and Expenditure with regard to borrowing of money by SFCs from Reserve Bank. The DAE will consult the IFD on each reference before taking a decision (Section 7(2) of SFCs Act);

(d) With regard to borrowing of money by the SFCs from the State Governments, the IDBI, after consulting the SFCs, and the State Government concerned to refer proposals individually to IFD. The IFD will then accord RBI's approval in each case (cf. Section 7(3) of SFCs Act);

(e) In respect of acceptance of deposits by SFCs, IFD to convey general guidelines to IDBI for communication to SFCs. (cf. Section 8 of SFCs Act);

(f) The IFD will continue to receive and analyse the monthly and quarterly returns from SFCs as hitherto for purposes of assessing the resources position of SFCs, preparation of statistical statements, notes, etc. (cf. Section 38(1) and (2) of SFCs Act); and

(g) The expertise now available to IFD, in its Planning Division with regard to SFC's work, training, references relating to industrial finance, etc. should form part of IDBI and the concerned staff in that Division should be transferred to that Bank. The Division will continue to be located on the fourth floor of IFD. (However, the compilation of data received from commercial banks regarding their advances to small-scale industries and transport operators, now being handled in the Planning Division of IFD, will be transferred to Department of Banking Operations and Development.)

In consequence of the above decisions, the staff concerned with the work would also stand transferred to IDBI with effect from the date the work is taken over by IDBI. They now form part of the Operations Division, Planning Division and Inspection Division of Central IFD and its regional offices at New Delhi, Calcutta and Madras. The particulars of staff to be so transferred are listed in the annexure to the note. The General Manager, IDBI, who has been furnished with a copy of the list, has accorded his consent to take them over.

4. In this connection, there is only one issue which needs further consideration of the authorities. The IFD has one-man offices at Indore, Jaipur, Patna and Trivandrum. D.G. (Se.) is of the view that IDBI should also take over the staff attached to these offices. The IDBI, on the other hand, have stated that they already have liaison officers at these centres/regions and the takeover may not be of much use to them. The one-man offices have been attending to promotional work in the field of financing of small-scale industries. This, in the present context, inevitably includes occasional inspection work on behalf of the Credit Guarantee Corporation. Considering the role of such offices, the Chief Officer, IFD has stated in his note dated 22nd September 1975, after discussion with D.G.(N), that these offices may continue to remain part of IFD for attending to developmental work relating to advances granted by commercial banks to small-scale industries. We are afraid this may not be an acceptable proposition. The object in creating the one-man offices as advised to Efficiency and Development Sub-Committee is as follows:

(i) to help the State Financial Corporations in:
   (a) formulation of policies;
   (b) introduction of special schemes for assisting industries;
   (c) bringing together entrepreneurs and financial corporations and assisting them in preparation of schemes, negotiations of terms, etc.; and
   (d) attending to developmental functions which are increasingly becoming the responsibility of the Bank.

(ii) to study the regional and/or sector-wise problems, affecting the industries from time to time so as to help the Bank to evolve appropriate policies and issue suitable advices to the financial institutions; and

(iii) to undertake intensive studies to identify the potential for small-scale industries in different districts of the States, and to have an effective follow-up action.

5. The IFD has been playing a major role in reorienting the loan policies of State Financial Corporations. The one-man offices have been giving an useful feedback to Planning Division of IFD. In this context, the one-man offices have established contacts with SFCs, the Department of Small-Scale Industries in the State Governments, and the Small-Scale Industries Service Institutes. In terms of the provisions of Public Financial Institutions Laws (Amendment) Act, 1975, the SFCs, are statutorily placed under the care of the IDBI. That Bank has, it needs to be conceded, been so far preoccupied with large industrial units and projects. It will take some time for it to develop that comprehensiveness of attitude to industries in which there is equal and constructive understanding of the wide spectrum from very large to very small industries. We feel, therefore, that it will be advantageous to that institution to take over the one-man offices also, as suggested by D.G. (Se.).

6. Pending a decision on this issue, it is proposed to arrange for the transfer of the listed staff to IDBI with effect from 1st March 1976, as the Act provides for taking over any of the functions of Reserve Bank either from the appointed day or at any time thereafter. If this date is approved, it will also reduce financial adjustments for part of the month. This may kindly be approved.

7. The staff listed in the Annexure who are proposed to be transferred to IDBI fall in the following categories:

(i) Officers in Grade 'B' appointed/promoted prior to 1.1.1970 and the higher grades, who are covered by Group Seniority System;

(ii) Officers in Grade 'B' appointed/promoted on or after 1.1.1970 and of officers in Grade 'A', both Promotees and Direct Recruits who are covered by the Combined Seniority Scheme as per Administration Circular No. 15 dated 22nd May 1974; and

(iii) Non-officer staff, for example, Banking Assistants, Clerks, Stenographers, Typists, Peons, etc., who are covered by the Combined Seniority Scheme applicable to their respective cadres.

8. The staff covered by the Combined Seniority Schemes, that is those in categories in (ii) and (iii) above will have a settled position vis-à-vis their counterparts in IDBI, and it will not be difficult to determine their seniority in the IDBI. In regard to officers in category (i) above, the following alternatives were discussed between the General Manager, IDBI and the Chief Officer, IFD, for merging the seniority of the officers who may go to IDBI and decide to stay there:

(a) On the basis of the length of service in their substantive grade (this has been adopted by the Bank for merging the seniorities of the officers in Grade 'A' belonging to various Groups); or

(b) On the basis of the date of confirmation in the substantive grade (as per Staff Regulation 28); or

(c) On the basis of their date of confirmation in Grade 'B'.

The general consensus was in favour of adopting the first alternative, although it was decided to leave the matter open for consideration at higher level. Recently, the Bank has appointed a Departmental Committee which would, *inter alia*, suggest measures for determining inter-group seniority. It is proposed that the basis suggested by the Committee may also be adopted in case of the aforesaid officer staff.

Pending a decision on this issue, it is proposed to advise the officers, who will be transferred to IDBI that their seniority in IDBI will be advised to them separately.

9. The Chief Officer, IFD has asked for a minimum complement of staff for attending to the residual items of work relating to SFCs as noted against items (c) to (f) of point 3 of the note. This matter will be separately processed.

Although the work relating to SFCs stand transferred to IDBI with effect from 16.2.76, it would be permissible under the Act to transfer men from a different date and for the sake of convenience, we have suggested that 1st March 1976 be the material day for the transfer of staff.

2. Pending decision on the case of one-man offices, Draft Admn. Cir. has been prepared (vetted by Legal Deptt.), which may please be approved.

The proposal made in point 6 of the above note requires to be discussed with the Chairman, IDBI, to ascertain whether the proposed date of 1st March 1976 is acceptable to them. The issue relating to taking over of one-man offices by IDBI, as referred to at points 4 and 5 may also perhaps be discussed again between D.G.(N.) and D.G.(Se.) and suitable orders thereon given.

The other proposals made in the above office note regarding transfer of IFD staff to IDBI are in order.

18.02.76

D.G.(N.)

1. Regarding the proposed transfer of the listed staff of IFD to IDBI with effect from 1st March 1976, CM may informally consult the General Manager, IDBI, who, I think, should have no objection to it.

2. The matter relating to taking over of one-man offices of IFD by IDBI did come up for discussion, but no finality was reached. I agree with D.G.(Se.) that IDBI may also take over these one-man offices.

18.02.1976

D.G.(Se.)

I agree that the services of the officers and staff to be deputed from the IFD to the way be transferred as from 1st March 1976. Technically, this will curtail by weeks the period of eighteen months within the staff so departed will have to exercise options to revert to the Reserve Bank, but reduction in the period will be very slow. No difficulties are likely to be created on this account.

2. In order that the officers and other employees who are transferred may know that their services have been placed at the disposal of the IDBI, the administration circular may however be issued within a day or two.

3. It will be hardly worthwhile for us to consult the IDBI formally or informally about either of the two points referred to in D.G.(N)'s note dated 18.2.76. The IDBI may be informed about these decisions and so far as the one-man offices are concerned, they may be asked to decide in due course whether these officers should

continue or whether the officers concerned should be transferred to other offices, including liaison offices under the IDBI.

R.K. SESHADRI
19.2.76

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INTERNAL NOTE
2.9.1978

DEPARTMENT OF NON-BANKING COMPANIES

Comprehensive legislation to regulate deposit-acceptance and other activities of financial companies

While examining in depth the provisions of Chapter IIIB of the Reserve Bank of India Act, 1934 and the directions issued thereunder in order to assess their adequacy in the context of ensuring the efficacy of the monetary and credit policy of the country and affording a degree of protection to the interests of the depositors who place their savings with non-banking companies, the Raj Study Group on Non-Banking Companies had made several recommendations for the tightening up of the regulatory measures for acceptance of deposits by non-banking companies. Most of the recommendations made by the Group were accepted by us as well as the Government. In this connection, a reference is invited to Memorandum No.B-18 dated 3rd October 1975 submitted to the Central Board of the Banks. With a view to giving effect to these recommendations, the Directions earlier issued to financial and miscellaneous non-banking companies were replaced by two new sets of Directions effective from 1st July 1977. Similarly, the Companies (Acceptance of Deposits) Rules, 1975 were amended effective from 1st April 1978. Further, a Bill entitled 'The Prize Chits and Money Circulation Schemes (Banning) Bill', drafted by us and forwarded to Government for necessary action was introduced in Parliament in its last Budget Session, and it is likely to be enacted into a law soon. A Bill captioned 'The Chit Funds Bill' was also drawn up by us in the light of the recommendation of the Raj Study Group to be enacted as a central legislation. The Central Government initially called for the comments of the State Governments on the Bill. . . . The Reserve Bank of India Act is also being amended with a view to prohibiting unincorporated bodies from accepting deposits from not more than a specified number of persons, and the necessary provisions in this regard have been incorporated in the Banking Laws (Amendment) Bill, 1978 which is also expected to be introduced in Parliament at an early date.

2. In paragraph 5.54 of its Report, the Raj Study Group has pointed out that most of the financial companies are para-banking institutions which accept deposits from the public for the purpose of lending and/or investment. As such, the activities of these companies in regard to deposits, loans and advances, etc., should be regulated broadly on the lines of the provisions contained in the Banking Regulation

Act, 1949. While issuing the Non-Banking Financial Companies (Reserve Bank) Directions, 1977 effective from the 1st July 1977, only such of the recommendations of the Group as could be implemented immediately within the framework of the existing provisions of Chapter IIIB of the Reserve Bank of India Act, 1934 had been incorporated in the said Directions. It had then been decided that the other recommendations regarding management, capital structure, control of advances, restrictions on the opening of branches, circumstances in which financial companies may be ordered to be wound up, powers for amalgamation, etc. may be included in a comprehensive legislation to be enacted for the purpose as these provisions could better form part of a package deal in the context of allowing certain classes of financial companies to raise funds by way of deposits up to ten times their net owned funds. (as against the present ceiling of 25 per cent of the net owned funds)

3. In context of the above aspects, a Bill entitled 'The Non-Banking Financial Companies Regulation Bill', was drafted by Shri B.N. Chikarmana and forwarded to Central Office. After a few rounds of discussion by the undersigned with him in Bombay as well as in Calcutta, the various provisions of the Bill have been finalized, taking into account the recommendations made in the Report of the Raj Study Group as also certain other developments. A copy of the Bill is placed below. A statement containing brief Explanatory Notes relating to the provisions made there is also attached. While drafting the Bill, we have taken note of legislation on similar subjects obtaining in other countries and a few welcome provisions from the Protection of Depositors Act, 1963 of the United Kingdom as well as the Borrowing Companies Act, 1969 of Malaysia have been drawn upon so as to make the provision in the present Bill as comprehensive as possible. Since, on the enactment of the Bill into a law, certain provisions in Chapter IIIB of the Reserve Bank of India Act, 1934 are proposed to be repealed, such of these provisions as are deemed to be necessary have also been incorporated in the Bill. Similarly, certain essential provisions from section 58A of the Companies Act, 1956 have also been incorporated at the relevant places in the Bill. Though the Bill is, to a large extent, self-contained, it has been expressly provided that the provisions thereof shall be supplemental to and not in derogation of, the provisions of the Companies Act, 1956. This is because the Bill only provides for 'registration' of financial companies with the Reserve Bank and in respect of matters such as incorporation, memorandum and articles of association, meetings etc., the companies would be governed by the Companies Act. It is reported that the Committee's recommendations include, *inter alia*, those relating to prohibiting private limited companies from accepting deposits, restrictions on inter-corporate investments, etc. Full details of the Committee's recommendations are not yet available. In the light of the decisions which Government might take on the recommendations in consultation with the Reserve Bank, it might, perhaps, be necessary to review some of the provisions made in the present Bill so as to ensure that the provisions made therein are in tune with the policy decisions taken by Government on the Committee's Report.

4. A copy of the Bill is being forwarded to the Department of Banking Operations

& Development for their comments, if any, on policy issues. Simultaneously, a copy of the Bill is being marked separately to the Legal Department for vetting.

Submitted for information please.

2.9.1978

JOINT CHIEF OFFICER
DEPARTMENT OF BANKING OPERATIONS & DEVELOPMENT
CALCUTTA

C.O.(IFD)

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IDBI.B.No.32/75–76 ITEM NO. 7

MEMORANDUM TO THE BOARD
Reorganization of IDBI

Having regard to the present functions and activities of IDBI and the new challenges and opportunities thrown open by the national priorities and the 20-Point Programme by the Prime Minister, I have, on taking over as Chairman of IDBI, given immediate thought to enlarge the scope of its activities and streamline and strengthen the administrative set-up to bring about the much-needed dynamism in its approach and practices. While doing so, careful attention has been given to the recommendations made by the Narasimham Committee to speed up sanctions procedures in IDBI, and also to the recommendations made by the Kumar Committee regarding handling of exports on deferred credit terms. Some of the more important measures to be taken by IDBI with immediate effect are indicated below:

1. Decentralization

At present, IDBI has three Regional Offices, viz., Calcutta, Delhi and Madras but they have very restricted authority to do business, and most of the cases are required to be referred to the Head Office in Bombay. This, besides time consuming, has resulted in a lot of resentment in the minds of the public, as for simple matters, without Head Office instructions, nothing can be done. The Regional Offices, therefore, will have the following delegated authority:

(i) All refinance cases up to Rs 30 lakhs. The figure of Rs 30 lakhs has been decided as, under the SFCs Act, no SFC is authorized to sanction loans for more than Rs 30 lakhs to an industrial unit. Similarly, work relating to sanction and disbursement of bills rediscounting limits will also be entirely transferred to the Regional Offices. However, sanctioning of annual limits bank-wise and policy formulation will be handled in the Head Office.

(ii) All direct finance cases up to Rs 50 lakhs provided no participation from any other all-India institution is involved. Such direct finance cases will be within the overall policies of the Head Office.

(iii) All work relating to appraisal, documentation, follow-up, recovery, etc. in respect of (i) and (ii) above will be the responsibility of the Regional Offices, subject to overall guidance of Head Office.

(iv) Small- and medium-sized projects suffer, to a great extent, in two respects, viz., management and costing. Action will be taken to recruit qualified and licenced personnel from the managerial and accounts lines in the Regional Offices to advise and introduce systems for the benefit of the entrepreneur of small and medium projects covered under IDBI finance.

(v) All projects having a total project cost of up to Rs 1 crore and covered under IDBI finance will have management guidance from the Regional Offices. This will ensure good management and recovery.

(vi) The Calcutta and Madras Regional Offices have been upgraded and placed under Deputy General Managers like the New Delhi Office. Further, a Regional Office for the Western Zone is being set up shortly under the charge of a Deputy General Manager. The Regional Office will be located at Ahmedabad. In order to keep the Dy. General Managers comparatively free from day-to-day desk work, to begin with, each of these three Regional Offices will have one Manager to attend to the daily routine work, so that the Dy. General Manager may devote more time to developmental and promotional activities. Further, the Regional Offices will be strengthened with more technical and financial officers and other supporting staff. This will be done gradually on the basis of the workload.

(vii) An Export Credit Cell and a Regional Development Cell are being set up immediately in all Regional Offices. The Export Credit Cell will attend to matters relating to IDBI's export credit schemes and also handle the IDA and other foreign lines of credit. The Regional Development Cell will be involved in the implementation of measures for development of backward areas and removal of regional imbalances. In due course, the Regional Offices will be given necessary authority to process export proposals.

When the above proposals are fully implemented, about 65 per cent of the total business transacted by it will be covered under the decentralization programmes.

2. Delegation of Powers to the Officials

At present, there is inadequate delegation of powers to the officials at the Head Office and Regional Offices. The present delegation covers, to a certain extent, refinance and rediscounting assistance. For quick disposal of cases powers are being delegated appropriately to various cadres of officers including the Executive Directors. For this purpose, a separate memorandum is being put up to the Board.

3. Reorganization of the Export Department

3.1 The Export Department in the IDBI is responsible for taking care of the engineering exporters exporting engineering and capital goods on deferred credit terms. IDBI has been appointed by the Government as a focal point for giving a package clearance on behalf of the Reserve Bank of India, ECGC, IDBI and concerned commercial banks of the exporters. It is also expected to render counselling services to the engineering exporting community. The Department has introduced quite a few schemes which have turned out to be popular for exporting goods on credit terms.

3.2 In 1974, Government of India appointed Export–Import Bank Committee to prepare a blueprint for setting up an Export–Import Bank. The Committee submitted its report in August 1975.

3.3 In the opinion of the Committee, the new institutional framework is to be chosen from any of the three options, namely:

(i) a major restructuring of IDBI;
(ii) a subsidiary of IDBI; or
(iii) a separate Export (or Export–Import) Bank. The Committee felt that the first two courses of action would have three main advantages: (a) availability of staff expertise already built up by IDBI in this field; (b) availability, presumably at no cost, of existing facilities in IDBI with regard to appraisal, administration and accounts; and (c) absorption of losses arising from export transactions in the profits from the other operations of IDBI. These advantages may also be available to a subsidiary of IDBI. The Committee carefully considered the first two courses of action and recommended that a beginning might be attempted 'by restructuring IDBI or, next, forming a subsidiary of IDBI'.

3.4 According to the Committee, the restructuring of IDBI as envisaged by it should be effected by a division of IDBI into two separate wings—one for domestic operations and the other for exports, both wings to be of the same status; strengthening and upgrading the present Export Department and placing it in charge of an executive who would have considerable delegated authority and freedom for decision, and would report directly to the Chief Executive of IDBI.

3.5 The Committee has, however, urged the creation of a separate Export–Import Bank 'if for any reason it is possible for Government and others concerned to accept in toto' the proposals for restructuring IDBI or the establishment of a subsidiary of IDBI.

3.6 I am of the firm opinion that, to begin with, strengthening of the Export Department in IDBI with adequate authority and staff and raising its status to that of an International Finance Division would be preferable to the setting up of a subsidiary of IDBI. The establishment of a subsidiary will be time-consuming and is not justified by the volume of present business in IDBI. IDBI's disbursements under its various export finance schemes have not, so far, exceeded Rs 22 crores per year. The question of setting up a subsidiary could be considered if the volume of business (disbursements) exceed Rs 100 crores.

3.7 In view of the foregoing, I have already upgraded the Export Department as the International Finance Wing under the charge of an Executive Director.

4. Coordination with IFCI, ICICI, LIC, UTI and IRCI

4.1 At present, the only coordinating machinery is through the forum of Inter-Institutional Meetings held every month. This forum attends to the following tasks:

(i) formulating common operational policies in the field of industrial assistance;
(ii) discussing specific proposals for assistance for coordinating appraisal, sharing assistance and deciding conversion terms;
(iii) formulating strategies for follow-up of assisted units, especially problems units, including relaxation of conditions for grant of assistance, appointment of nominee directors, etc.

4.2 The concept of lead institution has been introduced for follow-up work. Under this scheme, one of the institutions designated as 'lead' institution gives approvals under the loan agreement on behalf of all institutions, for example, appointment of managing directors, expansion schemes, etc. In regard to pre-sanction (appraisal) work, while one of the institutions is designated as the lead institution, all the institutions carry out separate appraisals themselves, though in a coordinated manner, and if need be, by referring again to IIM. Separate appraisals and frequent references to IIM, even on simple operative matters lead to delays in sanction of assistance.

4.3 In order to make coordination more effective and fruitful, I contemplate the following action:

(i) IIM to be attended by Chairman/Chiefs of all institutions mainly to deal with important operational matters. Any proposal beyond the limit up to which a financial institution is allowed by IDBI to support on its own or in participation with another institution and requiring IDBI assistance will be examined in IDBI immediately on receipt thereof and a flash report will be prepared. This will broadly indicate either the acceptance of the proposal as received or with any modifications. The copy of the flash report will be sent to each institution concerned (including the Bank/s). The IIM will discuss the proposal and decide, *inter alia*, to (a) who should be the lead institution and (b) who should be the common solicitor to take care of the legal aspects IIM shall meet once a month.
(ii) In the IIM, besides the matter referred to above, important issues like promoters' contribution business plans for institutions, as a whole, on the basis of a detailed review of applications pending and in the line, so as to ensure allocation of institutional funds to various industries and sectors, keeping in view national priorities will also be considered. The main idea here is to develop consensus on important matters so that Government may formulate its policy on the basis of the consensus reached.
(iii) The concept of lead institution at the appraisal stage will be made more meaningful by locating entire responsibility for appraisal on the 'lead' institution, particularly in the case of smaller projects, say with cost up to Rs 5 crores. The 'lead' institution will give its appraisal report to other institutions for consideration at their Boards. This will reduce the time factor for sanction of proposals significantly when more than one all-India institutions is involved. The work of documentation and disbursal will be done by the 'lead' institution on behalf of all the participating institutions. The 'lead' institution will work on the basis of the time-bound programme to ensure that no

proposal under any circumstances will be detained without sanction and first disbursement beyond a maximum period of six months.

(iv) IDBI is already having nominees on the Boards of IFCI and IRCI. So far, Deputy Governor, RBI, in-charge of IDBI, used to be on LIC's Board. With delinking of IDBI from RBI, IDBI representation on the Board of LIC is considered essential for effective coordination. Similar representation is also desirable on Boards of ICICI and UTI.

Coordination with IRCI is already ensured through nominees of IDBI, IFCI and ICICI on the IRCI Board. Its activities are also distinct and do not require coordination through the IIM forum.

5. Coordination with Commercial Banks

5.1 With the delinking of IDBI from RBI, link with commercial banks through RBI will no longer be there. As an apex term-lending institution, linkage is considered essential mainly on two grounds, viz., (i) meaningful coordination in the field of industrial finance, and (ii) for financial support of commercial banks in the projects approved by IDBI and other all-India institutions.

5.2 So far, IDBI's contact with commercial banks has been mainly through refinance and rediscounting assistance, from occasional association of banks in consortium arrangements for providing term finance to very large projects (such as, Southern Petrochemical and Mangalore Fertilizers) and respect of certain other projects where working capital deficit persisted. For an effective coordination with commercial banks, following steps will be desirable:

(i) Nomination of IDBI officers on Boards of State of India, its subsidiaries and all nationalized banks.

(ii) Six monthly meetings of Chairman, IDBI with Chairmen of commercial banks will be coordinated with periodical meetings of the Chairman, IDBI with RBI Governor.

(iii) Devising standing arrangements for participation of banks in all or most of the projects with cost above Rs 25 crores. This will avoid delays in making efforts at a later stage to associate banks in case of gaps.

(iv) The institutions to identify, at the IIM stage, commercial banks if needed, besides the bank of the entrepreneur, which could take care of working capital required of their assisted industrial units. The flash report as an appraisal report of the 'lead' institution will be freely made available to banks.

(v) Banks giving working capital finance to industrial units assisted by IDBI and other institutions to be closely associated with post-disbursement follow-up work. Banks will furnish quarterly reports regarding operations in cash credit/overdrafts accounts, inventory position, company's financial position as also summary inspection reports to the financial institutions.

The inspection reports of all-India financial institutions will also be made available to commercial banks.

(vi) Credit authorization, in respect of term loans beyond Rs 25 lakhs should be made automatic if an all-India institution is involved in the project. In case no all-India institution is involved, RBI, as a matter of procedure, should refer all such cases to IDBI for its views. The latter course will avoid sanctioning of term finance to projects by banks which have been either rejected or not considered viable by all-India term-lending institutions.

6. Coordination with State Level Institutions, viz., SFCs and SIDCs

6.1 The IDBI will have close association with State Financial Corporations (SFCs) mainly through

(i) Regular inspection and supervision of SFCs' operations;

(ii) IDBI can nominate 2 directors on each SFC Board. It will be desirable to put Regional Chiefs and senior officials of the regions on the Boards of the concerned SFCs. The second nominee could be an outside professional.

6.2 The long-term objective is to improve appraisal and follow-up standards of SFCs and to transform them into Regional Development Banks which are not security-minded but project-oriented, and are equipped to give technical and managerial assistance for project implementation and operation, particularly in small-scale sector. In the immediate context, IDBI will do the following:

(i) Augmentation of training activities and upgradation programmes for improvement of operational efficiency as already initiated under the IDA line of credit.

(ii) Creation of a special SFCs Department in the IDA. This Department, in addition to normal serving of SFCs, in particular gives special attention to ensure proper allocation of SFCs' loan portfolio among different industries and districts, with special emphasis on assistance to the small-scale sector, new and technician entrepreneurs and the specified backward districts. For this purpose, IDBI will issue operational guidelines and scrutinize their business plans.

(iii) SFCs Conferences which have, so far, been held every alternate year, will be made an annual feature.

So far as State Industrial Development/Investment Corporations (SIDCs/SIICs) are concerned, IDBI has made a detailed study of their operations and formulated proposals for granting refinance assistance to them. The basic task of reorganizing SIDCs/SIICs has to be taken up immediately.

7. Prime Minister's 20-Point Programme and the IDBI

7.1 The main focus of the 20-Point Programme is improving the lot of the common man, and the IDBI would be able to play an important role in achieving this objective. With a view to diffusing fruits of industrial progress, enhanced emphasis on the development of backward areas and creation of a generation of new and technical entrepreneurs is necessary. It has been widely accepted that promotion of small- and medium-scale industries that help to reduce concentration of income and property deserve a preferential treatment. Keeping these objectives in mind, the following schemes, some of which are new for IDBI's activities, are being taken up on priority basis.

1. Assistance to SIDCs

A reference is already made about bringing SIDCs into the fold of IDBI's activities so as to promote, through these agencies, balanced regional development, especially by encouraging location of projects in backward areas. While doing this, preference could be given to labour intensive projects that exploit locally available resources. To start with, needs of relatively less-developed states may be given a priority in allocating funds to SIDCs.

2. Financing Entrepreneurs' Equity

A number of competent new and technical entrepreneurs do not have resources adequate enough to satisfy financing institutions' requirement of minimum desired level of promoter's contribution of 15 per cent of the project cost. IDBI will take a lead in this field and operate such a scheme in respect of its directly financed projects. Secondly, it will also encourage the SFCs or SIDCs to initiate such schemes by assuring refinance assistance in respect of their loans against promoters' equity. It is only through such schemes that entrepreneurial ability of the financially less-favoured class could be put to more effective social and economic development.

3. Finance for Hire-Purchase Schemes

A number of Small-Scale Industries Development Corporations (SSIDCs) are supplying machinery on hire purchase basis. IDBI will soon initiate a new scheme whereby each of such State level agencies gets a small credit limit of IDBI, and it is proposed to make available the finance at the same concessional rate as that applicable to refinance to SFCs in respect of their loans to SSI units.

4. Transport Operators

The existing schemes of bills and refinance do take care of the needs of transport operators. Under the bills rediscounting scheme, there is no stipulation regarding the promoter's minimum contribution for financing purchase of trucks. But under the refinance scheme, there is an insistence of 15 to 25 per cent minimum of promoter's contribution, depending on whether the promoter is owner-driver or otherwise. Under the 20-Point Economic Programme, the scheme relating to National Permit for goods transport operators envisages, among other things, that 25 per cent of the permits should be granted to new entrepreneurs including ex-Army personnel and unemployed drivers. IDBI would not insist on promoter's minimum contribution while refinance loans given by the SFCs and banks to the permit holders that get licence under the category of the 20-Point Programme.

5. Consultancy Services

IDBI has taken lead to establish three consultancy organizations already. IDBI will soon establish at least one such consultancy organization in each of the relatively less industrialized states. These consultancy organizations will be strengthened by posting adequate technical staff so that these organizations play an effective role in identifying viable projects, preparing detailed project profiles up to their bankable stage and locating entrepreneurs who would implement them. It is necessary to ensure a bias in favour of projects suited to the needs of SSI units and new and technician entrepreneurs. These consultancy organizations would serve as a focal point for IIGs at the state level and generate a climate for industrial growth, especially by organizing training programmes for development of new entrepreneurs. They could also play a very useful and constructive role by providing necessary marketing intelligence to the needy, small and medium entrepreneurs who cannot possibly afford hiring private market intelligence consultancy services.

6. New Apprenticeship Scheme

The twentieth point in the Prime Minister's 20-Point Programme relates to enlarging scope of training programmes, especially of the weaker sections of the population. IDBI will also provide facilities to 100 apprentice trainees with commerce, economics, engineering and technical qualifications who could be subsequently absorbed in the organization if found suitable. Those who do not fully meet our requirements may prove to be adequate for SFCs, SIDCs, etc. These agencies would find it advantageous to recruit IDBI trained personnel. It is an advantage in making the apprenticeship scheme as a regular feature to meet IDBI's growing requirements of manpower. IDBI would also encourage its assisted companies especially those which are doing well to augment apprentice training programmes and our nominee directors may be required to take active interest in this matter.

7.2 The Schemes 1 and 3 discussed above could be initiated only after Government issues a notification specifying that SIDCs as well as SSIDCs are eligible institutions for IDBI's financial facilities. Scheme 2 also has to wait for a Government notification empowering IDBI to finance promoter equity which will be held in trust until a stage when the promoter is able to buy it back. I have already written to the Government on these points for enabling the IDBI to undertake these new activities. As regards schemes 4–6, I have taken a decision to go ahead with them immediately.

8. Assistance to Sick Units

A. IDBI assisted units

8.1 In order to attend to units which have grown sick or are showing signs of sickness, IDBI will have a full-fledged Department (Loans Department No. VI) with sufficient complement of technical and other staff for: (a) diagnosing the factors leading to sickness and (b) devising time-bound programme of remedial action. The Department should be in a position to depute its own personnel, where necessary, and where this is not possible the Department will appoint outside competent professionals to take care of the unit on the basis of the action plan prepared by the Department. In other words, the Department should be in a position to provide intensive care to problem units.

8.2 As a preventive measure, IDBI will tone up its monitoring system as follows:

(i) Project Teams will be associated with the project right from appraisal to recovery of loans and will be primarily responsible for close follow-up. Their association and regular visits will establish better rapport with the assisted unit.

(ii) The top management of the assisted unit will meet the General Manager of the Domestic Finance Wing at least once in six months for an overall discussion on the project.

(iii) Commercial banks are in day-to-day contact with their clients. They will be requested to send the concerned Branch Manager's periodical reports about operations in the account, inventory position, working of the unit and its financial position. IDBI will also make its inspection reports freely available to banks.

(iv) Annual reviews of all accounts and half-yearly reviews of difficult accounts (with action taken) will be undertaken. The concerned Regional and Branch Office will also visit the assisted units to discuss their problems. They will submit their reports to the Head Office half-yearly.

(v) There will be a nominee of IDBI or a participating all-India financial institution on the Board and Managing Committee of every assisted sick unit. The concerned Loan Department will regularly brief him and get the necessary feedback.

(B) Modernization/Rehabilitation Programmes of Units Referred to IDBI by Government

8.3 Recently, the Cabinet Committee while considering the proposals of the Ministry of Commerce for an integrated national cotton textiles policy decided that priority should be given in the allocation of resources to the programme for modernization and rehabilitation of sick mills, preference being given to the units under the National Textile Corporation; for this purpose, IDBI is required to set up a special cell which should start functioning from the beginning of April 1976. The Ministry of Finance, Department of Banking has requested IDBI to take early steps to implement the decision of the Cabinet Committee. The Department of Banking has also advised IDBI that besides cotton textiles industry, modernization/rehabilitation programme of sugar, cement and engineering industries is also required to be assisted to save the units from becoming 'sick'. The IDBI is in touch with the Government and has enquired about exact financial implications and the funds likely to be made available to IDBI by the Government for the purpose.

8.4 Under the existing schemes of lending, modernization/rehabilitation programme of industrial units is assisted by IDBI through the Bills Rediscounting Scheme under which the maximum repayment period is seven years. However, the Government now desires that the units implementing modernization/rehabilitation programmes may have to be given longer repayment period with three to five years grace period. It is, therefore, clear that the modernization/rehabilitation programmes of these units will have to be assisted by IDBI under the direct loan/underwriting schemes. The work in this connection will be taken over by Loans Department V.

8.5 To implement the above programme, the following measures will be taken:

(i) Government will be requested to prepare guidelines for units to become eligible for special assistance;

(ii) Once a unit comes under surveillance and assistance of IDBI, the nature of weakness will have to be first ascertained by deputing experts;

(iii) If on assessment, the view taken is that the unit is not likely to be viable, say within a period of five years, the merger of the sick unit with another unit will have to be actively considered. For this purpose, whatever assistance is required to be provided to the transferee unit, will have to be considered by the all-India financial institutions and commercial banks jointly.

(iv) Where a sick unit could be made into a viable unit, appropriate changes in the management set-up will be effected by appointing suitable persons directly by term-lending institutions under the Management Guarantee System as explained in para 9 (i).

(C) *IRCI assisted units*

8.6 So far, IDBI has not directly got involved into the projects assisted by IRCI. In order to coordinating of policy matters and assistance programme, Loans Department will get directly involved in the projects under IRCI and render assistance. The assistance could be either in the management, technical or finance field on the merits of each case.

9. Management of assisted projects

The current practice in IDBI is that it keeps in touch with the assisted concerns mainly through periodical progress reports and ad hoc inspections. In some cases, nominee directors are appointed. However, so far, adequate attention has not been given to the management aspect of the assisted concerns. As a result, IDBI comes to know of the troubles in the assisted projects fairly late. To overcome the situation, the following action will be taken:

(i) Wherever financial institutions feel that the management of a project leaves scope for improvement, right from the beginning that project should be under the close surveillance of financial institutions. This will not only take care of the scarce resources of financial institutions made available to projects, but will also develop healthy convention in the management field as has developed in Japan and certain other developed countries. In this context, management guarantee, which is not so uncommon in certain industrially developed countries, would be considered actively.

(ii) At present, nominee directors are appointed on the boards of assisted concerns from a panel of persons finalised jointly by the various all-India financial institutions and approved by the Banking Department in the Ministry of Finance, Government of India. The role of the nominee directors in many cases has been more of a passive nature. In order that the nominee directors play a more effective and useful role, selection of nominees will be made more from the professional groups. With this object in view, the Chairman, IDBI will review the panel and select suitable nominees. The idea is that the nominee directors should be able to work more effectively by carrying out the directions of IDBI and provide a feedback regarding the operations of the company.

(iii) In the case of assisted concerns which are in bad shape or likely to prove so, immediate steps should be taken by IDBI to place one of its senior officer as a full-time director of the concern to take care of IDBI's interests. In this context, it may be pertinent to mention that in Japan, at the initial stage itself, the financial institutions place their own men in senior positions in the assisted concerns on a whole-time basis and they, besides looking after the work of the concerns, periodically met financial institutions for reporting purposes. This way, a close liaison is maintained and it has paid good dividend to the financial institutions in Japan.

10. Regional Development Programme

IDBI has taken various steps in initiating projects in different backward areas. However, while doing so, sufficient emphasis does not seem to have been given in areas where either the entire state or a major portion of the state has been classified as backward. The following actions will be useful to remedy the situation:

(i) In the states of the types mentioned above, immediate action will be taken in cooperation with the leading banks in those areas concerned and SIDCs to identify and initiate projects.

Besides financial assistance, IDBI's technical and financial offices will get directly involved in setting up and running those projects till they are handed over to entrepreneurs nominated by SIDCs or the concerned State Government.

(ii) To start with, a few backward districts will be picked up from the Eastern, Central and Hill Regions as pilot projects and the operational areas will be enlarged on the basis of the experience gained.

11. Problem Accounts

11.1 At present, there are 197 operating accounts with an aggregate outstanding balance of Rs 152.03 crores. Of these, 74 accounts are creating anxiety and the extent of default towards interest and principal aggregates to Rs 16.48 crores. Out of these 74 accounts, 34 accounts need immediate attention to protect IDBI's interest as the defaults are of a persisting nature. Besides these accounts, there are quite a number of other accounts in which equity and preference shares have devolved on IDBI because of underwriting commitments. Some of these accounts would also need immediate attention as the assisted units are in bad shape.

11.2 As of date, only a very small cell with limited staff has been taking care of only five accounts, and the rest of the problem accounts are being handled in a routine manner. It will, therefore, be necessary to organize immediately a Project Care Cell with adequate financial and technical staff for taking care of IDBI's interest as well as to nurse the projects in trouble. This will be done by Loans Department VI.

12. Documentation

12.1 In IDBI, certain documents like the loan agreement, deed of hypothecation, undertaking to execute the legal mortgage, power of attorney, etc. have been standardized. However, the principal document is the Memorandum of Entry in connection with the equitable mortgage and relevant resolutions. Although the latter documents have been standardized to a large extent, these are required to be sent to the other participating financial institutions/banks for their approval. This is a point where all the time is taken.

12.2 Another area of major delay relates to executing of loan agreements where approval is to be obtained by the companies from its shareholders and the Central Government under Section 81(3) (b) of the Companies Act, 1956. IDBI has already taken up the matter with the Government for simplification of the procedure to cut down delays.

12.3 IDBI will take immediate action to standardize the Memorandum of Entry with other participating institutions to reduce the time factor. IDBI's Legal Advisor will attend all IIM meetings and advise all members of IIM on the basis of common legal policy. For this purpose, all financial institutions at the Central and State level will work through a Common Solicitor instead of separate solicitors as at present, and the coordination in this matter will be done by the Legal Advisor of IDBI. This will, to a large extent, eliminate delays. IDBI will examine immediately whether by forming a trustee company for the purpose of taking a floating charge over the assets of the assisted companies, the time factor could be further reduced.

13. Resources Position

13.1 As regards the sources of funds, apart from the accruals through repayment of loans by borrowers and internal cash generations, borrowings from the RBI and through bonds and debentures have, so far, constituted the main sources. The position for 1974–75 is as follows:

	% to total sources of funds in 1974–75
a) RBI's NIC (LTO) Fund	31.6
b) Repayments by borrowers	36.3
c) Short-term borrowings from RBI	15.7
d) Market borrowings by way of bonds	6.0
e) Internal cash generation (interest, commission, etc.), drawings of liquid resources etc.	10.4
Total	100.0

13.2 Estimating requirement of resources for IDBI during the next few years up to 1979–80 is bound to be a somewhat difficult task in view of the fact that several new responsibilities will have to be undertaken in view of the enlarged role assigned to the restructured IDBI. On the basis of certain assumptions, an assessment is made about overall requirement of resources and the projections given below will be taken rather as to indicate figures of the trends to follow. It may be noted that the resources requirements as projected below are in addition to those receipts that would accrue as repayment from the borrowers, and also internal cash generations.

Year (July–June)	Additional Resources Required (Rs crores)
1976–77	282
1977–78	313
1978–79	321
1979–80	329

13.3 The additional resources of Rs 282 crores requires during the year 1976–77 will have to be met as under:

(i) The RBI has been making NIC (LTO) funds to the IDBI from out of profits. These allocations were stepped up from Rs 86 crores in 1974–75 to Rs 125 crores in 1975–76. In addition, the RBI also provides short-term accommodation against the lodgement of rediscounted bills. In order to meet the demand for additional resources in 1976–77, RBI should make available about Rs 165 crores under the NIC (LTO) allocations for the coming year. It is also necessary that this facility is made available to the IDBI at a reasonable rate of interest of 6 per cent, the same as in coupon rates on its bonds.

(ii) Besides the NIC (LTO) allocations, the amount that IDBI could raise through bonds should be stepped up to Rs 67 crores during 1976–77.

(iii) The budget for 1976–77 provides that surcharge now levied at 5 per cent on the income tax paid by companies can be saved by those who pay the money in deposits with the IDBI for five years. This will certainly make resources available to the IDBI, and it is estimated that for the year 1976–77 it should be possible to get about Rs 50 crores which may increase up to Rs 65 to Rs 70 crores by 1979–80. It may be added that these figures indicated here are based on certain assumptions made regarding profitability of the corporate sector during the period to follow, and also that surcharge would continue to remain at the present rate of 5 per cent.

13.4 Unless funds are provided by IDBI at a lower rate of interest, it will be difficult for IDBI to work profitably because of the mounting defaults in payment of interest and repayment of principal by the borrowers.

14. Recruitment of Staff

Now that the RBI machinery will not be available for recruitment of our staff, immediate steps have to be taken in this regard to recruit staff at various levels for our urgent needs. For this purpose, the Chairman will appoint a selection board consisting of three persons from outside with proven administrative ability, plus an Executive Director from IDBI. One of the outside persons will be an eminent financial expert.

15. Administrative Set-up

On the basis of the broad ideas I have set out above regarding the reorganization programme of IDBI to meet the objectives of the Government in restructuring the IDBI as the apex term-lending institution in the country, both in the fields of domestic term financing and international financing, I have, with effect from 8th March 1976, created two distinct and separate wings in the IDBI, with equal status, viz., the Domestic Finance Wing and the International Finance Wing. Certain areas of work which need to remain independent of these two wings will be under my direct charge. The Organization Chart of the restructured IDBI is attached. It will be observed therefrom that each wing has been placed under the charge of an Executive Director. Shri C.S. Venkat Rao has been appointed as the Executive Director of the Domestic Finance Wing, and Shri O.P. Gupta as Executive Director

of the International Finance Wing. Sarvashri Venkat Rao and Gupta have vast knowledge and experience in their respective fields. In order to give support to the two wings, certain appointments have already been made by posting persons from within and it is necessary to make additional appointments for certain specialized categories on the basis of requirements from RBI Banks, etc.
16. The Board is requested to pass the following resolution.

'Resolved
That the Chairman's Memorandum IDBI. B.No.32/75–76 dated 17th March 1976 be and is hereby recorded.'

Industrial Development Bank of India — Raghu Raj
17th March 1976 — Chairman

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International Seminar on Banking and Development*

The following Report on the International Seminar on Banking and Development presents a record of the views expressed at the Seminar on the various subjects. There was no attempt at the Seminar to draw agreed conclusions. The object of the Seminar, on the other hand, was to obtain an exchange of views and a comparison of mutual experiences on problems that arose in the process of adaptation and orientation of the banking and financial system in developing countries to the new and varied needs of development. The Report is to be read in this light.

An International Seminar on Banking and Development, sponsored by the Reserve Bank of India, was held from 9 to 12 February 1970, in Bombay. The participants in the Seminar included a number of Governors, Deputy Governors and senior officials of several central banks, bankers and economists from the developed and the developing countries.

After the inaugural session, the Seminar discussed the theme of Banking and Development in terms of: (a) Commercial Banking and Development, (b) Specialized Financing Agencies, and (c) Central Banking and Development, in three separate sessions held on 10th, 11th and 12th February 1970. These sessions were presided over by Governor Mubiru (Uganda), Governor Ismail (Malaysia), and Governor Phillips (Australia), respectively.

The Seminar was inaugurated by Shri L.K. Jha, Governor of the Reserve Bank of India. In a message on the occasion of the Seminar, the Prime Minister Smt. Indira Gandhi stressed the vital importance of economic growth for the poorer countries. 'Of the many structural and institutional changes that are necessary in developing countries, not the least important is the adaptation of the financial institutions to

*The Reserve Bank of India is shortly bringing out a volume containing the papers presented at and the proceedings of this Seminar.

serve the objectives of development and to bring about greater mobility of resources to meet the emerging needs of the economy. While each country has to find its own answer to its problems, the experience of other countries, developed and developing, can provide important and useful guidelines.'

Inaugurating the plenary session, Governor Jha referred to what he called the central banker's dilemma in developing countries, namely, of the equal concern which Central Banks in such countries had to pay to growth as well as stability, especially when, more often than not, these two factors exercised pulls in opposite directions. He referred to the fact that the tools employed by Central Banks in developed countries did not serve too well than those in developing countries. Central Banks in the latter had to benefit from the experience of those in the developed countries.

During the plenary discussions on the first day, it was stressed that the problem of development was a continuing one, and no country could regard itself as having reached the peak of its development efforts. It was pointed out that the problem of financing development was thus one of importance to central banks of all countries, whether developing or developed. Even developed countries have within their jurisdiction underdeveloped areas.

It was stressed that financial institutions had a crucial role to play in the development process. Such institutions had to play an important role in the mobilization of voluntary savings. One had, however, to guard against the danger of attempting to transplant institutions which have done well in a particular environment to countries and situations where the environment is quite different. For instance, a view was expressed that it was not necessary to rely on the financial market mechanism in every country. While financial markets might, in certain situations, be helpful, they might, in certain circumstances, lead to a misallocation of resources in relation to a national economic plan. However, regardless of how far reliance was placed on market mechanism, there was need for appropriate and economic pricing policies—especially pricing of capital and of foreign exchange.

While inadequacy of savings and pressure on financial resources in relation to investment needs was the general case, it was pointed out that this was, by no means universal. Thus, there were instances of developing countries having fairly well-developed financial systems, whose external payments position was strong and where the banking system's liquidity was comfortable. Yet there was a dearth of adequate and suitable local investment openings. Here it was a problem of putting the resources to fuller use. Development financing organizations could supplement monetary policies by channeling finances to developing areas. The Seminar recognized that for the effective and purposive functioning of monetary policy, some other conditions had to be fulfilled. The most important of them was the type of fiscal policy pursued. The Japanese example of overloaning by banks was cited as an indication of a somewhat unorthodox credit policy against the background of fiscal orthodoxy.

Monetary policy, it was generally agreed, should help create a proper environment for savings and this was possible only when inflation was under control. In cases where the industrialized countries took sharp deflationary measures to correct continuing inflation, this could affect the world economy and impede development efforts in less-developed countries.

One of the speakers said that in countries such as Yugoslavia which were moving from a centralized to a decentralized system, the efficient operation of the financial mechanism in mobilizing and allocating savings became more important.

II

In the discussion on Commercial Banking and Development, speakers stressed that in order to accelerate the process of economic growth, commercial banks should play a greater role in development. While the basic concept of banks being trustees of public deposits was stressed, banks should interpret the concept of security while lending in a broader and more meaningful way to cover assured repayment, rather than the presence of collateral security.

Banks could with advantage seek to tag on saving schemes to lending in rural areas and to the small man as a means of deposit mobilization and credit expansion over a wider area as well as of spreading the banking habit.

It was observed that in the matter of spreading banking business in rural areas, interest rates alone, thought important, might not be a decisive factor. The banks should seek to provide a variety of services to the community which they served.

There was some discussion on the relative advantages of unit versus branch banking in the context of the wider spread of banking. It was felt that unit banks were apt to be small, and not likely to have sufficient resources to function on a viable basis, and hence there were certain limitations to a widespread resort to setting up of such banks. In the circumstances, it might be better to ensure that the branches functioned with a greater degree of local autonomy.

Deposit mobilization required constant attempts at innovation. Commercial banks had to constantly seek to improve the services offered. Competitiveness among banks is helpful in improving their efficiency and services to the community.

III

In the session on Specialized Financial Agencies, several speakers stressed the need to set up development financing institutions to stimulate investment in a country as a whole, or in the developing areas and to act as a catalytic agent to raise investment above the level of current savings. It was recognized that development financing institutions could provide a useful link between foreign financial institutions and domestic borrowers. It was mentioned that whether development banks specialized in certain fields of activity or were multiple financing agencies would depend on the size of a country and the diversified needs of development, but a preference was expressed against a proliferation of institutions.

While in the initial stages, development banks would have to draw their resources from budgetary allocations, it should be the endeavour of the development banks at later stages to resort to the capital market for their resources. The central bank had a specific role to play in providing the appropriate environment for the success of the issues of development banks.

It was indicated that in some countries the problem was not one of relative paucity of savings but of investment opportunities. In such cases, development banks should assist in drawing up a programme of development either for the country or in specific sectors so as to increase the demands to be made on them.

A number of speakers suggested that as far as possible, concessional rates of interest by the development banks should be limited to exceptional cases. Charging market rates of interest by development banks would not only impose financial discipline on the borrowers but also facilitate their borrowing programme in the market at appropriate rates.

It was suggested that development financing institutions should pay with regard to the commercial viability of transactions. The importance of ensuring the repayment of the loan was also stressed. In this context, the need for having a credit intelligence and credit information system was pointed out.

Some of the speakers stressed that it was advantageous to have a link between development banks and the central bank. It was suggested that while conditions differed from country to country, the central bank being the agency to coordinate the activities of all financial institutions and for ensuring economy in the possession and use of funds, such a link would be beneficial.

It was recognized that in certain situations it was necessary to provide infrastructural facilities which would not be suitable for financing by development banks, but would have to be provided by budgetary support or by special agencies set up for that purpose.

The views was expressed that notwithstanding the increasing role of commercial banks in term lending, there were certain functions which development banks alone could discharge. Development banks were likely to have the necessary technical competence to evaluate projects and also to be in a position to undertake certain long-term financing operations.

IV

In the discussion on Central Banking and Development there was a consensus that, with all the refinements of theory and the statistical and other data available, there could be no precise rules and techniques in matters of central banking. Central banking, thus, remained an art to be perfected by practice. Not all the Central Banks can use the traditional means of credit control and monetary policy, and there is room for adaptation and innovation. An important task of the Central Bank is to give advice to Government, sharing the latter's concern with economic development. The Central Bank should publish relevant material—statistical and other—to help educate public opinion in these matters.

Price stability and development have been major concerns of Central Bankers, but monetary policy, by itself, cannot ensure either objectives. Monetary policy has to be viewed as part of economic policy in general, and fiscal policy is of vital importance in this context. Coordination between budgetary and monetary measures thus becomes essential.

The question was posed whether the Central Bank could reasonably be expected to contract credit sufficiently in a situation where the budget had the effect of expanding money supply as much as and even more than what could be accommodated in a non-inflationary manner. Credit policy might even, in such a situation, need to provide for some degree of expansion so as to maintain productive activity. This means that while the Central Bank has continually to endeavour to advise the Government in these matters, the flexibility of credit policy was not unlimited.

The level of money supply for an economy and the rate of its increase were viewed as questions of basic importance. There was general agreement that the expansion in money supply has to bear a fairly close relationship to the growth in national product, if reasonable price stability is to be maintained. However, it was not easy to say to what extent this broad relationship should be modified to take account of short-term fluctuations. In several developing countries, the high variability of agricultural output from season to season complicates the problem. Very much depended on the safety valves in the system, the commodity stocks available, unutilized capacity, foreign exchange reserves, etc.

There might be need for variations in short-term interest rates. The long-term interest rate structure has to take into account, among other things, the requirements of development and the profitability of investment in the aggregate. The other weapons of credit control and relaxation need to be used in the light of each country's special circumstances. Stress was laid in this connection on the development of forecasting techniques. Instead of trying to react to a situation as it arose, the emphasis should be on anticipating likely developments and influencing them through timely appropriate measures.

Monetary planning and flow-of-funds analysis evolved in the specific context of each country can be helpful in facilitating rational decision making in the field of credit and monetary policies. This would depend on the availability of data and suitable personnel for the work. A monetary framework would provide a valuable cross-check for the various forecasts that are made in Government Departments. In this area, a Central Bank could play a useful role through statistical and research work that would seek to explain better the working of the monetary system and its impact on general economic activity.

All financial institutions and the Central Bank in particular are concerned with development and not merely with stability, although stability should receive simultaneous and continuous attention. This is because the absence of stability constitutes a danger to growth. Both development and stability are matters which cannot be achieved by financial institutions and Central Banks alone. It also depends on overall investment policy and the relation between investment and output.

The Central Bank should be continuously in dialogue with the other sectors of the economy to contribute to the realization of the objective of development with stability. The Central Banks should endeavour to build up lines of communications with Government on the one hand, and business and industry, on the other, in this regard. In the central banking field, there is need for improving the scope of public intelligence including technical documentation. The research publications of the Central Bank should be such as to produce an impact on the people, and this could be done if economic intelligence was also made intelligible.

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Dr I.G. Patel
Chief Economic Advisor

Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi
August 3, 1967

My dear L.K.,
This is more in the nature of the kind of loud thinking I would like to do with you if it were possible for me to come to Bombay.

2. We have been evolving the doctrine for some time that whatever scope there is for expansion of credit in the economy should be reserved, not for the Government budget, but for productive activity, whether public or private. I wonder, however, whether we have adequate institutional arrangements to make this possible. If money supply is to grow in keeping with the growth in production, it can happen only if the Resere Bank is able to add to its assets from year to year. If an increase in assets in the form of Government securities is ruled out and if, as in our circumstances, an increase in foreign exchange reserves is also ruled out as not practicable, we are left only with an increase in those assets which represent the indebtedness of the private sector, including the financial institutions. As far as the private banking system is concerned, somehow, perhaps as a consequence of the absence of a proper Bill market, we have got into a situation in which although the Reserve Bank extends credits to the banking system during part of the year, this credit returns to the Reserve Bank in the remaining part of the year, so that from one year to the other, there is no increase in the indebtedness of the banking system to the Reserve Bank. It is true that the Reserve Bank, of late, has been financing the IDB and several institutions for agricultural credit. I wonder, however, if we do not need arrangements whereby the Reserve Bank financing of these institutions grows steadily from year to year rather than in a sporadic manner whenever new institutions are created and have to be capitalized.

3. One possibility would be for the Government to stop giving loans to IDB, etc. and ask these institutions to raise money in the market with heavy support by the banking system including the Reserve Bank. Similarly, in regard to agriculture also, perhaps arrangements could be worked out whereby the Reserve Bank would be willing to take securities floated, let us say by commercial banks, for the explicit purpose of financing fertilizer distribution or hire purchase for tractors and the like. In other words, the proper thing would be to shed a part of the load on the Government Budget and to pass it on to the Reserve Bank appropriately and in a manner which gives the Reserve Bank greater say in the credit policy of the institutions which it helps to grow from year to year.

4. At one stage, I was also toying with the idea that the financing of State Electricity Boards which is a major and growing activity should be taken out of the purview of the Government, and be put in the hands of a newly created holding company which will be responsible for finding the resources for the State Electricity Boards

and also for enforcing proper financial discipline on them. I understand that even today some of the public-sector enterprises which are well-established, find a part of their working capital requirements from the Government. At any rate, they find a part of their working capital requirements during the initial years from the Government by way of overcapitalization. Here again, the same institutional arrangements could be made whereby productive activities can find credit requirements not from the Budget but ultimately from the Reserve Bank through proper institutions.

5. Obviously, it is only the Reserve Bank which can expand credit overall and take a view about how much expansion should be allowed and in what sectors. Perhaps if such institutional arrangements are made, one could also have an institution like a Credit Council which would be serviced by the RBI. The credit requirements of different agencies could be ascertained and scrutinized and the Credit Council which would have representatives of the Reserve Bank, Ministry of Finance and the Planning Commission, would take a view about where more credit should be channelled and where less. In short, the kind of arrangement I am contemplating would pave the way not only for a reasonable expansion in money supply without deficit financing by the Government, but also for a more rational and coordinated credit policy in general.

6. You will, no doubt, be thinking about the Banks in the context of the AICC Resolution. The main problem, it seems to me, is that of ensuring two things: (a) that mobilization of deposits from all over the country should increase rapidly from year to year, and (b) that loans given from such mobilization topped up with whatever icing the Reserve Bank decides to put on it, should be made in accordance with a more carefully worked out overall plan of action. The intermediate stages of finding the right managers and training them, devising the mixture of incentives and disincentives and even deciding on who shall be the shareholders and who shall be the Board of Directors are, in my judgement, secondary issues as long as the two primary objectives are served. Whatever the solution adopted in regard to ownership, one will have to consider how these two objectives are to be ensured, and I am afraid we have not yet done enough thinking *de novo* on these questions.

With best regards,

Yours sincerely,
I.G. Patel

Shri L.K. Jha
Governor
Reserve Bank of India
Bombay – 1

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Ref. DBOD.No.Sch.1236/C.96–67

RESERVE BANK OF INDIA
CENTRAL OFFICE
DEPARTMENT OF BANKING
OPERATIONS AND DEVELOPMENT
BOMBAY NO. 1
POST BOX NO. 1030
August 9, 1967
Sravana 18, 1889 (Saka)

To
All Scheduled Commercial Banks
Dear Sirs,

At a meeting which I had with the Chairman and/or Chief Executives of the larger Indian and foreign banks on 31 July 1967, I indicated to them the need for scheduled commercial banks enlarging their assistance to priority sectors like agriculture, exports, small industries and, in the context of the current recessionary trends, to the domestic engineering industries, especially those having export potentialities. To this end, I mentioned that the Reserve Bank of India and the Industrial Development Bank of India would introduce certain measures to facilitate an increase in the flow of commercial bank credit at lower rates of interest to these sectors. I enclose a Memorandum which sets out the measures which the Reserve Bank is now bringing into effect. A separate communication will follow regarding the steps to be taken by the Industrial Development Bank of India.

2. The point had been raised at the meeting referred to above that during the slack season, banks would find it more advantageous to use their own resources, currently earning less than the rate at which refinance is proposed to be offered by the Reserve Bank, to finance the sectors mentioned above rather than have recourse to the Reserve Bank. I had indicated that banks could approach the Reserve Bank for accommodation whenever they felt the need for such assistance in relation to their credit operations in respect of these sectors, but since the prime object of the Bank is to bring about a reduction in the level of interest rates charged to the sectors mentioned in paragraph 1 to the levels indicated in the Memorandum attached, the Bank believes that ceiling rates in respect of advances to these sectors should be observed by banks, irrespective of whether or not banks seek refinance from the Reserve Bank in respect of any of these classes of transactions on the concessional terms indicated above.

3. The question of relief in respect of the net liquidity ratio had also been raised at the meeting referred to above as it was felt that lending to the sectors mentioned above at the rates suggested would mean banks working on low differential margins and that the impact of making such advances even though refinanced at the rates indicated would otherwise be to lower banks' net liquidity ratio. It has been decided that for the purpose of computing the net liquidity ratio, the *increase* in a bank's advances to each of the sectors mentioned in the preceding paragraphs and those

in respect of small-scale industry which are guaranteed by the Credit Guarantee Organization over the average of such advances during the period July to October 1966 inclusive (for the slack season) and November 1966 to April 1967 inclusive (for the busy season) will not be taken into account. Whether a bank has any borrowing from the Reserve Bank outstanding or not, the rate at which it can borrow from the Bank will be determined as if an equivalent amount of advances had not been made. In view of the relief now being afforded in respect of the computation of the net liquidity ratio, banks should have no resource constraint in enlarging considerably the volume of their assistance to the sectors for which the concessional refinance terms are being offered.

4. As already indicated by me at the meeting, it has also been decided to exclude from the application of the norm (referred to in the Bank's letter DBOD.No.Sch.666/C.962–67 dated May 3, 1967) relating to the total of unsecured guarantees and unsecured advances, (i) packing credit advances, (ii) Export D/A bill advances, (iii) advances in respect of machinery supply bills which have been accepted by the purchaser's bank, (iv) advance to finance, on hire purchase or deferred payment basis, sales of machinery/equipment for agriculture, dairying or fisheries as well as of trucks/commercial vehicles, and (v) advances granted to exporters against their deferred receivables by way of cash subsidies, excise duty drawbacks, etc. Further, modifications in the policy towards unsecured advances will be announced when the Working Group now examining this question has made its recommendations.

5. A number of points relating to the distribution of banks' advances were also clarified at the meeting on July 31, 1967. It was made clear that the Directive issued last October requiring that not less than 80 per cent of the incremental advances in the busy season should be to industry and against export/import bills was no longer in force, and should not be invoked to restrict credit to any sector. As regards the current slack season, while banks should continue to effect a sizeable reduction in their credit against seasonal commodities in short supply, the advice contained in the Bank's letters to the larger banks in this regard need not apply to advances against raw jute, whether to mills or trade in view of the larger market arrivals of the new crop. Similarly, advances against sugar to mills and to the I.S.M.A.'s Export Division need not be subject to reduction beyond what is indicated by the releases ordered by Government. Advances against gur, however, need to be drastically curtailed.

6. In the face of a slowing down in the rate of deposit accretion and the emergence of heavy credit demands on the banking system, it is necessary to have purposive planning of credit expansion. Banks should keep in close touch with the Reserve Bank regarding their credit plans, both for the busy season and for the near future. Such contacts could also help to draw attention to cases where genuine productive activity may be hampered by lack of adequate credit.

7. I would like to take this opportunity of impressing upon banks once again the need to increase their assistance either directly or indirectly to the agricultural sector for production, marketing and development. It is proposed to discuss, in greater

detail, with representatives of commercial banks the manner in which they could enlarge their assistance to the agricultural sector.

8. Please acknowledge receipt.

Yours faithfully,
GOVERNOR

Encl: sheet

MEMORANDUM

The Reserve Bank is reintroducing with immediate effect the facilities of the Bill Market Scheme under Section 17(4) (c) of the Reserve Bank of India Act; the Scheme, for the present, will be restricted to the refinancing of credit granted to the sectors mentioned in the following paragraphs.

2. The Reserve Bank will be prepared to provide refinance, irrespective of a bank's net liquidity ratio, at a preferential rate of 4½ per cent per annum in respect of packing credit advances made by scheduled commercial banks to exporters of engineering and metallurgical products. This facility, which will be available in respect of both manufacturer-exporters and merchant-exporters, will be subject to the following conditions:

(a) The bank's advance will carry a rate of interest not exceeding 6 per cent per annum.
(b) There should be a firm export order or a letter of credit in favour of the domestic exporter. However, in special cases, and to take into account traditional trading practices in respect of certain export commodities, the Reserve Bank will be prepared, on a representation being made to it, to waive this requirement. Such waiver will be considered at the time of approving the bill limits in respect of these transactions.
(c) The bills to be lodged with the Reserve Bank in respect of such packing credit advance should not be of more than 90 days' maturity. However, in appropriate cases, the Bank will be prepared to make one more fresh advance against a fresh set of bills.

3. The Reserve Bank will also be prepared to provide refinance, irrespective of a bank's net liquidity ratio, at bank rate in respect of packing credit advances made by scheduled commercial banks to exporters of products other than engineering and metallurgical. This facility, which will be available in respect of both manufacturer-exporters and merchant-exporters, will be subject to the following conditions:

(a) The bank's advance will carry a rate of interest not exceeding 8 per cent per annum.
(b) There should be a firm export order or a letter of credit in favour of the domestic exporter. However, in special cases, and to take into account traditional trading practices in respect of certain export commodities, the Reserve Bank will be prepared, on a representation being made to it, to waive

this requirement. Such waiver will be considered at the time of approving the bill limits in respect of these transactions.

(c) The period of the packing credit advance to the exporter should not exceed 90 days prior to shipment in respect of any single transaction for which refinance is availed of.

4. Refinance will also be available to scheduled commercial banks, irrespective of their net liquidity ratio, at bank rate under Section 17(3A) of the Reserve Bank of India Act in respect of postshipment export bills denominated in currencies other than Indian rupees, and they will be expected to lend to their customers at a rate not exceeding 8 per cent per annum.

5. The Rupee Export Bill scheme will continue to operate as at present.

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D.O.No.G.8–67

Camp: Calcutta
August 10, 1967
Sravana 17, 1889 (Saka)

My dear I.G.,

I was delighted to get your D.O. No. CEA/1253/67 of 3rd August. I hope you will not think me unduly rash if I give a spontaneous response to your suggestion which is obviously borne out of a good deal of thought.

Quite frankly, your idea appeals to me. It would, I think, make for a good deal of streamlining of the system, but before any headway can be made, some thought has to be given to the quantitative implications both on the budget and on the RBI of the proposed change.

Further, it is important that the economic implication of such a change should be clearly understood. Obviously, we have to provide for an expansion in the monetary assets of the Reserve Bank to match the increase in reserve money needed to sustain the required monetary expansion. Implicit in your approach seems to be the thought that asset creation for a given money supply increase would progressively be smaller than now. At the same time, we have to guard against a monetary expansion which is well above the rate of real income growth even after allowing for a secular decline in income velocity. Such restraint I feel can be better exercised by making the RBI responsible for monetary expansion to take care of the working capital needs of all industry and agriculture whether in the private sector or the public sector, provided in the Budget deficit financing is fully eliminated. A transfer of certain financial obligations from the Exchequer to the Bank will not generate more resources for the economy, and it is specially important that the relief which the budget gets should not result in the amounts being spent in other ways. There has been a tendency in the past in each Plan to underestimate the requirements of working capital. There should be no assumption that because budgetary provisions will not be made for it, the working capital needs can be taken care of without any impact on the size of the Plan.

You have hinted at the possibility of having an institution like the Credit Council which would be serviced by the Reserve Bank to help in bringing about a rational and coordinated credit policy. Clearly, the object of any such device would be to have some credit planning both dimensionally and directionally and in tune with Plan priorities. At my recent meeting with the bankers of which the minutes have separately gone to you, when I indicated to them the need for credit planning and for close consultation between the Reserve Bank and the banking system to discuss banks' resources position and the sectoral disposition of their assets' portfolios, I was vaguely groping towards an arrangement of this kind but confined to the present responsibilities of RBI. I am trying to bring into being an informal machinery for consultation and coordination of credit activities not only as regards commercial banking activities but as between these and the agricultural and industrial banking systems. However, if the orbit of operations is enlarged, it will clearly be necessary to introduce representatives of the Planning Commission and Finance Ministry as you have suggested in these deliberations.

As I have said, these are only first reactions. I should like to think over the matter further in consultation with my colleagues here.

I entirely agree with you about what the basic problem is in regard to the future of banking in this country. Here again, I would need a little time to think, but as Panandikar had promised at least a synopsis of his report before the Deputy Prime Minister goes to Japan, I was hoping to have a look at it before attempting an answer to the basic questions which you have posed.

As you have very rightly observed, it is much easier to discuss these things than to correspond about them. Why not make it a point to come to Bombay once a month? Anyway, I am planning to be in Delhi between the 26th and 28th.

Yours sincerely,
L.K. Jha

Dr I.G. Patel
Chief Economic Advisor
Ministry of Finance
Department of Economic Affairs
Government of India
New Delhi

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Ministry of Finance
Department of Economic Affairs

Regarding Shri R.K. Hazari's note dated 6.1.1971 which Seshadri handed over to me this morning, Government do not propose to interfere in whatever the Reserve Bank considers the appropriate course of action under the circumstances. We presume, however, that:

(a) changes in deposit rates will be announced simultaneously with other changes;

(b) the question of a commitment charge on advances to Food Corporation would not be linked up with the changes at this stage;

(c) on an average, the rate on advances given by commercial banks will not increase by more than 1 per cent.

2. It is for your consideration whether action could not be taken tomorrow itself rather than waiting till Saturday.

3. It is important that in giving any publicity, the positive aspects of deposit mobilization, continuance of priority treatment for the priority sectors and timely action to check undue credit expansion and price rise are emphasized. You will, no doubt, agree that publicity which might lead to much more meaning being read into the action cannot be desirable under any circumstances. Nor is the action proposed such as to give an impression that it is intended to deal with a very serious situation.

I.G. Patel

Governor, RBI 7.1.71

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Central Bank of India
Bombay -1
31st January 1973

My dear Hazari,

You will recall the discussions in Delhi about transfer of accounts. To the best of my recollection, it was decided that there should be a complete ban on transfers of accounts for a period of three months, regardless of whether the limits involved are more or less than Rs 25 lakhs. Since the Reserve Bank circular of 13th January 1973 imposing certain restrictions on transfers of accounts involving limits of Rs 25 lakhs and over was published in the newspapers after the above decision was taken, there is scope for misunderstanding as to whether the ban on transfers of accounts applies only to such limits. I have, therefore, to request you to kindly advise banks to ensure that they do not take over any accounts for a period of three months. You will appreciate that even when transfers of accounts are disallowed, big borrowers will continue to take advantage of inter-bank competition to secure lower rates of interest on new accounts, so that the current instability in this matter will continue, and the pressure for reduction of rates on old accounts will remain unabated. The pressure for lower rates is exercised by the borrowers in the public sector, no less from those in the private sector. Further, where a party has borrowing arrangements with several banks, and this is the case with many large borrowers, a divergence in the rates of interest charged by the banks concerned leads to the limit bearing the higher rate of interest being utilized to the minimum extent. Both these problems can be dealt with only by the Reserve Bank of India prescribing a minimum rate of interest for certain categories of big borrowers. Since the Reserve Bank has laid down rates of interest payable on different categories of deposits, it would be reasonable to fix a minimum rate of interest on at least some categories of advances. This would safeguard the profitability of banks which is currently threatened by excessive competition among them in this respect.

I shall be grateful if the Reserve Bank would give a speedy decision in this matter. If the Reserve Bank is in favour of free competition among banks in the matter of interest rates, they may make this clear, so that banks will thereafter consider themselves free to quote competitive rates, subject to the Reserve Bank's conditions about liquidity and the individual banks' own assessment of the overall impact on their profits.

Each bank has to safeguard its profitability by maintaining an optimum credit–deposit ratio, because it is constantly adding to its deposits and consequently to its interest burden, and also incurring development expenditure. The responsibility for this rests primarily with the bank itself which must maintain a constant awareness of the way a decline in profits will affect its ability to build up its reserves, to perform its development functions and to carry out its obligations to its customers and employees.

Today each bank is trying to improve its credit–deposit ratio more or less in ignorance of the interest rates actually charged by its competitors. It is for the Government and the RBI to consider: (a) whether the data available to them (or which under a system of nationalized banking should be available to them) about the rates actually charged by SBI and different nationalized banks should be shared with the banks and suitable guidance given to them, or (b) whether, in the absence of such data and such guidance, the banks should be left free to adjust their rates on the basis of such information as they are able to gather from their field offices about the competition offered by other banks, or (c) whether the banks should be restrained from acting on their own information (as some banks are at present) and should, at the same time, be denied the information available to the authorities about the rates actually charged by major banks. There is obviously some fairness in (a) or (b), but (c) would be quite unfair.

Neither a permanent ban on transfer of accounts (which, as stated above, does not touch the problem arising in cases where parties maintain accounts with different banks which charge different rates, or the one arising in respect of new accounts) nor the procedure of prior consultation or clearance provides a satisfactory solution. You will appreciate that a bank which seeks to deny a valued customer with whom it has built up a relationship over a long period of years, the benefit of a lower rate he expects to get from another bank is bound to incur his displeasure, especially when it seeks outside intervention in this matter or discriminates between an old customer and a new one to whom it readily offers a competitive rate for fear of losing his custom. A commercial bank cannot afford to strain its relations with its customers without good reasons. A party may be stopped from transferring its account, but nothing can stop it or its associates from transferring deposits or its inland or foreign bill business (which is often very remunerative) to another bank or from giving the bank a bad name in the business community for its obstructive or discriminatory attitude. Banks would have less practical difficulties if these commercial policy considerations could be kept in view.

I am sending a copy of this letter to the Department of Banking (Mr Bhide) for information, as the question has remained pending in my Board for quite some time.

With kind regards,

Yours sincerely,
B.N. Adarkar

Dr R.K. Hazari
Deputy Governor
Reserve Bank of India
Bombay

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N.C. Sen Gupta
Secretary

Ministry of Finance
Department of Banking
'Jeevan Deep' Parliament Street
New Delhi
22nd December, 1973

My dear Jagannathan,

We discussed in Calcutta the possible impact of the current credit restrictions on the banks' advances to priority sectors. You agreed that the priority accorded to the designated sectors should continue to be observed fully. As you know, at present, roughly 24 per cent of banks' lending go to these priority sectors. There should be no reduction in this percentage, but progressively the percentage should be increased so as to cover 33.3 per cent. I find that the instructions issued by the Reserve Bank (No.Sy.24–2087 dated December 11, 1973) do not refer to the priority sectors. Perhaps, a classificatory circular would be useful.

Yours sincerely,
N.C. Sen Gupta

Shri S. Jagannathan
Governor
Rserve Bank of India
Central Office
Bombay 1

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D.No. No. 127–SEA/74

Secretary

Ministry of Finance
Department of Economic Affairs
New Delhi
January 5, 1974

My dear Jagannathan,

At the meeting the other day in FM's room, you were sympathetic to the question of ensuring that the export sector is not discouraged in the context of the credit squeeze, nor the reins in this particular area pulled too tight. We also have an oil squeeze, and in this context the need to encourage exports becomes even more compelling.

2. In this context, I enclose an extract from a note which I have received from Tirumalai on the subject. I had asked him to let me have it before the meeting with FM the other day. Unfortunately, it turned up when the meeting finished. It is prepared somewhat hurriedly, but it puts across the message. In any case, discussions with the Ministry of Commerce to get into more detail in regard to the various difficulties experienced by exporters can easily be arranged should you think this useful.

3. The note particularly mentions the need for packing (or is it packaging?) credit which was also brought up at the meeting. This theme has come up repeatedly. There is also the question of banks being able to discount pay orders relating to export credits, excise drawbacks, duty drawbacks, et al. This particularly affects the smaller exporters.

4. I shall be very happy to hear from you about any steps taken by RBI in regard to the export sector generally. If the Finance Ministry can help in any way in this matter, we shall be very glad to do so.

5. Incidentally, I have not yet heard from you about the Cotton Corporation. The note of the Commerce Ministry on the subject approved by their Minister, I handed over to you in Calcutta. This is still with you. We would also like to know your thinking on jute in this same context of bank credit. Jute never came up at the FM's meeting.

With kind regards,

Yours sincerely,
M.G. Kaul

Shri S. Jagannathan
Governor
Reserve Bank of India
Central Office
Bombay

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D.O. No. CPC. 2726/C279–74 April 3, 1974

My dear Kaul,

You will recollect leaving with me a note containing an analysis of expansion of bank credit during the current busy season. In this connection, I request you to see also the note prepared in the Reserve Bank which is mainly confined to making certain observations on the concluding portions of the note that you left with me.

You had mentioned that you had not seen the article published in the Reserve

Bank Bulletin regarding the evolution of Reserve Bank's credit policy. I enclose for your retention a reprint of the article in question.

With kind regards,

Yours sincerely,
S. Jagannathan

Shri M.G. Kaul
Economic Secretary
Ministry of Finance
Government of India
New Delhi

(P.S. You had referred, in your conversation with me, to some article in *Economic and Political Weekly*. In case the article that you had in mind was that bearing the heading 'Dear Money, Indeed' in the issue dated 23rd March 1974, I may mention that the article is based on a misapprehension and, to add to this, has been based on a totally incorrect figure assumed to be Rs 4615.8 crores, when in fact the correct figure is Rs 461.58 crores. I enclose for your information a copy of the letter that has been sent to the Editor explaining our points. In case you think that FM has read this article also, you may kindly show him the correction.

You would not have missed the point that the series of measures that we took for increasing the cost of money to the banks began only in November 1972 and, more significantly, in March and May 1973. The article discusses 1972 statistics, and therefore is not to the point at all as to the effect of our 1973 measures.)

S. Jagannathan

Note 2

It is said that even allowing for the special nature of certain credits that have been sanctioned such as for oil companies, public sector undertakings, etc., the overall picture is still one of a higher level of bank credit expansion than what the Reserve Bank earlier considered warranted. The *total* expansion of credit is as has been stated, and the facts to be clarified are the extent and special nature of certain credits. The fact is that credit extended after sanctioning to public sector undertakings during the current season has been much larger than in 1972–73 busy season. As against a total expansion of about Rs 86 crores during the six-month period—end-October to end-April 1973, credit to public sector undertakings rose by Rs 38 crores in October 1973, and by Rs 76 crores in the following two months or by Rs 114 crores in all, in just three months. According to preliminary information available, credit to the public sector undertakings is likely to have maintained this monthly order of expansion. Therefore, if credit given to public sector undertakings as well as to the export sector are excluded from total bank credit, bank credit expansion to private sector (for other than export) would not turn out to be very much different from what was considered warranted by the Reserve Bank.

The note has not mentioned the point that the flow of credit to the priority sectors has also been higher than in the preceding season. Here again, the increase in credit was Rs 145 crores during the three-month period—October, November and December 1973, which was far higher than the total expansion of Rs 88 crores in the corresponding period of three months of last year.

In the light of the order of credit expansion and the sectoral components indicated above, it would have been appreciated and this is the fact to be kept in view that the credit expansion has been permitted with the knowledge of the Reserve Bank. The assistance provided by the Reserve Bank will have to be viewed against the order of expansion considered reasonable and the quantum of resources which the banks themselves could raise. As a result of the impounding of additional reserve requirements in June and again in September, something of the order of Rs 350 to 400 crores had been siphoned off. At the same time, the deposit growth turned out to be smaller, that is, Rs 430 crores between end-October 1973 and 22 March 1974 or by 4.5 per cent as against Rs 562 crores or 7.1 per cent last year. Refinance was provided to banks only after detailed discussions with each one of them about their funds' position and sectoral pattern of deployment. Similarly, rediscounts under the bills' rediscounting scheme have also been provided after detailed discussions and scrutiny.

The following figures relating to refinance may be noted in this connection. As of March 30, 1974, total refinance provided by the Reserve Bank stood at Rs 423 crores. The break-up of this under various heads will be as follows:

1.	2 per cent of DTL	Rs 212 crores
2.	Special refinance for Oil Companies (as a result of rise in imported crude prices)	Rs 14 crores
3.	Special refinance for food procurement	Rs 27 crores
4.	Special refinance related to exports	Rs 92 crores
	Total	Rs 345 crores
	Balance provided by way of discretionary accommodation mainly to help finance public sector undertakings	Rs 78 crores
	Grand Total	Rs 423 crores

It is mentioned in the note that to the extent to which non-bank financial institutions are in the market for participation certificates, and the extent to which LIC operates in the call market, the ability of banks to extend credit has increased. During the current busy season, there has been hardly any increase in the funds made available by the LIC and UTI (the total funds from which made available to the banks stand at about Rs 48 crores at present). Although figures are not available, total amount raised from non-bank institutions on a participation basis is not very large.

It mentioned that in the type of credit situation that has prevailed in the last few months, the banks have virtually been approaching the Reserve Bank as a lender of the first resort. This view is not factually correct. To the extent resources could be tapped from non-banking institutions such as LIC and UTI, banks have made use of them and resorted to the Reserve Bank only after. However, as pointed out earlier, the additional resources available to banks from non-bank institutions was not significant. A further point to be considered is that if LIC and UTI had gone off the market completely, the Reserve Bank would have provided more accommodation to banks given the judgement that the order of credit expansion was something which could be justifiably supported. The monetary impact of such larger Reserve Bank assistance would have been more expansionary.

Reserve Bank of India
Bombay
April 3, 1974

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D.O.No. 6928–CS/74

CABINET SECRETARY
NEW DELHI
12th August, 1974

My dear Kaul,

I understand that a Committee has been set up consisting of Additional Secretaries of two or three Ministries and a representative of the Reserve Bank of India to work out certain details of credit policy. I also understand that there is a Committee or a group of bankers to study this question. I have been told of a few problems which I am requesting that these Committees may take into consideration when formulating their views.

The first relates to the review of the top 25–50 accounts in each bank. It has been mentioned that this will operate differently in different banks, and it may be therefore desirable to lay down a credit limit up to which the accounts will be reviewed in each bank, which may be, say, Rs 1 crore or Rs 5 crores as may be considered appropriate.

Secondly, it may also be desirable to lay down certain guidelines with regard to the availability of credit for essential production programmes specially in the core sector, like power, fertilizers, commercial vehicles, scooters or articles of mass consumption and essential articles subject to whatever limitations are needed to prevent profiteering, hoarding, etc.

Doubtless, the committees will be considering these matters, but I am bringing these for your consideration. It may also be desirable to associate in the discussions representatives of the more important Ministries concerned in this programme like the Ministry of Heavy Industry, Industrial Development, Steel and Mines, Petroleum and Chemicals, etc.

Yours sincerely,
B.D. PANDE

Shri M.G. Kaul
Secretary
Department of Economic Affairs
New Delhi

D.O.No. 1561–174 August 16, 1974

Dear Shri Pande,

Kindly refer to your D.O. No. 6928-CS/74 dated 12th August, 1974 about credit policy. Two groups have been formed as desired by FM. One group is meant to look into problems of credit to public sector enterprises. The second group performs the same function for credit to the export sector. Narasimham, Additional Secretary in this Department and Balasubramanian, Additional Secretary in Banking are members of both groups. A.P.V. Krishnan, Additional Secretary in the Ministry of Finance (Dept. of Expdr.) and R. Tirumalai, Additional Secretary in the Ministry of Commerce are associated with the group on exports and Fernandes with the group on public sector enterprises.

2. I would like to say here that the guidelines in regard to availability of credit from banks are laid down by the Reserve Bank, because it is the Reserve Bank which is responsible for laying down and administering the policy aspects of such credit. The groups mentioned above will look into the manner in which the policy laid down by the RBI is affecting the sectors concerned, and where necessary changes are called for, we will bring the findings of the groups to the notice of the Governor, Reserve Bank.

3. I am also sending the Governor the suggestions you have made in regard to the review of the top 50 accounts in each bank, and availability of credit for essential production programmes.

4. In this context, you may be interested to see copy of a letter that I have recently written to the Governor, RBI on the subject of the policy regarding credit restraints.

With kind regards,

Yours sincerely,
M.G. KAUL

Shri B.D. Pande
Cabinet Secretary
New Delhi

Copy to:
1. Governor, RBI, Bombay.
2. Secretary, Department of Banking, New Delhi.
3. Secretary (E).

M.G. KAUL
16.8.1974

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Informal note prepared after discussions with Shri P.N. Dhar on 15.9.74, before discussions with PM.

16.9.1974

In consonance with the national policy of fighting inflation, aggregate credit expansion in 1974–75 will have to be restricted to a level, and a rate of growth, somewhat lower than in 1973–74.

Consequently, not all of the borrowers even in the priority categories, are likely to be fully provided by the banking system.

Specifically, this will require restraint in provision of credit, direct and indirect, to borrowers who could contribute to maintaining high prices or pushing them to unjustifiable levels. Since only a limited amount of commercial bank credit is provided directly to agriculture, principal points of action arise in: (a) supply of credit through cooperatives and (b) supply of credit to the marketing agencies and/ or processing industries. Some of the important elements in such action consist of the following:

1. *Cooperative Credit*

Overdues have continued to accumulate and explicit measures have to be taken not only to stop this tendency but to speed up recovery of past dues. This is largely a matter for the states to implement. In terms of national policy, this will imply restraint on the supply of credit to cooperatives, both from the Reserve Bank of India and the commercial banks.

2. *Redefinition of Priority Sector*

In respect of both agriculture and small industry, the criteria for provision of credit on a priority basis should be more strictly defined than at present. This is necessary to prevent undue appropriation of available credit by big farmers or the bigger units in the small-scale sector. Some steps have already been taken in this regard and these will have to be strengthened.

3. *Marketing Credit*

(a) *Cotton*: Cotton prices are at present very high. This affects adversely both exports and domestic consumers. It is necessary that commercial bank credit is not used by marketing agencies, irrespective of whether they are in public, private or cooperative sectors, to keep prices at an artificially high level. Hence, the access to bank credit by such agencies will have to be reduced.

(b) *Jute*: The crop prospects are such that no large-scale intervention in the market by the Jute Corporation of India is necessary to maintain prices. Likewise, it is not necessary to require jute mills to hold substantial stocks of raw jute as was necessary last year. Hence, allocation of bank credit for marketing of jute has to be on a smaller scale than in the previous year.

(c) *Sugar*: Bank credit is provided to the sugar industry, largely to ensure that payments to cane growers are not withheld because of the Government's policy regarding releases of sugar by the mills. Currently, the credit extended to sugar industry is not being repaid despite large realizations from exports and high prices of free market sugar. In this context, it is necessary that Government authorize a larger release of levy sugar. This will benefit the domestic consumers, and at the same time reduce the sugar industry's draft on bank credit.

(d) *Credit for public food procurement*: At present, bank credit is used both by the Food Corporation of India and by State Governments and their agencies, particularly Punjab and Haryana. This has come in the way of efficient management of food stocks on the basis of national considerations. In fact, state agencies have tried to finance stock building operations by using bank credit, despite shortages in the rest of the country. This has to be prevented by ensuring that Central control on food stocks is made effective. For this purpose, provision of bank credit to State agencies which are not functioning principally as agencies of Food Corporation of India will have to be restricted.

4. *Financing of Petroleum Products*

In the last eight months, substantial credit has been provided to the oil refining and marketing companies, both in the public and private sectors to bridge the deficiencies in cash inflows pending the adjustments in petroleum product prices, consequent on the higher price on crude. This situation should not be permitted to become a permanent feature of credit allocation. It is understood that the need for such credit will soon be obviated through appropriate adjustments in the prices of petroleum products.

5. *Priority Allocations*

It is the purpose of credit policy to accord preferential treatment to exports, industries in the core sectors and essential consumer industries like controlled cloth. However, in all of these, bank credit will be available for financing normal working capital. Bank credit should not be used for unnecessary build-up of inventories, financing of fixed assets, or for covering continuing operational losses. These criteria are, as a matter of course, applied to private sector units. It is necessary that similar discipline is brought to bear upon public enterprises, and the banking system is not compelled to afford special treatment.

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CREDIT PLANNING CELL

1975–76 BUSY SEASON CREDIT POLICY: DISCUSSIONS WITH THE MINISTRY OF FINANCE

The contents of the note on Monetary Budget for 1975–76 and Busy Season Credit Policy for 1975–76 Busy Season, prepared in the Reserve Bank of India, were discussed with the Government as under: (1) Preliminary meeting with Finance Ministry officials (Shri M.G. Kaul, Shri N.C. Sen Gupta and Dr Manmohan Singh) on 23.10.1975; (2) First round of discussions on 24.10.1975 with Shri C. Subramanian, Finance Minister when Shri P.N. Dhar, Shri H.N. Ray, Shri M.G. Kaul, Shri N.C. Sen Gupta, Dr A. Mazumdar, Shri M. Narasimham, Dr Manmohan Singh and Shri G. Ramchandran were present; (3) Discussions on Monetary Budget on 24.10.1975 in the light of revised budget deficit with Dr A. Mazumdar, Shri M. Narasimham, Dr Manmohan Singh, Shri K.N. Rao and Shri Iswaran; and (4) Final round of discussions with the Finance Minister and Ministry officials. From the Reserve Bank, the following were present: (1) Shri K.R. Puri (Governor), (2) Dr R.K. Hazari (Deputy Governor), (3) Dr K.S. Krishnaswamy (Executive Director), and (4) Shri A. Raman (Advisor).

I

In the preliminary meeting (Item No. 1 above), Shri M.G. Kaul mentioned that the Government had taken a decision that all operations of food and fertilizer procurement and distribution, except the subsidization provided in the Central Budget, should henceforth be handled by the commercial banking system. He agreed that this did involve financing of buffer stocks, which was hitherto regarded as budgetary responsibility, but that there was a 'change in theology'. Dr Hazari pointed out that financing of buffer stocks would be the equivalent of long-term investment and would ultimately become permanent financing by the Reserve Bank (as a substantial part of food procurement credit extended by banks is refinanced by the Reserve Bank); this would cut into the other investment obligations of both the Reserve Bank and the commercial banks.

Dr Manmohan Singh stated that there could be some more liberalization on export credit.

II

Initiating the discussions with the Finance Minister (Item No. 2), Dr K.S. Krishnaswamy said that in several areas in the industrial sector, there was a lack of demand. Investment was not accruing at the rate at which it should. There was a good deal of discussion on the cotton textile situation, but it was agreed that adjustment of excise duties was not a solution. The quality of controlled cloth had improved, and some relaxation in distribution of controlled cloth was desirable to help move stocks faster. Another solution to the cotton textile situation was also an adjustment in selling prices. There was a general consensus that the reduction effected, so far, in prices of cotton textiles was not commensurate with the fall in cotton prices.

Dr Krishnaswamy also referred to the prospects of accumulation of steel and coal, and both Dr Hazari and Dr Krishnaswamy suggested some selective encouragement in demand for steel. The outlook for world steel industry being bleak, export prospects were not encouraging. Dr Hazari mentioned the scope for lifting the bank on construction activity and for more railway orders for wagons.

Dr Krishnaswamy added that while there was no general recession of demand, it was worthwhile promoting demand selectively in respect of some engineering industries left with stocks. Private investment was likely to remain subdued and in other areas, Government may have to consider larger investment. The more recent projects expect term-lending agencies to provide more funds, their equity participation being less than what it should normally be.

Dr Krishnaswamy said that in the context of this overall situation and when prices have not shown any significant trend downwards, we have to exercise caution in formulating our policy. He recalled the earlier discussions in June with the Finance Minister when the feeling was that on a 5–6 per cent increase in real output, the increase in money supply could not go beyond 7.5 per cent. During the current financial year thus far, money supply had already arisen by 4 per cent and taking into account the likely demand for credit in the coming months, a target of 7.5 per cent increase was no longer sustainable. He then gave details of monetary and credit projections on the basis of a 10.4 per cent increase in money supply (as given in the technical paper appended to the note). Dr Krishnaswamy added that in the context of the bumper Kharif crop of both foodgrains and commercial crops, the projected increase of 10.4 per cent would probably leave prices unaffected for the next few months. The level of money supply at the end of the fixed year 1975–76 would be higher than what was envisaged earlier, and this factor was to be taken into account while assessing the prospects of price stability in 1976–77. However, assuming a good rabi crop and some increase in industrial aspect, an increase in money supply of about 10 per cent could perhaps be tolerated, and could leave enough flexibility to operate monetary and fiscal instruments next year.

The Finance Minister wanted to know whether the projected increase in credit (Rs 1,900 crores to commercial sector) would help contain buffer stocks of coomodities at levels indicated. Dr Krishnaswamy explained that the projected increase in credit provided for an expansion of Rs 250–300 crores for food procurement operations during the ensuing busy season period on the assumption that any 'buffer stocks' at end of March 1976 would be financed from budgetary resources. It had also taken into account the need to provide some support to raw cotton prices but not items like monopoly procurement of cotton by Maharashtra, which the Reserve Bank did not consider a viable one. A part of the requirements of the Maharashtra scheme would be met by the banking system. Regarding cotton, a point was made that mills had the bearest minimum stocks—2 weeks or so—and if they could be asked to stock up to 4 weeks, there would be a favourable impact. No price support was assumed for oilseeds, nor would the Reserve Bank advise it.

The Finance Minister observed that *all* transactions of a commercial nature relating to food and fertilizer operations will have to be isolated from the Budget and financed by banks. He did not distinguish, in this context, between trading stocks and buffer stocks, as seemed to be the practice so far. Regarding cotton operations, he mentioned that it will not be on the same footing as food operations and only marginal price support could be thought of. He added that we should be clear as to what sort of operations will be financed by the commercial banks and that the Cabinet should be apprised of its implications (in a note to be submitted to the Cabinet). He suggested an immediate detailed exercise to be undertaken to work out the implications of taking over of additional food and fertilizer operations by the banking system on bank credit to Government (Rs 1,150 crores) and on bank credit to commercial sector (Rs 1,900 crores).

Dr Hazari then outlined the broad features of 1975–76 busy season policy finalized by the Reserve Bank. He mentioned that the basic stance of tightness was to be maintained while providing for June flexibility in certain directions. In view of the benefits derived from the present structure of interest rates, there would be no change in this regard, except for item (3) below. Some of the specific points mentioned by Dr Hazari included: (1) subsidy on export credit should be raised from 1.5 to 4 per cent for deferred payments (also buyers' credits) and from 1.5 to 2.5 per cent for other exports; (2) IDBI's assistance in 1975–76 will have to be larger; (3) commercial banks will be advised to charge not more than 15 per cent (14 per cent if Government were prepared to withdraw the tax on interest income) on term loans for a period beyond three years; (4) minimum margin on cotton textiles to traders, dealers, etc. would be reduced from 40 to 25 per cent; (5) banks would be advised to fix a lower margin on controlled cloth; (6) some minor modifications in selective controls on oilseeds and rice mills will be made in margins (from 75 to 60 per cent for oilseeds and from 45 to 35 per cent for rice mills); and (7) the policy did not provide for buffer stocking of cotton but allowed some bridging finance for the Maharashtra Scheme.

III

The main point which emerged during discussions with the Finance Ministry officials on the afternoon of 24th October (Item No. 3) was that the Government budgetary deficit would show a considerable deterioration from the original figure of Rs 247 crores envisaged in the Budget. The budget deficit that is now anticipated is of the order of Rs 860 crores. Although budgetary receipts will show a net improvement of Rs 650 crores over the budget estimate, there will be an increase of Rs 274 crores in plan expenditure and of Rs 720 crores in non-plan expenditure. Added to this will be additional subsidy payments of Rs 100 crores on account of fertilizers. To this figure will have to be added the shortfall in payments by the FCI (Rs 80 crores) and the likely non-payment by Bihar (Rs 30 crores) to the FCI.

The net effect of the Government's proposals as to increase the net bank credit from Rs 1,150 crores to Rs 1,470 crores and of the credit to the commercial sector from Rs 1,900 crores to Rs 2,300 crores as a result of providing an additional Rs 200 crores for food and an additional Rs 200 crores for fertilizer.

IV

A note prepared in the light of the discussions and presented to the Finance Minister is appended. The revised projections indicated an increase of 14.9 per cent in money supply. This note was discussed on the 25th with the Finance Minister (Item No. 4).

Dr Hazari expressed the Reserve Bank's view that an increase of 14.9 per cent in money supply was disturbing and unsafe. The Finance Minister asked for suggestions for bringing down the growth of money supply. Dr Hazari stated that decisions on suggestions in this regard would depend on Government's judgement. The Governor observed, in this context, that there seemed to be scope for reducing food subsidy (by an adjustment in issue price). He also pointed out that any reduction in fertilizer prices would worsen the budget deficit (subsidy becoming larger). The Finance Minister observed that apparently, containment of monetary expansion to a lower rate would require the exercise of greater budgetary control henceforward. During the discussions, the point also came out that the scope for phasing investment in public and private sectors should be explored. It was noticed that the projected order of increase in money assumed an increase of over 14 per cent in bank credit to Government, would be in excess of the figure of 12.4 per cent, indicated to the IMF. If food and fertilizer transactions now proposed to be transferred to banks are also reckoned with, the increase in bank credit to Government would be larger than 14 per cent.

Dr Krishnaswamy made the following observations. Even allowing for the growth in real output of 5–6 per cent this year, and the availability of larger stocks at the beginning of the next financial year, a 15 per cent increase in money supply this year could mean a revival of expectations of price increase in the ensuing period. This would reverse many of the trends in the economy which, in the past few months, had contributed to stability. The inflationary danger for the coming year would be more, if along with a step up in investment expenditure, there was a further accumulation of food stocks. He added that in the context of the national policy of building buffer stocks *and* stepping up investment, it was inevitable that energetic measures had to be taken for raising domestic savings. Any revival of inflationary tendencies in the economy would make it virtually impossible to generate larger savings in the household sector. He observed that savings in the public sector was unsatisfactory and unless public enterprises avoided losses and actually generated surpluses, the problem would get greatly compounded over the years.

The Finance Minister observed that taking into account the health of the economy, if expansion in money supply of the order of 15 per cent is considered inflationary, we should explore all measures of controlling expenditure and raising larger investible resources. Dr Krishnaswamy said in the meeting with finance ministry officials, that it had been indicated that the scope for cutting down spending was limited; hence the only solution seemed to be to raise larger resources. In this context, Centre's assistance to States may have to be kept down to reduce the burden on the Central budget. While creating, at the same time, pressure to mobilize larger resources, in the State's sector, especially from agriculture State Road Transport Corporations/Electricity Boards. There also has to be rigid control on commercial bank credit and the interest rate structure has to be maintained as, at present, to assist this process. While every assistance has to be given to raising production through credit policy, care has to be ensured that no increase in money supply takes place to facilitate addition to inventories. Shri H.N. Ray also raised the point at this stage as to why there should be continuation of massive subsidy on food in the budget.

The Finance Minister desired that we should study all possible advances for bringing down the projected rate of increase in money supply of 14.9 per cent—cut in spending, raising of more resources or other methods.

The Finance Minister was in agreement with the features of 1975–76 busy season credit policy as outlined by Dr Hazari in the earlier meeting held on 24.10.1975.

A. Raman
October 27, 1975

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Ref. D.O.No.CPC.302/1313/75

December 3, 1975
Agrahayana 12, 1897 (Saka)

Dear Dr Saxena,

This has reference to your D.O. letter No. 81–JS (DEV)/75 of October 28, 1975 forwarding a copy of Shri T.A. Pai's letter to the FM regarding interest cost of industries.

As Government are aware, our interest rate policy is based on a number of considerations; to provide some incentive for savings, to discourage excessive inventories of goods and other physical assets, and generally to induce a more rational application of scarce funds—long-term as well as short-term. These objectives continue to be relevant and we are of the view that under present circumstances, it does not seem advisable to make any basic change in the structure of interest rates.

The climate of price inflation combined with the inadequacy of returns on financial assets like bank deposits had, until recently, shifted people's preferences to real assets—gold, real estate and goods. The higher deposit rates—5 per cent for savings deposits or the maximum of 10 per cent on term deposits have remedied this to some extent. It is important that this trend is not reversed by reducing interest rates on deposits.

With the changing mix of deposits and the higher cost of refinance from the Reserve Bank, the average cost of funds for the banks has gone up. Thus, as may be observed from the Table appended, the average of interest paid on 'working funds' by twenty-two public sector banks shot up almost by a full percentage point from 3.594 per cent to 4.534 per cent in 1974. In 1975, it would be still higher.

On the other hand, banks' 'establishment expenses' (including bonus), which as a proportion of the 'total working funds' has, by and large, remained stable during the past four years, 1971–74. There was some spurt in 'establishment expenses' (including bonus) in the first two years (1970 and 1971) of the nationalization of fourteen major banks, following a fast and sizeable expansion in branch network.

On the earnings side, about two-thirds of bank funds are pre-empted by low or negligible yielding assets: cash and reserves with RBI, pre-emptive investments in Government and other approved securities and the financing of a series of priority sectors (including small-scale industrial units with credit limits not exceeding Rs 2 lakhs), which stand exempted from the minimum lending rate prescribed by the Reserve Bank of India. Only 1 per cent out of four of total liabilities kept as reserves with RBI earns interest of 5.5 per cent. Investments in treasury bills fetch 4.6 per cent and those in Government and other approved securities around 6 per cent.

Thus, all of these earn less than the average cost of funds to the banks. Besides, because of the concessional rates charged to small borrowers in different priority sectors, about 50 per cent of the bank credit was given at rates below 11 per cent in June 1974 (when the minimum lending rate prescribed was 11 per cent). Even for the non-exempted categories of medium-scale and large-scale borrowers, the commercial banks adopt industry-wise and purpose-wise priorities in charging interest rates. As a result, the spread between 'interest paid on deposits and borrowings' and 'total earnings', each as percentage of 'total working funds', cannot be said to have risen disproportionately.

There are also some wider considerations in framing the interest rate policy. First, the interest cost forms a small part of the value of output—generally ranging from 2 to 4 per cent in different industries. Secondly, with better inventory management for which there is considerable scope, interest burden to industries should be lower than what the increase in the nominal rates suggests. A *quick* study of the finances of 226 public limited companies in the private sector shows that despite the sharp increase in interest rates, interest cost as a percentage of value of output increased just nominally from 2.6 per cent in 1973–74 to 2.7 per cent in 1974–75. Thirdly, the incidence of even this nominal interest rate gets further reduced as interest cost is a deductible expenditure for tax purposes; hence as much as 45 to 50 per cent of the interest cost is borne by the Government. Fourthly, the policy of low interest rate had created distortions in the use of short-term and long-term funds—larger inventories, general laxity in cost consciousness, substitution of capital-intensive technology replacing labour even in areas where economies of scale do not call for such substitution and the like. Lastly, the increase in the rate of interest for large borrowers is an important safeguard against such borrowers pre-empting bank credit disproportionately to their requirements, and thus reduce the availability of credit for small borrowers.

It is wrong to consider the current recession as the one requiring a relaxation in interest cost, particularly in regard to lendings by the commercial banks—a substantial proportion of which is for inventory financing. To the extent the commercial banks give term loans, the recent advice by the Reserve Bank to keep the term loan rates at around 15 per cent will further benefit the investors. Even the withdrawal of commitment charges on unutilized portion of credit limits will tend to reduce the interest burden.

The system of charging interest at monthly rates is not widespread; the general practice is to charge it on a quarterly basis. We are also advising the banks to discontinue the practice of charging interest at monthly rests, wherever it exists.

With regards,

Yours sincerely,
K.S. Krishnaswamy

Dr D.N. Saxena
Joint Secretary
Ministry of Finance (Department of Banking)
Government of India
New Delhi

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April 30, 1976

My dear Manmohan,

When I telephoned to you yesterday afternoon to indicate the measures Governor intends to announce at his forthcoming meeting with bankers at Calcutta on May 7, you informed me that Economic Secretary desires that such communications from the Reserve Bank should be in writing. Hence this letter.

As you may be aware, at his meeting with the bankers on March 12, 1976, the Governor had agreed to meet with the bankers again at the beginning of the traditional slack season. In pursuance of this, we have invited the principal banks in the public and private sectors to a meeting to be held in the Reserve Bank of India, Calcutta on May 7, 1976. I enclose copy of a communication sent to the banks which indicates the principal items that will be discussed at this meeting.

The Governor wishes to utilize this occasion also to indicate certain modifications in the Reserve Bank's refinance policy. The main modifications are indicated below:

(1) The basic refinance limit allowed to each bank equal to 1 per cent of its demand and time liabilities as of last Friday of September 1975, will be allowed to continue till the end of October 1976. This basic limit which will amount to about Rs 140 crores is intended primarily to assist banks in dealing with day-to-day problems of clearing, etc.

(2) The rest of refinance facilities will continue to be on a discretionary basis. Discretionary refinance related to export performance given to the banks during the busy season of 1975–76 will also be continued till the end of October 1976. However, banks will be informed that where their export credit performance requires additional support from the Reserve Bank, we will be prepared to reconsider on merits further refinance facilities in this category. Such refinance related to export performance will continue to be available at a rate of interest of 11.5 per cent.

(3) All other discretionary refinance limits which are due to expire at the end of April 1976 will be allowed to expire as of that date. However, banks can apply for special discretionary refinance limits which will be considered on merits and appropriate accommodation will be extended.

(4) With regard to refinance for public food procurement operations, the present formula is as follows:

(a) For the first Rs 450 crores, no refinance.
(b) Between Rs 450 and 600 crores, refinance at 50 per cent.
(c) Above Rs 600 crores, refinance at 100 per cent.

This formula was introduced last year when the total requirements for food procurement operations were estimated at Rs 1,100 to Rs 1,200 crores. Since then, the demand on the banking system for food procurement credit has vastly increased and stands presently over Rs 1,580 crores. For the next few months, FCI has sought additional accommodation and so have the State Governments and State Government agencies engaged in the procurement of Rabi crops. Altogether, it is expected that the peak requirement of food refinance during July–August 1976 will be around Rs 2,050 crores. In view of this, it is proposed to adopt the following refinance formula in respect of food procurement for the slack season, 1.5.1976 to 31.10.1976:

(a) The level of banks' commitment of resources will be increased from Rs 523 crores in the old formula to Rs 800 crores. In other words, on the first Rs 800 crores, no refinance will be provided.

(b) On all additional food procurement credit, that is, over and above Rs 800 crores, refinance at the rate of two-thirds of the incremental credit will be provided. On this basis, the proposed refinance formula will mean, at the peak food credit of Rs 2,050 crores expected in July–August 1976, RBI's refinance commitment of Rs 833 crores and banks commitment of resources at Rs 1,217 crores. The immediate impact on the banks is expected to be of the order of Rs 70 crores as may be seen from the table below:

Food Credit as on 23rd April 1976

i.	Total Food Credit	Rs	1586	crores
ii.	Refinance entitlement as per current formula	Rs	1061	crores
iii.	Actual availment by banks	Rs	592	crores
iv.	Refinance entitlement as per proposed formula	Rs	524	crores
v.	Repayment required iii–iv	Rs	68	crores

To take care of undue difficulties in individual cases arising from this change, RBI will provide *ad hoc* accommodation on merits of each case for a temporary period, say, up to end of June, and review the position later.

(5) As regards bill rediscount accommodation, the following limits have been sanctioned to scheduled commercial banks for the current busy season:

(a)	basic rediscount limit (at bank rate of 9 per cent)	Rs	150	crores
(b)	additional limits (at varying rates)	Rs	141	crores
	Total	Rs	291	crores

The basic limits will be extended till October 31, 1976 and the additional bill rediscount limits till the end of June 1976 when the position will be reviewed.

(As may be observed, the principal change that will be made is with regard to food refinance entitlements. In view of the substantial deposit resources with the banks as well as of availability of funds in the call money market, it is not anticipated that banks will have serious problems. In case any individual bank is in difficulties, we shall, of course, provide assistance on an *ad hoc* basis.)

(6) Apart from the above, Governor desires to announce the following pattern of interest rates in regard to refinance:

(a) On the basic refinance limit equal to 1 per cent of demand and time liabilities, the rate of interest will be 10 per cent per annum, as at present.

(b) On refinance for food procurement, the rate of interest will be 10 per cent, as at present.

(c) On discretionary refinance related to export performance, the rate of interest will be 11½ per cent per annum, as at present.

(d) On other discretionary refinance, the Reserve Bank retains the option to vary the rates of interest depending on the magnitude and purposes of such refinance. However, the maximum rate of interest that may be levied on such discretionary refinance will not be more than the maximum ceiling rate of interest which the banks are allowed to charge in terms of the Governor's letter to the banks dated March 12, 1976. This means that compared to the present maximum rate of interest of 18 per cent leviable by the Reserve Bank on discretionary refinance, the proposed maximum rate will be corresponding to the ceiling rate of 16.5 per cent less the tax on interest income in the case of large banks; 17.5 per cent less the tax on interest income for banks with deposits between Rs 25 crores and Rs 50 crores. In the case of banks with deposits of less than Rs 25 crores, since no ceiling rate has been imposed, there is no corresponding maximum of interest on RBI refinance. However, it is not intended to charge these small banks more than for other banks. Hence, the effective maximum rate of interest on discretionary refinance would be reduced from the 10 per cent to somewhat lower rates.

I believe Government will have no objection to these changes. In case the Government wish to discuss this with the Governor of RBI, he will be in Delhi in the early part of next week and Economic Secretary or you may wish to contact him.

With kind regards,

Yours sincerely,
K.S. Krishnaswamy

Dr Manmohan Singh
Chief Economic Advisor, Ministry of Finance
Department of Economic Affairs
Government of India, New Delhi

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The Present Monetary Situation

I find the present monetary and price situation quite disturbing. Money supply over the year is 12 per cent higher as against 7 per cent in the previous year; on a fiscal year basis, the comparable figures are approximately 7 per cent and 4 per cent respectively. Though wholesale prices have declined slightly during the second half of July, the index is still about 1 per cent higher over the year and about 8 per cent higher than in March 1976.

The striking features of the present situation are as follows:

1. There is a large inflow of funds from abroad which, given the inadequacy of investment, both public and private, is increasing the foreign exchange assets of the banking sector and, therefore, adding to money supply. This inflow is likely to continue for some time, say, at least a year or two, because our exports are picking up, imports of food and fertilizer are expected to decline without an offsetting increase in other imports, the rupee is less weak and more stable than many other currencies and remittances through official channels are booming. It will take some time for these foreign exchange assets to get absorbed in a general increase in the level of investment.

2. There has been a substantial turnaround in the Government's budgetary position. The Government's deficit, howsoever measured, is substantially lower than it was last year. It is a fairly safe guess that the substantially smaller deficit indicates not merely larger receipts and some effort to keep down administrative expenditure, but also continuance of a low level of investment. It is possible that the investment expenditure will be stepped up after October or so, in order to fulfil the indications in the annual plan and the budget. Since the need for increase in public investment is imperative, it can be expected that in the rest of the fiscal year the budget would not be as much of a restraining factor in the monetary situation as it has been so far.

3. Bank credit has expanded by a very large magnitude as well as proportion. The bulk of this expansion has, no doubt, been on account of food, fertilizer, export and other high priority purposes. The pattern of credit expansion is now directed, scrutinized and monitored by the Reserve Bank more frequently and effectively than before, but the overwhelming fact is that the total volume of bank credit for all purposes taken together is largely responsible for the disproportionate expansion of money supply. There is a possibility—as has happened in some years immediately preceding—of a spurt in bank credit during the months of September and October. If this possibility fructifies (may be due to larger drawals for fertilizer, oil, export, etc.), the expansion of money supply will get a further boost, just on the eve of increase in budgetary outlay.

4. There is a definite change of price expectations in the market. The prices of the main cereals may be kept down by larger releases from public stocks, and the prices of cotton and edible oils may be restrained by the impact of recent official pronouncements, but the range of essential goods in the cost of living index is so wide that it appears doubtful whether prices can be kept stable or properly restrained by action aimed at individual commodities. It is very difficult, for instance, to control the prices of pulses, potatoes, onions, vegetables, meat, marine products, and while the prices of cloth, edible oil, soap, etc. are amenable to control, ensuring their availability at these prices is not always feasible.

The table annexed compares the movement of monetary indicators between March 26, and July 30, 1976 with the RBI projections made in March 1976 when, among other things, it was agreed with Government that an expansion of 12 per cent in money supply (M–1) could be considered as the safe outer limit for fiscal 1976–77. One of the welcome but upsetting changes since then is that the foreign exchange assets have risen significantly instead of staying constant; this change alone would, at the present level, be roughly 2 per cent more to the monetary expansion and since this welcome factor is likely to remain buoyant, the change over the year, as a whole, would be substantially larger. Some of the other comparisons would need some minor amendment to allow for changes between 26 March and 31 March as well as the inevitable changes that come about with the passage of time after estimates are made, but it is clear that a fairly large part of the monetary expansion postulated for the year has already taken place while the 'normal' season for expansion in budgetary expenditure and bank credit still lies ahead. Besides, a fairly large part of the monetary expansion over the year as well as fiscal year has been under currency which portends a large potential expansion of money supply as a whole.

In order to curb the expansionary trend and influence of the banking portion of money supply, I suggest that the following measures be taken:

(a) With effect from Friday, September 3, the proportion of aggregate demand and time liabilities required to be kept by scheduled commercial banks with RBI should be raised from 4 per cent to 5 per cent. Simultaneously, banks should be required to progressively reduce their drawal of refinance from RBI (whether on food or other accounts) in a phased manner by end-October to a reasonable level, significantly lower than their present drawals. Banks should also be advised to be more careful in their supervision over export credit and accommodation granted for textiles, edible oils, steel and metals.

(b) After some time, say, in October or latest November,Bank Rate should be raised from 9 per cent to 10 per cent and the ceilings which were imposed or advised in recent months on lending rates, inter-bank rates, etc., should be either lifted completely or suitably revised upwards. Only export credit rates may remain unchanged together with term-lending rates.

(c) All demands made for reduction in rates of interest on loans or deposits must be firmly rejected.

R.K. Hazari
Deputy Governor

Bombay
August 15, 1976

Table: Monetary Indicators

	1976–77	
	RBI Projection in March 1976 (Rs Crores)	Actual: 26 March till 30 July
1. Money Supply (M–1)	1550 (+12.0)	845 (+6.7)
a. Currency	600	386
b. Demand Deposits	950	467
2. Money Supply plus Time Deposits (M–2)	3200 (+15.2)	1830 (+8.6)
3. Factors affecting money supply:		
a. Net bank credit to Government	1300	605
i) RBI net credit to Government	800	244
ii) Other banks' net credit to Government	500	361
b. Bank credit to commercial sector	2280 (+17.1)	911 (+6.8)
i. RBI credit	100	79
ii. Other banks' credit	2180*	832
c. Net foreign exchange assets of banking sector	Nil	356
d. Net monetary liabilities of banking sector of which	2050	1018
i) Time Deposits	1750	985

* Including Rs 250 crores each, that is Rs 500 crores for food and fertilizer.

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No. 6(1) Ec.Dn./77

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI
27th January, 1977

I am directed to circulate herewith the minute of the meeting held on 20 January 1977 under the Chairmanship of Finance Minister to discuss the monetary and credit situation.

M.L. KAPUR
Asstt. Eco. Advisor

Ministry of Finance

1. Shri Pranab Mukherjee
   Minister for Revenue and Banking
2. Shri H.N. Ray
   Finance Secretary
3. Dr Manmohan Singh
   Secretary (Economic Affairs)
4 Shri G. Ramachandran
   Secretary (Expenditure)
5. Shri M. Narasimhan
   Secretary (Banking)
6. Dr R.M. Honavar
   Economic Advisor
7. PS to FM

Reserve Bank of India

1. Shri K.R. Puri
   Governor
   Reserve Bank of India
2. Dr K.S. Krishnaswamy
   Deputy Governor, Reserve Bank of India
3. Shri J.C. Luther,
   Deputy Governor, Reserve Bank of India

Minutes of the meeting held on 20.1.1977 under Finance Minister's Chairmanship to discuss the monetary and credit situation.

Present

Shri Pranab Mukherjee
Minister for Revenue and Banking

Shri H.N. Ray
Finance Secretary

Dr Manmohan Singh
Secretary (Economic Affairs)

Shri K.R. Puri
Governor, Reserve Bank of India

Dr K.S. Krishnaswamy
Deputy Governor, Reserve Bank of India

Shri J.C. Luther
Deputy Governor, Reserve Bank of India

Shri G. Ramachandran
Secretary (Expenditure)

Shri M. Narasimhan
Secretary (Banking)

Dr R.M. Honavar
Economic Advisor

The meeting commenced with the Governor, Reserve Bank of India, explaining the factors responsible for the rather steep increase in money supply in the current fiscal year. He stressed that the main factors responsible were food credit and the sharp increase in foreign exchange assets, and also mentioned that there has been a sharp rise in non-food credit as well. He pointed out that a large proportion of this expansion in non-food credit went to priority sectors and exports. Among the priority sectors he mentioned industries like coal, steel, cement and cotton textiles, but added that there was hardly increase in the credit extended to the textile industry in spite of an increase in production. He pointed out that public sector projects were also receiving large amounts of credit. Banks were experiencing a great deal of difficulty in restricting credit because of two factors. Firstly, in a number of industries, although production has not been increasing as rapidly as in the early part of the current financial year, large inventories have been accumulated because of lack of demand for coal, steel and cement as instances in point. If the banks were to deny credit to these industries to carry these inventories, there would be large scale closures and a consequential decline in output and employment. Secondly, he pointed out that an increase in prices of a large number of industrial raw materials led to a sharp rise in the value of inventories, and this again made it difficult for the banks to restrict credit for fear of affecting production adversely.

2.He stressed that the Reserve Bank was aware of the consequences of such an expansion of money supply and had now begun to monitor closely bank lending to industry, particularly for maintenance of inventories of raw materials and finished products. The Bank was now getting much more information on the details of bank lending than before and was therefore in a much better position to regulate credit to different sectors. He maintained that in a situation in which maintaining output and employment were important considerations and there were other policy objectives to be promoted, banks had to be circumspect in utilizing the curtailment of credit as a policy instrument. He, therefore, felt that the attack on the problem of an increase in money supply should come from two other directions, namely, a reduction in food stocks and a reduction in foreign exchange assets.

3. There was discussion on the current situation and the factors responsible for the sharp increase in money supply. It was agreed that an increase in money supply of the order of 16 per cent during the current year coming on top of an increase of 11.7 per cent in 1975–76 implies a serious inflationary threat. Therefore, the prime objective of policy should be to limit the growth of money supply.

4. There was a difference of opinion as to the amount of regulation that should be exercised with regard to non-food credit. On the one hand, it was argued that

since the peak of the busy season is approaching, controlling the expansion of non-food credit would impose serious hardship on industries like sugar, jute and cotton textiles. Restriction of credit may mean that not only would there be many closures in cotton textile and jute industries, but cane growers would not receive payment for their supplies to sugar mills. Therefore, any regulation of non-food credit, particularly of the type which has been imposed recently by the Reserve Bank, would have to be moderated so far as these industries were concerned. In any case, there was no scope for a further tightening of non-food credit. Credit policy should be tightened in other directions, viz., reduction in production of coal and steel so that stocks go down, reduction in receivables by public sector enterprises, reduction in food credit, etc.

5. On the other hand, it was argued that if credit policy is to accommodate factors like increases in stocks and increases in prices, the whole purposes of monetary regulation would be defeated. It would only mean an acquiescence in the speculative activities of certain interests in the name of employment. Since the objective of a restrictive monetary policy was to compel industry to reorganize its ways of working in such a way that the demand for credit would be reduced, the proposal to make available credit as and when needed by these industries would render monetary policy ineffective as an instrument of economic policy. Therefore, the recent steps taken by the Reserve Bank to impound a proportion of the accrual of deposits since the beginning of January were welcome. It was stated that taking into account the likely growth in deposits in the remaining months of the year, there would be adequate resources with the banking system, even after complying with the new directives to meet the requirements of the busy season, and of seasonal industries like sugar provided suitable action was taken on other fronts. The Reserve Bank's view was that the present policy could accommodate the genuine needs of seasonal industries like sugar.

6. A point was raised about the failure of the Banks to comply with the RBI's directives regarding the higher statutory cash reserves and the statutory liquidity ratio. It was pointed out that compliance takes time, and that sudden action by banks would lead to a serious disruption in their working. There was, however, no question of a willful defiance on the part of banks.

7. It was also agreed that food procurement was a datum as it was a basic instrument of Government policy. But the inflationary consequences of such a policy in the present context needed to be pointed out and even though suggestions in the past to reduce food stocks by 2 to 3 million tonnes by sale to trade to mop up a sizeable volume of money supply have not been accepted, an attempt should be made once again to persuade Government that such an action was absolutely necessary if the country is not to be subject to serious inflationary pressures in the coming year. It was also agreed that an attempt should be made to draw down foreign exchange reserves so that the expansionary impact of the growth of reserves would be moderated. However, in any monetary planning, it had to be recognized that drawing down of reserves was bound to be a slow process.

8. The Finance Minister summed up the discussion by stating that in the interest of price stability, there was no alternative to a restrictive monetary policy. He also

stated that there was no question of relaxing the recent measures adopted by the RBI for further control of non-food credit. The genuine needs of seasonal industries and priority sectors had to be met by redeployment of credit and not by relaxation of overall monetary discipline.

9. It was also pointed out that whatever may be the theory of monetary control, in practice, the Reserve Bank and the Commercial Banks were subjected to continuous pressure to relax their restrictive policy by various authorities such as the Central Ministries and the State Governments. It was agreed that the Reserve Bank should not yield to such pressures. It was agreed that the objective of policy should not definitely be to finance stocks, irrespective of larger economic considerations merely because this would lead to difficulties so far as the individual units were concerned. Therefore, Reserve Bank should monitor much more carefully the current utilization of bank credit. In any case, a much more restrictive type of credit planning will have to be done for 1977–78 in view of the additions to money supply that have already taken place in 1975–76 and 1976–77. For this purpose, it was agreed that representatives of the Department of Economic Affairs and the Department of Banking should have detailed discussions with the Reserve Bank before a credit plan for next year is finally drawn up.

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Credit Planning Cell March 3, 1977

Main issues discussed at a meeting presided over by the Cabinet Secretary on February 9, 1977

1. The Cabinet Secretary Shri B.D. Pande pointed out that the Government had taken all necessary measures to keep inflation in check, assist production and use foreign exchange through liberalization of imports. He also referred to several harsh measures taken by the Government such as impounding of wages and salaries. There is almost nothing now left for the Government to do. He also mentioned that the Government budgetary deficit may be considerably less than last year and mentioned that the budgetary position may even show a surplus.

2. With regard to price trends, the Cabinet Secretary said that the wholesale index consisted of hundreds of items all of which are not amenable to Government controls. At the macro level, such widespread price increases result from large monetary expansion.

3. The Cabinet Secretary asserted that while the Government's policies were directed towards the objectives outlined above, the fly in the meeting was monetary policy which did not seem to be consistent with the general economic policies of the Government. Therefore, unless something definite was done now, we would not be able to restrict further monetary expansion during 1977–78 and there may be a rise of another 15 to 16 per cent. Considering that agricultural production will be lower and that it may not be possible to repeat the same growth rate in industrial production as that occurred in 1976–76, national income may not show any substantial rise. We must, therefore, have a consistent policy so that money supply

does not go up by more than 7 to 8 per cent. He enquired from the Reserve Bank as to what ought to be done to restrain monetary expansion, both from the Reserve Bank side as well as from the Government side. He again emphasized that something positive has to be worked out immediately as otherwise we will be in 'real trouble'.

4. Shri J.C. Luther, Deputy Governor, Reserve Bank, explained in detail the current monetary and credit situation with particular reference to its relevance to the price behaviour. He brought out that the monetary expansion has taken place on account of three major factors: (i) expansion in food credit to assist building up of buffer stocks, (ii) expansion in credit to the priority sectors, and (iii) a sizeable growth of foreign assets. He also gave figures of the sectoral deployment of non-food credit during the current financial year, and also drew attention to the general stability of prices since September. He made the point that the bulk of price increases occurred between April and June 1976 and allowing for the increase in prices of a few commodities like cotton and oilseeds, the increase in wholesale prices is not as large as it is made out.

5. Shri Luther mentioned that the Reserve Bank would, as is always the practice, take an integrated view of the factors responsible for monetary expansion and their relevance to the increase in commodity prices. He also said that preliminary thinking on the parameters relevant for monetary expansion in 1977–78 has already taken place in the Reserve Bank. There has also been a preliminary meeting between the Reserve Bank and the Department of Economic Affairs and the Department of Banking on these aspects. These exercises will be renewed after the end of March when some up-to-date information would become available.

6. Dr Manmohan Singh also emphasized the difficult price situation and felt that the effects of such large monetary expansion which is taking place currently will be felt on the price situation after a time lag and would create macro imbalances. This would happen despite all administrative measures. He, therefore, felt that the present rates of growth in money supply calls for serious concern. He was, however, of the view that the Reserve Bank effort to restrict credit without hurting production should be supported. Dr Manmohan Singh, however, raised the point as to how we could reconcile the objective of containing money supply with the directive given by the Department of Banking regarding the minimum share of priority sector advances at 33.1/3 per cent by March 1979.

7. Shri Luther, in response to a query raised by Shri H.N. Ray, Finance Secretary about the increases in credit in the light of the variations in industrial production, mentioned that there has been no flow of credit inconsistent with the overall policy. (Shri Roy had mentioned that the index number of industrial production in September was lower than in the peak reached in March 1976.) Shri Luther also mentioned, again with reference to Shri H.N. Ray's comment, that banks are being allowed to comply with the increased cash reserve requirements in a phased manner so as to not create any immediate dislocations in credit arrangements.

8. Shri M. Narasimhan, Secretary, Banking said that he would not subscribe to any view suggesting going back on the target of reaching 33.1/3 per cent of bank credit in favour of priority sectors by March 1979, because this was a commitment given by the Minister for Revenue and Banking to the Parliament. Shri Narasimhan

mentioned that there should be no difficulty for the banking system to comply with this target if only the excess credit which is already in the pipeline (on the basis of the application of Tandon Committee norms) could be redeployed by banks. The Cabinet Secretary also endorsed Shri Narasimhan's point relating to the target of 33.1/3 per cent and the scope for redeployment of credit.

9. The Cabinet Secretary, while concluding the deliberations, mentioned the following additional points:

(a) For 1977–78, the level of food procurement credit need not go above the level of Rs 2,300 crores. He felt that the level may even come down because there may not be imports and production will also be lower.
(b) It will be unrealistic to assume that there will be no substantial increase in foreign exchange reserves. The import programme for next year has already been cleared but still there would be a substantial surplus in balance of payments and the foreign exchange reserves may again rise by another Rs, 1000 crores or so. (On this point, when Shri Luther said that the Government had indicated a definite programme for the deployment of foreign exchange reserves, Shri Pande felt that the Reserve Bank should have an independent view of its own.)
(c) Through larger efforts for deposit mobilization, particularly time deposits, it may be possible to create more substantial contractionary influences on money supply, particularly in respect of deposits arising from the inflow of foreign exchange.
(d) Reserve Bank should evolve a more positive programme indicating the specific steps that will be taken to restrain monetary expansion during 1977–78.

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D.O. No. CPC.76/C. 279–77 July 6, 1977
A. Raman
Advisor

Dear Shri Row,
This is with reference to your telephonic conversation with the Governor. As desired by the Governor, I enclose a note giving material for the preparation of a reply to Prof. C.N. Vakil. This has been approved by the Governor.

With kind regards,

Yours sincerely,
A. RAMAN

Shri K.N. Row
Joint Secretary, Department of Economic Affairs
Ministry of Finance
Government of India
New Delhi

Encl:

1. The memorandum voices the apprehension that the process of reduction in interest rates which, though initially selective, may soon get generalized. It is also felt that under the existing situation, the reduction in interest rates will help only to strengthen the forces of commodity speculation.

The accent of credit policy continues to be one of restraint. Apart from the lag effects of the increase in money supply recorded last year, expansionary impulses on money supply continue to emanate from further increases in foreign exchange reserves and larger requirements of the Food Corporation of India to finance food procurement as well as fertilizer transactions. At the same time, current expectations are that the growth in national output may not be much higher than in 1976–77. In this situation, the need to continue the present policy of monetary restraint remains as strong as heretofore.

The Reserve Bank has formulated its credit policy which was announced on May 27, 1977 bearing in mind the emphasis of policy mentioned above. The policy aims at restraining overall monetary expansion, and in fact the area of automatic refinance facilities has been curtailed. While credit thus remains generally tight, the Reserve Bank has attempted some rationalization of the interest rate structure. This has involved some lowering of the rates for certain sectors.

An area where the interest rates have been lowered relates to term loans beyond three years for capital investment which incidentally forms a small proportion of bank credit. The reasons for this are quite obvious. The cost of investment capital is high and this has been one of the factors making for a high-cost economy. The attempt, therefore, was to streamline the rates of interest charged by commercial banks on term lending so as to bring them on par with the rates of interest charged by term-lending institutions.

As there is no general reduction in interest rates, there need be no apprehension that the lowering of interest rates would lead to commodity speculation. It may also be noted that the selective credit controls have not only been retained but have been tightened in appropriate cases, for example, the margin requirements have been tightened in some areas, particularly oilseeds. The enhanced margins which banks were required to observe prior to February 16, 1977 were also restored. Banks are now more attuned to lending on the basis of inventory norms so that credit discipline is maintained.

2. The memorandum has pointed out that under conditions of past and expected inflation, the powerful instruments of credit policy are general weapons like quantitative restrictions on credit and steep hikes in interest rates; both short- and long-term rates should tend to go up.

In the credit policy that has been currently designed, the lendable resources of banks have been further regulated. In terms of the current cash and liquidity requirements, 49 per cent of incremental deposits would be required to be kept as cash or liquid assets. In other words, only about one-half of the deposit accretion is available for lending to both the public and private sectors including food procurement operations. In addition, the assistance from the Reserve Bank in the form of refinance and rediscount has also been severely restricted. This will be borne out from the fact that borrowings from the Reserve Bank of India came down from

Rs 967 crores at the end of March 1977 to Rs 563 crores by the end of June 1977 (a decline of Rs 404 crores). Similarly, bill rediscount assistance has also come down from Rs 184 crores to Rs 116 crores. Thus, the objective is to keep the supply of money under severe check and it is possible to control credit expansion without a further increase in interest rates which are already high and which can only have counterproductive effects. While the policy has been directed towards restraining monetary expansion, it has, at the same time, been oriented towards promoting investment, assisting production and exports and augmenting supplies of essential consumer goods and industrial raw materials through imports. There is thus a greater degree of selectivity in the deployment of credit.

3. The memorandum has taken exception to the bifurcation of savings accounts and has pleaded that we should immediately return to the status quo ante in regard to the interest rate policy which prevailed before the changes came about in May 1977. The memorandum points out that the argument that the reduction in short-term deposit rates was necessary to increase the incentive on long-term deposits, is perverse. The memorandum raises the question whether this objective should not have been achieved by raising both the rates, long-term deposits slightly more than that of short-term deposits.

The main reason why the bifurcation of savings accounts was brought about was that the chequeable savings deposits were operated more or less as current accounts, and there was no reason why such current accounts should be paid interest at 5 per cent. Even here, the Reserve Bank has permitted this class of depositors to earn 3 per cent. At the same time, the rate of 5 per cent is protected for the genuine savers. The bifurcation has thus sought to correct the distortions which have, all along, prevailed in the savings deposits system. Similarly, opportunity has also been taken to widen the spread between extreme short-term deposit rates and long-term deposit rates. The rationale behind this streamlining is that the savings character of term deposits should be rewarded more than the short-term placement of funds character of such deposits.

4. The memorandum has also posed the following points: the authorities at one stage wanted to increase the influx of outside funds by liberalizing terms of lending to financial institutions; at the same time, they are expecting holders of financial resources to contribute more to owned funds. The memorandum feels there is a severe contradiction here. One does not see such a contradiction. The basic rationale behind the changes in the deposit rates is also to make possible greater interest in equity by holders of financial resources.

To sum up, the readjustment in term loan rates and a streamlining of deposit rates would, by no means, constitute a change in the emphasis of the current monetary policy which continues to recognize the need for maximum possible restraint. For this purpose, the necessary monetary weapons have been employed and it is the determination of the Reserve Bank to employ them to the fullest extent possible to ensure that the overall credit expansion is well within what is warranted by the requirements of the economy consistent with the need of monetary stability. There is thus nothing in the credit policy which could give rise to changes in price expectations.

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D.O.No. CPC 96/C.279/79 July 16, 1979

My dear Manmohan,

I refer to your letter D.O.No. 1337–SSEA/79 of July 3, 1979 as also Malhotra's letter No. 548-S/AS(EF)–79 of June 5, 1979. The attached note prepared in the Credit Planning Cell details the steps that have been taken by RBI in the past few months to restrain the expansion of credit. These measures relate both to aggregate credit expansion as well as credit for trade in specific commodities. The impact of these measures on bank credit to the non-preferred sectors is evident in Table 1 on page 8–A of the attached note.

Despite these restrictive measures, the increase in money supply during this financial year has been about the same as in the corresponding period of last year. The principal expansionary forces appear to be credit to Government and credit for food procurement (see table below). Further, almost the entire expansion in money supply during this financial year has taken the form of currency, which makes it even more a matter of concern.

	(Rs. Crores)	
	Increase from 30.3.79 to 22.6.79	Increase from 31.3.78 to 23.6.78
Money Supply	968	971
Net Bank Credit to Government	1406	434
Food Procurement Credit	688	520

For curbing credit expansion, we have already immobilized 50 per cent of deposits of banks and abridged their access to other sources. As food credit comes down in the next few months, we could perhaps cut back further on our refinance for food procurement. But this can only be marginal. I do not think we should tamper, at this stage, with the refinance facilities we have given in respect of export and credit to small farmers. My assessment of the current situation is that further intensification of quantitative restraint on banks is undesirable and probably infeasible. Likewise, while we would continue to press from reduction in the relative share of large and medium industry and trade in bank credit, it would be unrealistic to expect a large change in a matter of months. Draconian measures to restrain credit further will inevitably have to be applied across the board; and at least in particular areas, this could well result in disruption of productive activities and creation of shortages. We must clearly recognize the administrative limitations, both in RBI and in the banks that make it impossible to fine-tune the allocation of credit to the extent that we would like.

Bearing this in mind, I suggest that there are basically two courses of action available to us. Both are unpalatable, but they are not mutually exclusive.

(i) The restraint on credit must be allowed to affect, if necessary, even the preferred sectors, that is, priority sectors and sick units. In a situation where the norms for entitlement to bank credit are being generally tightened and delegation down the line is being restricted, it would no longer be easy to shield the preferred sectors from the scarcity of credit. The problem of overdues in these sectors will also have to be dealt with severely.

(ii) The cost of credit to the borrowers must be raised. This is clearly necessary to induce borrowers to use credit more efficiently and maintain production and trade activities with less recourse to bank borrowing. Especially as expectations of further inflation gain strength, the present levels of lending rates would not be compatible with the need for further monetary restraint. The increase in the cost of credit may be brought about in either of the following two ways:

(a) raising ceilings on interest rates; or

(b) making only a part (rather than the whole) of interest cost a deductible expense in computing income-tax liability.

In the light of the current concern regarding the inflationary pressures in the economy, I would suggest that serious consideration be given to both the courses of action. I shall be glad to discuss these matters with you whenever you like.

With warm regards,

Yours sincerely,

I.G. Patel

Dr Manmohan Singh
Secretary
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

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Credit Planning Cell
Review of Recent Banking Trends

Placed below is a note reviewing the recent banking trends. The note also examines some of the implications for credit policy. The note has been prepared as a background for discussions.

S.S. Tarapore
3.9.1981

Ad(M)

Personally, my view is that we would be in a better position to evaluate the banking situation in mid-October 1981. First, there has been a distinct declaration in the growth of deposits during the six weeks since July 10, 1981. Secondly, the bulk of the excess liquidity seems to be concentrated in the SBI. Of the total excess liquidity of Rs 698 crores for the banking system, SBI accounts for Rs 538 crores (Table 4). Furthermore, the impact of the July 1981 measures would also begin to be reflected in a declaration in the pace of deposit growth during the second half of 1981–82. I would, therefore, not agree, at this stage, with the suggestion made in the note that

CRR be raised further by 1 percentage point. However, we could review the situation in mid-October.

2. I would go along with the suggestion made in the note that the second phase of the SLR be prepared by three weeks. However, to synchronize with this, the Central Government borrowing a programme scheduled for $2^{nd}/3^{rd}$ week of October may also be brought forward to the first week of October.

N.A. MAJUMDAR
4.9.1981

CREDIT PLANNING CELL

Review of Recent Banking Trends: Some Implications for Credit Policy

In May 1981, certain monetary measures were introduced and these were further reinforced substantially in July 1981. This note reviews the trends in banking up to 21 August 1981, and an estimate is attempted of the sources and uses of funds of the banking system during the second half of 1981–82. Finally, some credit policy issues are raised as a background for discussions.

I. Trends in the First Half of 1981–82

2. There has been a strong uptrend in aggregate deposits in the current financial year with a growth of Rs 2,937 crores (+7.8 per cent) up to August 21, 1981, the comparable increase in 1980–81 was Rs 2,078 crores (+6.6 per cent). There has been a marked decline in the weekly average rate of growth from about Rs 170 crores in the first fifteen weeks up to July 10, 1981 to Rs 63 crores per week in the subsequent six weeks (Table 1). For the first half of 1981–82, it is estimated that the increase in aggregate deposits would be around Rs 3,500 crores (9.2 per cent) as compared with an increase of Rs 2,725 crores (8.6 per cent) in the first half of 1981–81. If the increase in aggregate deposits in the full financial year 1981–82 were only Rs 6,600 crores (17.4 per cent) as projected earlier, the share of the first half in the total for the year would be 53 per cent, which would be quite contrary to the normal trend that the share of the first half is less than that in the second half.

3. The trend in non-food credit is somewhat disturbing as the increase in the current financial year up to August 21, 1981 was Rs 1,260 crores (5.4 per cent) as compared with an increase of only Rs 433 crores (2.2. per cent) in the comparable period of 1980–81. In the first fifteen weeks of the current financial year up to July 10, the average weekly increase in non-food credit was Rs 59 crores, while in the subsequent six weeks the average increase was Rs 64 crores; the increase is large in the week of July 17, but even if this is excluded the pace of increase is still high (Table 2). The pace of increase in non-food credit is of concern, especially as there has been a decline in credit to the petroleum companies in the current financial year up to August 21, 1981 of Rs 84 crores. It is estimated that the increase in non-food credit in the first half of 1981–82 would amount to Rs 1,600 crores (6.8 per cent) as compared with a comparable increase of only Rs 774 crores (4 per cent) in the first half of 1980–81. If the non-food credit in the full financial year 1981–82 is to be contained within the guideline set out in May 1981, the share of the first half

would amount to 39 per cent if the total for 1981–82 were within the guideline (Table 3); this is historically an unusually high rate for the first half and it would therefore appear that the guideline for the full financial year is unlikely to be adhered to.

4. The liquidity of the banking system was 35.6 per cent as on August 21, 1981 and the excess liquidity, based on a 34 per cent SLR, was a little under Rs 700 crores excluding excess balances with the Reserve Bank; on a rough calculation, these excess cash balances appear to be close to Rs 350 crores. Thus, the banking system, as a whole, would be able to meet the increase in the SLR, in two phases at the end of September and the end of October 1981 from its own resources. The excess liquidity is, however, not evenly distributed among the major banks. As on 21 August 1981, the SBI's liquidity was 39.2 per cent while that of all the other banks was 34.5 per cent (Table 4). However, if excess cash balances are taken into account, most of the banks would be able to meet the enhanced SLR requirement without any difficulty. (A few banks like UCO and Punjab and Sind appear to be in a liquidity bind.)

II. Estimates for the Full Financial Year 1981–82

5. An attempt has been made to prepare revised estimates of the sources and uses of funds for the full financial year 1981–82 with a break up into the two half years. The major changes from the earlier projections are outlined below:

(a) *Deposits*: It is assumed that the increase in deposits in the second half will be at least equal to the increase in the first half, and on this basis the estimate for the full financial year 1981–82 is put at Rs 7,000 crores (18.5 per cent) as compared with Rs 6,600 crores (17.4 per cent) estimated earlier. The estimate of Rs 7,000 crores is in line with the estimate of deposit growth reflected in the scaled down estimates obtained from the credit budgets. The banking system already has sufficient liquidity to meet the enhanced SLR requirement and as such the growth of deposits in the second half is not expected to be significantly inhibited by the need for liquidity provisions.

(b) *Non-Food Credit:* On the basis of the revised deposit estimates and adjusting for reserve requirements and food credit, it is estimated that the expansion of non-food credit in 1981–82 would amount to Rs 4,400 crores; this is based on a modest increase of Rs 2,800 crores in the second half of 1981–82 as compared with an increase of Rs Rs 3,300 crores in the second half of 1980–81. However, it should be noted that in the second half of 1980–81, there was an increase in petroleum credit of about Rs 250 crores while in the second half of 1981–82, a decline of about Rs 150 crores is forecast for petroleum credit. In the second half of 1981–82, there are likely to be additional requirements, over and above the provisions made in our earlier demand derived estimates, to the tune of about Rs 200 crores for fertilizers and about Rs 250 crores for edible oils; the increase in credit demand for sugar is not expected to be felt in 1981–82. In the case of increased imports by public distribution agencies, the SBI has already agreed in the credit budget discussions that these credit requirements would be provided for by the SBI within its non-food credit expansion. Hence, at this stage, it would not appear necessary to alter the basic guideline for the banking system as a whole that the non-food credit expansion in 1981–82 should be contained within the expansion in 1980–81, that is, the expansion should be marginally below Rs 4,074 crores.

III. Credit Policy Issues

6. The above brief review of banking trends points to the likely necessity for certain further measures. As already stated above, the growth of deposits and non-food credit have been showing signs of a slowdown in recent weeks and tentatively two trigger points have been suggested for the first half of 1981–82 (viz. a deposit growth of Rs 3,500 crores and non-food credit expansion of Rs 1,400 crores), and if these are exceeded by the end of September 1981 there would be a strong case for further measures.

7. To the extent that an assessment is to be made in early September 1981, there is sufficient reason to believe that these trigger points would be exceeded by the end of September 1981. The two options would be to initiate certain measures in early September 1981 or to defer these to late October 1981. The case in favour of the earlier date is that the measures would be effective before further credit expansion takes place and the banks would have more time to make the adjustments. Furthermore, even if there is any overshooting in the extent of tightening of the policy, rapid relaxation would be possible by providing RBI accommodation or in an extreme case, a pact of the impounded deposits could be released.

8. The argument in favour of deferring the measures till the end of October 1981, would be that a clearer impact of the July 1981 measures would be visible and the element of conjecture would be greatly reduced.

9. On balance, the more prudent course would be to opt for early measures with a more accommodative refinance/rediscount policy to take care of problems of banks which face a liquidity bind even though they are adhering to the credit guideline set out in May 1981. The possible measures which could be considered are as follows:

(i) *SLR*: In July 1981, it was announced that the SLR will be raised from 34 per cent to 35 per cent of total demand and time liabilities—34.5 per cent effective from 25 September 1981, and 35 per cent, effective from October 30, 1981. In view of the comfortable liquidity position of the banking system, the effective date of the second phase of the increase in the SLR could be brought forward from October 30, 1981 to October 9, 1981, that is, advanced by a period of three weeks. The effective date for the first phase of the increase from 34 per cent to 34.5 per cent could remain unaltered at September 25, 1981.

(ii) *CRR*: With a view to keeping a tight rein over primary money creation and its direct impact on monetary expansion as well as to slow down the pace of expansion of bank credit, the CRR could be increased from 7 per cent to 8 per cent in four increases of 0.25 per cent each, phased over the four months end-October 1981 to end-January 1982. The additional cash balances maintained with the Reserve Bank as on October 31, 1980, under the 10 per cent incremental cash reserve ratio, should not be allowed to be withdrawn. The increase in the

CRR would immobilize about Rs 450 crores of the banks resources and enable an effective correction of the excessive credit expansion of recent months. The measure would help maintain a better control over the monetary expansion generated by the excessive primary money creation, and would effectively curtail credit expansion in 1981–82 to a level within the guideline set out in May 1981.

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DO.No. S.85–2861 December 26, 1969

My dear I.G.,
I believe you have got a copy of a note which Seshadri had prepared regarding public borrowing in the Fourth Plan. One element of it was an estimation of the total amount that would be raised by the Centre, the States and public bodies like electricity boards. On this, as you know, some discussions have taken place in the Planning Commission, and further studies are in progress. We shall be separately keeping you in touch with our thinking on this.

My present letter relates to certain issues of detail, if you like, which have a bearing both on the pattern of borrowing—the shares of the Centre, the States and the public bodies—and the techniques by which they are to be achieved.

Although looked at as a total figure, the public borrowing programme for this year seems to reflect a substantial improvement on past performance, there are some significant features of it which have to be highlighted. On the whole, the Centre seems to have fared worse than in the past and we are unlikely in the Reserve Bank to have sold as much of Central securities as we had to subscribe to. The States, no doubt, have fared better than before but the improvement is more qualitative than quantitative. The State securities have not gone to a discount, but the total volume of their net borrowing is only marginally higher than before. The bulk of the improvement of the increase has been in the borrowings by public bodies. This shift reflects, in a sense, the higher yield consciousness of the investors in approved securities. The anxiety for better yields of the EPF and LIC is well known to you. Investment by banks also has shown a higher degree of preference for better yield particularly as with State loans not going to a discount, the compensatory attractions of Central loans is no longer as strong.

Another feature of this year's borrowing programme has been that we have been able to achieve an improvement in the borrowing programmes of the more backward States as well as of those States which were not too active in this area. The fact that the larger banks have been nationalized has undoubtedly helped in this.

The first issue which arises against the background set out above is whether some realignment of yields is called for between Central loans on the one hand, and State loans and loans by public bodies on the other with a view to ensure a somewhat better attention to Central loans in the future. I think the answer to this clearly is in the affirmative, and the real question to face is whether it should be done by a marginal improvement in Central yields or a marginal lowering of the yields of other securities. In facing this question we are, as always, confronted with the dilemma of choosing between a course which is economically more sensible and one which, from the point of view of the Exchequer, seems more economical. My own feeling is that the arguments in favour of the economists' point of view, if I may so designate it, have gained a good deal of added strength in the recent past. The EPF is committed to certain yields on the provident fund deposits of employees. If anything, the pressure is going to be in an upward direction. Any attempt to lower yields will breed discontent and lead to demands for subscription to debentures and other safe but higher yielding investments or for an increase in the proportion that is to be put in non-Central securities. Yet another consideration is that with the nationalization of banks and with the stepping up of banks' contribution to approved securities, we cannot but take into account the importance of ensuring profitability of the banks which will, in fact, produce additional resources for the Exchequer. The time to quantify the improvement in Central securities is not yet, but do you agree with the view that this is now inescapable?

The second problem is of ensuring a pattern of distribution which would be more rational and more conducive to the objectives and priorities of planned development. In the past, the responsibility for settling the borrowing programme of individual States as well as of different institutions has rested primarily with the Reserve Bank with increasing measures of consultations with the Finance Ministry, and a larger voice for the Planning Commission in regard to the borrowings by State Governments themselves. The present practice is the result of historical evolution. At one time when borrowing depended upon a judgement of the market response to borrowings by different State Governments and agencies, the Reserve Bank could bring to bear what might be called expert judgement of a non-political nature on the subject. Increasingly with planning, the Finance Ministry and the Planning Commission have been having a say though final responsibility of settling with the State Governments still rests with the Reserve Bank. I do not regard this position to be satisfactory. In effect, this means that on the one hand we have to encourage the shy States to come forward with larger borrowing programmes, and on the other we have to have a running argument with those who are used to borrowing more or who have now woken up to the possibility of larger borrowings. Since the considerations on which we now say yes or no are predominantly related to such things as the importance of helping the more needy States or of judging the priority between different sectors of development—between housing and electrification for example—would it not be more appropriate to find an alternative method of allocation?

The thought that all borrowing may be centralized and the Centre could apportion a fare share to each State has crossed our minds. However, we all feel that this would not be the right answer. Past experience showed that the response was not so good when all borrowing was undertaken by the Centre, and even today the efforts made by individual State Government do play a part in securing additional contributions. It would, to my mind, be much more sensible that once the total figure of State borrowing was agreed between the RBI and Government, the allocation of it to different States was done by the Government rather than by us.

What about the institutions? Some are clearly in the central field like the IFC and the ARC. The requirements of these will have to be pre-empted. In regard to the rest, one could choose between decisions being taken at the Centre or a total figure being given to each State within which all public authorities under the State Government could be fitted in by the State Government itself. I personally prefer the latter course not only because such decentralization of decision-making is desirable in itself, but also because the State Governments are in a better position to take into account the needs of all the institutions under them including municipal bodies, while you or the Planning Commission may not be as well placed in this respect. I shall welcome your thoughts and comments on this.

If there is to be any attempt to evolve a pattern of sharing between the States of the estimated market borrowings in any year, the question will have to be considered whether there should be a precise formula—perhaps the same formula as is adopted for distributing Plan assistance. While a formula of this kind does relieve everyone concerned of all charges of discrimination or favouritism, there is a loss of flexibility. Only the other day when I was speaking to PM about large overdrafts of a number of States led by Rajasthan, she observed that Rajasthan has indeed very serious problems on hand because of the drought affliction which has become chronic for certain parts of the State. When I pointed out that this is a problem which the Centre has to take care of, she expressed some unhappiness at the fact that with the rigid formula of inter-State allocations, there is no manoeuvrability left to deal with special and unforeseen problems. It is, therefore, that I am posing this question so that it may not go by default. In the same breath, I must add that the kind of overdraft which Rajasthan and some other States have developed cannot be redeemed by any possible adjustments in their access to market borrowings.

Finally, there is one more connected issue to which I should refer. I have spoken earlier of the difference between the more aggressive States and those which are backward in the matter of tapping institutional finance for their purposes. If we bring the approved securities within the framework of a national discipline, we shall succeed in narrowing this gap. However, there are borrowings from banks which are over and above their subscription to approved securities. In respect of these, some States undoubtedly are much better placed than others. I do not know that we could or should immediately try to bring these under an overall discipline, but individual cases of large borrowings from the banking system may need growing attention in the future.

I shall be grateful for any comments or thoughts that you may have on what I have said above.

Yours sincerely,
L.K. Jha

Dr I.G. Patel
Special Secretary
Department of Economic Affairs
Ministry of Finance
Government of India
New Delhi

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D.O.No.5038 SEA/73

Ministry of Finance
Deptt. of Economic Affairs
New Delhi
November 12, 1973

M.G. Kaul
Secretary

My dear Jagannathan,

May I recall our correspondence about the Centre floating additional market borrowings during the current financial year? Our proposal was for an additional amount of Rs 200 crores for the Centre, but you had suggested at that time that we might consider Rs 100 crores in view of the state of the money market. I notice that deposits have been growing very significantly in the last few months and the indications are that they will continue to do so even in the ensuing busy season. I would, therefore, reiterate our earlier proposal for an additional allocation of market borrowings to the extent of Rs 200 crores; this seems quite possible even taken into account the likely demands for credit that might emerge in the busy season.

2. I would like to raise another point arising out of the Reserve Bank's earlier action in impounding reserves of the commercial banks. I notice that the effect of this impounding has been that the Reserve Bank's holding of Government of India treasury bills has increased substantially. It might be argued that as the Government deficit is an autonomous variable in the system, it does not matter from the point of view of monetary impact whether this deficit is financed by recourse to treasury bills or by raising market debt. However, in terms of presentation, the deficit as defined in the Budget could be reduced if the impounded reserves were to be invested in dated securities because market borrowings, as you are aware, are treated as a normal budgetary resource. I am, of course, aware that the monetary impact is not different but presentationally this has considerable advantage. I shall be grateful if you could kindly consider the possibility of either funding the treasury bills held by the Reserve Bank to this extent or in the alternative, requiring commercial banks to invest in dated securities by raising the statutory liquidity ratios. The impounded reserves may have to be released to the banks for this purpose.

3. This matter was discussed with FM who has asked that we should obtain your views in this regard.

With kind regards,

Yours sincerely,
M.G. Kaul

Shri S. Jagannathan
Governor
Reserve Bank of India
Bombay

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Ref.No.C.78–3181

RESERVE BANK OF INDIA
CENTRAL OFFICE
SECRETARY'S DEPARTMENT
BOMBAY NO. 400001
March 4, 1977

To
All brokers on the Bank's approved list in Bombay

Dear Sirs,

SALE AND PURCHASE OF GOVERNMENT OF INDIA SECURITIES — SWITCH AND OTHER TRANSACTIONS

As you are aware, during the past few years, Reserve Bank has been extending facilities to banks and provident funds for improving the return on their investments by converting their holdings of low-yielding securities into higher yielding ones, subject to a certain annual limit. In allowing this facility, it was intended that while banks would be free to operate freely in the market and have dealings with other institutional investors without limit, the facility for switching over to a higher yielding loan/s would be made available by the Reserve Bank to a limited extent only during the financial year. It has, however, been observed that in respect of some of the switch contracts entered into by the brokers with the Reserve Bank, deliveries have been effected by banks other than those on whose behalf the contract was stated to have been made by the broker. In other words, some of the banks have availed themselves of the switch quota of other banks, in addition to their own, for converting their holdings, thus circumventing the ceiling imposed by the Reserve Bank on such switches. In order to check such and similar irregular practices which Bank views with disfavour, it has been decided to adopt the following procedure with immediate effect. We may add that as brokers of the central banking institution, the Bank expects highest professional standards from brokers on its approved list and the Bank would not like them to be a party directly or indirectly to any transaction which is not in keeping with the letter and spirit of the Bank's instructions:

(i) Before contracting for a switch transaction involving amounts of Rs 25 lakhs or over, satisfactory documentary evidence should be produced regarding the order for the switch placed with the broker. The broker should also satisfy himself to the extent possible that the institution placing the order is actually holding the securities proposed to be sold.

(ii) Deliveries of securities to the Bank should be made through S.G.L. transfer only, unless otherwise specifically agreed to by the Bank in special circumstances at the time of making the contract. In case, the concerned seller is not maintaining an S.G.L. account with our Public Debt Office, the delivery should be completed by tendering actual scripts.

(iii) Deliveries of securities in respect of switch transactions should be effected simultaneously as far as possible and in any case both the sides of the transaction should be completed within seven days from the date of the contract.

(iv) The Bank will not enter into any contract for sale of securities as part of switches three weeks before the half-yearly interest payment date of the concerned loan and deliveries of securities will be stopped two weeks before such due dates of interest.

2. It has also been observed that in respect of contracts entered into with us for outright purchase (that is, outright sale by the Bank) at times delivery is not taken within a period of one week. It has, therefore, been decided that in future if delivery is not taken within a period of one week, the Bank will have the option either to cancel the contract altogether or to change the rate of sale.

3. Please acknowledge receipt.

Yours sincerely,
SECRETARY

No.C.78–3182 of date.
Copy forwarded to the Manager, Reserve Bank of India, Securities Department, Bombay.

DEPUTY SECRETARY

No.C.78–3183 of date.
Copy forwarded to the Manager, Reserve Bank of India, Calcutta/Madras/New Delhi/Bangalore/Ahmedabad.

DEPUTY SECRETARY

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D.O.No. C–169–3847 May 25, 1978

My dear Hirubhai,

You will kindly recall our discussion recently on the question of mounting overdrafts of State Governments. This matter was also discussed by me with the members of the Committee of the Central Board at the meeting held on 24th May, 1978.

2. I enclose for your information a copy of the note prepared on the subject which was discussed by the Committee. As desired by the Committee, I have sent out telegrams to the Finance Ministers of the State Governments where accounts have been overdrawn with the Bank for considerable length of time, urging upon them to consider means to rectify the position, if necessary, in consultation with the Union Ministry of Finance. I enclose copies of the telegrams for your information.

3. On 24th May 1978, the total amount of overdraft of State Governments was about Rs 471 crores. Out of the eight overdraft states, in the case of three, viz., Rajasthan, Haryana and Nagaland overdraft have been outstanding for a relatively short period. However, five states, viz., Bihar, Madhya Pradesh, Punjab, Uttar

Pradesh and West Bengal have had persistent overdrafts with the Reserve Bank. I am giving the present overdraft position of these 5 states in the following table for your ready reference.

States	Amount of overdraft on 24.5.1978 (Rs crores)	Overdraft continues since	No. of days the overdraft continues
1. West Bengal	118.78	16.12.1977	125
2. Uttar Pradesh	145.32	4.4.1978	40
3. Madhya Pradesh	54.52	8.2.1978	83
4. Punjab	46.00	8.8.1977	204
5. Bihar	77.52	4.7.1977	250

4. What is disturbing is that not only overdrafts have not been cleared for a long period, but also that some states like Punjab and West Bengal which had only occasionally resorted to overdrafts in 1976–77 had persistent overdrafts in 1977–78. The overdrafts of all these states were cleared with Central Government's assistance at the end of June 1977. However, the above-mentioned five states overdrew on their accounts with the Reserve Bank almost immediately thereafter.

5. Reserve Bank informs the State Government of the overdraft position as soon as it emerges, and requests it to clear it immediately. It has, however, become a normal practice with the State Governments to advise the Bank that they have brought the position to the notice of the Government of India whose decisions were awaited on the request for grant of special ways and means assistance to clear the overdrafts.

6. While I appreciate that it may not be possible for all State Governments to clear their overdrafts immediately without special assistance from the Government of India, you are, no doubt, aware that it is not our practice in general to carry any overdraft position in our books from one fiscal year to another. Something definite has to be done, therefore, before the end of June in any case. At the same time, merely clearing the overdrafts in a routine manner by the Government of India will not prevent their re-emergence almost as soon as they are cleared. I would suggest, therefore, that discussions may be held with the State Governments concerned as soon as possible, with a view to arriving at some course of action which they would abide by and which would be consistent with the observance of financial prudence by all concerned. Otherwise, there is every danger of the practice spreading to other states.

7. In my recent discussions with the Seventh Finance Commission, I had occasion to refer to this problem and to suggest that perhaps the Commission could take a view on the content to which the deficits of the states concerned were result of factors beyond their control for which special remedies may have to be devised. Deficits beyond that resulting in overdrafts that have to be cleared should clearly be recoverable, if necessary, in a phased manner. Without such a determination in a suitable manner, some State Governments will be encouraged to think that

STATE GOVERNMENTS' MINIMUM BALANCES AND LIMITS FOR ADVANCES FROM THE RESERVE BANK

(Rs in crores)

Effective from	Minimum balances	Limits for normal or clean ways and means advances	Limits for special or secured ways and means advances	Additional special ways and means advances
1	2	3	4	5
1. 1st April 1938	1.85	1.85 (*Same* as the minimum balance)	Ad hoc	–
2. 1st April 1953	3.94	7.88 (*Twice* the minimum balance)	Rs 2 crores for each State	–
3. 1st March 1967	6.25	18.75 (*Three* times the minimum balance)	37.50 (*Six* times the minimum balance)	On merits
4. 1st May 1972	6.50	78.00 (*Twelve* times the minimum balance)	39.00 (*Six* times the minimum balance)	Ad hoc
5. 1st May 1976	13.00	130.00 (*Ten* times the minimum balance)	130.00 (*Ten* times the minimum balance)	On exceptional occasions

	Type of Accommodation	Rate of Interest charged
1. 1st April 1938	a) Normal ways and means advances	1% below the Bank Rate
	b) Secured ways and means advances	
	i) up to Rs 50 lakhs	¾% below the Bank Rate
	ii) from Rs 51 lakhs to Rs 125 lakhs	½% below the Bank Rate
2. 1st March 1967	Normal and secured ways and means advances	1% below the Bank Rate
3. 1st May 1976	Normal and secured ways and means advances	
	i) for the first 90 days	1% below the Bank Rate
	ii) beyond 90 days up to 180 days	1% above the Bank Rate
	iii) beyond 180 days	2% above the Bank Rate

overdrafts to any extent can be indulged in without having to take any corrective action.

With kind regards,

Yours sincerely,
I.G. PATEL

Sri H.M. Patel
Finance Minister
Ministry of Finance
Government of India
New Delhi
Encls:

The rates of interest charged by the Reserve Bank on the advances to State Governments have also undergone revisions over the years as follows:

Prior to May 1976, the rate of interest charged was differentiated by the type and/or the magnitude of the accommodation provided; thereafter, the calibration has been in terms of duration for which the accommodation was being availed of. The interest rate was fixed at the Bank Rate on overdrafts outstanding up to seven days, and from the eighth day, the rate increased by 3 percentage points; while the charges on authorized accommodation were set at one percentage point below the Bank Rate for the first 90 days, 1 percentage point above the Bank Rate for the succeeding 90 days, and 2 percentage points above the Bank Rate for the period beyond 180 days.

Under Section 21A(1) (a) of the Reserve Bank of India Act, monetary transactions of the State Governments are carried out by the Reserve Bank without reference to the cash balance positions of the concerned State Governments. Advances up to the limits specified in the agreements between individual State Governments and the Reserve Bank, referred to earlier, are meant to tide over the discrepancies between the flows of individual State Government's receipts and the flows of its disbursements. When the discrepancies are larger than the limits for advances granted to the State Government, an overdraft with the Reserve Bank emerges on its account. This happens unobtrusively as the monetary transactions of the State Governments are effected simultaneously at various treasuries, sub-treasuries and banks. It is a prescribed procedure with the Reserve Bank to draw the attention of the State Government to its overdrawn position as soon as it emerges and to call upon it to clear the overdraft within seven days of its appearance. In response to such communications from the Reserve Bank, it has now become almost a practice with the State Governments to advise the Bank that they have brought the position to the notice of the Government of India whose decisions were awaited on the requests for grant of special ways and means assistance to clear the overdrafts.

Both the Reserve Bank and the Central Government have repeatedly impressed upon the State Governments to avoid and eliminate larger continuing overdrafts by making every effort to improve their resources position, and by the practice of fiscal discipline. (The Reserve Bank's efforts in this regard include, as during August/September 1977, discussions with Finance Secretaries of the states, running overdrafts on a continuing basis.) At the time of granting assistance to clear the overdrafts, the Central Government have all the more specifically stressed the need for fiscal discipline by the State Governments.

Regrettably, however, overdrafts have, in recent years, become a chronic feature in case of several State Governments despite the urging of the Reserve Bank and the Government of India, as also the Central Government assistance. Nor have the Central assistance and the exhortations of the Fifth Finance Commission, the Reserve Bank and the Central Government succeeded even in containing the overdrafts, much less reducing or eliminating them. The average of month-end levels of outstanding overdrafts more than doubled to Rs 86 crores during 1975 from around Rs 40 crores during 1974. It declined marginally to around Rs 84 crores during 1976, only to rebound to Rs 172 crores during 1977. During 1978 (up to May 15th), this has further increased to Rs 276 crores.

Statements 2 to 5 in the Appendix set out month-wise and state-wise figures of month-end and peal levels of overdrafts during 1976–77 and 1977–78. Between the two years, the peak levels have bounced up dramatically in case of the States of Madhya Pradesh, West Bengal, Punjab, Punjab and Bihar. The 1977–78 peak level at Rs 50 crores, Madhya Pradesh overdraft was more than seven times that in the preceding year; the West Bengal peak overdraft more than quadrupled to Rs 94 crores; the peak Punjab overdraft of Rs 71 crores more than trebled over the year, and in case of Bihar, the growth was short of double (Table 1 below). In the first month of current financial year, the peak level has further soared up to Rs 134 crores in case of West Bengal, some Rs 40 crores higher than the 1977–78 peak, and to Rs 71 crores in case of Madhya Pradesh, a rise of some Rs 21 crores over the

Table 1: Overdrafts of State Governments (Peak Level during financial year)

(Rs crores)

States	1976–77	1977–78	April '78
Bihar	48.90	90.24	84.04
Gujarat	1.81	24.71	8.56
Haryana	14.66	31.04	–
Himachal Pradesh	0.87	9.59	–
Karnataka	–	21.79	–
Kerala	29.15	34.79	–
Madhya Pradesh	6.22	49.72	71.04
Manipur	1.81	3.94	–
Nagaland	4.82	5.22	–
Orissa	12.63	14.91	–
Punjab	21.49	71.14	69.45
Rajasthan	4.22	30.72	7.27
Tripura	2.10	1.51	–
Uttar Pradesh	176.08	125.64	182.34
West Bengal	21.81	94.13	133.89

Table 2: Number of days for which overdrafts have been continuously outstanding

States	April–March		April	Up to 19 May
	1976–77	1977–78	1978	1978
Bihar	7	217	239	256
Gujarat	2	9	7	–
Haryana	11	59	–	8
Himachal Pradesh	6	11	–	–
Karnataka	–	46	–	–
Kerala	146	123	–	–
Madhya Pradesh	4	48	63	80
Maharashtra	–	2	–	–
Manipur	16	42	–	–
Nagaland	8	37	–	9
Orissa	10	32	–	–
Punjab	15	162	184	201
Rajasthan	7	16	15	2
Tamil Nadu	–	1	–	–
Tripura	14	24	–	–
Uttar Pradesh	154	72	20	37
West Bengal	7	123	105	122

1977–78 peak. The peak levels in April 1978 are lower than the 1977–78 peaks in case of Bihar and Punjab. But Uttar Pradesh overdrafts, the 1977–78 peak in case of which was Rs 50 crores lower than that in 1976–77 has risen to a level of Rs 6 crores higher than the peak in 1976–77.

There has also been an equally disconcerting growth in the duration for which overdrafts remain outstanding (Statements 6 and 7 in Appendix present monthly date for 1976–77 and 1977–78). It will be noted from the table below that the West Bengal overdraft, the peak level of which has been rising substantially over the years, was outstanding on May 19, 1978 continuously for 122 days; the Bihar and Punjab overdrafts have been outstanding for longer duration, but at Rs 76 crores and Rs 66 crores respectively, their levels are lower than the peaks in 1977–78 and also lower than the peaks in April 1978.

The growth in the amount of outstanding overdrafts and in the duration of the outstandings has taken place despite progressive enhancements of limits for authorized accommodation by way of normal and special ways and means advances, and in spite of the increases in interest rates charged indicated earlier. In 1978, the outstanding rose sharply from Rs 122 crores at end-January to a new peak of Rs 538 crores on 14 April 1978 and stood at Rs 480 crores on May 19, 1978 with Uttar Pradesh, West Bengal, Bihar, Punjab, Madhya Pradesh, Haryana, Rajasthan and Nagaland making up the total. The overdraft position of these states together with their authorized borrowings from the Reserve Bank as on May 19, 1978 are shown below (Table 3).

Uttar Pradesh, West Bengal, Bihar, Madhya Pradesh, Punjab and Kerala resorted to almost continuous overdrafts in 1977–78 and remain overdrawn in the current financial year, except for Kerala which cleared its overdraft in March 1978. Out of the six states, only Uttar Pradesh and Kerala were persistently overdrawn with the Reserve Bank during 1976–77.

At the end of July 1976, West Bengal had no overdraft with the Reserve Bank. It was overdrawn in September 1976, February and March 1977, but cleared the overdrafts by moth-ends. West Bengal's receipts of Central loans almost doubled from Rs 117 crores in 1976–77 to Rs 231 crores in 1977–78. The rate of growth of sales tax receipts also showed a rise in that year in case of West Bengal (as also in case of Madhya Pradesh and Orissa), and receipts from excise duties, entertainment tax and land revenue also showed an improvement. And yet, since April 1977, West Bengal has been continuously overdrawn with the Reserve Bank, with the amount of the overdraft sizeable most of the time and standing at Rs 118.34 crores on May 19, 1978, and its duration generally growing even though fortunately the State was spared unforeseen natural calamities. Uttar Pradesh, on the other hand, had an overdraft of as much as Rs 102.52 crores at end-July 1976, the amount outstanding

Table 3: Outstandings as on 19 May 1978

(Rs crores)

State	Normal ways and means advances availed	Secured ways and means advances availed	Overdrafts
Uttar Pradesh	17.00	12.50	143.44 (37)
West Bengal	10.00	3.70	118.34 (122)
Bihar	7.00	3.25	75.60 (256)
Punjab	6.00	6.00	66.05 (201)
Madhya Pradesh	8.00	8.00	54.49 (80)
Haryana	3.00	3.00	13.05 (8)
Rajasthan	6.00	–	7.79 (2)
Nagaland	1.00	–	1.21 (9)
Others	16.84	6.95	–
Total	74.84	43.40	479.97

Note: Figures in brackets are number of days overdrafts are outstanding.

on May 19, 1978 being Rs 40.92 crores higher despite decline in 1977–78 in receipts from sales-tax and land revenue from the levels in 1976–77.

In the case of Bihar and Madhya Pradesh, aggregate disbursements rose faster than aggregate receipts during 1977–78. Increases in non-Plan expenditure also contributed to growth of disbursements in Bihar. Revenue expenditure in both these states rose sharply during 1977–78 largely due to increase in wages, and dearness allowance paid to State Government employees. The rate of growth of transfer of resources from the Centre to the Bihar Government decelerated from 13.5 per cent during 1976–77 to 4.6 per cent during 1977–78, mainly due to the decline in loans from the Centre. Among the State's own tax receipts, sales tax recorded a lower rate of growth of 7.1 per cent compared with 22.7 per cent during the preceding year. The deceleration in the growth rate of sales tax during 1977–78 was also observed in the case of Haryana, Karnataka, Kerala, Punjab and Rajasthan. During 1977–78, receipts of land revenue in Madhya Pradesh declined in absolute terms. The discharge of debt and interest payments as a proportion of aggregate disbursements of Punjab rose sharply from 14.7 per cent during 1976–77 to 24 per cent during 1977–78.

The above indicates that there are substantial differences in the financial behaviour and record of various State Governments influencing their budgetary position. It is interesting to note that during 1977–78 none of these states suffered from any major unforeseen natural calamity.

The persistent overdrawn positions are a reflection of continuing gaps between states' receipts and their disbursements, and in absence of unforeseen natural calamities these have to be considered as the result of less than adequate and prudent financial discipline by the States concerned. If the State Governments remain overdrawn when natural calamities are not involved, the overdraft accommodation is a draft on resources by them beyond that agreed to, by the Central Government in planning for the economy at the beginning of the financial year. Such draft, which is not reckoned in the monetary and credit arrangements for the year, has consequences for the overall level of deficit financing as well as for the distributive justice as between the States. To promote maintenance of the health of the economy, it is imperative to terminate such drafts on resources by the States.

If the Bank is satisfied that the amounts sought to be drawn by a State Government are in excess of the permissible limit, it is legally open to the Bank to dishonour cheques issued by that Government. The Fifth Finance Commission in 1969 also recommended such stoppage of payments for a State Government which failed to clear overdrafts within a specified period, when called upon by the Bank to do so. Such suspension of a State Government's payments by the Reserve Bank would, however, threaten the credit of that Government within the meaning of Article 360(1) of the Constitution of India, which provides for the declaration of a financial emergency in any part of India.

In the context of the constitutional arrangements and relationships between the Central and State Governments as evolved over the years, it is appropriate that the Central and State Governments mutually work out arrangements to clear the present overdrafts which are at an inordinately high level. On clearing the decks, these

Governments need to conform to mutually agreed arrangements in regard to the management of the finances of State Governments, so that the latter's resources match their aggregate expenditures without any State being able unilaterally to violate arrangements, in spirit, if not in letter. In devising such arrangements the question of basic imbalance, if any at present, in the resource position of the states would be considered, which in fact, is under examination of the Seventh Finance Commission. Recognition will also have to be accorded, in the arrangements mutually agreed upon between the Central and State Governments, to the circumstance that overdrafts arise either wilfully or otherwise. Overdrafts are a barometre of bad financial management, and arrangements devised should accordingly provide for incentives for efficiency in financial management, and

STATEMENT 1

Minimum Cash Balances and Limits for Normal Ways and Means Advances and Secured Ways and Means Advances availed of as on May 19, 1978

(Rs crores)

States	Minimum cash balance	Limit for normal ways and means advances	Availed of as on 19.5.78	Limit for ways and advances maximum	Special means (secured) operative	Actual availed of as on 19.5.78
Andhra Pradesh	1.00	10.00	–	10.00	9.75	–
Assam	0.40	4.00	–	4.00	3.65	–
Bihar	0.70	7.00	7.00	7.00	3.25	3.25
Gujarat	0.70	7.00	4.52	7.00	7.00	–
Haryana	0.30	3.00	3.00	3.00	3.00	3.00
Himachal Pradesh	0.20	2.00	–	2.00	0.06	–
Karnataka	0.80	8.00	8.00	8.00	8.00	6.95
Kerala	0.60	6.00	4.32	6.00	4.15	–
Madhya Pradesh	0.80	8.00	8.00	8.00	8.00	8.00
Maharashtra	1.50	15.00	–	15.00	15.00	–
Manipur	0.10	1.00	–	1.00	–	–
Meghalaya	0.10	1.00	–	1.00	0.25	–
Nagaland	0.10	1.00	1.00	1.00	–	–
Orissa	0.60	6.00	–	6.00	6.00	–
Punjab	0.60	6.00	6.00	6.00	6.00	6.00
Rajasthan	0.60	6.00	6.00	6.00	–	–
Tamil Nadu	1.10	11.00	–	11.00	11.00	–
Tripura	0.10	1.00	–	1.00	–	–
Uttar Pradesh	1.70	17.00	17.00	17.00	12.50	12.50
West Bengal	1.00	10.00	10.00	10.00	3.70	3.70
Total	13.00	130.00	74.84	130.00	101.31	43.40

Statement 2

Overdrafts of State Governments, 1976–77 (As on the last working day of each month)

(Rs crores)

States	April	May	June	July	August	September	October	November	December	January	February	March
1. Andhra Pradesh	–	–	–	–	–	–	–	–	–	–	–	–
2. Assam	–	–	–	–	–	–	–	–	–	–	–	–
3. Bihar	@	–	–	@	–	–	–	–	–	–	–	–
4. Gujarat	–	–	–	–	–	–	–	–	–	–	–	–
5. Haryana	@	@	@	–	–	–	–	–	–	–	–	@
6. Himachal Pradesh	@	–	@	–	–	–	–	–	–	–	–	@
7. Karnataka	–	–	–	–	–	–	–	–	–	–	–	–
8. Kerala	19.65*	23.60*	12.41**	1.47	@	@	@	@	@	@	9.04	19.17*
9. Madhya Pradesh	–	–	–	–	–	–	–	–	–	–	–	@
10. Maharashtra	–	–	–	–	–	–	–	–	–	–	–	–
11. Manipur	–	0.14	@	0.48	0.48	@	–	0.0035	@	–	0.10	0.43
12. Meghalaya	–	–	–	–	–	–	–	–	–	–	–	–
13. Nagaland	@	0.14	@	–	@	@	–	–	2.09	–	–	4.82
14. Orissa	–	–	@	–	–	@	–	@	1.56	–	2.70	@
15. Punjab	17.99	2.28	6.97**	@	–	–	@	–	4.12	@	–	8.50
16. Rajasthan	0.37	@	@	–	–	–	3.58	@	–	–	–	@
17. Tamil Nadu	–	–	–	–	–	–	–	–	–	–	–	–
18. Tripura	1.11	0.34	@	0.17	@	@	–	–	@	–	–	0.04
19. Uttar Pradesh+	130.23*	106.26*	63.46*	102.52*	87.14*	@	36.01*	34.72*	44.03*	9.44*	32.18*	@
20. West Bengal	@	–	–	–	–	@	–	–	–	–	@	@
Total	169.35	132.76	82.84	104.64	87.62	–	39.59	34.72	51.80	9.44	44.02	32.96

Note: – In September 1976, all states were in credit. * Drawn throughout the month. @ Drawn during the month, but no outstandings at the month-end. ** Position as on June 28. Cleared with Central assistance on June 29. +Uttar Pradesh did not clear overdraft on June 29, 1976.

Statement 3

Overdrafts of State Governments, 1977–78 (As on the last working day of each month)

(Rs crores)

States	April	May	June@@	July	August	September	October	November	December	January	February	March	April	As on 19 May
1. Andhra Pradesh	–	–	–	–	–	–	–	–	–	–	–	–	–	–
2. Assam	–	–	–	–	–	–	–	–	–	–	–	–	–	–
3. Bihar	79.29	88.52*	66.07*	19.47	22.15*	49.54*	44.79*	13.80*	20.61*	27.59*	30.41*	28.84*	83.32*	75.60
4. Gujarat	@	–	–	–	–	–	–	–	–	–	–	–	@	–
5. Haryana	9.92	19.39	@	4.33	@	–	@	–	–	–	–	@	–	13.05
6. Himachal Pradesh	@	–	0.96	–	–	9.59	@	0.04	@	–	–	–	–	–
7. Karnataka	@	–	–	–	@	–	@	4.60	17.35	8.33*	@	@	–	–
8. Kerala	27.43*	29.45*	31.67*	11.71*	10.69*	22.70*	20.35*	4.20*	6.90	2.59	3.72	@	–	–
9. Madhya Pradesh	6.49	4.10	4.00	16.67	3.36*	–	7.06	@	5.47	–	10.66	12.13*	62.21*	54.49
10. Maharashtra	–	–	–	–	–	–	–	@	–	–	–	–	–	–
11. Manipur	2.52	3.83	@	0.45	@	0.92	–	–	0.56	–	–	@	–	–
12. Meghalaya	–	–	–	–	–	–	–	–	–	–	–	–	–	–
13. Nagaland	1.86	@	@	–	–	–	–	–	–	–	–	@	–	1.21
14. Orissa	@	4.20	4.25*	–	–	–	1.81	3.95	14.23	0.65	–	@	–	–
15. Punjab	30.75*	32.03*	60.89*	1.43	@	4.30	19.15*	7.65*	18.22*	31.17*	36.63*	65.08*	60.40*	66.05
16. Rajasthan	@	5.43	7.97	4.93	@	–	–	0.84	2.36	–	–	@	3.28	7.79
17. Tamil Nadu	–	–	–	–	–	–	–	–	–	–	@	–	–	–
18. Tripura	–	0.82	0.67	–	–	–	–	–	@	–	–	–	–	–
19. Uttar Pradesh	77.20	70.30*	71.72*	33.97*	4.40*	24.83	40.32	12.58*	6.35	20.29	23.53	7.94*	142.27*	143.44
20. West Bengal	51.24	56.10*	71.46*	20.64*	39.89*	67.75*	67.33*	3.83*	26.98	31.22*	43.64*	78.21*	123.68*	118.34
Total	286.70	314.17	319.66	113.60	80.49	179.63	200.81	51.49	119.03	121.84	148.59	192.20	475.16	479.97

Note: * Drawn throughout the month. @ Drawn during the month, but no outstanding at the month-end. @@ As on June 28. On June 29, all states were in credit with Central assistance.

STATEMENT 4

Overdrafts of State Governments, 1976–77 (Peak level of each month)

(Rs crores)

States	April	May	June	July	August	September	October	November	December	January	February	March
1. Andhra Pradesh	–	–	–	–	–	–	–	–	–	–	–	–
2. Assam	–	–	–	–	–	–	–	–	–	–	–	–
3. Bihar	48.90	–	–	6.67	–	–	–	–	–	–	–	–
4. Gujarat	–	–	–	–	–	–	–	–	–	–	–	1.81
5. Haryana	4.66	3.23	2.66	–	–	–	–	–	–	–	–	5.23
6. Himachal Pradesh	0.79	–	0.24	–	–	–	–	–	–	–	–	0.87
7. Karnataka	–	–	–	–	–	–	–	–	–	–	–	–
8. Kerala	19.65	23.60	29.15	1.81	2.97	10.29	6.18	2.62	8.18	14.24	9.04	25.71
9. Madhya Pradesh	–	–	–	–	–	–	–	–	–	–	–	6.22
10. Maharashtra	–	–	–	–	–	–	–	–	–	–	–	–
11. Manipur	–	0.22	0.81	0.48	0.72	0.60	–	0.14	0.91	–	0.10	1.81
12. Meghalaya	–	–	–	–	–	–	–	–	–	–	–	–
13. Nagaland	2.04	0.14	1.20	–	1.12	0.69	–	–	2.09	–	–	4.82
14. Orissa	–	–	1.77	–	–	4.98	–	12.63	1.62	–	2.70	11.54
15. Punjab	21.49	18.00	12.83	6.70	–	–	6.86	–	5.09	11.05	–	18.84
16. Rajasthan	0.95	1.44	3.04	–	–	–	3.58	3.43	–	–	–	4.22
17. Tamil Nadu	–	–	–	–	–	–	–	–	–	–	–	–
18. Tripura	1.11	1.29	1.63	0.17	0.60	0.71	–	–	1.42	–	2.10	1.64
19. Uttar Pradesh	176.08	130.19	105.37	103.10	87.27	89.17	36.01	39.95	47.11	34.58	32.18	89.03
20. West Bengal	21.81	–	–	–	–	0.67	–	–	–	–	1.91	4.83

Statement 5

Overdrafts of State Governments, 1977–78 (Peak level of each month)

(Rs crores)

States	April	May	June	July	August	September	October	November	December	January	February	March	April	Up to 15 May
1. Andhra Pradesh	–	–	–	–	–	–	–	–	–	–	–	–	–	–
2. Assam	–	–	–	–	–	–	–	–	–	–	–	–	–	–
3. Bihar	88.70	90.24	85.21	22.22	40.63	49.54	54.24	63.10	20.61	30.76	30.83	56.90	84.04	83.32
4. Gujarat	24.71	–	–	–	–	–	–	–	–	–	–	–	8.56	–
5. Haryana	16.31	19.39	31.04	7.81	0.69	–	10.40	–	–	–	–	0.95	–	6.85
6. Himachal Pradesh	0.50	–	0.96	–	–	9.59	2.22	0.15	2.01	–	–	–	–	–
7. Karnataka	7.07	1.04	–	–	2.76	–	10.82	8.52	17.35	21.79	0.47	11.29	–	–
8. Kerala	29.07	30.22	34.79	11.71	14.76	24.17	22.33	19.69	6.90	4.50	3.72	17.90	–	–
9. Madhya Pradesh	11.70	16.76	11.11	17.51	11.47	–	8.25	2.78	5.47	–	11.68	49.72	71.04	62.21
10. Maharashtra	–	–	–	–	–	–	–	0.75	–	–	–	–	–	–
11. Manipur	2.53	3.83	3.94	0.45	0.38	0.92	–	–	0.56	–	–	–	–	–
12. Meghalaya	–	–	–	–	–	–	–	–	–	–	–	–	–	–
13. Nagaland	5.22	3.66	0.79	–	–	–	–	–	–	–	–	1.91	–	1.00
14. Orissa	2.89	4.20	8.56	–	–	–	2.83	7.99	14.23	0.88	–	14.91	–	–
15. Punjab	36.08	41.24	60.89	7.77	3.03	7.21	26.24	23.73	23.63	39.33	37.61	71.14	69.45	60.40
16. Rajasthan	1.92	6.11	7.97	8.17	5.11	–	–	3.05	2.36	–	–	30.72	7.27	4.27
17. Tamil Nadu	–	–	–	–	–	–	–	–	–	–	3.87	–	–	–
18. Tripura	–	0.82	1.51	–	–	–	–	–	0.11	–	–	–	–	–
19. Uttar Pradesh	125.64	75.66	73.09	34.36	38.21	24.83	40.51	69.92	20.26	30.98	23.53	84.96	182.34	142.28
20. West Bengal	66.14	59.09	71.46	24.46	40.20	67.75	9.02	66.57	26.98	42.01	43.64	94.13	133.89	116.34

STATEMENT 6

Number of days for which overdrafts have been continuously outstanding during 1976–77

States	April	May	June	July	August	September	October	November	December	January	February	March
1. Andhra Pradesh	–	–	–	–	–	–	–	–	–	–	–	–
2. Assam	–	–	–	–	–	–	–	–	–	–	–	–
3. Bihar	7	–	–	7	–	–	–	–	–	–	–	–
4. Gujarat	–	–	–	–	–	–	–	–	–	–	–	-2
5. Haryana	6	11	3	–	–	–	–	–	–	–	–	10
6. Himachal Pradesh	6	–	3	–	–	–	–	–	–	–	–	6
7. Karnataka	–	–	–	–	–	–	–	–	–	–	–	–
8. Kerala	98*	122*	146*	6	6	7	7	7	7	19	18	42*
9. Madhya Pradesh	–	–	–	–	–	–	–	–	–	–	–	4
10. Maharashtra	–	–	–	–	–	–	–	–	–	–	–	–
11. Manipur	–	2	7	4	7	6	–	2	6	–	3	16
12. Meghalaya	–	–	–	–	–	–	–	–	–	–	–	–
13. Nagaland	7	2	7	–	6	8	–	–	7	–	–	8
14. Orissa	–	–	5	–	–	2	–	7	7	–	1	10
15. Punjab	6	7	15	5	–	–	11	–	6	7	–	14
16. Rajasthan	1	3	7	–	–	–	2	6	–	–	–	5
17. Tamil Nadu	–	–	–	–	–	–	–	–	–	–	–	–
18. Tripura	6	8	7	1	7	7	–	–	6	–	6	14
19. Uttar Pradesh	29*	53*	78*@	105*	129*	154*	11	36*	60*	84*	19	43*
20. West Bengal	7	–	–	–	–	1	–	–	–	–	4	6

NOTE: *Drawn throughout the month. @ Overdrafts were not cleared in June 1976.

STATEMENT 7

Number of days for which overdrafts have been continuously outstanding during 1977–78

States	April	May	June	July	August	September	October	November	December	January	February	March	April	Up to 15 May
1. Andhra Pradesh	–	–	–	–	–	–	–	–	–	–	–	–	–	–
2. Assam	–	–	–	–	–	–	–	–	–	–	–	–	–	–
3. Bihar	19	44*	69*	24	50*	73*	98*	121*	146*	170*	193*	217*	239*	252*
4. Gujarat	–9	–	–	–	–	–	–	–	–	–	–	–	7	–
5. Haryana	23	48*	59	23	2	–	12	–	–	–	–	4	–	4
6. Himachal Pradesh	3	–	11	–	–	10	3	1	11	–	–	–	–	–
7. Karnataka	7	3	–	–	6	–	9	15	22	46*	1	8	–	–
8. Kerala	67*	92*	116*	26*	51*	75*	100*	123*	10	4	5	28*	–	–
9. Madhya Pradesh	17	23	22	22	48*	–	13	4	3	–	18	41*	63*	76*
10. Maharashtra	–	–	–	–	–	–	–	2	–	–	–	–	–	–
11. Manipur	13	38*	42	16	7	5	–	–	8	–	–	–	–	–
12. Meghalaya	–	–	–	–	–	–	–	–	–	–	–	–	–	–
13. Nagaland	22	37	8	–	–	–	–	–	–	–	–	4	–	5
14. Orissa	10	8	32*	–	–	–	6	12	19	5	–	8	–	–
15. Punjab	38*	63*	87*	25	6	18	43*	66*	91*	115*	138*	162*	184*	197*
16. Rajasthan	5	8	13	16	5	–	–	7	9	–	–	13	15	–
17. Tamil Nadu	–	–	–	–	–	–	–	–	–	–	1	–	–	–
18. Tripura	–	7	24	–	–	–	–	–	4	–	–	–	–	–
19. Uttar Pradesh	23	48*	72*	26*	51*	17	18	41*	17	17	15	38*	20	33*
20. West Bengal	23	48*	72*	26*	51*	75*	100*	123*	12	36*	59*	83*	105*	118*

NOTE: *Drawn throughout the month.

STATEMENT 8

Overall Surplus(+) or Deficit (–) of State Governments

(Rs crores)

	1975–76 (A/cs.)	1976–77 (R.E.)	1977–78 (R.E.)@	1978–79 (B.E.)@
1. Andhra Pradesh	+32.1	–52.9	–135.1	–77.3
2. Assam	+9.7	+7.9	–33.7	–6.6
3. Bihar	+37.4	+11.5	–2.5	+5.6
4. Gujarat	+10.3	–1.5	–11.3	–58.2
5. Haryana	–3.7	+6.9	+25.6	–34.8
6. Himachal Pradesh	+1.9	–0.4	–0.5	–4.4
7. Jammu and Kashmir	+3.7	–	–	–2.0
8. Karnataka	+5.2	–10.1	–46.5	–64.9
9. Kerala	–12.6	–22.0	–17.3	–19.7
10. Madhya Pradesh	+30.4	–0.3	–75.2	+28.7
11. Maharashtra	+30.2	+0.3	+12.0	–4.2
12. Manipur	–4.1	–1.7	+1.6	–9.9
13. Meghalaya	–2.3	+1.3	–0.4	–
14. Nagaland	–9.8	–4.2	+3.6	–0.1
15. Orissa	–2.4	+4.6	–8.9	–12.0
16. Punjab	–10.3	+26.4	+6.1	–12.9
17. Rajasthan	+1.4	–13.9	–24.9	–29.0
18. Sikkim	+0.1	–1.7	–0.2	+0.1
19. Tamil Nadu	+3.3	+1.6	–34.7	–14.3
20. Tripura	+1.9	+1.1	–5.7*	–6.3†
21. Uttar Pradesh	–33.5	+72.5	–26.5	+33.3
22. West Bengal	–14.3	+0.3	+27.1	–40.4
Total (1 to 22)	+74.6	+25.7	–347.4	–329.3

Note: @ Figures are provisional.
*Represents budget estimates.
+Projected.

disincentives in case of inefficiency, waste and profligacy. The Reserve Bank can give only a signal regarding bad financial management by a State Government; needed realignment to arrest deterioration and then to promote improvement in State Governments' financial operations should follow such signals through discussions among the concerned parties. Governor brought all the aspects of the matter to the notice of the Seventh Finance Commission in the discussion recently held at the Reserve Bank.

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D.O.No.C.169–4611 March 8, 1980

Dear Shri Venkataraman,

I wish to draw your attention to a statement made by Dr Ashok Mitra, Finance Minister, West Bengal, while presenting the State Budget on February 27, 1980. He has stated in his Budget Speech that out of the net overall deficit of Rs 43.30 crores, Rs 23.75 crores will be covered by the State's authorized credit limit with the Reserve Bank. He has also urged a review of the authorized credit limits of the State Governments with the Bank. I am quoting the relevant extracts from his speech for your ready reference:

> 'To repeat, the measures of additional resource mobilization indicated just now will, on the whole, provide approximately Rs 25 crores during 1980–81. This will help us to reduce the net overall deficit to Rs 43.30 crores, of which Rs 23.75 crores will again be covered by our authorized credit limit with the Reserve Bank of India. . . .
>
> 'I would also strongly urge a review of the authorized credit limits of the State Governments with the Reserve Bank of India. A new set of regulations governing these limits were unilaterally announced with effect from October 1978. These were not discussed with the State Governments, and experience over the past eighteen months has confirmed their impracticability. Particularly since the dues of the State Governments are often, for various reasons, held up by the Centre, it is important to raise this credit limit with the Reserve Bank of India. Even otherwise, it is incongruous that while, in the current year, the Union Government has floated additional short-term treasury bills amounting to around Rs 2,500 crores, or nearly 15 per cent of the size of its overall annual Budget, a State Government, such as ours, is expected to function with authorized credit limit of Rs 23.75 crores, which is barely 1.5 per cent of our total annual transactions.'

2. Since the points raised by Dr Mitra have important policy implications, I might explain briefly the nature of ways and means advances granted by the Bank to the State Governments. The Bank makes two types of advances: (a) normal or clean ways and means advances which are extended without any collateral, and (b) special or secured ways and means advances granted against the pledge of marketable securities of the Government of India. The limits for clean and secured advances respectively are equivalent to 20 and 10 times the minimum balance which each State Government has to maintain with the Bank. All the states taken together at present enjoy a limit of Rs 260 crores by way of clean advances and Rs 130 crores against special advances, making a total of Rs 390 crores, although, due to inadequate holdings of the Central Government securities by certain states, the effective total limit at present is about Rs 368 crores. In the case of the West Bengal Government, the authorized limits for clean and secured advances are Rs 20 crores and Rs 10 crores, respectively. However, owing to inadequacy of the holdings of the Central

Government securities, the State Government at present enjoys a special ways and means advances limit of only Rs 3.75 crores, the aggregate limit by way of clean and secured advances thus being Rs 23.75 crores.

3. If any State Government draws on its account with the Bank beyond the ways and means limits sanctioned to it, an overdraft emerges in its account. The Central Government and the Reserve Bank have, from time to time, devised measures to regulate overdrafts which are unauthorized. A new scheme was introduced with effect from 1st October 1978 in terms of which special loans were granted to the concerned State Governments to assist them in clearing opening deficits so that they do not become a drag on the States' resources. Simultaneously, the limits for clean ways and means advances were doubled. Under the scheme, the Reserve Bank cautions a State Government as soon as 75 per cent of the total authorized limit of ways and means advances is availed of. In the event of indebtedness of the State Governments to the Bank continuing for over forty-five days, even within the limit of ways and means advances, the Government of India initiates discussions with the State Governments at the official level and, if necessary, follow these by discussions at the level of Chief Ministers with a view to rectifying the imbalance. The Bank keeps the Central Government and the State Governments informed of the daily overdraft position. The scheme envisages stoppage of repayment on account of the State Government concerned in case its overdraft persists continuously for more than seven working days. The Central Government is consulted at every stage of the action taken in connection with overdrafts.

4. As you are probably aware, the account of the West Bengal Government with the Bank had been overdrawn for a long time—from July 2, 1979 till December 22, 1979, and again from December 26, 1979 to February 19, 1980. Recently again, the State Government had run into overdraft with the Bank from February 29, 1980 and the overdraft was cleared only on 6th March 1980 with the release of assistance from the Central Government.

5. I have gone into these details to point out that the Central Government and the Reserve Bank have been fully aware of the need for the State Governments for temporary accommodation, but at the same time are keen that no State Government should borrow from the Reserve Bank beyond the stipulated limits. Ways and means advances to the State Governments are intended to provide only short-term accommodation to enable them to tide over temporary imbalances in their receipts and expenditures. It is important that these advances from the Bank should not be treated as budgetary resources by any State Government. It appears that the Finance Minister of the West Bengal Government has, in his Budget Speech, treated the temporary ways and means advances from the Bank as a resource to meet a part of the deficit of the State Government in 1980–81. You will appreciate that this is an unjustified use of the temporary overdraft facilities provided by the Reserve Bank, and if other State Governments also follow the example of West Bengal, it will create an unhealthy precedent from the viewpoint of fiscal discipline.

6. I thought you might like to consider writing to the State Government in this connection. I also intend to send a circular letter to all the State Governments emphasizing that the ways and means advances from the Reserve Bank are intended

to meet purely temporary fluctuations in their receipts and expenditures, and should not be treated as a budgetary resource to cover budgetary deficits.

7. The suggestion made by Dr Ashok Mitra regarding the review of the authorized credit limits of the State Governments with the Reserve Bank and the reference to 'incongruous' arrangements under which Union Government can borrow against treasury bills without a corresponding facility being available to the State Government raise larger questions of federal finance. All that I would suggest at this stage is that since the limits of ways and means advances to the State Governments were raised as recently as in 1978, it does not appear necessary to review these limits so soon again. Most of the State Governments have found these limits, by and large, satisfactory.

With regards,

Yours sincerely,
I.G. Patel

Shri R. Venkataraman
Ministry of Finance
Government of India
New Delhi 1

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Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi
January 24, 1981

Secretary

Dear Dr Patel,

May I invite your kind attention to Hasib's D.O. letter No. S.85–3155 dated January 5, 1981 addressed to Tiwari on the tentative estimates of investible resources for market borrowing programme in 1981–82?

2. It is observed from the estimates furnished by the Bank that the total market borrowing programme in 1981–82 will be at the same level as in the current financial year, that is, Rs 3,700 crores. We appreciate that the growth of bank deposits in the current year has been lower than anticipated and the share of investments in Government securities by EPF organizations has been reduced by 10 per cent from 1.1.1981. However, I would like to mention that the total requirement of market borrowing in 1981–82 would have to be substantially higher due to the following factors:

(i) In computing the resources for Plan 1980–85 the Centre's share of market borrowing has been assumed at Rs 15,000 crores. This implies that after excluding the current year's market borrowing programme, Rs 12,500 crores will have to be raised in the remaining four years. This can be possible only if the Centre's net market borrowing in 1981–82 is at least Rs 2,800 crores.

(ii) We are already committed to allow an increase of 10 per cent in the market borrowing programme of the States and their enterprises.

(iii) It was agreed in the meeting of the full Planning Commission held in August 1980, in which you were also present, that an additional market borrowing of Rs 1,000 crores would be raised. Subsequently, it was decided that this amount would be made available during 1980–85 to the states whose per capita income is below the national average. Therefore, the share of states in market borrowing will be much higher in 1981–82 as compared with the current year's level.

(iv) The allocation of market borrowings for financial institutions like IDBI etc. in the current year has proved inadequate and therefore, there will be need for a step-up in 1981–82.

3. Considering the above compulsions and the need for financing the approved Plan outlay without resorting to unduly large deficit, it will be necessary to increase the market borrowing programme in 1981–82 by at least Rs 600 crorees. If it is not possible to have a market borrowing programme of this order within the existing framework of SLR, the Bank may have to consider the question of raising the SLR from 34 per cent to 36 per cent; particularly because of the discontinuance of impounding of 10 per cent of additional deposits as additional cash reserves.

With kind regards,

Yours sincerely,
R.N. Malhotra

Dr I.G. Patel
Governor
Reserve Bank of India
Bombay

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Camp: New Delhi
February 16, 1981

My dear Malhotra

Kindly refer to your D.O.No.96/SSEA/81 of January 24, regarding the market borrowing programme for 1981–82. I have already handed over to you a note prepared in the Reserve Bank which analyses the issues involved further. We have also had a preliminary discussion on the subject. To recapitulate:

(a) Prima facie, given the borrowing of Rs 3,800 crores for the first year of the Sixth Plan, the proposed borrowing of Rs 4,300 crores for the second year would amount to front-loading in relation to the total market borrowing of Rs 22,500 crores envisaged for the Plan period as a whole. Since borrowing in one year establishes, in practice, a presumption for a significant increase next year, any front-loading becomes, in fact, a basis for ultimately being required to exceed the Plan target.

(b) The assumption of front-loading applies equally to the proposed borrowing for the Centre. I am not sure if it applies also to borrowing by State Governments as we have no indication of your intentions in this regard for

1981–82. I would be grateful if information on this is conveyed to us soon.

(c) It would appear from a reading of the Plan document that, as far as financial institutions are concerned, the envisaged borrowing of Rs 3,000 crores over five years will entail virtually no step-up over the level already reached for the first year—a level, which as you know, has proved inadequate. Here there is another built-in factor inviting us to exceed the Plan target. Under this item also, therefore, it would be useful for us to know your assumptions for 1981–82 for each of the institutions.

(d) To put it more generally, there seems to be a certain amount of built-in overestimation of the role that financial institutions should and can play in supporting market borrowing. (We will also have to examine soon what the Plan envisages by way of direct financing of Plan Schemes by financial institutions, and what it entails for the institutions.)

2. In view of the above, in our opinion, it would be prudent to keep the total market borrowing programme for 1981–82 somewhat lower than the figure mentioned in your letter. If this does not prove feasible given the presentational compulsions of the Budget, we will, of course, have to consider together the ways of honouring the assumptions in the Budget. I hasten to add, however, that the alternative suggested by you in para 3 of your letter is neither the only nor the most desirable means for 'achieving' the target of market borrowing. For one thing, a part of the requirements of, say, the IDBI or the State Electricity Boards, can and should be met outside the SLR requirements by special loans from the banks to them.

3. There is also the alternative, honoured by convention, of the Reserve Bank directly absorbing some more Government securities. The monetary effect of this would be the same as that of an increase in the SLR as (as already explained in the note), even a one per cent increase in the SLR will, as far as we can now foresee, require significant RBI lending to banks if their lending in turn is not to be unduly constricted. (As I have said repeatedly, contrary to the impression prevalent in some quarters even in the Ministry of Finance, the choice between banks subscribing to market loans and alternatively lending to its other clients is *not* a choice between the public sector and the private sector, but essentially between fixed capital and working capital.)

4. If there has to be additional RBI support in any case, there are good reasons for its being directly to Government loans rather than to banks to enable them to subscribe to Government loans as well as to meet their other requirements. From the point of view of the banks, it means a lesser sacrifice of income—and they can ill afford any loss in income given all their social responsibilities. From the point of view of protecting and preserving the instruments of monetary policy also, it is better that we do not render virtually ineffective the instrument of reserve requirements. As against the statutory requirements of 25 per cent the SLR has already been raised—it would appear for budgetary rather than monetary reasons to 34 per cent, and changes in SLR for budgetary reasons can only, in practice, be one-way changes. In short, while we will keep all the options open, it is by no means clear that your suggestion is the best possible alternative. As I have already explained

to you, the choice has a bearing on the forthcoming IMF negotiations also so that whatever we jointly decide, will also have to be in that perspective.

5. Finally, I hope you would not mind if I put on record what I have already mentioned orally, viz., that the last sentence of your letter can carry the implication that, in your judgement, the decision to discontinue the impounding of 10 per cent of additional deposits as additional cash reserves was not a sound one, and can, in effect, be reversed without any adverse consequences. In view of the needless controversy created around this subject and the clarifications already given to you in writing, any such inference would be clearly unfortunate, at least from my point of view. I am glad that you were good enough to dispel my doubts in this regard.

6. To conclude, we would be glad to receive the information I have requested in this letter. We will give the matter further thought, and in the light of the Budget as presented on 28th February, we will get together soon thereafter to consider how we should proceed further.

With best regards,

Yours sincerely,
I.G. PATEL

Shri R.N. Malhotra
Secretary
Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

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MEMORANDUM TO THE COMMITTEE OF THE CENTRAL BOARD

Shri M.R. Bhide, Deputy Governor, has been appointed as the Chairman of the Life Insurance Corporation till further orders. The Government of India are considering the question of appointing a successor to Shri Bhide, but it may not be possible for them to announce the appointment for some time. In the meantime, as Shri Pande has already handed over charge, the Government of India have indicated that they are anxious that Shri Bhide should be relieved as early as possible, so that he may be in a position to assume charge of his office as the Chairman of the Life Insurance Corporation.

2. I have considered this matter very carefully and I have come to the conclusion that it is not possible for the Bank to agree to the proposal that Shri Bhide should be relieved immediately of his duties and be permitted to resign his office as a Deputy Governor. He can only be relieved when his successor is appointed. Alternatively, the Government of India desire that Shri Bhide might be allowed to hold charge of the office of the Chairman of the Life Insurance Corporation in a part-time capacity, while working as Deputy Governor until such time as his successor as a Deputy Governor has been appointed. Shri Bhide is agreeable to this arrangement.

3. According to the proviso to sub-section (2) of Section 8 of the Reserve Bank

of India Act, 1934, it is open to a Governor or a Deputy Governor, to undertake at the request of the Central Government or a State Government such part-time honorary work, whether related to the purposes of the Reserve Bank or not, as may be permitted by the Central Board, if the part-time honorary work does not interfere with the duties of the Governor or the Deputy Governor, as the case may be. In view of the fact that a new Deputy Governor may be appointed very soon, and the period for which Shri Bhide may be required to attend to the duties of both the offices is, therefore, likely to be short, I recommend that the Committee, acting on behalf of the Central Board, may approve of the proposed arrangement. Shri Bhide will not draw any remuneration for his work as a part-time Chairman of the Life Insurance Corporation.

4. If the Committee accepts my recommendation, they are requested to pass the following resolution:

Resolved
That Shri M.R. Bhide, Deputy Governor, be and is hereby permitted to assume charge of the office of the Chairman of the Life Insurance Corporation and to attend to the duties of that office, while continuing to be a Deputy Governor of the Reserve Bank.

GOVERNOR

Reserve Bank of India
Central Office
Bombay

9th January, 1967

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D.O.No.G.8–108

BOMBAY
May 2, 1968

My dear Shri Naik,
I am grateful to you for the opportunity you gave me this morning to explain to you the problem we have in respect of the land at Nariman Point which we had agreed to take on a 99-year lease from the Maharashtra Government. As I told you, the rate per square metre settled with the Reserve Bank (Rs 5,000/-) is nearly ten times the rate at which Air India, The Indian Express, Mafatlals and the Shipping Corporation got their lease, and about 4.5 times as high as the rate at which the State Bank got an adjoining site. However, this is not the root cause of our anxiety. After a very close study of the matter in consultation with our Committee as well as with the Deputy Prime Minister, we feel that the original project of undertaking a major construction to accommodate most, if not all, of our offices is not one which we could or should pursue at this juncture. The capital cost of such a construction would run into Rs 4 crores or so; we have pressing needs for construction to provide accommodation for our lower paid employees. Bearing in mind our responsibilities as a public institution, specially

charged with the administration of our monetary policy, it is our feeling that our needs of office accommodation had better be catered for, by very much more modest outlays. It is on these considerations that we are anxious not to proceed with the signing of the lease or the construction of the building even though we have already spent a sum of about Rs 25 lakhs in developing the site.

I was happy to find that you showed understanding of the problem and were inclined to take a sympathetic view of our request. You took note of the fact that we have spent a fair amount of money on the development of the site and drew attention to the difficulty which you would have in accepting any settlement which should mean that the State Government, instead of receiving the rent which it expected from the Reserve Bank would, in fact, be expected to make some payments to it. I told you that once you agreed in principle to consider our request, it would certainly be possible to arrive at a settlement which would be fair to both.

You accordingly suggested that you would call a meeting along with your concerned Secretaries in order to arrive at the basis of a fair settlement. I shall be happy to attend such a meeting whenever you call it. Unfortunately, I am going out of India from the 8th May till about the end of the month; so a later date would have to be fixed for the purpose. In the meantime, Shri Damry could make available to your concerned Secretaries all the relevant data on the subject if you so desired.

With kind regards,

Yours sincerely,
L.K. Jha

Shri V.P. Naik
Chief Minister
Maharashtra Government
Bombay

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D.O.No.G.8–246

Bombay
November 6, 1968

My dear I.G.,

Off and on D.P.M. has expressed to me the view that the Reserve Bank should be a truly independent body and that to ensure this he would prefer to discontinue the practice of having an ex-Government servant at its head. I give this preamble in order to set down on paper some thoughts, both regarding current day-to-day relations between the Bank and Government, as well as about certain long-term aspects of the matter about which you and I have had some cursory discussions.

2. The independence of the Reserve Bank, as indeed of the Central Bank of any country, can never mean that it would follow a policy contrary to that of the Government. The Central Bank of any country must inevitably accept and implement the policies and adopt the objectives which the Government of the country has. Its independence is mainly operational within the field of

responsibility entrusted to it by law and subject to Government's overriding powers to give directives. The relationship between the Bank and the Government has, therefore, to strike a delicate balance within this framework of considerations.

3. In most countries, barring one or two solitary and uncomfortable exceptions, the Central Bank is located in the capital. The Governor meets the Finance Minister at least once a week: meetings with the Secretary of the Department as well as at other levels take place quite frequently and regularly. Most things are sorted out by discussions. The power to give directions to the Central Bank is rarely, if ever invoked.

4. In India, for purely historical reasons, the Bank is a thousand miles away from the capital. No doubt, the Governor goes to Delhi quite frequently and the Minister also visits Bombay from time to time, but the bulk of the work is by correspondence and personal contacts at other levels are, on the whole, few. What is more, with our accent on development and the necessity for controls, the areas in which both Government and the Reserve Bank take day-to-day decisions are wide and widening. As a result, quite often different views are taken on the similar problems in Bombay and in Delhi, leading to a certain lack of coordination, some overlap and duplication and a growing tendency both in the Bank and in the public to keep referring things to Government.

5. Let me illustrate what I am driving at by two examples. At the last Board meeting in Madras, it was reported that Government had decided that in the case of students going abroad on a scholarship which covered a part of their cost but not all of it, the existing practice of our releasing foreign exchange up to one-third provided at least two-thirds of the cost met by the scholarship should be abandoned, with the proviso that where part of the cost is met by scholarship the rest could be met by any external source whatever. This decision was taken by the Government without, I believe, any prior discussion with the Bank. It is also in conflict with the principle which has Government's approval that we do not allow students to go abroad if their expenses are to be met from a private source and not a body like a university or an approved foundation. Now clearly it is for the Government who lay down the policy and to make any change in it that they think fit. However, when an educational policy is settled at an inter-Ministerial meeting at which the Reserve Bank is represented, would it not be appropriate to have the convention of getting the Bank's comments before a change is made?

6. Apart from changes in policy, a large number of representations from students and others are dealt with by Government as well as at a higher level in the Bank. Usually, these are cases which are not fully covered by the existing regulations and have to be considered on merits. As there is no clear indication of the type of cases, if any, which should be dealt with by the Bank and what type of cases, if any, should be reserved for consideration by Government, there have been cases where, in respect of the same case orders passed by the Bank, have been reversed and in some cases they have been reinstated after reversal.

7. Let me go into another field. In a recent letter dealing with branches of foreign banks, Shiralkar observed that some of the localities in which foreign banks have been allowed branches in the port towns are residential areas and not business localities and so branches should not have been allowed there. Now this

is the kind of matter which is normally dealt with by the Local Boards of the Bank who are expected to know the local areas better than we in Bombay know or people in Delhi might know. Indeed, with the kind of development which has taken place in cities like Bombay and Calcutta, the definition between a residential and a commercial area is very difficult to make. But here again my point is: should we leave these things to be dealt with by Local Boards whose members have knowledge of the areas or should we try to centralize them in Bombay or in Delhi?

8. If we are to avoid confusion of this kind, it seems to me very desirable that an attempt should be made to set down on paper the kind of things which Government will decide and the kind of things which the Bank will decide. I suggest that as a first exercise, it would be better if you ask Y.T. Shah on the foreign exchange side and Shiralkar in regard to the rest of our activities (including IDBI) to try to put their ideas on the subject on paper which we can then discuss and finalize.

9. Side by side, and now I am looking to the long-term picture, we should consider whether, granted that the Reserve Bank is in Bombay and it is not feasible to change its headquarters to Delhi, there are any particular activities of the Bank which had better be located in Delhi. One could, for example, take the view that some sections of our Economic Department had better be located in Delhi. This might be more helpful to Government as well as to the Bank. Now if such a view is taken, it will not be possible to uproot all the people and move them to Delhi one fine morning. But if there is a sense of direction, one can try to have a phased plan for such a movement. Likewise, if apart from application of the rules, all decisions pertaining to foreign exchange are to be taken by Government, then it would be better for us to centralize our exchange control work in Delhi rather than in Bombay so that the officers of the Bank are constantly in touch with the Finance Ministry.

10. You may like to discuss these thoughts with Shiralkar and Shah and then perhaps when we meet we could discuss the lines on which we should proceed.

Yours sincerely,

Dr I.G. Patel L.K. Jha

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Memorandum to the Committee of the Central Board

Erection of two stone statues on either side of the main entrance of Reserve Bank of India building at New Delhi

The Committee of the Central Board at their meeting held on 26th April 1961 had approved that the further execution of the scheme for erection of the two statues at the entrance of the Bank's office building in New Delhi be proceeded with, at an overall revised estimated cost of Rs 2,69,600. The work of erection of these statues was taken up in December 1955 and finally completed in February 1968.

2. There was considerable delay in carving of the statues as well as in the

construction of pedestals due to non-availability of cement and proper machinery such as crane, etc. to lift up the huge stone statue pieces over the pedestal which resulted in an increase in the expenditure. The Bank has incurred a total expenditure of Rs 3,36,720.88 which exceeds the revised estimated cost of Rs 2,69,600 by Rs 67,120.88. This increase is mainly due to the following:

	Provision Rs	Actual Rs	Difference Rs
Cost of pedestals	–	35,121	35,121
Erection expenses	20,000	29,750	9,750
Exgratia payment made to Shri Ramkinkar for maintaining an establishment at New Delhi during 1964–65, incurring additional expenses etc. as a result of delay in construction of pedestals	–	17,000	17,000
Architects' fees, etc.	–	2,514	2,514
Miscellaneous	–	2,300	2,300
			66,685

3. The Committee are requested to approve of the excess expenditure of Rs 67,120.88 incurred in connection with the erection of the two stone statues and pass the following resolution at their next meeting:

Resolved

That the excess expenditure of Rs 67,120.88 incurred by the Bank in connection with the erection of the two statues at the entrance of the office building at New Delhi be, and is hereby, confirmed.

EXECUTIVE DIRECTOR

Reserve Bank of India
Central Office Premises Department
Bombay –1
Dated 24th July 1969

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MEMORANDUM FOR THE COMMITTEE OF THE CENTRAL BOARD

Subject: Appointment of Shri A. Baksi as Secretary to the Government of India, Department of Banking

The Government of India have decided to create a new Department of Banking, within the Ministry of Finance, to implement the provisions of the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969 and to look after the work relating to the nationalized and other banks, the term-lending agencies and other financial institutions and bank credit and other allied matters generally. Government propose to appoint Shri A. Baksi as the Secretary of the new Department. Shri Baksi will naturally cease to be a Deputy Governor with effect from the date on which he takes over charge at New Delhi.

2. Shri Baksi joined the Reserve Bank of India as a Deputy Governor on 24th January 1967 and was nominated as the Vice-Chairman of the Industrial Development Bank of India with effect from 1st February 1967 under sub-section (2) of Section 6 of the Industrial Development Bank of India Act, 1964. In the normal course, Shri Baksi would have retired from Government service in July 1969 and continued to be a Deputy Governor and the Vice-Chairman of the Industrial Development Bank of India until 23rd January 1972, but in the special circumstances of this particular case, Government has decided to release him from his undertaking to retire from Government service, and I have also considered it desirable to release him from the Reserve Bank for joining the new post to which he is being appointed.

3. It will be necessary to appoint a new Vice-Chairman for the Industrial Development Bank of India, and I propose to nominate Shri B.N. Adarkar as Vice-Chairman, with effect from the date on which Shri Baksi assumes charge of his office as Secretary of the new Department.

4. The Committee is requested to pass the following:

5. The Committee considered the Governor's memorandum dated 1st September 1969 regarding appointment of Shri A. Baksi as Secretary to the Government of India, Department of Banking and passed the following resolution:

Resolved

That the Governor's memorandum dated 1st September 1969 be recorded.

The Committee place on record their high appreciation of the valuable services rendered by Deputy Governor, Shri A. Baksi to the Reserve Bank during his tenure of Office. The Committee wish him success in the new assignment.

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October 14, 1969

My dear Baksi,

This is with reference to your letter No. 21–SDB/69 dated October 4, 1969, which I received in London.

2. As I told you this morning, I had put to PM my thought that rather than continue to confront Reserve Bank officers with *ad hoc* decisions on the many problems regarding their pay scales, promotion opportunities, seniority question, etc. taken by the Governor and Deputy Governor on the advice of the Chief Manager, it would be preferable to have an independent body, which will command their confidence to go into all these questions. As it is, precisely because

isolated decisions were taken on particular problems as and when they arose, we have today many obvious irrationalities which need to be ironed out by an objective impartial study of the problems. PM's response, I felt, was wholly sympathetic to this approach. I might add that before speaking to PM, I had mentioned my ideas both to L.P. Singh as the Secretary in-charge of services and to I.G. Patel who was then dealing with the banking system. They both saw merit in my approach and the latter was, in fact, present when I spoke to PM. Following this when I had my meeting with the Officers' Association on quite a number of issues which they had raised, I had told them that they would be looked into by an independent and impartial outside body, and it was in my attempt to finalize the composition of this body that I had written on 9th September to L.P. Singh to seek his views as to which ex-official would be best equipped to help on problems pertaining to cadres, promotions, etc.

3. You have expressed misgivings about the possible repercussions of our setting up a Pay Commission type of body on public sector banks and the Central Government itself. So far as the Central Government is concerned, apart from the fact that there have been at least two Pay Commissions in the past while the Reserve Bank has had none, you are doubtless aware that a third Pay Commission is under active consideration. In any event, the pay range, as explained in my letter to L.P. Singh which will be under the purview of the body that the Reserve Bank may set up, will not be going beyond the present pay range of IAS Joint Secretaries. As regards the State Bank and the nationalized banks, as you are aware, the officers even of the State Bank are in receipt of far higher emoluments than those in the Reserve Bank with the sole exception of the Heads of the two institutions. The officers' salaries in the newly nationalized banks are, if anything, a shade better. There is, therefore, no reason to apprehend that the proposed review will lend support to higher salaries in Government or in the nationalized banks. I doubt if the officers of the newly nationalized banks will ask for or welcome a Pay Commission type of study of their emoluments because they may well feel that this would lead to a downward revision of their scales to bring them in line with other public sector bodies rather than in an improvement. In any event, am I not right in thinking that it is Government's policy that when issues between employers and employees cannot be resolved satisfactorily by bilateral negotiations, an independent body should go into them and make appropriate recommendations rather than leave the matters to be the he cause of bitterness and sometimes strife?

Yours sincerely,
L.K. Jha

Shri A. Baksi
Secretary to the Government of India
Department of Finance
Ministry of Finance
New Delhi

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Conversion of the Post of Principal Advisor to that of Executive Director and Principal Advisor

I have been giving some thought to the question of the long-term arrangements that should be made for the overall supervision and coordination of the work of the Economic Department and the Statistics Department. Until 1957, work emanating from the two Departments was submitted to the Deputy Governor concerned directly by the head of those Departments, the Economic Advisor. The growing importance of economic and monetary problems dealt with by those and the other Departments of the Bank necessitated the creation of a post superior to that of the Economic Advisor and located in the Central Office itself. Accordingly, the post of Principal Advisor was created in 1957.

At their meeting on 11th February 1959, the Committee of the Central Board approved the Governor's proposal to keep in abeyance the post of Principal Advisor together with that of a retiring Deputy Governor, and to create temporarily two posts of Executive Directors, to one of which the erstwhile Principal Advisor, Dr B.K. Madan, was appointed. Work from the Departments of Economics and Statistics was routed through him to the Deputy Governor and Governor.

Subsequent changes in this arrangement have been largely *ad hoc* in character and taking into account certain factors which could not be said to be of a long-term character, Dr Madan after some time became Deputy Governor and Vice-Chairman of Industrial Development Bank of India. The view was then taken that with Dr Madan continuing to be available for overall coordination of economic work, another post for that purpose at Executive Director's level was not necessary. When Shri J.J. Anjaria was appointed as Deputy Governor, again in view of his specialized knowledge and experience, and particularly as he was in a position to devote more or less whole-time attention to economic and monetary problems, no provision of a post at Executive Director's level was felt to be necessary.

Meanwhile, with the growing importance of the work done in the Economic Department and the recognition that the Department, although technically one, was engaged in a number of specialized fields of study and research, it was decided with the Committee's approval to create a number of posts at what is known as Advisors' level, the Advisors concerned being in charge of particular lines of work, such as Balance of Payments, Agricultural Finance and the like. The need for an administrative head for the Department, as a whole, and also for coordination of the work of the different cells under each Advisor led us to revive the post of Principal Advisor, keeping the post of Economic Advisor in abeyance. Thus, the Deputy Governor, Shri Anjaria, is now assisted by a Principal Advisor, with three Advisors, each in charge of a separate wing of the Economics Department and one Advisor in the Department of Statistics.

Shri Anjaria relinquishes his office at the end of February 1970. We do not know whether Government will appoint in his place another Deputy Governor who will be able to devote his whole time to the work which Shri Anjaria was doing as a Deputy Governor. The increase in the workload at Deputy Governors' level on the Banking side on account of administration and on account of financing of industry and agriculture is such that it would not be safe to assume that Shri Anjaria's successor, if and when he is appointed, will, in fact, be able to devote his whole-time attention to the problems which in fact, were, in Shri Anjaria's field of responsibilities.

Regardless of this consideration, purely from the point of view of sound organization, it seems that the appropriate long-term arrangements would be for the overall supervision and coordination of the work of the Economic and Statistics Departments to be in the hands of an Executive Director who will normally, subject to the availability of a person of adequate competence, be selected out of the Reserve Bank officers who have worked in the Economic and Statistics Departments. This will leave greater freedom and flexibility to Government in the matter of selecting Deputy Governors, and also enable the Governor to distribute the work between them according to the exigencies of situation. An appropriate designation for the post which I have in view would be Executive Director and Principal Advisor. The Committee's approval to these proposals is sought.

Shri V.G. Pendharkar, at present Principal Advisor, is in my opinion and that of the Deputy Governors eminently suitable for appointment to the new post, and the Committee is requested to approve this appointment. Shri Pendharkar is, at present, devoting most of his time to the work of the Banking Commission of which he is the Member-Secretary. With the assumption of the higher responsibility in the Bank, we would expect him to devote some more time to the Reserve Bank's work than he is doing at present. Suitable arrangements in this behalf will be made in consultation with the Chairman of the Banking Commission and Government.

If the Committee agrees, it is requested to pass the following resolution:

Resolved

That the proposal contained in the Committee considered the Governor's memorandum dated 23rd February 1970 regarding conversion of the post of Principal Advisor to that of Executive Director and Principal Advisor and passed the following resolution:

Resolved

That the proposal contained in the Governor's memorandum dated 23rd February 1970 for the creation of the post of an Executive Director be approved, and that the person appointed to it should be entitled to the same terms as to emoluments and perquisites and other benefits, as are admissible to the other Executive Directors

Resolved further
That Shri V.G. Pendharkar now Principal Advisor be appointed to the new post of Executive Director with effect from 1st March 1970.

Resolved further
That the post of the Principal Advisor be held in abeyance.

GOVERNOR
23rd February 1970

Reserve Bank of India
Central Office
Department of Administration and Personnel
Bombay

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Memorandum to the Committee of the Central Board on April 4, 1970
Terms and Conditions of Appointment of Shri Adarkar and Shri Jagannathan as Governor

Necessary arrangements have been approved by the Central Government. Shri B.N. Adarkar will take over from me as the Governor until the date he is due to retire, namely 14th June, 1970. Thereafter, Shri S. Jagannathan, at present, India's Executive Director in the I.B.R.D. at Washington will be the Governor of the Reserve Bank of India for the full term of five years. Under sub-section (2) of Section 8 of the Reserve Bank of India Act, the salary and allowances of the Governor will have to be determined by the Central Board with the approval of the Central Government. As a meeting of the Central Board is not likely to take place before 13th July 1970, I suggest that the Committee may consider the terms and conditions of service indicated below and if they agree, authorize me to communicate them to Government.

2. Shri Adarkar should draw the salary which I have been getting, namely Rs 4,500/- per mensem and the pension equivalent of Government's contribution to his provident fund in respect of the period of his service under Government will be deducted from his pay. Shri Adarkar has indicated that he does not want to shift to the Governor's official residence, and that he would continue to occupy his present house. As the Governor is normally entitled to a free furnished house at Bombay and suitable accommodation in Calcutta, I recommend that no rent need be recovered from him, for the period of his appointment as Governor, for the flat at Bombay or for the use of the Governor's house at Calcutta. Shri Adarkar will be entitled as Governor to the use of a bigger car for official duties, and will be able to use this car for private purposes on payment of Rs 125/- per mensem. He will continue to be entitled to leave, medical facilities and provident fund contribution from the Bank on the same terms and conditions as at present, but if owing to the exigencies or service or in the public interest, any portion of

the admissible leave is not availed of during his tenure of office, he should be able to carry forward the leave to be enjoyed after the date of his retirement as Governor.

3. Sri Jagannathan will, be usual, draw a salary of Rs 4,500/- per mensem subject to income tax and without any retiring gratuity, the pension, if any, being held in abeyance. As he will be resigning from Government service before taking up his appointment as Governor, the pension, if any, which is commuted by him and the pension equivalent of the death-cum-retirement gratuity, if any drawn by him, will be reduced from his salary. He will be permitted, according to the practice, which has normally been followed, to contribute to the Reserve Bank of India Employees' Provident Fund under Regulation 5 (iii) and the Bank will contribute monthly to his provident fund account a sum equal to 8 1/3 per cent of his pay. Shri Jagannathan, like all his predecessors, will be entitled to a free furnished house in Bombay and suitable accommodation in Calcutta and also to the free use of the Bank's car for official duties. In case the car is used for private purposes, he will make a contribution of Rs 125/- per month to the Bank. Leave for a total period of four months, inclusive of the time spent in proceeding to and from the destination will be available to him. While proceeding on ordinary leave, he will be eligible to draw fare to and from the place of domicile in India, by air or by rail by the highest class of accommodation available for himself, and for each member of his family actually travelling. If necessary, the leave may be availed of in more than one spell, but the leave fare will be admissible on one occasion only. Pay during the period of ordinary leave will be Rs 4,500/- per mensem, subject to income tax and also the deduction, if any, on account of pension or the pension equivalent of any gratuity.

4. If owing to the exigencies of service, or in the public interest any portion of the admissible leave is not availed of during the tenure of his office, Shri Jagannathan will be entitled to such unutilized leave after his retirement from the Bank. The pay during the period of leave availed of on or after the date of retirement as Governor will be the pay, which might have been admissible, if the leave had been availed of before the date of retirement.

5. If the Committee approves of my proposals, it is requested that the following resolution may be passed:

Resolved
That the proposals in the Governor's memorandum dated 27th April 1970 be approved and that he be authorized to convey them to the Central Government for their approval.

GOVERNOR

Reserve Bank of India
Central Office
Bombay
Dated 27th April, 1970

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November 22, 1976

MEMORANDUM TO THE COMMITTEE OF THE CENTRAL BOARD
Halting Allowance for the Governor, Deputy Governors and Executive Directors

The existing rates of halting allowance for the Governor, Deputy Governors and Executive Directors which were last revised in November 1973 are as follows:

1. Governor	:	Rs 35/- per diem *or* actual hotel expenses
2. Deputy Governors and Executive Directors	:	Rs 30/- per diem *or* actual hotel expenses

The Directors of the Central Board are also paid halting allowance (known as 'subsistence allowance') at the rate of Rs 35/- per diem; this rate was also revised in November 1973.

2. There is, however, a special provision in respect of the Directors of the Central Board that if, at the request of the Director, the Bank arranges for accommodation at a hotel for the day or days of the meeting, the Director shall, for that period, draw halting allowance of Rs 10/- per diem to cover incidental expenses. In the absence of any such provision in the case of Governor and Deputy Governors, who are also the Directors of the Central Board, the Governor and Deputy Governors, when provided with hotel accommodation at the Bank's cost, are often out of pocket on account of certain incidental items of expenditure defrayed by them in the course of their stay at the outstation. It is, therefore, proposed that as in the case of the Directors of the Central Board, Governor and Deputy Governors may also be paid halting allowance at the reduced rate of Rs 10/- per diem to cover such incidental expenses when they stay in hotels, the bills for which are paid by the Bank. It is also proposed to pay the halting allowance on the same basis to Executive Directors who attend the meetings of the Central Board.

3. The Committee are requested to approve of the above proposal and to pass the following resolution at their next meeting:

Resolved
That the proposal contained in paragraph 2 of the Governor's Memorandum dated 22nd November 1976, be and is hereby, approved.

GOVERNOR

Reserve Bank of India
Central Office
Department of Administration and Personnel
Bombay 400001
Dated 22nd November 1976

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Memorandum to the Committee of the Central Board
Appointment of Executive Director

As I had mentioned to the Committee earlier, it is proposed to appoint Shri W.S. Tambe, now Joint Secretary to the Government of India, Ministry of Finance, Department of Economic Affairs, as Executive Director in the Bank. I have discussed the matter further with the Government and Shri Tambe. The Government have agreed to release Shri Tambe, and the latter is prepared to join us on our usual terms. He would, however, prefer to voluntarily retire from the Government before joining the Bank's service. For this purpose, he has already moved the Government and is likely to be relieved as from 31st May 1978. It is, therefore, proposed that Shri Tambe may be appointed in the Bank's service with effect from last June 1978.

2. On being appointed in the Bank, Shri Tambe will be governed by the Reserve Bank of India (Staff) Regulations, 1948. He will draw a fixed pay of Rs 3,025/- per mensem as admissible to the Executive Directors, besides being eligible for other allowances and facilities, as admissible to other Executive Directors in the Bank. He may also be reimbursed the expenditure involved in shifting his personal effects, etc. from New Delhi to Bombay, to the extent admissible under the Bank's rules. In respect of other conditions of service, he will be subject to the rules applicable to the Senior Officers of the Bank. His pension and death-cum-retirement gratuity as sanctioned by the Government, will be kept in abeyance till his retirement from the Bank's service.

3. The Committee of the Central Board are requested to approve of the above proposal and to pass the following resolution at their next meeting:

Resolved

That the proposal contained in the Governor's Memorandum dated 15th May 1978 regarding appointment of Shri W.S. Tambe as Executive Director in the Bank be and is hereby approved.

Governor

Reserve Bank of India
Central Office
Department of Administration and Personnel
Bombay
Dated 15th May 1978

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Memorandum to the Committee of the Central Board
Creation of Posts of Executive Directors

Since Shri C.S. Divekar relinquished his appointment as Deputy Governor on 11th November 1965, Shri D.R. Joshi, Executive Director, has been attending to his duties, in addition to his own. As the Committee is aware, Shri Joshi was appointed as Executive Director on a tenure basis for a period of five years, and this period is due to expire on 31st May 1966, when he would vacate his post (he has been permitted to avail of the leave due to him after that date, that is, with effect from 1st June 1966).

2. I have been considering the question of consequential arrangements and have come to the conclusion that a second post of Executive Director be created. A post of Deputy Governor is, at present, vacant. It is necessary, therefore, to make arrangements for filling the two posts of Executive Directors.

3. I propose to appoint Shri N.D. Nangia, who has been Chief Manager of the Bank, against one of these posts. As Chief Manager, Shri Nangia draws a fixed pay of Rs 2,700/- per mensem and I recommend that as Executive Director his pay may be fixed at Rs 2,750/- per mensem. He will continue to draw the allowances to which other Senior Officers of the Bank are entitled, viz., Local Pay, House Allowance and the Bank will also contribute to his Provident Fund at 10 per cent of his basic pay (including Local Pay) as heretoforce.

4. As regards the second post of Executive Director, I have arranged to obtain from the Government of India, on deputation, the services of Shri R.K. Seshadri, who belongs to the Indian Economic Service, and is at present working as Director of Banking in the Department of Economic Affairs in the Ministry of Finance, New Delhi. Shri Seshadri is drawing in the Government a pay of Rs 2,000/- per mensem. The Government of India have proposed that he may be paid, in addition, a special pay of Rs 250/- per mensem and I recommend accordingly. In addition, he will be eligible to draw the allowances as admissible to him in the Government, which at present are Rs 100/- per mensem Dearness Allowance and Rs 75/- per mensem City Compensatory Allowance. He will be provided with a Bank's flat and garage for which he will be charged 10 per cent of his pay (including special pay) as rent. During the period of his deputation, the Bank will pay to Government the usual leave salary and pension contribution payable by a foreign employer in respect of Central Government Officers on deputation. The Government of India have agreed to place his services on deputation for a period of three years from the date he reports himself for duty to the Bank, and the other terms of his deputation will be on the usual basis.

5. If the Committee approve of the proposals made above, they are requested to pass the following resolution:

Resolved

That the proposals made in Governor's Memorandum dated 3rd May 1966 to create two posts of Executive Directors and to fill them by appointment of

Sarvashri N.D. Nangia and R.K. Seshadri, the latter on deputation basis from the Government of India, on terms stated therein, be and are hereby, approved.

GOVERNOR

Reserve Bank of India
Central Office
Bombay
3rd May 1966

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Camp:
May 13, 1968

My dear Damri,

Just before I left Bombay, Mitra told me that in the Conciliation proceedings in Delhi over our emergency procedure relating to currency needs, we had claimed that this was a management matter while the workers were claiming that even in management, workers should have a say.

I felt a little concerned subsequently as to whether in a place like Delhi our case would be adequately represented without some special guidance from Bombay. I therefore tried to get a message relayed to you and to Shiralkar via London. I do not know if you got it in an intelligible form.

My concern is over the point that if we allowed the issue to become one of principle, namely, that the matter rests with the management, we might get the Conciliator to say that the workers participation in management is a desirable thing. I would much rather argue the case more frontly by saying that so long as we had to import currency paper, it was desirable for us to ensure that any usable currency that went back into circulation rather got destroyed. Now that currency paper is available indigenously, we cannot afford to spend more on examining used currency than what we would save as a result of such examination.

Secondly, I would put the management angle in a somewhat different perspective. No one could argue that 'P' form regulations should continue even if that were otherwise unnecessary, merely to ensure that the clerks working on it are kept employed. The same kind of consideration must govern whether or not some scrutiny of old currency notes is or is not necessary. What we do recognize is that any change in our procedure should not cause any unemployment or retrenchment.

Thirdly, the continuance of existence procedure not only means expansion of staff but even more on new buildings and vaults. The economy to be achieved by changing our procedure is not merely on the wage bill.

You may have already done the necessary briefing of our representative on the Conciliation but I thought having a little time on my hand in Stockholm, of writing to you about the matter.

I am also enclosing a copy of a note which I have recorded following my talks in Paris. You may like to pass it on to your other colleagues and to Narasimhan.

Kindly ask Narasimhan to send me copies of papers prepared for the next meeting of the Standing Committee of the National Credit Council.

With kindest regards,

Yours sincerely,
L.K. Jha

Shri P.N. Damri
Deputy Governor
Reserve Bank of India
Bombay 1

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Appointment of Directors to the Central Board of the Reserve Bank of India

Government of India issued a notification regarding the appointment of Shri Kamaljit Singh as a Director of the Central Board of the Reserve Bank of India on 25th June 1968. The text of the notification reads as follows:

> 'In exercise of the powers conferred by sub-section (4) of Section 12 read with clause (c) of sub-section (1) of Section 8 of the Reserve Bank of India Act, 1934 (2 of 1934), the Central Government hereby nominates Shri Kamaljit Singh, Managing Director, Marketing Division, Indian Oil Corporation, 254–C, Dr Annie Besant Road, Prabadevi, Worli, Bombay 25 as a Director of the Central Board of the Reserve Bank of India vice Dr Triguna Sen.'

The Legal Department was consulted about the reference to Section 12(4) which is the section which deals with the casual vacancies in the Board. On a strict interpretation, therefore, the appointment of Shri Kamaljit Singh would cover only the unexpired portion of Dr Triguna Sen. This means that Shri Kamaljit Singh's appointment would legally be for a period of four days, that is up to 30th June 1968.

I sent a telex to Delhi yesterday and also spoke to Shri D.N. Ghosh about this and the Government of India, I understand, now propose to issue another notification appointing Shri Kamaljit Singh for the full term as from July 1, 1968.

For information.

N. Narasimhan
26.6.1968

Governor may kindly see the telex message below. I understand that PM has approved of the appointments of all the four persons as directors of the Central Board of the Bank.

2. Shri M.P. Chitale is, at present, a director of the Dena Bank. Under Section 10(1) (e) of the Reserve Bank of India Act, this is not technically a disqualification for appointment on our Board, as the Dena Bank is not a banking company, but is a statutory corporation like the State Bank of India. There have been instances

in the past of directors of the State Bank of India being also directors of the Reserve Bank, but latterly we have been discouraging this practice. While it is not necessary to discriminate against the nationalized banks, as compared with the State Bank of India, we may as a matter of policy in future, ask the directors, both of the State Bank and the nationalized banks, to resign from the boards of these banks before they join our Board.

3. On this assumption, we may ask Shri Chitale to resign from the Board of Dena Bank. The question does not arise in the case of Dr Verghese Kurien as he is not now connected with any bank.

R.K. Seshadri
29.8.1972

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S.M. Joshi

The Governor
Reserve Bank of India
Bombay 1
1170 Sadashiv Peth
Poona 30
12th August 1972

Dear Shri Jagannathan,

I am extremely distressed to write this letter. You must have been reading the controversy about my acceptance of the Board Membership. Surely it was a welcome opportunity for me to study the working of the economic system of our country from the nerve centre of finance. It was really very educative for a social worker like me.

I did not know what to do when the National Committee of my party asked me to withdraw from the Board. After careful consideration of the issues involved, I came to the conclusion that it is in the interest of disciplined political life in our country to resign. So long as I am a member of the Party, I must submit to their directives. I do not know whether you would agree with me in this regard. I know the loss is mine.

I do not know to whom the letter of resignation should be addressed. Therefore, I am sending it to you. Kindly forward it to the appropriate authorities and oblige.

I express my sense of gratitude to you and your colleagues for the kindness shown to me all these days.

I hope the friendly relationship developed in this short period will continue in future also.

With kind regards,

Yours sincerely,
S.M. Joshi

Reserve Bank of India
Bhagatsingh Road
Bombay 1

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Memorandum to the Committee of the Central Board
Rates of Halting Allowance for the Governor and Deputy Governors

The existing rates of Halting Allowance for the Governor and Deputy Governors are as follows:

1. Governor	:	Rs 30 per diem *or* actual hotel expenses
2. Deputy Governors	:	Rs 25 per diem *or* actual hotel expenses

When the Governor and Deputy Governors stay in the Governor's flat at New Delhi, Calcutta and Madras, they are paid halting allowance at 50 per cent of the rates applicable to them.

2. The basic rates of halting allowance, viz. Rs 30/Rs 25 for the Governor and Deputy Governors respectively, were fixed by the Committee of the Central Board at their meeting held on 29th May 1935, but the provision for payment of actual hotel bills was introduced in 1947, with the approval of the Committee of the Central Board at their meeting held on 23rd July 1947. The Directors of the Central Board are paid 'subsistence allowance' at the rate of Rs 30 per diem for each day of travel or day or days of the meeting.

3. The rates of halting allowance fixed for the Governor and Deputy Governors have remained unchanged since 1935. The Central Government have revised the rates of halting allowance of Senior Government officials of comparable status on more than one occasion in the course of the past one decade or so. The last revision took effect from 1st January 1971. At present, the Secretaries to Government draw more halting allowance (that is, Rs 28 p.d.) than the Deputy Governor at places like Bombay, Calcutta and other centres classified along with it. The rates of halting allowance for all cadres of officers of the Bank have also since been increased, effective from 30th May 1973, in pursuance of the recommendation of the Cadre Review Committee, headed by Justice J.L. Nain, then a Sitting Judge of the Bombay High Court and now the Chairman of Monopoly and Restrictive Trade Practices Commission. Halting Allowance is now admissible to senior officers drawing pay above Rs 2,000 p.m. on the following basis: When such officers make their own arrangements, they are paid halting allowance @ Rs 30 per diem for all cities with a population of 3 lakhs and above, State Capitals, hill stations, and when they stay in hotels, they are paid halting allowance at the rate not exceeding Rs 50 per diem, subject to the production of duly receipted hotel bills. The Executive Directors of the Bank who are entitled to draw halting allowance at the rate applicable to the higher grade of officers of the Bank are now being paid halting allowance at Rs 30 per diem or actual hotel expenses.

4. Inasmuch as the Deputy Governors draw halting allowance at a lower rate, it creates an anomalous position. To remove this anomaly, it is proposed that:

(i) the rate of halting allowance for Deputy Governors may be raised to Rs 30 per diem or the actual hotel expenses;

(ii) Likewise, the current rate of halting allowance for the Governor (which is

Rs 30 per diem) may be raised to Rs 35 per diem. The same rate may also be applied for payment of 'subsistence allowance' to the Directors of the Central Board.

(iii) In accordance with the 'split rate' of halting allowance admissible to the higher officers of the Bank who are provided with Bank accommodation when on tour in Category I areas (State Capitals, hill stations and towns with population of 3 lakhs or more) viz., the charge paid to the Bank for the accommodation plus Rs 20, a similar rule may be made applicable to Deputy Governors and the Governor.

5. It is proposed that the above rates of halting allowance may be made effective from 1st November 1973.

6. If the Committee approves of the above proposals, it is requested that the following resolution may be passed:

Resolved
That the proposals contained in paragraph 4 of the Governor's Memorandum dated 20th November 1973 be and are hereby approved and that the new scales of the daily allowances for the Governor, the Deputy Governors and Directors of the Central Board be increased as proposed in the said paragraph with effect from 21st November 1973.

GOVERNOR

Reserve Bank of India
Central Office
Department of Administration and Personnel
Bombay 1
Dated 20th November 1973

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NO. B–4

MEMORANDUM TO THE CENTRAL BOARD

Revision of the rates of halting allowance for the Local Board Members of the Reserve Bank of India and reimbursement of taxi-fares to and from the airports in the case of Members of the Local Boards and Directors of the Central Board.

In terms of the resolution passed by the Central Board at their meeting held on August 22, 1964, members of the Local Boards of the Bank are reimbursed travelling expenses on the following scale for attending meetings of the Local Boards:

(i) *Air, rail or steamer fares*:

(a) If the journey is performed by rail, one fare by the route actually used by the highest class of accommodation actually availed of, plus one-third class fare for a servant, if taken.

(b) If the journey is performed by steamer, one fare by the highest class of accommodation actually availed of, plus one fare by the lowest class for a servant, if taken.

(c) If the journey is performed by air, one fare by the class of accommodation actually availed of, plus the excess freight paid on personal luggage, and one-third class fare by rail for a servant, if taken.

(ii) *Personal accident aviation insurance cover*:

Up to Rs 1,00,000 if taken.

(iii) *Halting Allowance*:

At Rs 20 for each day of travel and the day or days of the meeting.

2. It was also decided by the Board in 1964 that while the halting allowance for directors of the Central Board nominated under Section 8(1) (b) and 8(1) (c) or 12(4) of the Reserve Bank of India Act for attending meetings of the Central Board and its Committees should continue to be Rs 30/- per day for each day of travel or of the meeting, the Bank might, on a request from a director, arrange for accommodation at a hotel for the day or the days of the meeting, in which case the halting allowance payable would be at a reduced rate of Rs 10/- per day to cover incidental expenses. This facility was not, however, granted to members of the Local Boards.

3. The rates in the case of the members of the Local Boards are now unrealistic and will have to be revised. At its meeting held on November 21, 1973, the Committee of the Central Board approved of the proposal to increase the rate of halting allowance payable to the Deputy Governors, having regard to the rates of halting allowance now admissible to senior officials of the Central Government of comparable status and the revision of the rates of halting allowance in the case of the Bank's officers, in pursuance of the recommendations of the Cadre Review Committee. The halting allowance in the case of Deputy Governors was increased from Rs 25 to Rs 30 per day. The halting allowance for the Governor was raised from Rs 30 to Rs 35 per day, and the subsistence allowance in the case of the directors was also raised from Rs 30 to Rs 35. Decision was also made for the payment of the allowance of other cases at a split rate, namely, the lodging expenses admissible to the Bank plus Rs 20 per day.

4. In the light of these decisions, it is proposed that the halting allowance in the case of members of Local Boards should be increased from Rs 20 per day to:

(i) Rs 30/- per day in case the members are able to make private arrangements, or

(ii) The actual expenses for boarding and lodging, subject to a maximum limit of Rs 50/- per day, or

(iii) Rs 50/- per day, if a sum of Rs 25/- or more has been incurred on account of expenses separately for lodging, or

(iv) The actual expenses on account of lodging plus Rs 20/- per day, if the actual expenses for lodging are less than Rs 25/- per day,

whichever of these rates might be relevant.

5. In view of the withdrawal by the Indian Airlines of the facility for free transport to and from the airports, and the increase in taxi charges recently, it

has been represented by some members of the Local Boards that the expenses incurred by them on account of transport to and from the airport should also be reimbursed. This claim appears to be reasonable and it is proposed to reimburse the actual coach or taxi fares for two journeys, one to the place of temporary residence in the city or the office, and the other back from that place or office to the airport. Any other expenses on conveyance or taxi fares, if any, will be met within the daily allowance, as it is now proposed to be revised.

6. It has been our practice to provide on request transport to and from the airports in the case of the directors of the Central Board. In view of the difficulties which are likely to be experienced by the directors, it is proposed that the actual coach or taxi fares as the case may be, to and from the airports should also be reimbursed to them, in addition to the daily allowance.

7. If these proposals are approved, it is requested that the following resolution may be passed:

Resolved
Revision of the rates of halting allowance for the Local Board Members of the Reserve Bank of India and reimbursement of taxi fares to and from the airports in the case of Members of the Local Boards and Directors of the Central Board.

The Board considered the Deputy Governor's memorandum No. B–4 dated 29th January 1974 regarding the revision of the rates of halting allowance in the case of Members of the Local Boards, and the reimbursement of actual cases incurred by the Members of the Local Boards and the Directors of the Central Board for journeys to and from the airport, and desired that in the case of member or director using his own car for journeys to and from an airport, mileage at the rate applicable to the officers of the Bank might be paid. Subject to modification, the Board

Resolved
That the proposals in the Deputy Governor's Memorandum No. B–4 dated 29th January 1974 be and are hereby approved.

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The Reserve Bank of India (Maintenance of Services) Ordinance, 1979 No. 4 of 1979

PROMULGATED BY THE PRESIDENT IN THE THIRTIETH YEAR OF THE REPUBLIC OF INDIA

An Ordinance to provide, in the interests of the general public, for the prohibition of strikes in the Reserve Bank of India.

Whereas Parliament is not in session and the President is satisfied that circumstances exist which render it necessary for him to take immediate action.

Now, therefore, in exercise of the powers conferred by Clause (1) of Article

123 of the Constitution, the President is pleased to promulgate the following Ordinance:

Short title, extent and commencement

1. (1) This Ordinance may be called the Reserve Bank of India (Maintenance of Services) Ordinance, 1979.
   (2) It extends to the whole of India.
   (3) It shall come into force at once.

Definitions

2. In this Ordinance,
   (1) 'Bank' or 'Reserve Bank' means the Reserve Bank of India constituted under Section 3 of the Reserve Bank of India Act, 1934 (2 of 1934).
   (2) 'Strike' or 'Strike in the Reserve Bank' means the cessation of work by a body of persons employed in the Reserve Bank acting in combination or a concerted refusal or a refusal under a common understanding of any number of persons who are or have been so employed to continue to work or to accept employment, and includes:
   (i) refusal to work overtime where such work is necessary for the discharge of the functions of the Bank,
   (ii) any other conduct which is likely to result in, or results in, cessation or substantial retardation of work in the Bank.

Power to prohibit strikes in the Reserve Bank

3. (1) If the Central Government is satisfied that in the interests of the general public it is necessary or expedient so to do, it may, by order, prohibit strikes in the Reserve Bank.
   (2) An order issued under sub-section (1) shall be published in such manner as the Central Government considers best calculated to bring it to the notice of the persons affected by the order.
   (3) An order issued under sub-section (1) shall be in force for six months only, but the Central Government may, by a like order, extend it for any period not exceeding six months if it is satisfied that in the interests of the general public, it is necessary or expedient so to do.
   (4) Upon the issue of an order under sub-section (1):
   (i) No person employed in the Reserve Bank shall go or remain on strike,
   (ii) Any strike declared or commenced, whether before or after the issue of the order, by persons employed in the Bank shall be illegal.

Dismissal of employees participating in illegal strikes

4. Any employee of the Reserve Bank who commences a strike which is illegal under this Ordinance, or goes or remains on, or otherwise takes part in any such strike, shall be liable to disciplinary action (including dismissal) in accordance with the same provisions as are applicable for the purpose of taking such disciplinary action (including dismissal) on any other ground under the terms

and conditions of service applicable to him in relation to his employment.

Penalty for illegal strikes
5. Any person who commences a strike which is illegal under this Ordinance or goes or remains on, or otherwise takes part in any such strike, shall be punishable with imprisonment for a term which may extend to six months, or with fine which may extend to one thousand rupees, or with both.

Penalty for instigation, etc.
6. Any person who instigates, or incites other persons to take part in, or otherwise acts in furtherance of, a strike which is illegal under this Ordinance shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to two thousand rupees, or with both.

Penalty for giving financial aid to illegal strikes
7. Any person who knowingly expends or supplies any money in furtherance or support of a strike which is illegal under this Ordinance shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to two thousand rupees, or with both.

Power to arrest without warrant
8. Notwithstanding anything contained in the Code of Criminal Procedure, 1973 any police officer may arrest without warrant any person who is reasonably suspected of having committed any offence under this Ordinance.

Ordinance to override other laws
9. The provisions of this Ordinance and of any order issued thereunder shall have effect notwithstanding anything inconsistent therewith contained in the Industrial Disputes Act, 1947 (14 of 1947), or in any other law for the time being in force.

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Submitted to the Central Board Committee at the meeting held on 23rd January 1980

MEMORANDUM TO THE COMMITTEE OF THE CENTRAL BOARD
Rates of Halting Allowance payable to Governor and Deputy Governors

1. With the approval of the Committee of the Central Board, the rates of Halting Allowance payable to the Officer staff of the Bank were revised effective 26th December 1979. Consequently, the rates of Halting Allowance payable to the Senior Officers are now more than what are payable to the Governor and Deputy Governors. This obviously is anomalous.

The existing rates of Halting Allowance payable to Governor and Deputy

Governors are as under:

Governor	:	Rs 35/- per diem *or* actual hotel expenses
Dy. Governors	:	Rs 30/- per diem *or* actual hotel expenses

(Directors are paid the same amount as Governor and these rates came into effect from 21st November 1973.)

As compared to the above, Senior Officers of the Bank are now paid Rs 50/- per diem towards Halting Allowance.

2. We are currently reviewing the rates of Travelling/Halting Allowances payable to Directors in connection with attending the Board meetings, and our proposals in this regard will be placed before the next Central Board meeting. Nevertheless, in order to remove the above-stated anomaly, it is proposed to enhance the existing rates of Halting Allowance payable to Governor and Deputy Governors with retrospective effect from 26th December 1979.

3. At present, Governor and Directors of the Central Board are being paid Halting Allowance at slightly higher rate than Deputy Governors. Since Deputy Governors are also Directors of the Central Board, it is proposed to dispense with the disparity. Accordingly, Governor and Deputy Governors may be paid Halting Allowance at Rs 50 per diem. The existing facilities of reimbursement of actual hotel charges will continue to be in force.

If the Committee approve of the above proposals, it is requested that the following resolution may be passed:

Resolved

That the proposals contained in Deputy Governor's Memorandum dated 21st January 1980 regarding payment of halting allowance to Governor and Deputy Governors be and are hereby approved.

P.R. NANGIA
DEPUTY GOVERNOR

Reserve Bank of India
Secretary's Department Central Office
Bombay
Dated: 21st January 1980

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D.O.No.G.8–131

BOMBAY
June 17, 1968

My dear I.G.,

You and I have, from time to time, exchanged thoughts about the possibilities of simplifying those of our foreign exchange regulations which impinge on individuals. I thought I should indulge in some further loud thinking on the subject this time on paper, and with somewhat more concrete approach as to the lines on which we should advance.

Quite frankly, I feel that it is not too advisable for the Reserve Bank to get involved in a large number of problems which concern individuals rather than corporate bodies. Basically, we are organized to deal with the latter, specially the banks. When any clearance is sought from the Reserve Bank, we expect certain data and certain forms to be filled which may be child's play with a bank but seem formidable to average citizen. No less important is the consideration that a very high percentage of the time of Reserve Bank officials in Exchange Control is taken up in dealing with individual cases involving petty sums. As such cases have, as a rule, to be dealt with urgently, there is consequent delay in dealing with more important cases involving large sums of foreign exchange. Simplification and streamlining of procedures will not only result in public satisfaction but also enable much greater concentration of attention and effort on larger transactions pertaining to foreign exchange earnings and expenditure.

If we are to have the requisite degree of simplification, then a somewhat broad judgement has to be exercised. One reason why the machinery works so slowly is that the rules are very complicated because at the technical levels, both in the Ministry and in the Reserve Bank, in an attempt to plug all possible loopholes, too many tests and conditions have been imposed, each of which can be justified on merits and can only be relaxed on wider considerations of administration and policy.

I would begin with our travel regulations first. A lot of travel is pre-planned. The intending traveller can apply for necessary permission to go and, given reasonable efficiency, the Reserve Bank can say yes or no to him in good time. At the same time, we must recognize that there are occasions when a person has to travel on an emergency basis. Our officers try their best to deal with such cases as quickly as possible, but there are some problems which cannot be surmounted without a considerable and, in my view, unnecessary, expansion of staff. If an unforeseen disaster compels a man to travel within twenty-four hours, he can get the requisite clearance if he is a resident of Bombay or Delhi, but it is very difficult for a man in Cuttack or Ahmedabad to get such clearance in less than forty-eight hours at the very least. Then again, if a weekend or holiday intervenes, the time process gets lengthened. It is not easy to find a solution to this problem, but it should weigh with us in considering travel restrictions as a whole.

Let us first consider the procedures involved in giving P form clearance. The regulations are complex, and in many cases Reserve Bank's offices outside Delhi cannot pass the final orders, and in some cases a reference has to be made to Government and may require inter-ministerial consultation. True, there has been some delegation of late. What I am suggesting is whether a more radical simplification is not possible.

The P form restrictions were introduced because we felt that about half the people who go out of India without applying for foreign exchange, do so by relying on black market foreign exchange. What has happened over the years is that because a number of people have tried, from time to time, to bluff us, we have evolved a series of regulations which are unduly irksome to the honest man and carry little conviction to the public at large. For any simplification to be considered, we have to recognize that no set of rules can be completely fool-proof, or shall I say knave-proof! What we have to see is that hundreds of honest people do not feel harassed merely because there are a few crooks around.

The class of people who can afford to travel for pleasure at their own expense is very limited, and even more limited is the class of people who can afford to finance themselves by buying 10 rupees to the dollar. This being so, I cannot help feeling that for certain types of people, we could well afford to be liberal in granting P form clearance without foreign exchange without undertaking a detailed scrutiny to see if the invitation from abroad is genuine. I think artists and musicians as well as professors and scientists are the kind of people who could be given P form clearance fairly freely without any verification of the authenticity of the invitation on which they are going abroad.

Another class of cases where I think a wholesale relaxation could be made is those whose fare is paid in foreign exchange by somebody or some agency outside India. It is not unreasonable to suppose that if the fare has been paid abroad, then living expenses would also be provided. It could, of course, be argued that some people might be able to get the foreign exchange even for their fare in the black market; my feeling is that for the sake of this view it is not worth our subjecting everyone to rigorous screening procedure, and in any event suspicious cases should better be looked after *ex post facto* by Enforcement Branch than by our time-consuming procedures. There remains another class of cases which may be deemed to be objectionable on political grounds. I feel that the task of denying clearance to anyone on political grounds is not one which should be entrusted or operated through the Reserve Bank, and the exchange control mechanics. Cases challenging the legality of such restrictions are increasing. If the Judiciary has struck down some of the restrictions regarding the issue of passports, I think the P form regulations, if they are used for purposes other than of exchange control, would also become targets of successful challenge. Actually, the class of people who get their foreign exchange paid from outside are often invitees of international institutions.

Leaving aside the type of cases referred to above, we come to the class of applicants about whom no inference, one way or the other, is possible on apriori grounds. We deal with them by defining the kind of host whose hospitality they could accept; the degree of relationship has been revised from time to time. I do not think courts will uphold us in taking decisions such as hospitality from an uncle being eligible for some time, then becoming ineligible for another period, and then becoming eligible again. I would prefer a straightforward course of allowing anyone to go abroad on hospitality but not oftener than once in three years unless there is some reason for the additional journey. Such an approach would mean reasonable freedom to travel on the basis of hospitality once in three years. Additional journeys will have to be justified by giving grounds for undertaking them. The kind of ground I have in mind is that often an Indian couple living abroad is in need of a female relation when the wife is expecting a child.

What I am asking you to do is not to agree with what I have said in the preceding paragraphs in specific terms, but you might like to sound D.P.M. as to whether he sees merit in this approach as a whole. If he does, then we can attempt to formulate something more specific for his consideration and orders.

In regard to travel with foreign exchange, clearly our foreign exchange position, being what it is, we cannot become more liberal. However, on the procedural side, I think what is irksome is asking an individual to render accounts and produce vouchers for his expenses abroad. This does not apply across the board, but where it does, it can unnecessarily add to our work and create a feeling of harassing the individual. The simplification I would aim at is to eliminate such scrutiny except perhaps where large releases are involved for specific purposes.

Travel apart, there are two other types of cases where simplification is called for. Firstly, there are Indians living abroad and earning abroad. Their rupee account gets frozen in the sense that they can only spend limited amounts out of it, without Reserve Bank's permission. Credits to their account are also watched. Both these operations are to see that they do not convert their rupees into foreign exchange in the black market, or conversely they do not sell their foreign exchange earnings in the black market against credits in rupees. I think this control could, with suitable instructions, be delegated to the banks where the individuals have their accounts so that references to the Reserve Bank are reduced to the minimum, and if they do come, they come from the banks and not from the individuals. More latitude than at present would be justified.

Another class of Indians are those who have permanently gone abroad. They may have been allowed to take a part of their assets if they were entitled to it or they may not have been allowed anything at all. In either event, part or whole of their assets remains frozen in India. Here again, the accumulation of rupee funds in India owned by foreigners is not something which I consider desirable. If the process continues over time, the amounts may become uncomfortably large. While we prevent them from taking out the money in the form of foreign exchange, it seems to me that we should provide for some ways in which the money starts decumulating without any pressure on our reserves. I have two thoughts on the subject. One is that we may allow them to use their rupees for buying tickets to come to India and to spend as much time as they like here. Secondly, we may allow them to buy Indian goods of specified categories and values to be taken out with them or sent to them.

Finally, there are cases of Indians who have balances abroad with Reserve Bank's approval. If they want to change their form of holding or investment, they have to come to the Reserve Bank for permission. Here again, a wider view has to be taken. One possible view would be to get all these monies repatriated to India or at least as much of it as in excess of a specified minimum. This may mean some accrual to our reserves, but as this is a once-for-all character, the view has been taken not to undertake this operation until and unless we are facing a dire emergency. On this view, I feel that an individual who wants to change his investment from one form to another so as to improve his return on it should be given the requisite freedom to do so.

I do not know whether I have covered all the types of cases in which the Reserve Bank gets involved with individuals, but I would like you to think over the points I have made and to let me have your reactions as to the directions in which you feel we should proceed.

Yours sincerely,
L.K. Jha

Dr I.G. Patel
Special Secretary
Department of Economic Affairs
Ministry of Finance
Government of India
New Delhi

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D.O.No.G.8–130

Bombay
June 17, 1968

My dear I.G.,

This is just in the nature of a postscript to the talks we had when you came here for a day.

I take it that on Bhide's note regarding speculation in certain shares you will be sending him a reply and that we, for our part, should proceed on the lines of the discussion which you had with me and Adarkar.

On the import policy paper I have one or two further thoughts. I had told you to include newsprint among the things where, by developing domestic capacity, we can achieve substantial savings in foreign exchange. I would add that even when I was in the Industry Ministry, two projects for this purpose had been approved—none of them has made any progress as far as I know. It is the kind of thing which could well be undertaken in the public sector. The Soviet Union could well supply the equipment and technology. If they want to do it on a grand scale and harness the timber resources of the Himalayas, we might achieve something worthwhile in a very much wider perspective. Alternatively, even if we have to import the pulp for it, I believe the savings in foreign exchange are likely to be substantial.

Another potential for saving in foreign exchange lies in developing the production on a commercial scale of the pyrites as a substitute for sulphur in units producing sulphuric acid. This again was a project I had dealt with in the Industry Ministry. It is in the public sector and in the hands of a corporation. I do not know how fast it is moving.

However, the more important point on import policy which I think calls for some study is an attempt to project what are the likely levels of imports of the things on the liberalized list in the absence of restrictions. I find it difficult to believe that the low level of imports in the last two years can be attributed entirely or mainly to the recession. An item-wise study is, to my mind, called for to identify which particular declines could be said to have been due to recessionary conditions and also the order of likely increase in these items if industrial production shows an increase of 5 per cent this year. I think we may well find that the increased outlay would be nominal, and in any event if we want the higher production unavoidable. If this view is correct, then it would have a major bearing on any decision which we take to tighten import control, and also the areas to which the tightening should apply. So long as imports were being kept down, it was arguable that any increase in import licensing would mean an increase in imports. This assumption would not be equally valid in today's conditions. Also as a tool for future policy decisions an attempt to forecast import requirements may well prove worthwhile. I am trying to have some kind of a study made here, but probably someone like Marathe might be better placed to do so. Having two parallel exercises would not be a bad thing.

Finally, quite some time back Baksi had written a letter to Shiralkar about the policy which IDBI should adopt in respect of well-established industrial units seeking finance for expansion or diversification. It would help if a reply to it came pretty soon so that account could be taken of it in preparing papers for the IDBI Board.

Yours sincerely,

Dr I.G. Patel L.K. Jha

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Bombay
September 16, 1968

My dear Ramaswami,

Your D.O.No.2606–EA/68 dated 7th September 1968 asking for my comments on ARC's recommendations which concern the Department of Economic Affairs and the Reserve Bank. As I am going out of India in a couple of days, I am hurriedly jotting down a few comments on some of these recommendations. At the same time, I am sending down the papers to Adarkar who will, in consultation with the concerned people in the Bank, send you further comments without being inhibited by the views which I express.

Recommendation No. 40: I think it is desirable to have a Government resolution on foreign investment. As you know, there is a twenty-year-old statement by the Prime Minister on the subject, and one or two subsequent pronouncements by Finance Ministers. A new statement is clearly called for, in order to bring the statement in line with current policy, to consolidate at one place points which are covered by different statements and above all to provide a clear formulation in terms of which both Government officials and intending investors can operate. As it is, every decision assumes an *ad hoc* character and if criticized has to be defended without the sheet anchor of a policy statement. In regard to the substance of such a statement, Government have much more to contribute than the Reserve Bank. However, in the present context of a large number of old British interests wanting to sell out, I think we should reserve to ourselves some freedom to regulate such repatriation over a number of years. We cannot be bound forever by assurances given by the UK when the bulk of our sterling balances were blocked, and when they had given us the facility that capital repatriation would be debited to the blocked account and not to the free portion. I.G. is aware of my thinking on the subject.

Recommendations 45 to 51: I do not want to comment on these in detail and shall content myself with a few observations. It may not be altogether practicable to defer a C.G. Committee decision till the very end because a lot of the arrangements necessarily follow and cannot precede a C.G. clearance. So far as foreign exchange for studies abroad is concerned, the real point to ensure in order to avoid inconvenience, dislocation and harassment is that any change of policy which intensifies restrictions is notified one clear academic year before it is enforced. Stability for three yeas will not, by itself, help. It is inadequacy of notice which is important. Regarding accounts for medical treatment, like all other types of rendering of accounts, there is the danger of the persons concerned, particularly those who have not used medical treatment as an excuse, being subjected to a lot more of botheration than would be justified. Perhaps, we should have a certain scale of living expenditure which we would admit without details. For medical expenses, we can insist on vouchers. However, I would regrettably add that doctors, in many countries, charge a higher fee if receipts are asked for. So improved accounting may well mean higher foreign exchange expenditure. Finally, you may wish to have a look at the noting on the file relating to Tarlok Singh's medical expenses where both sides of the case have been argued. Regarding publication of something like a red book to indicate policies and procedures governing release of foreign exchange for invisible items, I am wholly in favour of it. I know it will mean a lot of botheration to the Reserve Bank staff. I also know that there is an Exchange Control Manual, but something which the public can have access to and understand is clearly necessary.

Recommendation 52: Calling for the abolition of P form control is the most controversial proposal. I.G. has asked me for my personal views. I shall try to see if I can put them down on paper before I go.

Recommendation 53: I agree that further simplification of capital issues procedures would be desirable. Regarding the closed season, my own thinking and the current thinking in the Reserve Bank is in favour of much greater freedom than has existed so far. Adarkar will write to you after discussing with Seshadri. However, I want to make one point. I think knowledge of the parties who are intending to make capital issues is available not only to Government but also to the public. The sanctions given by the Controller give useful information to the Stock Exchange and to the investors. I feel, therefore, that while application for permission should be dispensed with over as wide a range as possible, a system of giving notice to the Controller for a reasonable period before the issue would be worthwhile retaining. Whether it should be one month or three months is a matter which the experts can advise on better.

Yours sincerely,
L.K. Jha

Shri V.K. Ramaswami
Economic Advisor, Department of Economic Affairs
Ministry of Finance, Government of India, New Delhi

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BOMBAY
September 17, 1968

My dear I.G.,
You had asked me for my personal views on the ARC recommendation for the abolition of the P form. Hence this letter written in Delhi a couple of days before I leave and without any figures which you will have to call for from Bombay.

Let me say, at the outset, that basically the decision has to be at a high political level because the dominant considerations are not technical in nature. Whether we decide to retain the control, to tighten it, to liberalize it or to abolish it, there will be some undeserving beneficiaries of the policy and some who will suffer through no fault of theirs. Ultimately, the question will be one of deciding whether it would be better in the event to let a lot of unscrupulous people benefit in order that no honest man should suffer, or whether we should keep the restrictions as tight as possible to avoid abuses even though it may cause discontentment and perhaps even harassment to innocent citizens. A relevant factor to remember is that it is not a problem affecting the masses but only certain classes which include intellectuals, artists, politicians, businessmen and their wives as well as smugglers and blackmarketeers.

In any examination of the question it is important to remind ourselves that the P form was not intended to save foreign exchange. It was intended to prevent the acquisition of foreign exchange in the blackmarket for meeting travel expenses. Therefore, the question how much foreign exchange does the P form save is not relevant. What is relevant is an estimation of the illicit acquisition of foreign exchange which it prevents. Such an estimation is very difficult to make for obvious reasons. However, it would be correct to say three things. Firstly, the amount of illicit foreign exchange going into travel with or without P form and on account both of people who travel on a P form and people who travel with foreign exchange is a relatively small fraction of illicit foreign exchange involved in other operations, particularly smuggling. Secondly, it is by no means easy to any whether, if travel became freer, the totality of foreign exchange going into illicit channels would increase or there would only be a diversion from say smuggling to travel. Thirdly, with the very high cost of air tickets after devaluation and taking into account the fact that such a large number of Indians do manage to go out of India each year on business, for health, as members of delegations and under P form clearance, perhaps the pent-up demand for travel on account of people who would and could acquire foreign exchange in the blackmarket is not as great today as it was sometime ago. Having said all this, the fact does remain that if P form were to be abolished, there would be an increase of an indeterminate order in the amount of blackmarket foreign exchange being used for travel.

Looking at this question from another angle, I cannot help expressing the personal view that the location of a P form control in the Exchange Control Department of the Reserve Bank has not been an altogether happy decision. The

Reserve Bank is certainly equipped to exercise exchange control. P form regulations basically are a form of control on travel rather than on foreign exchange. True, the objective of the control is linked with foreign exchange. Measures through which the objective is to be attained are administrative in character. Thus, whether a man should be allowed to go on an invitation from a first degree blood relation or a third degree blood relation, whether he should accept the hospitality of a foreign government or a foreign institution or a foreign individual are matters in which Reserve Bank has little contribution to make. All the relevant decisions are, therefore, taken by the Government. Yet the administration is with the Reserve Bank. Because of the pressing nature and urgency of dealing with these applications, I feel the Exchange Control Department of the Reserve Bank is sometimes unable to bestow adequate attention to important cases in which large sums of foreign exchange are involved. In retrospect, I cannot help feeling that the regulation of travel is more appropriately a matter for Governmental agencies than for the Bank which could have been consulted occasionally if there were questions where it had any special knowledge. Whether in the event of a decision to retain P form control as a long-term feature of our policy, a change should be made is a matter on which I have no definite views. In the previous examination of the question of P form in the Reserve Bank in the recent past, our view has been that as a long-term measure it would not be justifiable to maintain a total ban on travel except for specific purposes for which adequate foreign exchange could be released such as business, education and health. Thinking has been in the direction of allowing individuals to go out not more than say once in three years with a limited amount of foreign exchange on austerity standards and for a limited period of time. Such a long-term solution may have to be introduced sooner or later, but whether we should do it so now or not is a matter on which no one can be dogmatic. However, if we decide to do so, then I would not see any reason to abolish the P form. We could tell people that opportunities to go abroad are not restricted to those who can conveniently arrange an acceptable invitation, and the discipline of going out only once in a few years could be applied to those who go on P form or with foreign exchange alike—unless, of course, there were specific reasons to justify additional journeys.

On the other hand, if the view were taken that we cannot promise even a limited amount of foreign exchange at an interval of number of years to anyone for the asking, then I would favour the idea of permitting anyone to go out on any invitation but only once in say three years. This would do away with the criticism that those who are in the fortunate position of having a close relation abroad can make many journeys while those whose relationship may be even more intimate, but is perhaps one degree removed in terms of blood, cannot have similar opportunities. In other words, a possible formula might be that anyone can go out on any invitation once in three years and no one can go out oftener unless there is justification for it. If this line of approach is accepted, a fair amount of detailed work will have to be done in the Bank to ensure a proper enumeration of the kind of cases where more frequent journeys would be permissible.

If neither of these alternatives is considered desirable at present, then we could certainly apply our minds to what I would call administrative simplification. The object of such a study would be to avoid harassment to those who do not know the rules too well and abuse by those who know how to get round the rules. If this approach is accepted, then we would need to set up a small working group of the officers of RBI and the Government. Such a study team would have to have a clear sense of direction because if such a group gets overzealous in plugging loopholes, it may end up by making the restrictions much more complicated and stringent, and if it starts with the exclusive object of removing hardship in all genuine cases, it may recommend a degree of liberality which may not be acceptable.

You will observe from what I have stated above that I have recommended no definite course but merely referred to a number of alternatives. This is because, as I said at the beginning, the decision has to be based on considerations which are wider than those which come within my purview. However, if I were to look at the question in a somewhat wider perspective than of exchange control, I would say that much of the criticism and discontent against P form control stems from two factors. Firstly, people feel specially in view of the judicial pronouncement on passports that a total embargo on going out of India except for certain approved purposes or in terms of rigid P form control, is not justified as a long-term measure. Secondly, there is the growing feeling that if P form is meant to stop access to the blackmarket for travel purposes, it is not really serving its purpose. For the kind of people who are wealthy enough to afford a holiday abroad with blackmarket foreign exchange are anyhow able to go out by complying with our procedures and requirements, and the kind of people who could not possibly afford such a jaunt are not able to go because the evidence of hospitality which they can produce does not conform to the kind of regulations which have been prescribed. As you know, in order to weed out spurious invitations, only a few categories of people are accepted as eligible hosts. Hospitality from people outside these categories, even though they may be men completely above suspicion, is ruled out because it is difficult for a controller to distinguish between one foreigner and another on the basis of his reliability and integrity. The real question is how far Government are prepared to go to remove these two grievances.

If you were to ask me that if I had the responsibility of taking a decision, my answer would be that I would announce that a P form, without question, will be given to all those who have not gone abroad for the last five years. I would see how many people take advantage of this in the coming eight to nine months. If the number is not too large as I suspect it would not be, then one could develop this policy further and we may well find that once the pent-up passion for travel is gone, the number of people who have to be restrained through P form may become too insignificant for the control to be continued. Once the size of the problem is known, one could even think in terms of giving a few pounds per traveller who would otherwise have to go out of the country more or less as a destitute. As it is, of the P form applications received, a very high percentage is being approved because they conform to our requirements. No one can say whether this is because knowing our regulations those who are not covered by them do not apply, or whether this is because the number of ineligibles wanting to travel on P form is not too large. No amount of studies can provide an answer to this question. A bold experiment would be justified. In the light of it, we could shape future policy.

Yours sincerely,
L.K. Jha

Dr I.G. Patel
Special Secretary to the Government of India
Ministry of Finance
Department of Economic Affairs
New Delhi

APPENDICES

APPENDIX 1

Key Events: 1967–1981

1967

2 January

M.R. Bhide, Deputy Governor, appointed as Chairman of the Life Insurance Corporation of India.

February

Industrial dispute between Reserve Bank of India and its workmen employees; Justice T.L. Venkatarama Aiyar appointed as arbitrator.

17 April

Size of currency notes reduced to economize the cost of imported currency note paper.

28 April

Reserve Bank's directive dated 28 October 1966 on credit expansion by banks ceases to operate.

April

Union Budget for 1967–68 seeks to limit the outlays of the central government strictly to resources that can be mobilized in a non-inflationary manner.

May

Committee on Foreign Collaboration under the chairmanship of Dr A. Ramaswamy Mudaliar submits its Report.

1 July

L.K. Jha appointed Governor of RBI.

Post of Secretary in RBI upgraded.

The Companies Tribunal (Abolition) Act, 1967, abolishes the Companies Tribunal set up under the Companies (Amendment) Act, 1963, and restores the old scheme of vesting jurisdiction in the central government or the court.

17 July

The Deposit Insurance Corporation (Amendment) Bill, 1967 introduced in the Lok Sabha with a view to extending the scheme of deposit insurance to cover state and central cooperative banks and larger primary non-agricultural credit societies, i.e. urban cooperative banks, with paid-up capital and reserve of Rs 1 lakh or more.

31 July

Branch expansion programme of banks extended by two years.

18 August

Monopolies and Restrictive Trade Practices Bill introduced in Rajya Sabha.

October

ECGC introduces a new guarantee known as the 'export performance guarantee' to serve as a counter-guarantee to banks in India, to enable them to give more credit freely.

November

The Reserve Bank provides certain guidelines in regard to bank advances against shares for creating a better climate in the capital markets, with a view to secure better alignment of the banking system with the need for economic planning.

2–4 December

Fifth Indian Cooperative Congress held at New Delhi.

14 December

Deputy Prime Minister and Minister of Finance announce in the Lok Sabha that the government will soon set up a commission to examine and report on matters that affect development of the banking industry.

22 December

National Credit Council (NCC) set up to assess the demand for bank credit, to determine priorities for the grant of loans and advances, to coordinate lending and investment policies as between commercial and cooperative banks, to consider other allied issues.

23 December

Banking Laws (Amendment) Bill, 1967 introduced in Lok Sabha following announcement of the policy of social control over banks with a view to secure better alignment of the banking system with the needs of economic policy, to introduce necessary reforms in banking in order to remove deficiencies, and to promote more purposeful distribution of credit consistent with basic economic and social objectives.

1967

Steering Group on Framework for Incomes, Price Policy under the chairmanship of Dr B.K. Madan submits Report.

Study Group for Banking Industry under the chairmanship of B.N. Adarkar constituted. (Report submitted in 1968.)

Working Group on Industrial Financing through Cooperative Banks (Part I) constituted under the chairmanship of P.N. Damry. (Report submitted in 1968.)

1968

1 January

Deposit insurance cover raised from Rs 1,500 to Rs 5,000.

2 March

Bank rate reduced to 5 per cent from 6 per cent.

16 March

First meeting of the National Credit Council and appointment of a Standing Committee with Governor, RBI, as chairman.

24 March

Agreement between Government of India and Governments of the Gulf states of Qatar, Dubai, Abu Dhabi Ajman, Sharjah, Ummal Qaiwan, Ras al Khaimah and Fujairah, as regards rupee notes returned by them repayable in sterling.

1 April

Demonetization of quaternary coins (the quaternary alloy rupee, half rupee, quarter rupee and cupro-nickel four-annas 'scalloped' coins).

April

Government of India appoints a Working Group to draw up a model scheme for the working of the Agricultural Credit Corporation proposed to be set up, as per the recommendation of the Informal Group on Institutional Arrangement for Agricultural Credit in the states of Assam, West Bengal, Bihar, Orissa and Rajasthan and the Union Territories of Manipur and Tripura, where the cooperative credit structure was considered to be weak.

1 May

The Bill for setting up the Agricultural Credit Corporation passed in Parliament.

3 May

The Companies (Amendment) Bill, 1968 introduced in Parliament for abolishing the system of managing agencies, as well as of Secretaries and Treasurers.

31 May

The first amendment to the Articles of Agreement of the International Monetary Fund approved by the Board of Governors. The First Amendment helped the IMF to introduce facilities based on SDRs in the Fund.

15 June

RBI announces Export Credit (Interest Subsidy) Scheme.

1 July

Public Provident Fund Scheme set up to be operated by the Union government through the agency of the State Bank of India and its subsidiaries.

24 July

Second Meeting of the National Credit Council and setting up of five Study Groups for further study on issues like deposit mobilization by banks, credit needs of industry/trade, organizational set-up for social control of banks, adoption of area/project approach in extension of credit and finance for road transport operators.

15 August

The Central Laws (Extension to Jammu and Kashmir) Act, 1968 becomes effective for making the Companies Act, 1956 applicable to all categories of companies in the state of Jammu and Kashmir.

1 September

Gold (Control) Act, 1968 passed to bring the administration of the control on a permanent statutory footing.

19 October

Diplomatic bond store accounts introduced. Authorized dealers could open such accounts in the names of foreign diplomats or trade missions in India.

27 December

The Deposit Insurance Corporation (Amendment) Bill, 1968 comes into force. The Bill proposed to extend the scheme of DI to cover state, central and larger primary non-agricultural credit societies, i.e. urban cooperative banks with paid-up capital of Rs 1 lakh or more.

1968

Without Reserve, house journal, introduced in the Bank; the name was given by G.I.S. Pais.

Agricultural Finance Corporation Ltd. incorporated.

Banking Laws (Amendment) Act, 1968 prescribing the constitution of the Board of Directors of banks comes into force.

Study Group on Area/Protect Approach in Implementing Schemes for Extending Commercial Bank Credit to Agriculture (including commercially viable projects in the Rural Electrification and Minor Irrigation Fields) constituted under the chairmanship of P.N. Damry. (Report submitted in 1969.)

Study Group on the Extent to which Credit Needs of Industry and Trade are likely to be inflated, and how such trends can be checked, constituted under the chairmanship of V.T. Dehejia. (Report submitted in 1969.)

Study Group on the Provision of Credit Facilities for Road Transport Operators constituted under the chairmanship of B.K. Dutta. (Report submitted in 1969.)

Study Group on Deposit Mobilization by Commercial and Cooperative banks constituted under the chairmanship of T.A. Pai. (Report submitted in 1969.)

Working Group on Banking Statistics (V.G. Pendharkar and others) set up to prescribe form for collection of data on sectoral allocation of credit. (Report submitted in 1968.)

Study Group on Export Credit System in India under the chairmanship of Yoshi Aki Toda. (Report submitted in 1968.)

Study Group on Organizational Framework for the Implementation of Social Objectives constituted under the chairmanship of Dr D.R. Gadgil. (Report submitted in 1969.)

1969

January

Pre-shipment Credit Scheme introduced. Refinance in regard to packing credit for exporters to be given under the amended Section 17(3A) of RBI Act, 1934 and not under Section 17(4)(C) as earlier. The change was meant to allow banks to get refinance from the RBI by giving declarations.

29 January

Banking Commission set up by Government of India with R.G. Saraiya as chairman. (Report submitted on 9 February 1972.)

1 February

Gold held in Issue Department of Reserve Bank of India revalued.

21 April

New draft of the Fourth Five-Year Plan (1969–74) presented in Parliament.

28 May

Company's (Amendment) Act, 1969 enacted, banning contribution to/for political parties/purposes.

19 July

The Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1969 (8 of 1969) promulgated.

Nationalization of fourteen major Indian scheduled commercial banks.

25 July

Banking Companies (Acquisition and Transfer of Undertakings) Bill, 1969 introduced in Lok Sabha.

1 September

RBI prescribes the pattern of interest on bank deposits, and prohibits payment of interest on current accounts and on deposits for a period of up to fourteen days as well as payment of brokerage on deposits.

24 September

National Institute of Bank Management (NIBM) registered under Societies Registration Act, 1860.

29 September

Cooperative Bankers Training College (CBTC) at Poona commences its first course.

November

Split in the Congress party.

December

Lead Bank Scheme introduced after considering the recommendation of the Study Group (with Prof D.R.Gadgil as chairman) and the Nariman Committee for adoption of an area approach for development of banking and credit structure.

1969

Expert Group on State Enactments having a bearing on Commercial Bank Lending to Agriculture constituted under the chairmanship of R.K. Talwar. (Report submitted in 1969.)

Study Group on Indigenous Bankers constituted under the chairmanship of H.T. Parekh. (Report submitted in 1971.)

Committee on Branch Expansion Programmes constituted under the chairmanship of F.K.F. Nariman. (Report submitted in 1969.)

Working Group on the Insurance of Loans and Advances granted by Commercial and Cooperative banks to certain priority sectors constituted under the chairmanship of S.S. Shiralkar. (Report submitted in 1969.)

Study Group on Banking Costs constituted under the chairmanship of Rameshwar Thakur. (Report submitted in 1971.)

1970

1 January

First allocation of special drawing right (SDR) by IMF for smooth functioning of international monetary system. Allocation to India in the first year worked out to about $131 million.

21 January

RBI removes the ceiling rate of interest on advances given by large scheduled commercial banks except for export credit.

January

RBI prescribes for the first time minimum interest rate to be changed by banks on advances against sensitive commodities.

5 February

Statutory liquidity ratio maintained by banks raised from 25 to 26 per cent by March 1970 (further raised by stages up to 28 per cent by August 1970).

10 February

Supreme Court strikes down the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969.

14 February

Fresh ordinance to take over undertakings of all selected fourteen banks with effect from the original date, viz. 19 July 1969.

February

Agricultural Credit Board set up within RBI by reconstituting the standing Advisory Committee on Rural and Cooperative Credit with fourteen members and the Governor as chairman.

1 March

Foreign Travel Scheme revised to allow residents to travel abroad without 'P form' formalities, provided they had not been outside India (except Nepal) during the three-year period prior to the date of the trip to be undertaken.

31 March

Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970), receives assent of the President of Indai.

1 April

Deposit insurance cover raised from Rs 5000 to Rs 10,000 per depositor in the same right and in the same capacity.

3 April

Managing agency system abolished by the Companies (Amendment) Act, 1969.

16 April

Non-resident (External) Account established for private individuals of Indian nationality or origin, resident outside India.

24 April

SLR raised from 26 to 27 per cent.

April

RBI approves issuance of participation certificates (PCs).

4 May

B.N. Adarkar appointed RBI Governor.

8 May

Indian currency retired from the Sultanate of Muscat and Oman because they introduced their own national currency.

1 June

Monopolies and Restrictive Trade Practice Act, 1969 comes into force.

16 June

S. Jagannathan appointed RBI Governor.

18 July

Central government reconstitutes Board of Directors of each of the fourteen nationalized banks under Section 7(3)(a) of the Banking Companies (Acquisition and Transfer of Undertaking) Act, 1970. The newly constituted Boards include a representative each from the Reserve Bank of India and Government of India, and a few non-officials.

2 August

Monopolies and Restrictive Trade Practice Act, 1969, Commission set up.

28 August

SLR raised from 27 to 28 per cent. Also NLR on excess borrowings from RBI raised from 32 to 33 per cent.

September

Committee on Differential Interest Rates constituted under the chairmanship of Dr R.K. Hazari to examine the question of differential rates for favouring borrowers of low income groups. (Report submitted on 25 March 1972.)

October

Study Group on Term Loan Participation Arrangement constituted under the chairmanship of K.N.R. Ramanujam. (Report submitted in 1971.)

FAO commemorative coins in the denomination of Rs 10 and 20 paise issue by Government of India through the offices of RBI to celebrate the twenty-fifth anniversary of the Food and Agriculture Organization.

1 November

New Bills Rediscounting Scheme introduced under Section 17(2)(a) of Reserve Bank of India Act becomes effective.

December

Standing Committee (I) set up by the RBI.

Parliament dissolved and general election was called for.

1970

Working Group on Financing of Industrial Estate set up with K.N.R. Ramanujam as chairman. (Report submitted in 1972.)

Reserve Bank of India Officer Cadre Review Committee set up with Justice J.L. Jain as chairman. (Report submitted in 1972.)

Working Group on Resource Mobilization, Profitability etc. of State Financial Corporations constituted under the chairmanship of K.N.R. Ramanujam. (Report submitted in 1970.)

Committee to Review the Special Credit Schemes of banks with particular reference to their Employment Potential constituted under the chairmanship of V.D. Thakkar. (Report submitted in 1970.)

Study Group on Enlarging the use of Bill of Exchange as an instrument of credit and Creation of Bill Market constituted under the chairmanship of M. Narasimmham. (Report submitted in 1970.)

Study Group on Bank Procedures constituted under the chairmanship of D.R. Joshi. (Report submitted in 1971.)

1971

1 January

Second allocation of SDRs made by the IMF.

9 January

Bank rate changed from 5 per cent to 6 per cent.

14 January

Credit Guarantee Corporation of India Ltd. promoted by RBI to administer one or more credit guarantee schemes.

January

Standing Committee (II) set up by RBI to advise the Agricultural Credit Board in regard to long-term credit for agriculture.

March

Military crackdown in East Bengal leads to serious financing problem for evacuees seeking refuge in India.

In the general elections that characterized the use of the slogan 'Garibi Hatao' (abolish poverty), landslide victory for Congress (Indira).

1 April

Credit Guarantee Corporation of India (Small Loans) Guarantee Scheme, 1971 brought into force.

8–10 April

Sixth Indian Cooperative Congress at New Delhi.

12 April

Industrial Reconstruction Corporation of India Ltd. promoted by IDBI registered as a public limited Company with headquarters at Calcutta.

Committee on Differential Interest Rates submits its Report to Government of India. (Government announces its decision on 25 March 1972.)

30 June

Old Bill Market Scheme closed.

1 July

Credit Guarantee Corporation of India Small Loans (Financial Corporations) Guarantee Scheme, 1971, introduced.

Deposit Insurance Corporation cover extended to 385 cooperative banks in the states of Maharashtra, Madhya Pradesh, Andra Pradesh and Union Territory of Goa, Diu and Daman.

Andhra Pradesh Chit Funds Act, 1971 comes into force.

15 August

Convertibility of the US dollar suspended.

22 August

Government of India announces that the gold and therefore dollar parity of the Indian rupee will remain unchanged. RBI announces that it will both buy and sell the pound sterling for ready delivery at rates to be determined every day on the basis of US dollars 13.3333 per Rs 100, and the standing value of that dollar equivalent at the London markets' spot rates for dollars plus $0.0175.

23 August

Rupee repegged from sterling to the US dollar.

August

India–Soviet Union Treaty for mutual support in the event of an attack by a third party.

1 October

Deposit insurance premium reduced to 4 paise per Rs 100 of assessable deposits.

Credit Guarantee Corporation of India (Service Cooperative Societies) Guarantee Scheme, 1971 introduced.

October

State-level Bankers' Committees set up to consider problems requiring inter-bank coordination.

18 December

Smithsonian Agreement concluded by rich industrial countries (G-10) for realignment of exchange parities. The US dollar devalued in terms of gold to $38 per ounce of gold as against $35 per ounce earlier.

20 December

Rupee repegged from US dollar to sterling. A central rate for the rupee in terms of sterling at Rs 100 = $5.2721 adopted by the government as a result of the Smithsonian Agreement, and the IMF notified that it would also take advantage of the wider band of 2.25 per cent on either side of this rate for buying and selling rate for sterling in $5.285 and $5.2592 per Rs 100 for buying and selling respectively.

December

Study Group on greater exchange of credit information among banks recommends establishment of a central agency in the form of an autonomous body called Credit Information Trust.

RBI asked banks for relaxations in credit limits as well as Credit guarantee provisions in view of the abnormal situation created by Indo-Pakistan conflict.

1971

East Pakistan army surrenders to the Indian army—Bangladesh comes into being.

Working Group on Finance for Tea Industry set up with B.K. Dutt as chairman. (Report submitted in 1972.)

1972

1 January

Third allocation of SDR made under the first basic period.

9 February

Banking Commission submits its report to Government of India.

25 March

Government of India announces concessional interest rates on advances by public sector banks to selected low income groups (Differential Interest Rate Scheme). The differential rate of interest is fixed uniformly at 4 per cent, i.e. 2 per cent below the Bank rate.

3 April

Import policy for 1972–73 stresses the importance of achieving self-reliance.

April

Committee on Banking Statistics set up with A. Raman as chairman. (Report submitted in 1972.)

April–May

Third United Nations Conference on Trade and Development (UNCTAD-III) at Santiago passes resolution concerning international monetary system.

23 June

Pound sterling left to float and exchange control imposed by UK virtually puts an end to the sterling area.

UK decides to join the European Economic Community.

26 June

The RBI's buying and selling rates for spot sterling fixed at 5.2910 and 5.2632 per Rs 100 respectively in view of the decision of the UK to allow the sterling to float on the exchanges.

26 July

Committee of Twenty established to work out international monetary reforms.

4 August

Minimum liquidity requirement increased to 29 per cent. NLR raised to 34 per cent.

August

Commemorative coins in connection with the twenty-fifth anniversary of Indian independence issued in denominations of Rs 10 and 50 paise.

3 November

Classification of foreign countries into two categories for purposes of the Indian Exchange Control: (a) External Account Countries (b) Bilateral Account Countries.

17 November

Minimum liquidity requirement raised to 30 per cent.

December

Basic Statistical Returns (BSR) Scheme introduced in place of Uniform Balance Book (UBB) with coverage in terms of deposits and advances of scheduled commercial banks.

1972

Introduction of combined seniority for Class III and officer staff.

Reserve Bank of India Act, 1934 and ARC Act, 1963 amended for enabling the RBI to grant long-term loans to the Corporation from the long-term operation fund.

Banking Laws Committee under the chairmanship of Dr P.V. Rajamannar constituted by the government for review of laws affecting and concerning banks.

Study Team on Cooperative Agricultural Credit Institutions in Maharashtra set up with Dr C.D. Datey as chairman. (Interim report submitted in 1974.)

Study Team on Overdues of Cooperative Credit Institutions constituted. (Report submitted in 1974.)

Committee on Delayed Payment of Bills of Small Industries on Government Departments and Large Industries set up with K.N.R. Ramanujam as chairman. (Report submitted in 1972.)

Working Group on Finance for the Coal Industry set up with P.C.D. Nambiar as chairman. (Report submitted in 1972.)

Study Team on the Two-Tier Cooperative Credit Structure in Kerala constituted with Dr C.D. Datey as chairman. (Interim report submitted in 1973.)

General insurance companies nationalized.

1973

1 January

UK enters the European Economic Community.

February

Second formal devaluation of the US dollar.

March

RBI deploys a series of restricted measures to contain the expansion of bank credit.

17 March

All advances to various public sector and quasi-government undertakings including State Electricity Boards, as also advances against the guarantee of central and state governments, brought under the purview of the RBI's Credit Authorization Scheme.

30 March

NLR raised to 37 per cent.

19 April

Economic Commission for Asia and Far East approves the proposal for setting up an Asian Clearing Union.

31 May

Bank rate revised from 6 to 7 per cent; CRR raised from 3 to 5 per for a period of one year ending 28 June 1974 with provision for payment of interest at the rate of 4.75 per cent per annum on such additional reserve, raised further to 6 per cent with effect from 8 September 1973 and 7 per cent with effect from 22 September 1973, to remain in force till last Friday of September 1974.

29 June

NLR raised to 39 per cent from 37 per cent.

13 July

Concessionary refinance entitlements withdrawn with the exception of (i) a limited amount of refinancing of export credit and (ii) refinancing credit given to primary cooperative societies and farmers' service societies.

1 September

Miscellaneous Non-Banking Companies (Reserve Bank) Direction, 1973 becomes effective. Directives sought to regulate the acceptance of deposits by companies under certain schemes.

19 September

The Foreign Exchange Regulation Act, 1973 enacted by replacing, with effect from 1 January 1974, the Foreign Exchange Regulation Act, 1947.

22 September

CRR raised to 7 per cent.

5–24 September

At the Committee of Twenty and annual meetings of the IMF, it becomes clear that there would be no early agreement on reforming the international monetary system.

1 October

'Pre-zero sterling accounts' (i.e. resident of India holding sums in pound sterling accounts prior to 8 July 1947 who had been permitted to maintain these accounts in sterling and to make foreign or domestic transfers out of them without special permission from the Reserve Bank) required to be repatriated before 1 November 1973.

10–17 October

Six members of OPEC increase crude oil prices by about 70 per cent.

16 November

Maximum rate on borrowing from RBI stepped up from 12 to 15 per cent (applicable to net liquidity ratio level of below 33 per cent).

November

Amendment of State Bank of India Act, 1955 and SBI (Subsidiary Bank) Act, 1959 receives the assent of the President. Amendment removes some restrictions as to the kind of bank's business along with other issues of internal management.

8 December

SLR raised from 30 to 32 per cent.

13 December

Call money market rate shoots up to all-time high of 30 per cent and the Indian Banks' Association has to intervene and fix a ceiling rate of 15 per cent.

23 December

Six OPEC members announce further hikes in the prices of crude oil.

24 December

RBI (Amendment) Bill 1973 introduced. Bill envisages extension of the scope of refinance facilities from RBI to scheduled commercial banks and state cooperative banks.

Form of balance sheet set out in the third schedule of the BR Act amended requiring banks to show inter-bank deposits as a separate item and foil window dressing by banks at the end of the year.

1973

Coal industry nationalized.

Committee on Cooperative Land Development Banks set up with K. Madhava Das as chairman. (Report submitted in 1974.)

Study Group on Extension of Credit Limits on Consortium/Participations Basis set up with G. Laxminarayanam as chairman. (Report submitted in 1974.)

Committee to Review the System of Lending under Consortium Arrangement set up with J.V. Shetty as chairman. (Report submitted in 1973.)

Study on Financing the Crash programme for the Development of Sericulture in Karnataka made by B. Venkata Rao.

Working Group on Export Financing including Deferred Payment set up under the chairmanship of M. Narasimham. (Report submitted in 1973.)

1974

1 January

Foreign Exchange Regulation Act, 1973 came into force.

1 April

The Reserve Bank raises the ceiling rate on savings deposits from 4 to 5 per cent, and the maximum rate on deposits for a period exceeding five years from 7.25 to 8 per cent to encourage savings.

Interest payable by RBI to commercial banks on additional deposit under Section 42(1) of RBI Act raised from 4.75 to 5.25 per cent.

4 April

India signs agreement to set up an Asian Clearing Union at ECAFE session in Colombo. Agreement came into force on 9 December 1974.

12–13 June

It is agreed to set up an Interim Committee at the IMF. Also agreed to have a method of valuing SDRs, guidelines for exchange rate floating, oil facility and early adoption of an extended fund facility.

June

Study Group to examine the Working of Control over Non-banking Companies constituted under the chairmanship of James S. Raj. (Report submitted in 1974.)

July

Measures to contain inflation initiated vigorously.

22 July

RBI announces a package of measures to contain credit expansion. Bank rate stepped up by 2 percentage points to a record level of 9 per cent.

Maximum rate of borrowing from RBI increased from 15 to 18 per cent.

Premature withdrawal of deposit to carry interest at least 2 per cent less than the rate applicable to the period for which the deposit had remained with a bank.

RBI prohibits banks from payment of interest on savings bank accounts opened in the name of any trading and business concern. (RBI directive of 17 June 1981 exempted organizations engaged in socially desirable activities, societies, etc.).

RBI announces general hike in structure of interest rates covering both lending and deposits. Maximum rate on fixed deposits of over five years raised from 8 to 10 per cent with effect from 23 July 1974.

29 *July*

CRR lowered from 7 to 5 per cent, SLR raised from 32 to 33 per cent.

July

Study Group to frame guidelines for follow-up of bank credit constituted under the chairmanship of Shri Prakash Tandon. (Report submitted on 9 August 1975.)

1 July

New basket of sixteen currencies for valuing SDRs introduced.

13 September

Extended fund facility (EFF) established in the IMF.

2 October

Interim and Development Committees set up.

22 *November*

RBI issues directives to regulate the interest payable by cooperative banks on deposits.

9 December

Asian Clearing Union established and its clearing operation to be denominated in member's currency or AMU which would be equivalent to one SDR.

Union of Burma Bank, Rangoon established.

13 December

Reserve Bank of India (Amendment) Act, 1974 with amendments of the provisions of Chapter IIIB of the RBI ACT, 1934, vesting the Bank with greater powers to exercise control over non-banking institutions receiving deposits and financial institutions, comes into force.

14 December

CRR reduced from 5 to 4.5 per cent.

28 December

CRR reduced to 4 per cent from 4.5 per cent, NLR lowered to 39 per cent.

1975

1 January

Capital of Deposit Insurance Corporation raised to Rs 2 crore.

1 February

The Companies (Amendment) Act, 1974 inserting a section 58A in the Companies Act, 1956, to regulate acceptance of deposits by non-banking companies, comes into force.

3 February

The Companies (Acceptance of Deposits) Rules, 1975 comes into force.

March

'Customer Service in Bank'—Working Group appointed by Government of India. (Report submitted in 1977.)

14 March

An oil facility for 1975 established in IMF.

19 May

N.C. Sengupta appointed RBI Governor.

1 August

A subsidy account set up to assist countries affected by the cost of using the 1975 oil facility.

9 August

Study Group to frame guidelines for follow-up of Bank Credit, constituted in July 1974 (chairman: Shri Prakash Tandon), submits Report.

20 August

K.R. Puri appointed RBI Governor.

31 August

Interim Committee agrees upon sale of one-sixth of the Fund's gold (25 milllion ounces) for benefiting developing countries, setting up of a Trust Fund, and restitution of one-sixth of the Fund's gold to all the members.

1 September

Rupee repegged from pound sterling to a weighted basket of currencies; margin would be maintained within 2.25 per cent on either side.

25 September

Exchange value of rupee delinked from sterling and linked to movements in a basket of selected foreign currencies (major trading partners).

26 September

Promulgation of Regional Rural Banks Ordinance, 1975. (Later replaced by Regional Rural Bank Act, 1976.)

2 October

Establishment of first regional rural banks (RRBs) in Uttar Pradesh.

1 November

Asian Clearing Union (ACU) commences clearing operations.

Foreign Currency (Non-Resident) Accounts Scheme in US dollar and pound sterling introduced for protecting the exchange risk of depositors who are non-resident Indians and persons of Indian origin.

Net liquidity ratio system of borrowing discontinued and basic refinance limit introduced.

FC(NR) Accounts Scheme: non-resident Indians and persons of Indian origin resident abroad permitted to open and maintain foreign currency (non-resident) accounts in designated foreign currencies.

15 November

Agricultural Refinance (Amendment) Act, 1975 comes into force and Agricultural Refinance Corporation renamed as Agricultural Refinance and Development Corporation; the change seeks to enlarge the activities of the Corporation.

29 November

Directives to non-banking financial companies amended, further extending time to liquidate deposits held in excess of the prescribed ceiling.

13 December

Banking Regulation (Companies) Rule, 1949 amendment prescribing the forms for reporting information by banking companies comes into force.

1975

Committee of Direction (consisting of senior representatives of Reserve Bank, State Bank and some other banks) constituted by RBI for an ongoing review of the lending norms recommended by the Study Group on follow-up of Bank Credit.

Committee on integration of Cooperative Credit Institutions under the chairmanship of Dr R.K. Hazari set up. (Report submitted in 1975.)

Study Team on the Working of the Exchange Control Department constituted. (Report submitted in 1975.)

Final Report of the Study Team on Cooperative Agricultural Credit Institutions in Maharashtra under chairmanship of Dr C.D. Datey submitted.

Study Group on the Working of the Lead Bank Scheme in Gujarat and Maharashtra constituted under the chairpersonship of Dr (Kum.) Meenakshi Tyaggarajan. (Report submitted in 1975.)

Companies (Acceptance of Deposits) Rules, 1975.

Working Group on Regional Rural Banks set up with M. Narashimham as chairman. (Report submitted in 1975.)

High Power Committee for Examining Bank Credit Problems of Small-Scale Industries constituted with I.C. Puri as chairman. (Report submitted in 1978.)

Committee on Integration of Cooperative Credit Institutions under the chairmanship of Dr R.K. Hazari set up. (Report submitted in 1975.)

Study Team on Cooperative Agricultural Credit Institutions in Maharashtra under chairmanship of Dr C.D. Datey submits final report.

1976

1975–76

Commodity prices record a decline of 6 per cent, in sharp contrast to an actual rise of 16.8 per cent in 1974–75.

A package of reforms relating to the future of the international monetary system reached at IMF.

Village Adoption Scheme introduced.

A separate comprehensive legislation in place of Chapter III B of the RBI Act, 1934, for the purpose of tightening control over deposit acceptance activities of financial companies, as recommended by the Study Group, accepted.

1 February

Duty drawback credit scheme introduced for grant of interest-free advance up to 90 days by banks to exporters against duty drawback entitlement.

9 February

Regional Rural Banks Act, 1976 (21 of 1976) receives assent of the President.

16 February

IDBI delinked from Reserve Bank of India.

Unit Trust of India which hitherto had been an associate institution of the Reserve Bank of India becomes an associate institution of the IDBI.

15 March

A ceiling on lending rates charged by larger commercial banks imposed so as to bring about on appropriate relationship between the Bank rate and the lending rate. Banks to use their resources more efficiently than before for augmenting incomes

30 April

Governors of the IMF approve Second Amendment of the Articles of Agreement.

April

Working Group on 'Operational efficiency and profitability of banks' constituted with J.C. Luther as chairman. (Report submitted in 1977.)

5 May

Trust Fund established in IMF. Proposal to sell one-sixth of the gold reserves of IMF over a period of two years through auctions to be announced by the Fund. One-sixth of the gold to be restituted to members.

June

Guidelines for charging of penal rates by banks issued.

1 July

Non-Banking Companies (Reserve Bank) Directions, 1977 and Miscellaneous Non-Banking Companies (Reserve Bank) Directions 1977, issued in supersession of the earlier directions, become effective.

Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977 issued by the government come into force.

Deposit insurance cover raised from Rs 10,000 to 20,000.

August

Working Group to examine the special socio-economic factors of the North-Eastern region to identify the factors impeding the flow of bank credit, and to make appropriate recommendation for speedy banking development in the region, set up with Kum. Nalini Ambegaonkar as convenor. (Report submitted in 1977.)

Expert Group on Agricultural Credit Schemes of commercial banks constituted in pursuance of the recommendations of the Estimates Committee of the Fifth Lok Sabha .

15 August

Development-oriented designed coins having a common theme, ‘Food and Work for All’, in the denominations of 50 rupees, 10 rupees issued for sale, and in 10 paise and 5 paise issued for circulation.

4 September

CRR raised from 4 to 5 per cent.

SLR raised from 37 to 38 per cent.

20 October

New two-rupee note with picture of ‘Aryabhatta’ issued with new series.

October

Working Group to study problems arising out of the Adoption of the Multi-agency Approach in Agricultural Financing, and to suggest solutions, set up with C.E. Kamath as chairman. (Report submitted in 1978.)

1 November

Duty Drawback Credit Scheme, 1976 introduced.

13 November

CRR raised to 6 per cent plus 10 per cent of the incremental demand and time liabilities accruing since 14 January 1977, and payment of 5.5 per cent interest on the additionally impounded reserves implemented. SLR raised to 39 per cent.

15 November

Guidelines for the levy of service charge on borrowal accounts (processing fees) issued.

1 December

Exchange Control Cells opened at Bhubaneswar and Gauhati.

1976

Cheques to incorporate two uniform code numbers for banks and bank branches.

High Power Committee constituted to monitor the progress of the Lead Bank Scheme, to issue policy guidelines for effective functioning of the Scheme.

Inter-Institutional Group on Financing of Gobar Gas Plants by banks under the chairmanship of S.N. De submits final report.

Committee on Transfer of Loan Account under the chairmanship of R.K. Talwar submits report.

1977

1976–77

Integrated Rural Development Programme (IRDP) initiated.

The government drops the proposal for amendments to the RBI Act prohibiting the acceptance of deposits by un-incorporated bodies in view of divergent opinions on the constitutionality of the amendment.

Government of India Notification that the current account balances maintained by cooperative banks are to be treated as cash reserves and liquid assets for the purpose of Sections 18 and 24 of the B.R. Act applicable to Cooperative Societies.

14 January

CRR on incremental deposits at 10 per cent imposed.

1 April

Union of Burma Bank, Rangoon joins Asian Clearing Union and designates the Myanmar Foreign Trade Bank, Rangoon for clearing operations.

April

Food for work programme introduced by government.

Money supply with the public introduces new reference series.

2 May

M. Narasimham appointed RBI Governor up to 30 November.

6 May

Compulsory Deposit Scheme for income tax payers extended by two years.

24 May

RBI directs authorized dealers to discontinue the ir discounting of foreign currency usance bills abroad.

27 May

Bill Market Scheme made available on discretionary basis.

31 May

RBI announces changes in the minimum interest rates payable by commercial banks on savings and term deposits.

1 June

The base level not eligible for refinance from RBI raised from Rs 1000 crore to Rs 1500 crore.

June

Committee to study all aspects of the Functioning of Public Sector Banks set up with James S. Raj as chairman. (Report submitted in 1978.)

Guidelines and procedure to be followed for transfer of borrowal accounts among hanks issued.

Review Committee on Regional Rural Banks set up with Prof M.L. Dantawala as chairman. (Report submitted in 1978.)

1 July

Interest rate structure of deposits lowered in selective way for rationalization of the structure.

For the first time, savings bank accounts classified in two categories—accounts with cheque facilities and without cheque facilities with rate of interest of 3 per cent and 5 per cent respectively.

Non-Banking Companies (Reserve Bank) Directions, 1977 and Miscellaneous Non-Banking Companies (Reserve Bank) Directions 1977 issued in supersession of the earlier directions, become effective.

Non-Banking Financial Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977 issued by the government come into force.

August

Expert Group on Agricultural Credit Schemes of Commercial Banks in pursuance of the recommendations of the Estimates Committee of the Fifth Lok Sabha, with Dr C.D. Datey as chairman, set up. (Report submitted in 1978.)

1 September

FERA 1973 extended to the state of Sikkim.

October

Working Group on Operational Efficiency and Profitability of Bank with J.C. Luther as chairman submits its Report.

1 November

Returning Indians Foreign Exchange Entitlement Scheme (RIFEE) introduced.

1 December

I.G. Patel takes over as RBI Governor.

1977

Committee on Urban Cooperative Banks set up with K. Madhava Das as chairman. (Report in 1978.)

Working Group to Examine the Role of Banking System in Providing Finance for Housing Schemes set up with R.C. Shah as chairman. (Report in 1978.)

Study Group on the formation of a consortium of Indian and Foreign Banks set up with P.C.D. Nambiar as chairman. (Report in 1979.)

Study Group on Interest Rates in Cooperative Credit Structure with K. Madhava Das as chairman set up. (Report in 1978.)

Second Working Group on Money Supply in India under the chairmanship of M.L. Ghosh submits report.

Study Team on Agricultural Credit Institutions in Bihar and Madhya Pradesh under the chairmanship of Dr C.D. Datey submits report.

Committee on Integration of Cooperative Credit Institutions under the chairmanship of G. Venkatanarayana submits report.

1978

17 January

High Denomination Bank Notes (Demonetization) Ordinance, 1978 (No. 1 of 1978). Demonetization of High Denomination notes (viz. Rs 1000, Rs 5000 and Rs 10000) effected and declared Holiday under NI Act 188. Later enacted as the High Denomination Bank Notes (Demonetization) Act, 1978 (No. 11 of 1978).

1 April

New IRDP launched

Companies (Acceptances of Deposits) Rules, 1975 amendments become effective.

April

Amendment to Non-Banking Companies and Miscellaneous Non-Banking Companies (Advertisement) Rules, 1977.

3 May

RBI commences auction of gold out of government stock among dealers holding licenses issued under the Gold (Control) Act, 1968.

27 May

The Deposit Insurance Corporation (Amendment and Miscellaneous Provisions) Bill, 1978 receives the assent of the President.

3 June

RBI (Amendment) Act, 1978 receives the assent of the President and comes into force with effect from 21 July 1978.

7 June

The Reserve Bank purchases 25 million grams of gold from the IMF under India's entitlement in respect of profits from sale of the Fund's gold for the benefit of developing countries and makes payment in foreign currencies of Rs 123 crore but valued at Rs 21 crore in the RBI balance sheets under statutory provisions relating to 'gold held in RBI'.

15 July

Deposit Insurance Corporation takes over the undertaking of the Credit Guarantee Corporation of India Ltd. and is consequently renamed Deposit Insurance and

Credit Guarantee Corporation (DICGC). The capital of DICGC increased from 2 crore to 10 crore fully contributed by Reserve Bank as the only shareholder.

16 August

Amendment of Regulation 7 of the Reserve Bank of India Scheduled Bank's Regulation 1951 for classification of banks' savings deposits into demand and time liabilities as required under Section 42(2) of RBI Act, 1934.

21 August

Scheme for export of gold jewellery with facility for replenishment of gold by import introduced by Government of India.

8 October

Working Groups set up at a meeting of the Prime Minister with the chief executives of major commercial banks and financial institutions for greater flow of credit to the neglected and weaker sections of the society, and for augmenting employment opportunities with the help of bank finance, with Ms. Kusumlata Mittal as chairperson. (Report in 1978.)

27 October

Finance Minister's high-powered meeting to look into the problems of sick units.

October

Steering Committee to frame and review policies in respect of RRBs constituted.

November

Private sector banks advised about a formal obligation on them to undertake, on the same basis as public sector banks, responsibilities in regard to priority sector advance, credit–deposit ratio in rural and semi-urban branches, Differential Interest Scheme, etc.

1 December

SLR raised from 33 to 34 per cent.

Exchange Control Cell of the Hyderabad office of the RBI upgraded as a full-fledged office.

12 December

Prize Chit and Money Circulation Schemes (Banking) Act, 1978 comes into force.

26 December

RBI acquires gold from the IMF under its restitution plan, which involves a payment of Rs 7 crore, and shown in the Reserve Bank's books at Rs 6 crore in accordance with the statutory provision.

December

The Banking Law (Amendment) Bill, 1978 seeking to amend, *inter alia*, the RBI Act, 934, with a view to prohibiting the acceptance of deposits by unincorporated bodies except from a specified number of depositors introduced in parliament lapses in view of the dissolution of the then Lok Sabha.

1978

Revised Exchange Control Manual brought out.

Study Team on Agricultural Credit Institutions in Uttar Pradesh with Dr C.D. Datey as chairman submits report.

Committee to Estimate the Demand for Pump-sets during 1978–83 and study the Policy and Procedure of Financing it constituted with Dr Nilkantha Rath as chairman. (Report in 1979.)

Study Group to Assess the Credit Needs of Handlooms submits report.

Committee on Credit Control System constituted with Sampat P. Singh as chairman. (Report submitted in 1978.)

Inter-Institutional Group on Coordination between Term-Lending Institutions and Commercial Banks constituted with A.K. Bhuchar as chairman. (Report submitted in 1978.)

Ground water over Exploitation on Committee set up with J.K. Jain as chairman. (Report submitted on 1980.)

1979

1978–79

The Banking Laws (Amendment) Bill, 1978 introduced in the Lok Sabha. The Bill contains amendments to Bankers Books Evidence Act, 1891, Banking Regulation Act 1949, State Bank of India Act, 1955, State Bank of India (Subsidiary Banks) Act, 1959, DICGC Act, 1961 and Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970.

A new cell called ‘Rural Planning and Credit Cell’ set up to ensure proper implementation of the multi-agency approach to credit in rural areas.

1 January

SDR 4 billion allocated as the first of the three annual allocations in the basic period, 1979–81.

30 January

Exchange rate for the rupee determined with reference to a basket of a selected number of major international currencies with the pound sterling as the intervention currency and a wider band adopted not exceeding 5 per cent instead of 2.25 per cent on either side of the middle rate.

23 February

Chit Funds Bill, 1979, drawn up by the RBI, introduced in the Parliament. The Bill is intended to regulate the conduct of conventional chit fund business on a uniform basis throughout the country.

2 March

The Executive Board of the IMF, on completion of the review on conditionality, codifies the existing guidelines.

30 March

Penalty for non-compliance of CRR and SLR introduced.

June

Setting up of National Industrial Tribunal and referring of the industrial dispute between workmen employees and RBI for adjudication.

9 June

National Rural Development Seven Year Bond issued.

21 June

Participation certificate brought under SLR/CRR with effect from the last Friday of July 1979.

28 June

OPEC announces increase of 25 per cent in crude oil prices.

9 July

Seven-year National Rural Development Bonds issued by Government of India.

13 September

Maximum rate on advances stepped up from 15 to 18 per cent for larger banks and from 16 to 19 per cent for smaller banks.

1 October

Rate of interest on savings/term deposits raised.

1979

Working Group on Apex Financial Institutions for the Small and Decentralized Sectors of Industry set up with W.S. Tambe as chairman. Submits report.

Study Group on Pension Scheme set up with W.S. Tambe as chairman. (Report in 1981.)

Working Group on Integration of Credit Guarantee Schemes for Small-Scale Industries and Other Small Borrowers with H.L. Anand as convenor submits report.

Working Group to Review the System of Cash Credit with K.B. Chore as chairman submits report.

Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development (CRAFICARD) set up with B. Sivaraman as chairman. (Report in 1981.)

1980

1979–80

Reserve Bank advises that: (i) public sector banks should strive to raise the proportion of advances to priority sectors from 33.33 per cent to 40 per cent by 1985; (ii) banks should actively provide financial support to the weaker sections of the population.

1 January

A new series of Rs 100 notes with a different colour scheme with a novel feature incorporated below Asoka Pillar issued.

At the IMF, SDRs allocated to members as per the rules under the 1979–81 basic period.

17 January

Gold Jewellery Export Replenishment Scheme suspended in view of the high level of international gold price.

March

Banks advised to step up priority sector advances to 40 per cent of total advances by 1985.

1 April

Sixth Five Year Plan launched.

March

RBI appoints two Working Groups: (i) to examine and report on the modalities of implementation of Priority Sector Lending and the Twenty-Point Programme by banks with K.S. Krishnaswamy as chairman; (ii) to review the system of data collection for monitoring banks' advances to Priority Sectors and Twenty-Point Programme with A. Seshon as convenor. (Report in 1980.)

13 March

RBI constitutes, pursuant to decision taken at the Finance Minister's meeting on 6 March 1980, a Working Group to examine and report on the modalities of implementation of the Twenty-Point Programme.

15 April

Nationalization of six private sector banks. Bill passed by the Lok Sabha on 16 June 1980 and received the assent of the President on 11 July 1980.

1 July

Deposit insurance cover raised from Rs 20,000 (in force since 1976) to Rs 30,000.

Refinance against advances to farmers under Small Farmers' Window discontinued.

11 July

Banking Companies (Acquisition and Transfer of Undertakings) Ordinance, 1980 enacted (40 of 1980).

27 July

Participation certificates treated as deposits and come under CRR and SLR in phased manner by 29 September 1979.

14 October

New scheme permitting export of gold jewellery against gold supplied by foreign buyers introduced by the government in substitution of the earlier scheme, viz. Gold Jewellery Export Replenishment Scheme introduced on 17 August 1978 and suspended on 17 January 1980.

19 October

Government authorizes PDO, RBI and SBI and its subsidiaries to repay National Defence Gold Board, 1980, in gold with effect from 27 October 1980.

29 October

Instruction on the modalities of implementation of priority sector lending and the Twenty-Point Economic Programme issued.

31 October

Banks exempted from the requirement of keeping additional CRR of 10 per cent of their incremental net demand and time liabilities accruing since 14 January 1977.

December

Adoption by Reserve Bank of India of the recommendations of the Chore Committee.

Working Group to Review the System of Cash Credit.

1980

Reserve Bank of India (Note Refund) Rules further liberalized.

Indianization of foreign companies and dilution of foreign equity under Section 29(2) FERA, 1973.

National Bank for Agriculture and Rural Development Act, 1981 (61 to 1998).

Study Group to Examine issues relating to the setting up of Soft Loan Assistance Fund for Rehabilitation of Sick Small-Scale Industrial Units set up with Dr P.D. Ojha as chairman. (Report in 1985.)

Working Group to Review the Training Arrangement in Banks set up with P.D. Kasbekar as chairman submits report.

Working Group to Review Reserve Bank Officers Training with V.R. Cirvante as chairman submits report.

Committee on Financing of Tea Industry set up with K.B. Chore as chairman. (Report in 1981.)

1981

1980–81

Tax on interest income by the bank reimposed at 7 per cent in the budget. Interest rates on advances adjusted upward on a pro-rate basis to include the tax element with the intention to pass on the tax burden to the borrower.

'Rural Women's Advancement' commemorative coins in Rs 100, Rs 10, 25 paise and 10 paise issued by the government. While 25 paise and 10 paise coins are for regular circulation, coins in the denomination of Rs 10 and Rs 100 are sold by India Government Mint, Bombay, as proof sets/uncirculated coins.

New branch licensing policy covering the period January 1982 to March 1985 emphasizing special attention to cover unbanked pockets in less accessible areas of different states taken up.

1 January

Deposit Insurance and Credit Guarantee Corporation's authorized capital raised to Rs 15 crore.

Third and final allocation of SDRs to members of IMF made under the basic period, 1979–81.

Neighborhood Travel Scheme introduced for travel to Bangladesh, Mauritius and Sri Lanka. This arrangement not to combine with the existing Foreign Travel Scheme.

15 January

Government of India announces special bearer bond to mop up 'unaccounted money'.

2 February

Special Bearer Bond, 1991 of face value of Rs 10,000 each for canalizing unaccounted money for productive purposes introduced by Government of India placed on sale and remains on tap till 30 April 1981. (Government of India announced its decision, in October 1981, to place these bonds on sale again from 1 to 31 December 1981.)

March

CRAFICARD furnishes recommendations for institutional credit for agriculture and rural development.

2 March

Revised deposit and lending rates become effective.

Interest rates on deposits revised upward.

New Lending Rates Policy prescribed; records a shift from earlier practice of prescribing various ceiling rates for different categories of borrowers to a rationalized system of four slabs of fixed rates for different categories on gradation basis for bringing uniformity in the rates charged by different banks for the same category of advances, particularly of priority sector advances; earlier policy of prescribing general minimum lending rates (MLR) abolished. Lending rates applicable to RRBs advised on 23 March 1981.

11 March

Executive Board of the IMF introduces the policy of enlarged access.

1 April

Credit Guarantee for SSI Scheme introduced by DICGC, Credit Guarantee Organization (Reserve Bank), and central government's Credit Scheme which was in operation since July 1960 stands cancelled; at the government's request the DICGC will discharge the obligation of the government out of the government's scheme as their agent.

2 April

New series of Rs 50 notes with new colour scheme and new 'note' issued.

April

Department of Administration and Personnel reorganized into Department of Administration and Personnel Policy Department.

RBI issues amendments to the Direction to Non-Banking Companies consequent to amendments made to the Companies (Acceptance of Deposits) Rule, 1975.

Department of Accounts and Expenditure set up in April 1965 reorganized into three departments: Department of Currency Management, Department of Expenditure and Budgetary Control, and Department of Government and Bank Accounts.

1 May

All authorized dealers (ADs) in foreign exchange allowed to release foreign exchange quotas to eligible travellers under the Foreign Travel Scheme (previously, only fourteen nationalized banks and SBI were permitted).

2 May

RBI advises banks to charge interest on advances against fixed deposits at 2 per cent higher than the rate of interest payable on the deposit.

May

CRR to go up from 6 to 7 per cent in two stages and interest rate on discretionary refinance and on rediscounting of bills raised from 11 per cent to 14 per cent.

1 July

Sub-office at Gauhati converted into a full-fledged Issue Office.

11 July

Bank rate raised from 9 per cent fixed on 23 July 1974 to 10 per cent.

Ordinance promulgated by Government of India prohibiting companies (including banking companies), cooperative societies, firms to repay any person any deposit otherwise than by an account payee cheque/draft when such repayment amounts to Rs 10,000 or more.

31 July

CRR raised to 6.5 per cent from 6 per cent which was fixed on 13 November 1976.

21 August

CRR raised from 6.5 to 7 per cent.

25 September

SLR raised from 34 per cent fixed on 1 December 1978 to 34.5 per cent.

1 October

Reserve Bank changes exchange rate quotations from a 'ready' or 'cash' basis to 'spot' basis (delivery after two business days); however, quotation on a 'cash' basis will be applied in exceptional cases and for valid reasons upon application.

6 October

Government of India, Ministry of Industry announces a set of new policy guidelines on industrial sickness (modified on 15 February 1982)

30 October

SLR raised from 34.5 per cent to 35 per cent.

RBI raises CRR from 7 to 7.25 percent from 27 November 1981, to 7.5 per cent from 25 December 1981, to 7.75 per cent from 29 January 1982, and to 8 per cent from 26 February 1982 (last phase rescinded later).

November

Working Group to review the working of the Lead Bank Scheme set up.

10 December

Working Group to review the existing system of inspection of commercial banks and to suggest improvements appointed by RBI.

December

Special Bearer Bonds launched by the government.

1981

Banking Laws (Amendment) Bill, 1978, lapses and a new Bill to give effect to the government's suggestion introduced.

Reorganization of Research Departments.

Committee to Examine the Legal and Other Difficulties Faced by Banks and

Financial Institutions in Rehabilitation of Sick Industrial Undertakings and suggest Remedial Measures, including changes in the law, set up with T. Tiwari as chairman. (Report in 1983.)

Study Group on Deployment of Resources by State and Central Cooperative Banks set up with Dr M.V. Hate as chairman. (Report in 1981.)

Study Group on Agricultural Credit Institutions in Himachal Pradesh and Jammu Kashmir with K. Madhava Das as chairman submits report.

Working Group on Savings set up with Prof K.N. Raj as chairman. (Report in 1982.)

Working Group on Accounting Procedure and Maintenance of Records at Bank Branches set up under the chairmanship of Shri M.N. Goiporia, chairman, Dena Bank. (Report in 1981.)

APPENDIX 2

The Reserve Bank of India, 1967–81

GOVERNORS

Name	*Period*	
	From	*To*
P.C. Bhattacharyya	01–03–1962	30–06–1967
L.K. Jha	01–07–1967	03–05–1970
B.N. Adarkar	04–05–1970	15–06–1970
S. Jagannathan	16–06–1970	19–05–1975
N.C. Sen Gupta	19–05–1975	19–08–1975
K.R. Puri	20–08–1975	02–05–1977
M. Narasimham	02–05–1977	30–11–1977
I.G. Patel	01–12–1977	15–09–1982

DEPUTY GOVERNORS

Name	*Period*	
	From	*To*
M.R. Bhide	29–02–1964	25–01–1967
B.K. Madan	01–07–1964	31–01–1967
B.N. Adarkar	16–06–1965	03–05–1970
A. Bakshi	24–01–1967	08–09–1969
Prof J.J. Anjaria	01–02–1967	28–02–1970
P.N. Damry	13–02–1967 13–02–1972	12–02–1972 15–03–1973
R.K. Hazari	27–11–1969	26–11–1977
V.V. Chari	17–11–1970	30–11–1975
S.S. Shiralkar	18–12–1970	25–07–1976
R.K. Seshadri	26–07–1973	25–07–1976
K.S. Krishnaswamy	29–12–1975	31–03–1981
P.R. Nangia	29–12–1975	15–02–1982
J.C. Luther	04–01–1977	01–06–1977
M. Ramakrishnayya	02–01–1978	31–01–1983

CENTRAL BOARD OF DIRECTORS AS ON JUNE 30

1966	
R.G. Saraiya	Raja Bajrang Bahadur Singh
B.N. Mookerjee	V.S. Tyagaraja Mudaliar
C.N. Vakil	Triguna Sen
N.A. Palkhivala	C.P.N. Singh
P.L. Tandon	Prof M. Mujeeb
Arvind M. Mafatlal	K. Sreenivasan
G. Basu	M. Sudarsanam
S. Bhoothalingam	
1967	
R.G. Saraiya	Raja Bajrang Bahadur Singh
B.N. Mookerjee	V.S. Tyagaraja Mudaliar
C.N. Vakil	C.P.N. Singh
N.A. Palkhivala	Prof M. Mujeeb
P. L. Tandon	K. Sreenivasan
Arvind N. Mafatlal	J. Ramdave Row
G. Basu	S. Jagannathan
1968	
R.G. Saraiya	Raja Bajrang Bahadur Singh
B.N. Mookerjee	V.S. Tyagaraja Mudaliar
C.N. Vakil	C.P.N. Singh
N.A. Palkhivala	Prof M. Mujeeb
P.L. Tandon	J. Ramdave Row
Arvind N. Mafatlal	V. Shanmugasundaram
G. Basu	Kamaljit Singh
I.G. Patel	

1969

S.L. Kirloskar	V.N. Puri
Bhaskar Mitter	J. Ramdave Row
C.N. Vakil	V.S. Tyagaraja Mudaliar
N.A. Palkhivala	C.P.N. Singh
P.L. Tandon	Prof M. Mujeeb
Arvind N. Mafatlal	V. Shanmugasundaram
G. Basu	Kamaljit Singh
D.C. Kothari	I.G. Patel

1970

S.L. Kirloskar	V.N. Puri
Bhaskar Mitter	J. Ramdave Row
P.L. Tandon	V. Shanmugasundaram
Arvind N. Mafatlal	Kamaljit Singh
G. Basu	D.C. Kothari
C.P.N. Singh	P.B. Gajendragadkar
Prof M. Mujeeb	A.M. Khusro
A. Baksi	

1971

S.L. Kirloskar	V.N. Puri
Bhaskar Mitter	J. Ramdave Row
P.L. Tandon	Kamaljit Singh
Arvind N. Mafatlal	D.C. Kothari
G. Basu	P.B. Gajendragadkar
V. Shanmugasundaram	A.M. Khusro
A. Baksi	

1972

S.L. Kirloskar	V.N. Puri
Bhaskar Mitter	J. Ramdave Row
Arvind N. Mafatlal	A.M. Khusro
G. Basu	Bhabatosh Datta
Kamaljit Singh	S.M. Joshi
D.C. Kothari	C.P. Srivastava
P.B. Gajendragadkar	N.C. Sen Gupta

1973

M.L. Dantwala	Bharat Ram
A.N. Haksar	C. Ramakrishna
P.B. Gajendragadkar	K. Kanungo
A.M. Khusro	V. Kurien
Bhabatosh Datta	G. Parthasarathi
C.P. Srivastava	M.P. Chitale
N.C. Sen Gupta	

1974

M.L. Dantwala	Bharat Ram
A.N. Haksar	C. Ramakrishna
P.B. Gajendragadkar	K. Kanungo
A.M. Khusro	V. Kurien
Bhabatosh Datta	G. Parthasarathi
M.P. Chitale	N.C. Sen Gupta

1975

M.L. Dantwala	Bharat Ram
A.N. Haksar	C. Ramakrishna
A.M. Khusro	K. Kanungo
Bhabatosh Datta	V. Kurien
M.P. Chitale	G. Parthasarathi

1976

A.N. Haksar	Bharat Ram
A.M. Khusro	C. Ramakrishna
M.P. Chitale	V. Kurien
K. Kanungo	Akbar Hydari
N.C. Sen Gupta	D.P. Singh

1977

A.N. Haksar	Bharat Ram
A.M. Khusro	C. Ramakrishna
M.P. Chitale	V. Kurien
K. Kanungo	Akbar Hydari
Manmohan Singh	D.P. Singh

1978

M.L. Dantwala	A.M. Khusro
A.N. Haksar	M.P. Chitale
Bharat Ram	V. Kurien
M.V. Arunachalam	Akbar Hydari
B. Venkatappiah	D.P. Singh
Jehangir P. Patel	Air Chief Marshal P.C. Lal (Retd.)
S.L. Kirloskar	Manmohan Singh

1979

M.L. Dantwala	M.P. Chitale
A.N. Haksar	V. Kurien
Bharat Ram	Akbar Hydari
M.V. Arunachalam	D.P. Singh
B. Venkatappiah	Jehangir P. Patel
Air Chief Marshal P.C. Lal (Retd.)	S.L. Kirloskar
Chhedi Lal	K.N. Raj
Manmohan Singh	

1980

M.L. Dantwala	M.P. Chitale
A.N. Haksar	V. Kurien
Bharat Ram	Akbar Hydari
M.V. Arunachalam	D.P. Singh
B. Venkatappiah	Jehangir P. Patel
Air Chief Marshal P.C. Lal (Retd.)	S.L. Kirloskar
Chhedi Lal	K.N. Raj
R.N. Malhotra	

1981

M.L. Dantwala	M.P. Chitale
A.N. Haksar	V. Kurien
Bharat Ram	Akbar Hydari
M.V. Arunachalam	D.P. Singh
B. Venkatappiah	Jehangir P. Patel
Air Chief Marshal P.C. Lal (Retd.)	S.L. Kirloskar
Chhedi Lal	K.N. Raj
R.N. Malhotra	

APPENDIX 3

Ministry of Finance, 1967–81

MINISTERS

	Year/s	*Name*	*Remarks*
1.	1966–67	Sachin Choudhuri	
2.	1967–69	Morarji R. Desai	Dy. P.M.
3.	1969–70	Smt. Indira Gandhi	P.M.
4.	1971–74	Y.B. Chavan	
5.	1975–77	C. Subramanian	
6.	1977–78	H.M. Patel	
7.	1979	Charan Singh	Dy. P.M.
8.	1979	H.N. Bahuguna	
9.	1980–82	R. Venkataraman	

DEPUTY MINISTERS

	Year/s	*Name*	*Remarks*
1.	1965–66	J.N. Misra	
2.	1968–69	Jagannath Pahadia	
3.	1970–71	K.R. Gonesh	
4.	1972–77	Smt. Sushila Rohtgi	
5.	1980	Maganbhai Barot	
6.	1981	Janardhana Poojari	

MINISTERS OF STATE

	Year/s	*Name*	*Remarks*
1.	1967–68	K.C. Pant	
2.	1969	P.C. Sethi	
3.	1970–71	V.C.Shukla	
4.	1972–75	K.R. Ganesh	
5.	1974–77	Pronab Mukherjee	
6.	1977–79	Satish Agarwala	
7.	1977–79	Zulfiquarulla	
8.	1979	S. Gopal	
9.	1979	R.N. Mirdha	
10.	1980–81	Jagannath Pahadia	
11.	1980–81	S.S. Sisodia	
12.	1981–82	Maganbhai Barot	

SECRETARIES, ECONOMIC AFFAIRS

	Year/s	*Name*	*Remarks*
1.	1966–68	S. Jagannathan	
2.	1968–70	Dr I.G. Patel	Spl. Secy.
3.	1970–72	Dr. I.G. Patel	
4.	1972–76	M.G. Kaul	
5.	1976–80	Dr Manmohan Singh	
6.	1980–82	R.N. Malhotra	

BANKING SECRETARIES

	Year/s	Date		Name	Remarks
		From	To		
1.	1968–69	1.1.1968	30.9.1969	S.S. Shiralkar	Add.Secretary
2.	1969–72	1.1.1969	31.3.1972	A. Bakshi	Secretary
3.	1972–76	4.8.1972	30.7.1976	N.C. Sen Gupta	Secretary
4.	1976–77	9.11.1976	2.5.1977	M. Narasimham	Secretary
5.	1977	1.3.1977	9.8.1977	K.P.A. Menon	Add. Secretary
6.	1977–80	10.8.1977	31.3.1980	M.R. Shroff	Add. Secretary
7.	1980	4.4.1980	20.8.1980	S.V.S. Juneja	Add. Secretary
8.	1981–83	3.3.1982	30.9.1983	R.K. Kaul	Add. Secretary

APPENDIX 4

History Cell, Department of Economic Analysis and Policy, Staff Members and Associates since 1988

CONSULTANTS/SPECIAL OFFICERS

Dr (Ms) C.J. Batliwalla
Late Prof S. Ambirajan
Dr A. Vasudevan
Late Y.S.R. Sarma
Dr N. Gopalaswamy
A.L. Verma
S.R. Shetty
R.D. Bangar
Y.P. Sethi

EDITOR

T.C.A. Srinivasa Raghavan

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Dr T.K. Chakrabarty, *Adviser-in-Charge*
Shri K.M. Thirunavukkarasu, *Assistant General Manager*
Shri V.S. Warang, *Manager*
Shri A.K. Jangam, Private Secretary
Shri A.L. Verma, *(O-in-C) Retired July 2003*
Dr N. Gopalaswamy, *Retired February 2002*
Shri M.Y. Khan, *Transferred April 1998*
Shri P.M. Bhatia, *Retired March 1999*
Shri M. Joseph, *Retired September 2002*
Shri A.A. Chougle, *Retired February 2000*
Shri C.N. Vazirani, *Retired October 1999*
Shri S.A. Joseph, *Transferred January 1999*

Shri K. Balasubramanian, *Transferred January 1999*
Smt A.S. Lakkadghat, *Retired November 2001*
Shri M.I. Koshy, *Transferred August 2001*
Shri K.S. Rao, *Transferred August 2000*
Smt M.R. Bhalkikar, *Retired 2004*
Shri P.T. Kurien, *Retired March 2001*
Shri N.R. Chauhan, *Transferred November 2000*
Shri N.H. Siddiqui, *Transferred April 2002*
Smt Sarojini Venkatachalam, *Retired 2004*
Shri M.N. Tarambale, *Transferred December 2002*
Smt C. Nair, *Transferred December 2001*
Dr D. Singh, *Retired June 2003*
Shri A.S. Chauhan, *Retired October 2001*
Smt R.P. Kartha, *Transferred September 2002*
Dr V.B. Angadi, *Retired 2004*
Shri B. Shaikh, *Transferred December 2003*
Smt E.M. Fernandes, *Transferred 2003*
Shri R.D. Shinde, *Transferred May 2003*
Shri O.P. Sharma, Retired January 2003
Shri A.K. Ray, *Transferred February 2003*
Shri K.M. Jacob, *Retired June 2004*
Shri D.D. Garg, *Retired August 2003*
Shri R.K. Jain, *Transferred August 2003*
Shri K.U.B. Rao, *Attached to Chairman, Advisory Committee, Hyderabad, transferred 2002*
Dr Amaresh Samantaraya, *Attached to Chairman, Advisory Committee, New Delhi*
Ms Sushila Panjawani, *Attached to Chairman, Advisory Committee, New Delhi*
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Shri Ashok Bathija, *CO, Mumbai*
Shri S.V. Wagh, *CO, Mumbai*
Shri R.K. Sunder, *CO, Mumbai*
Smt S. Talpade, *DEAP, Mumbai*
Smt Balbir Kaur, *DEAP, New Delhi*
Smt Gunjeet Kaur, *DEAP, New Delhi*
Shri Rajan Goyal, *DEAP, New Delhi*

Smt Sangita Misra, *DEAP, New Delhi*
Shri Pawan Kumar, *DEAP, New Delhi*
Smt Saroj Thapliyal, *DEAP, New Delhi*
Shri Rakesh Chander Singh, *DEAP, New Delhi*
Shri Muneesh Kapur, *DEAP, Mumbai*
Shri A. Karunagaran, *DEAP, Mumbai*
Shri P.K. Nayak, *DEAP, Mumbai*
Shri B.C. Sapkal, *DEAP, Mumbai*

SUPPORTING MEMBERS

Smt R.A. Kelkar
Shri R.H. Patil
Shri A.V. Satam
Shri C.H. Salunke
Smt A.A. Jadhav
Shri S.S. Kahar
Shri H.K. Shreshtha
Shri R.K. More, *Retired May 1998*
Smt L.S. Haldankar, *Transferred September 1998*
Smt N.V. Joshi, *Retired December 2003*
Smt S.H. Gajare, *Transferred September 1998*
Shri H.R. Amberkar, *Transferred September 1998*
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Smt G.J. Kodiyalmath, *Transferred September 2004*
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Shri P.B. Rane, *Transferred July 2002*
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Shri S.K. Bamble, *Transferred September 1999*
Shri S.S. Shaikh, *Transferred September 1999*
Shri B.L. Golambade, *Retired April 2000*
Shri T.B. Tambe, *Retired 2004*
Shri K.V. Sonawane, *Transferred April 2002*
Shri M. Arjunan, *Transferred April 2004*
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Shri R.R. Shringarpure, *DEAP, Mumbai*

Shri G. Koshti, *DEAP, Mumbai*
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Shri Jagdish Chandra Sharma, *DEAP, New Delhi*

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