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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 blackmarketers 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.