Appendices

APPENDIX 4.1

Committee to Review the Working of the Monetary System: Recommendations and their Implementation

Set up as a monetary institution, the Reserve Bank was enjoined with the responsibility of operating the currency and credit system to the country's advantage. Till the mid-1980s, the Bank operated only a credit policy, the focus of which was on regulating the quantum and flow of credit particularly between the Government and the commercial sector, given the estimated resources of banks and FIs. The monetary system, as such, was not comprehensively reviewed. In 1982, the Governor, Dr Manmohan Singh set up a committee under the chairmanship of Prof Sukhamoy Chakravarty to undertake a comprehensive review of the working of the monetary system in India.[1] The committee submitted its report in April 1985.

The mandate to the committee covered almost every aspect of the monetary system that required a review of the relevant policy issues, bearing in mind the need for long-term changes. The terms of reference included: (i) a critical review of the structure and operation of the monetary system in the context of the basic objectives of planned development; (ii) an assessment of the interaction between monetary policy and public debt management in so far as they had a bearing on the effectiveness of monetary policy; (iii) an evaluation of various instruments of monetary and credit policy in terms of their impact on the credit system and on the economy; and (iv) recommend measures for improvement in the formulation and operation of monetary and credit policies and suggest specific areas where the policy instruments needed strengthening.

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1. The other members of the committee were Shri M.P. Chitale, Shri R.K. Hazari (former Deputy Governor), Shri F.A. Mehta and Dr C. Rangarajan (Deputy Governor) with Shri J.C. Rao as the Secretary.

BACKDROP

The Governor, Dr Manmohan Singh, in his inaugural address at a seminar organised by the Maharashtra Economic Development Council, Mumbai in November 1982, had hinted at the forthcoming committee. Mentioning that India had a large number of instruments that had a bearing both on the management of aggregate demand and the allocation of resources among different sectors, he posed several questions: how did monetary and credit policy fit into this; how much weight ought to be placed on monetary and credit policies to achieve our national objectives; how could monetary planning be harmonised and co-ordinated with national planning; how effective were various instruments of monetary control in achieving the given objectives; what were the implications of the growing number of financial instruments and intermediaries for the success of our monetary and credit policies; and how did the increasing openness of our economy impinge on the effectiveness of monetary and credit policies. He believed that the time had come for a detailed and comprehensive analysis and evaluation of these and related issues. Dr Manmohan Singh, "after considering all the relevant factors," came to the conclusion that a thorough review of the functioning of the monetary system in India was called for. His concluding statement confirmed that monetary policy was looked upon more as an instrument of planning in a closed and controlled economy rather than as an independent instrument to achieve the objective of price stability.

Prof Sukhamoy Chakravarty,[2] a year after the submission of the report, explained that since the mid-1960s, several major changes had taken place in the economic management of the country, which had a significant impact on the monetary and financial system. The combined effect of these changes, partly structural and in part conjectural implied that a careful look was called for at the functioning of the monetary system, especially from the point of view of ensuring non-inflationary planned development in the years to come. He also observed that in an increasingly open economy, there was the added need to heighten export competitiveness, which depended, among other things, on the rates of domestic inflation relative to world inflation and that inflation in India had rarely been coupled with favourable redistribution effects.

Prof Chakravarty[3] stated in the context of the committee that:

> It should be obvious that the terms of reference before the Committee, while far ranging, had a very definite focus on planning and the role of public debt in financing the plans. In addition, the problem of evolving an appropriate credit policy, which will help best in raising productivity

2. *Sir Purushotamdas Thakurdas Memorial Lecture* delivered in 1986.
3. Chakravarty, S. (1993). *Selected Economic Writings of Sukhamoy Chakravarty*. New Delhi: Oxford University Press.

of resources use as well as expanding resource base, was highlighted as a major conceptual problem. Finally, there was the operational dimension having to deal with instrumentalities of formulating monetary and credit policies.

MAJOR RECOMMENDATIONS

The major areas covered by the committee were the objectives of monetary policy, co-ordination between monetary policy and fiscal policy, regulation of money supply, maintenance of price stability, interest rate policy and regulatory measures pertaining to bank credit.

MONETARY POLICY OBJECTIVES

The committee concluded that the monetary system must necessarily be supportive of the national development strategy as articulated in the successive Five Year Plans and should seek to perform the following tasks:

(i) Mobilise savings of the community and enlarge the financial savings pool.
(ii) Promote efficiency in allocating savings of the community to relatively more productive purposes in accordance with national economic goals.
(iii) Enable the resource needs of the major 'entrepreneur' in the country, *viz.*, the Government, to be met in adequate measure.
(iv) Promote price stability.
(v) Promote an efficient payments system.

Although the committee viewed monetary policy as an arm of the economic policy and agreed that its objectives could be no different from the overall objectives of the economic policy, the effectiveness of various instruments of economic policy in pursuing different objectives was not always the same. The committee recognised that price stability was a major concern for monetary policy, since monetary policy instruments were more effective than other policy instruments in achieving this objective. Another reason was that in a society in which a significantly large proportion of the population was in the unorganised sector, price rise went against social justice. Against the background of historical experience, the committee suggested that an average annual increase in the WPI of no more than 4.0 per cent should be the objective. Dr C. Rangarajan later termed this guideline as 'reasonable', the achievement of which would require considerably improved demand and supply management.[4]

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4. Rangarajan, C. (1988). *Issues in Monetary Management.* Presidential Address at the Annual Conference of the Indian Economic Association. Calcutta. December 29.

MONETARY TARGETING

Besides suggesting a certain degree of co-ordination between the Government and the Reserve Bank in evolving and implementing the agreed policy, the committee recommended that the regulation of M_3 should be undertaken in a framework of monetary targeting in terms of a range, using feedback with necessary support from an appropriate interest rate policy. The choice of M_3 was based on the fact that money multiplier relating to M_1 was prone to sudden and large movements as a result of seasonal shifts between currency and deposits. Such influences over M_3 were not significant and hence money multiplier for M_3 was relatively more stable.[5]

The committee stated that a constant money supply growth was not feasible in the Indian context where supply shocks were frequent and where significant structural changes were sought to facilitate the growth process. According to Dr Rangarajan, this did not, however, take away the need for regulating the overall growth in M_3 over a period of time, and a scheme of monetary targeting with feedback would ensure the necessary co-ordination between the fiscal and monetary authorities in steering the growth of money supply consistent with real growth and an acceptable order of increase in prices.[6]

Based on the relationship between money, output and prices, the committee suggested that the target for monetary expansion should be set at 14.0 per cent or in a range around 14.0 per cent, based on the assumption that the real output would expand by 5.0 per cent, income elasticity of demand for broad money at 2.0 per cent and the acceptable rise in prices at 4.0 per cent.

CO-ORDINATION BETWEEN MONETARY POLICY AND FISCAL POLICY

The committee pointed out that the major cause of the substantial growth in M_3 since the 1970s had been the rise in Reserve Bank credit to the Government. The main reason for the high degree of monetisation of debt was the relatively low yields on government securities and the low discount rate on Treasury Bills, which had remained unchanged since 1974 at 4.6 per cent per annum. It, therefore, recommended that a proper framework for the regulation of Reserve Bank credit to the Government be evolved through co-ordination between the Reserve Bank and the Government by suitable restructuring of yields on government securities and by revising the discount rate on Treasury Bills. These measures were also expected to facilitate greater participation in the government's borrowing programme by the non-bank sector of the public and hence reduce the growth in reserve money attributable to Reserve Bank credit to the Government.

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5. Pages 104–105 of the report.
6. Rangarajan, C. (1987). *An Analytical Framework of the Chakravarty Committee Report on the Monetary System.* Lecture delivered at the meeting sponsored by the Society of Auditors. Madras. August 29.

The committee suggested a change in the definition of budgetary deficit to 'net RBI credit to Government', so that an economically meaningful and definite measure of the monetary impact of fiscal operations became available.

INTEREST RATE POLICY

The report envisaged a role for the interest rate policy as supportive of the regulation of M_3, but did not make any significant departure from the position where important interest rates were administered. Nonetheless, as the principal participants in the money and capital markets were in the government sector, certain guidelines with regard to the determination of interest rates were presented in the report. The report clearly recognised that borrowings by the Government should be at a slightly lower rate compared with the other organised sectors, but had to be positive in real terms. Assuming a rate of growth of the economy of the order of 4.0 to 5.0 per cent, which could be taken as a ceiling on the pure rate of interest for the economy as a whole, the maximum real interest rate on long-term government borrowings was suggested at 3.0 per cent per annum. Along with Treasury Bills, for which only a marginally positive real interest rate was recommended, the average interest rate on the entire spectrum of government borrowings from the market was expected to be even lower than 3.0 per cent.

Another point made was that even when interest rates did not play an allocative role, there was need to see that the interest rate structure of the organised financial system was in reasonable correspondence with market perceptions. On the understanding that interest rates on bank deposits should be positive, after adjusting for inflation to encourage small savers, the committee suggested a maximum real rate of interest of 2.0 per cent on bank deposits. In the case of lending rates, the committee suggested that the maximum lending rate could be fixed at 3.0 per cent above the maximum nominal deposit rate, so that banks had a reasonable margin over cost of raising funds and could thus function as viable economic units even though an element of cross-subsidisation could be built into the lending rate structure. In order that the credit requirements of the productive sectors were adequately met within the overall limits set for monetary expansion, the committee recommended that banks should have greater freedom in determining their lending rates.

OTHER IMPORTANT RECOMMENDATIONS

The committee examined various aspects of bank credit and made recommendations regarding credit policies and procedures to facilitate more efficient use of bank credit. It stressed the importance of providing bank credit in the form of loans and recommended promoting bill finance instead of cash credit. It also highlighted the disruptive effect on credit flows arising from tardy payments to suppliers by large public sector and private sector units as also the Government, and recommended that interest on delayed payments should be

provided for in the purchase contracts. The committee also expressed the view that problems associated with improving the effectiveness of priority sector lending were principally related to organisational re-orientation and effective communication and monitoring. It emphasised the importance of strengthening the credit delivery system in the area of priority sector lending, so that adequate and timely credit could be made available to this sector.

PROCESS OF IMPLEMENTATION

The Governor, Shri R.N. Malhotra, set up a task force in the Reserve Bank, with one member drawn from the Ministry of Finance. The task force set out to examine the recommendations of the committee from the viewpoint of implementation and its report was submitted at end-1985. Based on the report, the Governor apprised the Finance Minister, Shri V.P. Singh, in a detailed letter dated January 14, 1986 of the proposals for implementation, which were prefaced with the following important observation:

> While the Committee has set out a logical framework of the monetary system towards which we should ultimately work, the current milieu would require that any changes should be undertaken in full recognition of their implications and after careful preparation. In considering the Committee's recommendations, the Task Force has adopted a pragmatic approach. In the light of the views of the Task Force on such matters as are of direct concern to the Government, I am setting out my own recommendations for your kind consideration.

Both the Reserve Bank and the Government acted promptly in implementing the recommendations.

REDEFINITION OF THE CONCEPT OF BUDGETARY DEFICIT

The committee suggested a change in the definition of budgetary deficit to 'net RBI credit to Government' and Governor Malhotra commended the suggestion as it 'fully reflected' the increase in net Reserve Bank credit to the Government and also put the extent of monetisation of Government debt into 'sharper focus'. He urged an early changeover to the new definition of budgetary deficit, as it would be of considerable advantage in the effective co-ordination between monetary and fiscal policies. This had one important implication in that the increase in Reserve Bank holdings of government securities would be reflected in the budgetary deficit. The correct course would, therefore, be not to assume any Reserve Bank support to dated securities when determining the size of the market borrowing programme, the letter added.

MONETARY TARGETING

For a number of years, the Reserve Bank and the Government were engaged in a dialogue on a consistent set of projections for the deposit and credit aggregates, against a backdrop of certain perceptions of the real growth of the economy and the expected inflation rate, and it was in this context that the market borrowing programmed was finalised. For the fiscal year 1986–87, the Governor stated in his letter dated January 7, 1986 to the Finance Secretary that the Reserve Bank would suggest that for 1986–87 the key aggregates set out by the Bank be given serious consideration, and after discussions these could be given the status of agreed targets between the Government and the Reserve Bank, and as the year progressed, policy responses could be developed with reference to these targets. The Governor recommended that specific targets be worked out for: (i) net Reserve Bank credit to the Government; (ii) total net bank credit to the Government; and (iii) overall liquidity (M_3). The Reserve Bank was of the view that these three aggregates could be given a 'trial run' in 1986–87 as internal targets and after a successful outcome, there could be a move to a system where the targets were made public.

GOVERNMENT SECURITIES: MATURITY PATTERN AND COUPON RATES

While endorsing the committee's recommendation that the maximum maturity period for government securities should be reduced from 30 years to 15 years as part of a gradual adjustment, the Reserve Bank was of the view that the maximum maturity period could initially be reduced to 20 years in 1986–87 and, in light of this experience, a further reduction to 15 years could be considered in 1987–88. Shri Malhotra also suggested that the current coupon rate need not be raised, though there was need for increasing the coupon rates on maturities up to 20 years. Accordingly, for maturities of 5, 10, 15 and 20 years the existing coupon rates of 9.0 per cent, 9.5 per cent, 10.0 per cent and 10.5 per cent per annum, respectively, were proposed to be raised by one percentage point, *i.e.*, to 10.0 per cent, 10.5 per cent, 11.0 per cent and 11.5 per cent, respectively.

A related point was that even though the coupon rates on various maturities up to 20 years would go up, the enhanced rates would still be highly concessional, since banks, which were the major investors in these securities, paid a rate of 11.0 per cent on 5-year deposits. This change was also expected to improve the prospects of floatation of securities of state governments, as there had been some difficulties in successfully floating securities of state governments and other institutions.

TREASURY BILLS: DISCOUNT RATE AND FUNDING

The committee recommended that the discount rate on Treasury Bills should be marginally above the short-term inflation rate. Based on the average inflation rate over the past five years of about 7.0 per cent, the Governor urged: "early implementation so that in 1986–87 the discount rate on 91-day Treasury Bills would be raised from 4.6 per cent to 7.5 per cent." The Reserve Bank viewed

the higher rate as substantially lower than the rates applied to WMA of the state governments, which were provided at rates varying from 9.0 per cent for the first 90 days to 12.0 per cent beyond 180 days. Moreover, it was pointed out that as on July 19, 1974 the Treasury Bill rate was 4.6 per cent, while the coupon rate on central government securities of the longest maturity was 6.25 per cent, *i.e.*, the difference between the two rates was only 1.65 percentage points as against the prevailing difference of 6.9 percentage points. Under the new proposal, this difference would be reduced to 4.0 percentage points, which would still be quite large. To drive home his proposal, the Governor stated:

> I am aware of the impact of this change on the Government budget, but am afraid that correction of this historical distortion is long overdue and the longer this adjustment is postponed, the greater the future adjustment problem. To minimise the burden on the budget, I would suggest that towards the end of the current financial year or in early 1986–87, there should be a funding of existing Treasury Bills into securities of the order of Rs. 20,000 crore (or more depending on the outstandings at the time of the funding) at a rate of 4.6 per cent; this funding operation should be considered as a one-shot operation.

In the context of the committee's repeated stress that monetisation of the government debt must be kept to the minimum, the Reserve Bank expressed the view that it was essential to explore techniques of placing the short-term debt of the Government outside the Reserve Bank. In this connection, the increase in the discount rate on 91-day Treasury Bills from 4.6 per cent to 7.5 per cent would certainly be 'a step in the right direction', the Reserve Bank averred, though this by itself would not be sufficient to enable an absorption of the short-term government debt outside the Reserve Bank in the immediate future. Therefore, the Governor proposed that an attempt should be made in 1986–87 to place at least a part, say, about 20.0 per cent, of the total Treasury Bills to be generated during that year outside the Reserve Bank. With this objective, two measures were proposed. The first was to effect an increase in the discount rate for 91-day Treasury Bills from 4.6 per cent to 7.5 per cent immediately after the proposed funding operation. Holders of these bills would be provided rediscounting facilities as hitherto. The second proposal was the introduction in 1986–87 of 180-day Treasury Bills on auction basis offered outside the Reserve Bank on which there would be no rediscounting facilities with the Reserve Bank, which by itself would encourage development of a secondary market in these bills. The discount rate would be determined at the auctions, subject to such regulations as the Reserve Bank might consider necessary.

The strategy of funding outstanding Treasury Bills was also expected to benefit the Government's fiscal operations by smoothening the process of filling the budgetary gap. The Reserve Bank reasoned in the following manner:

> Under the present arrangement, the Government has to seek Parliamentary authorisation for a high turnover of Treasury Bills (Rs. 1,50,000 crore in 1985–86) and erroneous adverse publicity results from such a large turnover. A major part of this high turnover is caused by the fact that, in the absence of funding, the outstanding Treasury Bills are unduly large and, illustratively, an outstanding of Rs. 25,000 crore would necessitate an annual turnover of Rs. 1,00,000 crore. The funding of a large part of the outstanding bills will largely relieve this problem. I am aware that, in addition, the rapid rediscounting of bills by banks also unnecessarily increases the turnover of Bills. I propose to increase the administrative charges on rediscounting bills and we are also exploring the recycling of bills, which would significantly reduce their turnover. Again, the introduction of the 180-day Treasury Bill on auction basis without rediscounting facility with the Reserve Bank would also reduce the turnover of Treasury Bills.

DEPOSIT AND LENDING RATES OF BANKS

The committee recommended that there should be rationalisation of deposit and lending rates and that these rates should be, to some extent, deregulated. The Reserve Bank found that the bankers who were consulted appeared to be apprehensive of deregulation of the rates. The committee's formula of a 2.0 per cent real rate and an average long-term inflation rate of 9.0 per cent gave a deposit rate of 11.0 per cent for five years, which incidentally was the current 5-year deposit rate. The 1-year deposit rate of 8.5 per cent also appeared to be in line with the committee's recommendations. The Reserve Bank conveyed its desire to continue with the prevailing structure of interest rates on deposits.

The Reserve Bank was not in favour of deregulating deposit rates as it felt that if deposit rates were deregulated, they might rise, and this might not be in alignment with the policies aimed at bringing down the overall structure of lending rates as inflation abated. The communication from the Bank stated: "An increase in deposit rates would warrant increases in lending rates, and it would hardly be feasible to have uncontrolled increases in lending rates to preferred sectors."

The committee recommended that the minimum lending rate of banks should be 3.0 percentage points above the maximum deposit rate, and that there should be only one concessional rate below the minimum lending rate. The task force had pointed out that prescribing only one concessional rate below the minimum lending rate and freeing all rates above the minimum lending rate would neither be feasible nor desirable. The chairmen of some of the banks, who were consulted, were also not in favour of any major deregulation of lending rates. There was a likelihood that freeing the rates above the minimum lending rate could result in large borrowers using their strong bargaining power to lower lending rates to levels that would adversely affect banks' profitability. While conceding that it was

necessary to rationalise lending rates and avoid multiple prescriptions, the Reserve Bank felt that such rationalisation could be considered at an appropriate stage when interest rates were reviewed and that any changes in the deposit-lending rates of banks would need to take into account the impact on banks' profitability.

OTHER MATTERS

The committee made a number of other recommendations regarding the mode of lending, recovery of advances made to the priority sector, instruments of monetary policy and development of the money market. The Reserve Bank was of the view that these were matters related essentially to the banking system and, hence, consultation with banks and proper study would be necessary to bring about well-planned implementation of some of these changes. The question of the need for discount houses and the development of the money market were matters that needed further detailed examination. Therefore, the Governor, Shri R.N. Malhotra, advised the Government that he proposed to set up a working group to report on these matters and added that the introduction of Treasury Bills of the type suggested would have an important bearing on the development of the money market.

Governor Malhotra's 8-page letter to the Finance Minister, Shri V.P. Singh, concluded that he would be glad to discuss these issues with him at his convenience. A copy of the letter was endorsed to the Finance Secretary and the Chief Economic Adviser.

THE GOVERNMENT'S RESPONSE

The response of the Government was prompt and positive. The Governor discussed the recommendations of the Chakravarty Committee with the Finance Secretary on January 30, 1986. This was followed by a letter dated April 3, 1986 from Shri K.S. Sastry, Joint Secretary (Budget) to the Deputy Governor, Dr C. Rangarajan, conveying the Government's approval to the proposals made by the Reserve Bank. First, the Reserve Bank's proposal to revise the interest rate structure for government and government-guaranteed loans was approved in toto. Second, the Government agreed to the issue of 180-day Treasury Bills on auction basis for subscription by outside parties subject to a maximum interest rate of 7.5 per cent per annum. However, *ad hoc* Treasury Bills issued to the Reserve Bank or other Treasury Bills discounted with the Reserve Bank would carry an interest rate of only 4.6 per cent. Third, the Government was agreeable to the funding of Treasury Bills held by the Reserve Bank as special securities at that point carrying interest at 4.6 per cent. The amount to be funded was to be decided with reference to savings available in the budget provision made for the discharge of Treasury Bills.

The Government showed its earnestness in implementing the recommendations. In the 1986–87 Union Budget, it was announced that the Government had accepted in principle the recommendations of the Chakravarty

Committee with regard to the measurement of budgetary deficit, by accounting changes in the entire Reserve Bank credit to the Government, including changes in the Reserve Bank's holdings of long-dated securities on the basis of modalities worked out in consultation with the Reserve Bank. Further, to bring about better co-ordination between fiscal and monetary policies and make their overall management more scientific, the Government decided to set overall monetary targets and monitor them regularly. This arrangement was put in place in 1986–87 on an experimental basis.

IMPLEMENTATION PROBLEMS

The Economic Survey for 1986–87 revealed that within the first year of implementation of the recommendations, it was noticed that *ex ante* there were several problems in the estimation of Reserve Bank credit to the Government, particularly where the budget for the next year was under preparation in the months of January/February every year and it became necessary to have as firm an estimate of the deficit as possible at the RE stage. On an analysis of the past data of variations in the net Reserve Bank credit to the Central Government, it was found that there was no stable and predictable relationship between the full year credit extended by the Reserve Bank to the Central Government and that extended in the first nine months of that year. Transactions in Treasury Bills and the long-dated securities by parties other than the Reserve Bank showed wide swings during the course of a fiscal year. In fact, the week-to-week fluctuations in the holdings of Treasury Bills by the banks were particularly pronounced. In the case of long-dated securities, the factors causing fluctuations were variations in the liquid assets of banks, as also the transactions in securities by financial institutions under the buy-back arrangement, especially by institutions that kept their accounts exclusively with the Reserve Bank.

In addition to absorption by the Reserve Bank of dated securities floated under the market borrowing programme, Reserve Bank credit to the Central Government included rupee coins and special securities issued by the Central Government to the Reserve Bank for borrowings against collections under the compulsory deposit (IT payers) scheme and for payment of charges on drawings from the IMF. There were also disparate practices with regard to the valuation of Treasury Bills and dated securities, which in the monetary data were based on the Reserve Bank's book value (*i.e.*, purchase price), whereas in the fiscal accounts, the transactions were based on the face value of the securities. The different methods of recording the transactions by the Government and the Reserve Bank resulted in an asymmetry in the fiscal and monetary data, according to the Economic Survey, 1986–87. In view of the technical problems in achieving 'a one-to-one correspondence' in the fiscal and monetary accounts, the Government decided to show Reserve Bank net credit to the Central Government as a 'memorandum item' in the budget documents.

INTRODUCTION OF 182-DAY TREASURY BILLS

The Chakravarty Committee recognised the need to explore new financial instruments that could provide alternative avenues for short-term investments for which an active secondary market could develop in future. Specifically, the committee recommended that Treasury Bills should be developed as a monetary instrument with flexible rates, which would enable the banks to better manage their short-term liquidity. Following this, from November 28, 1986, Treasury Bills of 182-day maturity were issued on a monthly auction basis.

MONETARY TARGET EXERCISE

In developing this exercise, several technical problems connected with the choice of variables, the volatility in the variables and their seasonal variations were required to be resolved. The choice of variables was necessarily influenced by the fundamental objectives of controlling aggregate fiscal and monetary outcomes, and the feasibility of predicting the full year outcome based on available information. On the basis of these criteria, three monetary variables, namely, aggregate monetary resources (M_3), net Reserve Bank Credit to Central Government (NRBICG), and net Bank Credit to Government (NBCG), were selected as early warning signals with respect to growth in M_3 in the economy. NRBICG, a key component of the stock of reserve money, although volatile, served as the single most important explanatory variable for year-to-year changes in M_3 in the economy. NBCG had the virtue of including the full recourse to bank borrowing by the Government and, being less volatile than the NRBICG, it provided a better indicator of within-year trends. M_3 was considered as the appropriate indicator of the degree of overall liquidity in the economy, as it exerted a substantial influence on the rate of inflation in the economy.

APPENDIX 5.1

Exchange Control : Operations and Regulations

DEVELOPMENTS IN FOREIGN TRADE POLICY

In recognition of the need to maximise export earnings in a situation of rising trade deficit and a continuing unfavourable trading environment around the world, the emphasis of the export strategy during the 1980s was to keep export controls at the minimum. Broadly, the policy in vogue in the late 1970s was continued during the 1980s, and controls were imposed only on select commodities whose supply position demanded export restrictions in the larger national interest.

The foreign trade policy for 1982–83 emphasised the reduction of the technology gap, particularly in the export sector, through a system of liberal import allocations for upgrading and developing technology. Another noteworthy feature was establishing administrative machinery for effective monitoring and evaluation of the flow and utilisation of imports, particularly under the export promotion schemes.

Substantial procedural changes were introduced, designed primarily at enabling actual users to obtain inputs expeditiously, maximise production and improve productivity. Keeping in view the need to encourage investment and facilitating timely execution of production programmes, 100 new items of raw materials, components and consumable were put under the OGL for import by actual users. A noteworthy procedural liberalisation was that a number of items could now be imported under the OGL by both actual users and others. The waiver of the actual user stipulation was intended to assist small industrialists who could now buy them off-the-shelf and thus cut down on the cost of holding inventory. The restrictions on imports of several commodities were kept under close and constant review in light of the output performance of the domestic industry. The facilities for import of capital goods and equipment available to NRIs returning home to settle or residents abroad investing in India through foreign exchange remittances were further liberalised.

Export trading houses were henceforth entitled to bulk advance licences. The scheme of duty-free import of raw materials by manufacturers against their replenishment (REP) licences, which had been in operation for two years in respect of select products, was further expanded to cover several new export products.

In the interests of continuity and stability, the Exim policy for 1984–85, announced on April 12, 1984, maintained the general framework as in the preceding year. Thus, the policy for import of raw materials, components and spares and the facilities for supplementary and automatic licences including repeat licences to actual users to import raw materials, components and consumables continued and remained unaltered. The OGL list was enlarged by adding 149 new items, including 94 items of industrial machinery. Simultaneously, 53 items were removed from the OGL in light of developments in the domestic industry,

bringing the net addition of items to the OGL to 96. Export promotion continued to be an important facet of the foreign trade policy. The 1984–85 policy carried the progressive liberalisation in the policy witnessed since 1979–80 a step further.

FOREIGN TRADE POLICY: 1985–1988

The Government announced the Exim policy for three years ending March 1988, instead of one year, as had been the practice. The licensing, however, continued to be on an annual basis. The Government's new economic philosophy, namely, liberalisation, updating/upgrading the technology to international standards and exposing Indian industry to global competition, were visible in the policy during the period 1985–1988.

Restrictions were placed on free OGL imports by the ONGC, OIL and the GAIL. Henceforth, they had to obtain prior clearance from the empowered committee on indigenisation of the Ministry of Petroleum and Natural Gas. On the other hand, the long-term import policy for export/trading houses was liberalised in June 1986, allowing these houses to import non-OGL capital goods, except for restricted items against their REP additional licences.

FREE TRADE ZONES SET UP DURING THE 1980s

MEPZ[1] was established in 1984. As a multi-product zone, it dealt in export of engineering goods, garments, perfumes, electronics, leather products, plastics and rubber, toys and musical instruments. Total exports from the zone during the year 1988–89 rose by 46.3 per cent to ₹ 24 crore from ₹ 16.4 crore in the previous year. However, exports were still short of the targeted amount for the year.

NEPZ[2] was established in 1984 with an investment of ₹ 16.2 crore. In the second phase, development of additional 200 acres of land was taken up. Principal exports from the zone include computers-cum-electronics, readymade garments, and light engineering goods. During 1988–89, exports from the zone increased by 33.0 per cent to ₹ 21.3 crore from ₹ 16 crore in 1987–88, but were still lower than the target of ₹ 30 crore stipulated for the year, mainly due to non-utilisation and delays in installing the capacities on account of power shortages.

FEPZ,[3] located on the eastern bank of the river Hooghly at Falta, was established in 1984. The Central Government and the West Bengal Government spent an aggregate amount of ₹ 28.1 crore on developing the infrastructure for the zone. In all, 64 export proposals were approved for Falta by March 1989.

CEPZ,[4] a multi-product zone, was established in 1984. By end-March 1989, 62 units had been given licences. Exports from the zone were higher by 58.0 per

1. Madras Export Processing Zone.
2. Noida Export Processing Zone.
3. Falta Export Processing Zone.
4. Cochin Export Processing Zone.

cent during 1988–89 over that in the previous year. An export target of ₹ 15 crore was set for the year 1989–90.

TRADE AGREEMENTS AND ECONOMIC AND TECHNICAL CO-OPERATION WITH OTHER COUNTRIES

The most common features of these agreements were that: (i) MFN treatment would be extended to the other nation for both commodities and services in mutual trade; (ii) payments for transactions would be settled in freely convertible currencies through normal banking channels in accordance with the foreign exchange regulations in force in the respective country; (iii) the agreements would initially be operative for an year or two with provisions for renewal as also for modifications or termination on the prescribed notice being served by either of the signatories; (iv) the agreements would be reviewed periodically by joint committees set up for monitoring progress, discussing problems arising in the process, identifying areas that offered scope for increased trade and co-operation between India and these countries and helping to exchange information of interest to each other; and (v) each country would provide facilities for organising and/ or participating in exhibitions in its territory and arrange for mutual visits by technical, commercial and business delegations.

India maintained cordial and close economic and commercial relations with other countries, thus paving the way for trade agreements and protocols. During 1984–85, India signed fresh long-term trade and payments agreements with the USSR, the GDR, Poland and Romania for the period 1986–1990, when the earlier agreements expired. Another agreement on mutual deliveries of goods and commodities for 1986–1990, envisaging an increase in the trade turnover with the USSR by 1.5 to 2 times, was signed during 1984-85. A salient feature of the agreement was export of machinery, equipment, materials and services from India for civil and industrial projects in the USSR. A protocol on the delivery of machinery and equipment to India from the USSR on DPT was also signed for the period 1986–1990. A trade and payments agreement was signed with Poland for a five-year period from January 1986 to December 1990 on February 22, 1986 at Warsaw. Along with the agreement, a long-term trade plan on reciprocal delivery of goods and essential commodities between India and Poland during 1986–1990 was also put in place.

The trade and payments agreements with Romania and the GDR were renewed for five years till December 31, 1990. The agreement with Romania covered important commodities, such as, import of steel products, fertilisers/ chemicals, capital goods and railway equipment from Romania and export of manganese, iron ore, bauxite, cotton, coffee, pepper and engineering goods from India. The trade protocols for 1986 were signed with all the five countries, with whom India had long-term trade and payments agreements.

The trade protocol with China providing for exchange of goods worth US$ 100.0–160.0 million during 1986 was signed in November 1988. Under the protocol, China would import from India iron ore, chrome ore, steel products, tobacco, finished leather, mining and building machinery, instruments and tools. The protocol of the Indo-Finnish Joint Commission signed in April 1985 identified products for special thrust for export to Finland from India, which included agricultural products, leather goods, engineering goods and electronic components. Important items of import from Finland included newsprint, pharmaceuticals, fertilisers, hot and cold steel, coils and non-ferrous products. India signed a protocol for co-operation in trade and other fields of activity with Egypt in November 1985. A trade protocol on transfer of technology, which would help boost India's exports, was signed with Switzerland in September 1985 at Indo-Swiss Joint Commission. In October 1985, India signed an agreement with Sweden for assistance of S. Kr. 30.0 million for an integrated programme for technical co-operation in trade promotion. The focus of this programme was on developing exports of select labour-intensive products produced by SSIs in specific geographic areas.

India signed a MoU with Pakistan on January 10, 1986, containing a number of provisions to boost mutual trade. Pakistan, under this MoU, allowed the private sector to import 42 items from India.

MoU were also signed with Afghanistan and Ethiopia. The bilateral textile agreement with Norway allowed, for the first time, free access for export of traditional folklore textile products and products made from handloom fabrics to Norway markets. The agreement was initially effective for 18 months from July 1, 1985 but had provisions for extension for one more year. In February 1986, a bilateral agreement on economic and technical co-operation was signed between India and Maldives.

RELAXATIONS/SIMPLIFICATION OF PROCEDURES AND OTHER DEVELOPMENTS

INVESTMENT BY NON-RESIDENTS OF INDIAN NATIONALITY OR ORIGIN

The facility for portfolio and direct investment in equity shares of Indian companies available to non-residents of Indian nationality or origin (including overseas bodies owned by such persons to the extent of at least 60.0 per cent) was extended to investment in preference shares and debentures (convertible and non-convertible). The portfolio investment scheme for NRIs was modified in light of the experience gained in its operation. Under the modified scheme, designated banks could purchase equity shares and convertible debentures without the Reserve Bank's specific approval for each transaction, to the extent of 1.0 per cent per non-resident investor, subject to an overall ceiling of 5.0 per cent of the total paid-up equity capital of the investee company and 5.0 per cent of the total paid-up value of each series of convertible debentures issued by the company.

EXPERT COMMITTEE ON EXPORTS AND IMPORTS

The Reserve Bank appointed an expert committee to review the exchange control regulations relating to exports and imports and to suggest measures to simplify and streamline the documentation and procedures in November 1982. In terms of the recommendations of the committee, the process for simplification and rationalisation of exchange control procedures and also for improving the quality of customer service was undertaken in consultation with the Government.

ACU: PAYMENT FOR TRANSACTIONS THROUGH ACU

To encourage intra-regional trade between member countries of the ACU,[5] it was decided that all eligible payments on account of current international transactions (other than payments relating to travel) between India and other member countries in the ACU, except Nepal, be settled compulsorily through the ACU mechanism. The new arrangement was brought into force from January 1984. Export and import transactions involving settlement of DPT were kept outside the purview of compulsory settlement procedure. In such cases, however, there was no bar on the advance/down payment against shipping documents being settled through the ACU.

With effect from August 1, 1985, the Reserve Bank arranged to announce its rates for purchase and sale of the ACU currencies on a daily basis. This was in response to the decision taken by the ACU that exchange rates for ACU currencies against the domestic currencies of the participating countries should be quoted by the respective central banks on a daily basis to overcome the problem of divergence between the rates fixed for the accounting period and the actual daily rates.

The seventeenth meeting of the board of directors of the ACU was hosted by the RBI in Bombay on March 2 and 3, 1989. The board noted with satisfaction that only 26.0 per cent of the total transactions among the participants were settled in foreign exchange in 1988 as compared with 36.0 per cent in 1987. Further, ways and means to expand the scope of ACU's activities and its membership was also discussed. A noteworthy outcome of the meeting was the decision to introduce swap arrangement amongst ACU members as a temporary facility for members facing deficit at the time of bi-monthly settlements.

SALE/TRANSFER OF SHARES OF INDIAN COMPANIES BY NRIs

To facilitate the sale and transfer of shares of Indian companies held by non-residents of Indian nationality or origin to citizens of India or PIO, the Central

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5. The ACU was established in December 1974 on the initiative of the ESCAP with the objectives of providing a facility to settle, on a multilateral basis, payments for current international transactions, promoting use of the participants' currencies in current transactions and promoting monetary co-operation among the participants.

Government issued a notification on May 4, 1983 exempting such transfers from the provisions of the FERA, 1973. The exemption covered cases where: (i) the shares were purchased by the transferee from the stock market through a member of a recognised stock exchange in India; and (ii) the proceeds of the shares sold by the transferor were credited to his NRO account with an AD in India, with no right of repatriation outside India.

ORDINARY NON-RESIDENT ACCOUNTS FOR CORPORATE BODIES

A measure of liberalisation of investment facilities available to OCBs/trusts in which at least 60.0 per cent ownership/beneficial interest was held directly or indirectly, but ultimately by non-residents of Indian nationality or origin was introduced in April 1984. ADs were permitted to open and maintain NRO accounts in rupees in the names of such OCBs/trusts, subject to the condition that the initial deposits for opening such accounts should be made by remittance from abroad in an approved manner or out of rupee funds originating in India, which were otherwise eligible for credit to such non-resident accounts.

INDIANISATION OF FOREIGN COMPANIES

As on June 30, 1984, the number of cases in which final orders under section 29 (2)(a) of the FERA, 1973 were passed requiring dilution/Indianisation of foreign companies to specified levels came to 379. During the year, 17 more companies complied with the directive, bringing the total number of such companies to 349. The remaining 30 companies were at various stages of compliance.

As at the end of June 1987, final orders under section 29(2) of FERA requiring indigenisation/dilution of foreign equity to a specified level were issued to 389 companies including 14 companies, which opted for winding up their activities in India instead of indigenisation. Of these, 368 had complied with the FERA directives by that date. The remaining 21 companies were at various stages of compliance.

FORWARD EXCHANGE COVER

In view of the changing external trade and payments scenario and emergence of new lines of activities, a review of the regulations relating to forward sale and purchase contracts of foreign currencies undertaken by ADs was made. It was found necessary to enlarge the scope and coverage of some of the existing facilities and introduce forward cover facilities for some emerging business activities. Accordingly, the Reserve Bank introduced a number of changes in the package of forward cover facilities with effect from December 28, 1985. The new areas where forward cover facilities were introduced included: (i) roll-over forward cover for repayment of foreign currency loans; (ii) cross-currency forward cover for payments towards imports financed out of foreign currency loans where the goods were invoiced for payment in a currency/currencies other than the

currency of the loan; (iii) cross-currency forward cover in respect of repayment of instalments of a loan obtained in one foreign currency by an Indian airline or a shipping company for acquisition of aircrafts/ships from out of revenue earnings in other foreign currencies; (iv) forward cover for charter hire payments by Indian airline and shipping companies/shippers; (v) forward cover for remittance of technical know-how fees; (vi) forward cover for remittance of erection and commissioning charges; and (vii) forward cover for re-transfer abroad of funds temporarily brought into India by Indian companies/firms executing turnkey/civil construction/service contracts abroad.

RIFEE SCHEME

Under the RIFEE scheme, prior to December 26, 1985, eligible non-residents of Indian nationality or origin returning to India for permanent settlement were entitled to avail of foreign exchange up to 25.0 per cent of the total amount repatriated to India and balances held in their NR(E)A or FCNR (A) at the time of transfer of residence. The limit for foreign exchange entitlement under the scheme was raised from 25.0 to 50.0 per cent with effect from December 26, 1985.

EXPORT-IMPORT PASS BOOK SCHEME

The Government of India introduced an export-import pass book scheme for manufacturer-exporters to provide duty-free access to imported inputs for export production. This scheme, broader in its coverage than the advance licensing scheme, was intended to help regular registered manufacturer-exporters to obtain their requirements of imported articles, such as raw materials, duty free to suit their production/export time schedules.

WORKING GROUP ON EXCHANGE CONTROL

The working group on exchange control constituted by the Reserve Bank submitted its report in January 1986. Several recommendations made by the working group for simplification and selective liberalisation of exchange control policies for better customer service were accepted and implemented by the Bank. These related, *inter alia*, to foreign travel under the special travel schemes, remittance facilities available to non-residents of Indian nationality or origin, remittance of dividend by non-FERA companies and agency commission on exports.

SALE OF US DOLLARS BY THE RESERVE BANK

The Reserve Bank introduced a scheme for sale of US dollars to ADs effective February 2, 1987. Earlier, the Bank was selling only spot pound sterling while it bought, both on spot and forward basis, four currencies, *viz.*, pound sterling, US dollar, DM and Japanese yen from ADs. The scheme, which was confined to Bombay, was intended to assist the healthy growth of the local exchange market

as also to help importers get finer rates from ADs. There was no ceiling on the amount of dollar purchases.

REMITTANCE OF DIVIDEND TO NON-RESIDENT SHAREHOLDERS OF INDIAN COMPANIES

Prior to July 31, 1986, ADs could remit dividend to non-resident shareholders without the prior approval of the Reserve Bank, if the equity shares held by non-resident shareholders in a non-FERA company did not exceed 25.0 per cent of the total issued equity capital of ₹ 5 lakh in face value. To facilitate prompt remittance of dividend to non-resident shareholders, the Reserve Bank granted general permission to ADs with effect from July 31, 1986 to make remittances towards equity dividends to non-resident shareholders of all non-FERA companies, irrespective of the face value of equity shares or percentage of the issued capital held by the non-resident shareholders. Applications of only FERA companies were now required to be submitted to the Reserve Bank for prior approval.

INVESTMENT BY NRIs

To provide further incentives to NRIs and overseas bodies, owned directly or indirectly to the extent of at least 60.0 per cent by NRIs, for investing in Indian companies with the benefit of repatriation of capital and income earned, certain additional facilities were offered. These included: (i) bulk investments up to 100.0 per cent of equity capital in sick industrial units; (ii) investments in new issues of Indian shipping companies and companies engaged in the development of computer software or oil exploration services under the 40.0 per cent scheme; (iii) investments in medical diagnostic centres under the 40.0 per cent and 74.0 per cent schemes; and (iv) investments in private limited companies under the 40.0 per cent scheme.

RELAXATION IN EXCHANGE CONTROL PROCEDURES RELATING TO EXPORTS

To render prompt service to exporters, the powers delegated to ADs in certain exchange control areas were enhanced from April 23, 1987. These included: (i) Permission to allow reduction up to 10.0 per cent of the invoice value of an export shipment or ₹ 10,000, whichever was less, on account of disputes about quality and quantity on behalf of all regular exporter-clients. Earlier, ADs could consider such applications only from exporters who held blanket permits. (ii) Permission to remit commission or agree for deduction of the commission amount from the invoice of the relative export shipment up to ₹ 1 lakh in respect of shipments of goods included in the select list of export products and up to ₹ 50,000 in respect of shipments of other export products, provided the rates at which commission was paid were within the prescribed ceiling rates. (iii) Permission to effect remittances towards export claims up to 10.0 per cent of fob value of the shipment or ₹ 30,000 whichever was less. (iv) Grant of

pre-bid clearance for bids/offers for export of engineering goods on DPT and execution of turnkey/civil construction contracts abroad up to the value of ₹ 5 crore. The monetary ceiling on the powers delegated to the Exim Bank to grant such pre-bid clearances was raised from ₹ 5 crore to ₹ 20 crore.

SCHEMES FOR EXPORT OF SILVER JEWELLERY AND ARTICLES

The Government introduced from December 8, 1986 a scheme for export of silver jewellery and articles against silver supplied by foreign buyers. Under the scheme, silver required for the manufacture of articles/jewellery had to be supplied free of charge by foreign buyers so that there was no net export of silver from India. Export of jewellery and articles (including studded ones) was permitted only if the value added in the export was at least 20.0 per cent. Under a second scheme introduced the same day, exports of jewellery and articles (other than coins) made of silver were entitled to the benefit of replenishment of silver, provided they satisfied the value added and other requirements laid down by the Government.

SCHEME FOR EXPORT OF SILVER JEWELLERY

To obviate the need for the HHEC and STC to approach the Reserve Bank for permission each time silver was to be imported or silver jewellery was to be exported under the scheme for export of silver jewellery, the Bank granted special permission to the HHEC and STC to import silver metal and export silver jewellery/articles under the scheme initially for a period of one year effective December 30, 1987.

SCHEME FOR MANUFACTURE AND EXPORT OF GOLD AND SILVER JEWELLERY AND ARTICLES

The Government introduced the scheme for export of gold and silver jewellery and articles from EPZs and 100.0 per cent export-oriented complexes. The Government permitted the SBI to make available to such units gold imported by it under the gold jewellery export promotion and replenishment scheme, and the MMTC was also permitted to import gold into India for supply to such units to enable them to manufacture jewellery for export. In order to obviate the need to secure specific export licences from the Reserve Bank as required under section 13(2) of FERA, the Reserve Bank granted special permission to these units to send out Indian gold/silver jewellery under the provisions of the scheme.

PROJECT EXPORTS

During 1986–87 (July–June), the working group on project exports accorded approvals to 107 proposals involving an aggregate value of ₹ 3,703 crore. These comprised 23 proposals for civil construction contracts (₹ 1,464 crore), 44 proposals for turnkey contracts (₹ 1,747 crore), 10 proposals for deferred payment

contracts for supply of engineering goods (₹ 168 crore) and 30 proposals for consultancy contracts (₹ 323 crore).

JAPANESE YEN AND DEUTSCHE MARK PURCHASES BY THE RESERVE BANK

The facility of spot sale and sale for delivery up to one month of Japanese yen and Deutsche mark to the Reserve Bank was restored to ADs effective November 2, 1987 to cover their spot purchases from their overseas branches and correspondents for crediting rupee funds to their accounts in India.

FORWARD DELIVERY RATES FOR POUND STERLING: REVISION IN FORWARD MARGIN

Effective December 7, 1987, the forward margin charged by the Reserve Bank on its purchases of pound sterling was changed to a slab basis, depending on the Reserve Bank's rupee-pound sterling rate, to make the forward margins more consistent with changes in the rupee-pound sterling rates. The forward discount was fixed at GBP 0.0040 per ₹ 100 per month instead of GBP 0.0060 hitherto. Extension of forward purchase contracts in pound sterling continued to be permitted by the Reserve Bank on payment of a charge of GBP 0.0075 per month over the contracted rate.

FOREIGN TRAVEL SCHEME

Travel under the foreign travel scheme could now be combined with travel abroad for any other purpose, except for tours on export promotion or business grounds, *Haj* pilgrimage and travel under the NTS.

FOREIGN TRAVEL UNDER SPECIAL TRAVEL SCHEME

Under the FTS, Indian residents were eligible to undertake visits to any country (other than Bhutan and Nepal) once in two calendar years and were entitled to draw foreign exchange up to the equivalent of US$ 500 per capita. Similarly, under the NTS, Indian residents were eligible to visit any country in the group of eight neighbouring countries (*viz.*, Bangladesh, Burma, Malaysia, Maldives, Mauritius, Pakistan, Seychelles Islands and Sri Lanka) once in two calendar years and could draw foreign exchange up to the equivalent of US$ 250 per capita. According to changes made with effect from April 7, 1986, foreign travel under these schemes could be undertaken only once in three calendar years instead of two. Further, a combination of FTS and NTS for the purpose of drawing exchange was not permissible.

FOREIGN EXCHANGE CONSERVATION (TRAVEL) TAX

Effective October 15, 1987, persons drawing exchange for travel abroad were required to pay, unless specifically exempted, foreign exchange conservation (travel) tax at a rate of 15.0 per cent of the rupee equivalent of the foreign exchange

released to them, under the provisions of the Finance Act, 1987. The foreign exchange conservation (travel) tax rules, 1987 laid down the detailed procedure for collection of the tax and its deposit into government account, refund of the tax following surrender of unutilised exchange, exempted categories of travel and allied matters.

LEVY OF CESS ON PAYMENTS TOWARDS IMPORT OF TECHNOLOGY

Under the Research and Development Cess Act, 1986, a cess at the rate of 5.0 per cent was levied on every industrial concern on all payments made towards such import of technology effective December 1, 1987. The proceeds of the cess collected by the Central Government were transferred to the IDBI, which would administer the above Act by crediting the amounts to a venture capital fund to be used for providing equity capital or any other form of financial assistance to industrial concerns attempting commercial application of indigenous technology or adapting imported technology to wider domestic applications.

SURRENDER OF UNSPENT FOREIGN EXCHANGE TRAVELLERS ON RETURN TO INDIA

Under a notification issued by the Reserve Bank on February 27, 1988, the maximum period allowed for surrender of any amount of unspent foreign exchange brought back to India was uniformly fixed at 90 days from the date of return in respect of all travellers, as against the earlier condition of surrender to an AD not later than 60 days from the date of return of the traveller, if the amount was within US$ 200 or its equivalent and within 30 days if the amount exceeded US$ 200 or its equivalent.

GUIDELINES FOR EXPORT OF CONSULTANCY/TECHNICAL SERVICES ON DPT

In the past, Indian companies/firms undertaking execution of overseas consultancy and technical service contracts were required to stipulate the terms of payment under which the full contract value was payable against progress bills before completion of the contract. The Bank evolved broad guidelines for exporters of such services under which they were able to bid for overseas service contracts on DPT, on a selective basis.

LIBERALISATION OF INTERNATIONAL CREDIT CARD FACILITY

Effective November 23, 1987 liberalisation measures were introduced in the international credit card facility available to holders of blanket exchange permits issued by the Reserve Bank. The facility of holding international credit cards was also extended to firms/companies holding exchange permits issued under the CAFEX scheme.

EXPORTS TO OVERSEAS INDIAN-OWNED WAREHOUSES APPROVED BY THE RESERVE BANK

During 1987–88, the Bank permitted the Electronics Trade and Technology Development Corporation Ltd, a Government of India undertaking, to establish a warehouse in the US for promoting the exports of Indian electronic goods to the US. Considering the longer time required for sale of goods on 'stock and sell' basis, the statutory time limit prescribed for realisation of proceeds of exports made to Indian-owned warehouses established abroad with the approval of the Reserve Bank was fixed at 15 months as against the period of 6 months prescribed for normal exports.

ENGAGEMENT OF FOREIGN NATIONALS

Before August 1988, companies/firms were required to obtain prior permission from the concerned administrative ministry of the Government to engage foreign technicians/technical experts, except in cases where the engagement was for a short period not exceeding three months for attending to an emergency or breakdown of plant/machinery. This procedure was modified and the Reserve Bank dealt with all types of applications for engaging foreign technicians/technical experts by companies and firms in India, subject to compliance with the following conditions: (i) the total duration of the engagement of the foreign technician/s or technical expert/s by any Indian company/firm should not exceed 12 months in a calendar year; (ii) the payment towards fees/remuneration to any single foreign technician/technical expert should not exceed US$ 500 per day; and (iii) in the case of payments in foreign exchange on a company-to-company basis, the total payment by any Indian company to all foreign companies/firms taken together on account of services of foreign technicians/ technical experts should not exceed US$ 50,000 in a full calendar year.

Further, companies/firms holding blanket exchange permits were permitted to utilise these permits to meet expenditure in foreign exchange to engage foreign technicians/technical experts, provided they had obtained the Reserve Bank's prior permission for such engagement.

RUPEE LOANS/OVERDRAFT TO NRIs FOR DIRECT INVESTMENT IN INDIA

To encourage investment in India by NRIs, the Reserve Bank started considering, on merit, applications by ADs for grant of rupee loans/ overdrafts to non-residents of Indian nationality/origin against security of fixed deposits in their NRE/FCNR accounts for making direct investments in India, on non-repatriation basis, in the following areas in addition to manufacturing activities and export-oriented trading activities: (i) hospitals (including diagnostic centres); (ii) hotels with 3, 4 or 5 star rating; (iii) shipping companies; (iv) development of computer software; (v) oil exploration services; and (vi) any industry listed in appendix I to

the Ministry of Industry's press note dated February 2, 1973 or any other export-oriented industry.

NRI BOND ISSUE BY SBI

The NRI bond issue opened on November 14, 1988 and closed on February 15, 1989. The maturity period of the bonds was seven years and they carried 11.5 per cent per annum interest compounded at half-yearly intervals. The principal amount of the bonds on maturity and the periodic interest thereon was payable to the bond holders after converting the amounts into rupees at the SBI at the telegraphic transfer (TT) buying rate for US dollar prevailing on the date of payment. To enable holders of NRI bonds to raise rupee funds to meet their genuine financial requirements in India, they were granted the facility of obtaining rupee loans against the security of the bonds for specified purposes.

EXCHANGE RISK ADMINISTRATION SCHEME

With a view to provide a measure of protection to the sub-borrowers of the ICICI, IDBI and IFCI, against the exchange risk inherent in their medium and long-term borrowings in foreign exchange, these three FIs launched the ERAS with effect from April 1, 1989. The benefit of cover under the scheme was available to foreign currency sub-loans disbursed on or after April 1, 1989 by the FIs out of their ECBs.

The repayment obligations in respect of the principal amounts of the sub-loans were rupee-tied at the rates prevailing on the dates of disbursement. The interest liability of the sub-borrowers, the spread of the FIs and the exchange risk premium was merged into a 'composite cost' with ceiling and floor rates. The actual rate within the band was announced from time to time and was payable at quarterly intervals. The exchange risk premium in the composite cost was credited to the exchange risk administration fund set up and administered by the IDBI.

NEW BLANKET EXCHANGE PERMIT SCHEME

The Reserve Bank introduced a single broad-based permit scheme for exporters in place of the separate blanket permit schemes, namely, the Reserve Bank and the ITC (import trade control) blanket permit schemes. The main features of the new scheme were: (i) the list of approved purposes for which foreign exchange could be availed by holders of blanket permits was expanded considerably to obviate frequent applications from exporters to the Reserve Bank; (ii) monetary ceilings prescribed for foreign exchange expenditure for the approved purposes were either removed or considerably enhanced to afford greater freedom to exporters; and (iii) the quantum of exchange entitlements was related to specific percentages of realised fob value of goods exported and their classification in accordance with product lists prepared by the Government. The scheme was further liberalised in 1988–89. The 100.0 per cent export-oriented units holding green cards issued

by the Ministry of Commerce were eligible for blanket permits during the initial period of two years of their operations, irrespective of their export performance. This facility was extended to new units operating in the export processing zones, even if such units did not have to their credit the required minimum export performance during the initial two years of operations. Besides, the number of approved purposes for which exchange could be drawn against blanket permits was considerably enlarged to cover more items, which stood at 24 in 1988-89.

APPENDIX 6.1

Committees and Working Groups

BANKING

COMMITTEE TO CONSIDER FORMATS OF PUBLISHED ACCOUNTS OF BANKS AND FULL DISCLOSURE IN SUCH ACCOUNTS

The Reserve Bank appointed a committee in March 1982 under the chairmanship of Shri A. Ghosh, Deputy Governor. The committee had representatives from banks, the NIBM, the Government, the Reserve Bank, and a chartered accountant to examine the formats of the published accounts of banks and consider the need, if any, for full disclosure by banks of their liabilities/assets.

The terms of reference of the committee included:

(i) to examine the desirability of greater or full disclosure in the published accounts of banks, public accountability of banks, requirement of maintaining confidentiality between banker and customer and the requirement of maintaining the image, reputation and credit-worthiness of banks;

(ii) to suggest whether it was necessary to make any further provisions in the existing laws if greater or full disclosure was not considered necessary or appropriate;

(iii) to suggest suitable changes/amendments in the formats of the balance sheets and profit and loss accounts, having regard to: (a) the need for greater or full disclosures, (b) the expansion of banking operations both area-wise and sector-wise, (c) the need for improving the presentation of accounts, and (d) the presentation of accounts of other companies;

(iv) to look into the practices broadly followed by banks in accounting/classifying various items of liabilities and assets and income and expenditure, and to suggest standard accounting concepts, which would facilitate a uniform and comparable presentation of such items in the published accounts, and compliance with various statutory requirements; and

(v) to consider evolving suitable norms for creation of provisions for income tax and other taxes, bad and doubtful debts and depredation in government securities on a scientific basis.

The committee held several meetings with the chairmen of banks and representatives of regional councils of the ICA, the ICWA, the Chambers of Commerce and management institutes before finalising its recommendations.

WORKING GROUP TO REVIEW THE EXISTING SYSTEM OF INSPECTIONS

The Reserve Bank appointed a working group, in December 1981, under the chairmanship of a retired senior officer of the Bank to review the existing system

of inspection of commercial banks in the public and private sectors and to suggest improvements/modifications. The group was asked to review the existing system of inspection of UCBs and RRBs. The terms of reference also covered an examination of: (i) the question of in-class as well as on-the-job training of inspection staff of the Reserve Bank; and (ii) the existing machinery for monitoring the progress of inspections and the follow-up of their findings.

Pursuant to the recommendations made by the working group on simplification of inspection forms and synchronisation of the inspection system in banks with the basic data required for purposes of inspection, the inspection forms were revised and forwarded to regional offices for their use.

WORKING GROUP TO REVIEW THE ACCOUNTING SYSTEM AT BANK BRANCHES

The Reserve Bank constituted on July 11, 1981 a working group to review the accounting system at bank branches in the context of generating data for various statutory and other returns relating to deployment of credit, particularly data relating to priority sector lending. The terms of reference of the working group were:

(i) to look into the existing systems of maintenance of accounts at the branch level, including maintenance of the main books of accounts like general ledgers and loan ledgers, as also various systems of maintenance of sub-day/supplementary books, loan balancing and other records, particularly at the rural and semi-urban branches and suggest changes that would facilitate: (a) generation of summary data regarding deployment funds and lending to various categories of priority sectors, (b) generation of data for compiling the returns and schedules prescribed by the Reserve Bank and for furnishing information required by the Reserve Bank, central and state governments, returns required by the head office/controlling offices of banks for control and supervision as well as for statistical purposes;

(ii) to review the information system introduced by the Reserve Bank and examine the feasibility of integrating the system with the control/statistical returns required to be submitted by banks;

(iii) to suggest other measures necessary to ensure the availability of data on a regular basis and without delay; and

(iv) to any other matters that are incidental or related to the terms of reference.

The group could appoint study groups, comprising bank officers who had sufficient operational experience, which could be assigned specific tasks. It could also conduct sample studies of the existing system of accounting in a few banks, and such studies could be entrusted to individual banks and/or the NIBM, Pune.

The report of the working group was examined and processed. Banks were asked to implement the recommendations relating to maintenance of separate

subsidiaries for different segments of priority sector advances, separate loan ledgers for different segments of priority sector borrowers and introduction of the loose-leaf system of maintaining loan ledgers.

STANDING CO-ORDINATION COMMITTEE FOR TRAINING ARRANGEMENTS IN BANKS

To strengthen the training arrangements in banks with a view to providing motivated and trained manpower, a standing co-ordination committee under the chairmanship of a Deputy Governor of the Reserve Bank was constituted in March 1986 to co-ordinate, monitor and guide the training arrangements in banks on an on-going basis. The third meeting of this committee was held on June 20, 1988. The important decisions taken at the meeting were as follows:

(i) banks should conduct an evaluation test for trainees at the end of the induction programme for base-level officers (both direct recruits and promotee officers);

(ii) the model course design for induction training programme for base-level officers was finalised for adoption by banks; and

(iii) while drawing up the training programme for officers, banks were advised to keep in mind the views of the Parliamentary Consultative Committee attached to the Ministry of Personnel, Public Grievances and Pension. The proposals reiterated that bank officials at all levels needed to be suitably briefed about the nature, scope and details of various development programmes of the Government by suitable training inputs. Further, there was even greater need for these functionaries to overcome their mistrust of the poor and to engender suitable attitudinal changes to make them take a genuine interest in the sphere of development administration rather than treat these activities as unwelcome but unavoidable chores.

WORKING GROUP ON OPERATIONS OF INDIAN BANKS ABROAD

There was a quantum jump in the volume of business as also diversification of such business during the 1970s in the overseas sector of Indian banks. Against the backdrop of the need for banks to focus on developing sound marketing and business strategies and to take fresh initiatives, which were deemed necessary to give a sense of direction to their international operations, the Reserve Bank set up a working group to appraise the operations of Indian banks operating abroad, assess their growth potential and make recommendations for improving the business performance of banks. The working group was appointed on July 29, 1988 with chief officers and executives from the SBI, BoI, BoB and NIBM in addition to the controller, ECD, Reserve Bank, as members.

SMALL GROUP TO CONSIDER NATIONAL CLEARING OF OUTSTATION CHEQUES

The Reserve Bank examined the feasibility of introducing national clearing of outstation cheques in consultation with the IBA with a view to reducing the time involved. Accordingly, the Bank appointed a small group of representatives from the Government of lndia (Ministry of Finance), the Electronics Commission, the IBA and the Reserve Bank to consider:

(i) the feasibility of introducing MICR/OCR technology for cheque writing and to recommend a suitable system for national clearing of outstation cheques;

(ii) details on standardisation of the cheque form with reference to size, quality of paper and printing specifications;

(iii) tentative schedules for introducing the system; and

(iv) related matters, particularly those relating to the feasibility of introducing the giro system as part of national clearing for quicker remittance of funds, which also required mechanisation.

INDUSTRIAL SECTOR

COMMITTEE OF DIRECTION

The COD had been constituted by the Reserve Bank in 1975 to consider and advise, on an on-going basis, on problems arising from the implementation of the recommendations of the Tandon Study Group on follow-up of bank credit and other related matters. The committee had representatives from the Reserve Bank, IDBI and commercial banks. The committee had set up five sub-committees: four to review the inventory/receivable norms for various industries, *viz.*, engineering, electrical, textiles, glass and leather and the fifth to evolve lending norms for units in the trading group. The recommendations of the sub-committee on the textiles group were accepted by the COD and the Reserve Bank with some modifications and banks were advised of the revised norms in June 1984. The recommendations of the sub-committee on the electrical group were also accepted by the COD.

The COD served as a forum to examine on an ongoing basis the problems arising from the implementation of the recommendations of the Tandon, Chore and Marathe Committees.

WORKING GROUP TO REVIEW THE SYSTEM OF CASH CREDIT

The report of the working group, which was submitted in September 1979, was accepted by the Bank with certain modifications, and commercial banks were advised on December 8, 1980 to implement the accepted recommendations. The major decisions taken by the Reserve Bank on the recommendations made by the working group were:

(i) Enhancement of borrowers' contribution

The contribution from borrowers towards working capital out of their long-term sources should hereafter be not less than 25.0 per cent of the current assets required for the estimated level of production, which would mean a minimum current ratio of 1.33:1 (as against 25.0 per cent of working capital gap, *i.e.*, total current assets minus current liabilities other than bank borrowings). In case a borrower was not in a position to comply with this requirement immediately, the existing need-based credit limits already enjoyed by the borrower should not be curtailed; the excess over the credit limits permissible to the borrower should be segregated and treated as WCTL, which would be made repayable in half-yearly instalments within a definite period, not exceeding five years. The WCTL should carry a rate of interest that should in no case be less than the rate charged for the relative cash credit and banks may, at their discretion, even charge a higher rate of interest not exceeding the ceiling. In addition, suitable provision should be made for charging the penal rate of interest in the event of any defaults in the timely repayment of WCTL.

In respect of such borrowers, if additional limits became necessary on account of increased production, banks were asked to ensure that the WCTL component was not enhanced and additional limits were allowed on the basis of an incremental current ratio of 1.33: 1.

(ii) Separate limits for peak level and non-peak level

Separate limits should be fixed, wherever feasible, for peak level and non-peak level credit requirements, indicating the periods during which the relative limits would be utilised by borrowers.

(iii) Ad hoc or temporary limits

Banks should consider very carefully requests from borrowers for *ad hoc* or temporary limits in excess of the sanctioned limits, which should be allowed only for a pre-determined short duration and given through a separate demand loan or non-operable cash credit account. As such, additional accommodation would put the bank's credit planning out of gear, and banks should charge additional interest of one per cent per annum over the normal rate. However, in exceptional circumstances, such as natural calamities, banks may not charge any additional interest.

(iv) Drawal of funds to be regulated through quarterly operative limits

Borrowers should indicate before the commencement of each quarter the funds required during the quarter, *i.e.*, the operative limit, which should be within the limit sanctioned for peak level/non-peak level periods. The quarterly statements should form the basis for a quarterly review of the account and the operative limit indicated by the borrower should eventually set the level of drawings in that quarter, subject to a tolerance limit of 10.0 per cent either way. Excess or under-utilisation of the operative limit beyond the tolerance level should be considered as an irregularity in the account and banks should initiate necessary

corrective steps, including dialogues with the borrowers, to prevent recurrence of such irregularities.

If a borrower did not submit the returns within the prescribed time, banks may charge penal interest of one per cent per annum on the total outstanding for the period of default in the submission of quarterly returns. In case the default persisted, banks should review the position, and where they were satisfied that action was necessary, the accounts of such borrowers may be frozen.

The measures suggested under items (i) to (iv) above were applicable to all the borrowers without exemption, having aggregate working capital limits of ₹ 50 lakh and above from the banking system. Sick units under the nursing programme, or where rehabilitation measures were under active consideration by banks, would not be covered by the measures indicated in items (i) and (iii) above.

(v) Encouragement of bill finance

Banks were advised to discourage the sanction of cash credit against book debts and take steps to review all such accounts and convert such cash credit limits into bill limits, wherever possible.

(vi) Drawee bill system

In respect of borrowers with aggregate working capital limits of ₹ 50 lakh and over from the banking system, banks were required to extend at least 50.0 per cent of the cash credit limit against raw material inventory to the manufacturing units, whether in the public or private sector, by way of drawee bills.

(vii) Dues of PSUs to SSIs

Banks should insist that PSUs and large borrowers maintained control accounts in their books to give precise data regarding their dues to small units and furnished the data in their quarterly information system. This would enable banks to take suitable measures for ensuring payment to small units without delay.

As various problems/issues arising from the implementation of the recommendations of the group were brought to the notice of the Reserve Bank, it organised a seminar in July 1981, where senior executives of banks, representatives of the IDBI, ICICI and NIBM participated. In light of the consensus reached at the seminar, the following relaxations were made by the Reserve Bank:

(i) As some of the borrowers, for instance: (a) new companies floated prior to December 8, 1980; (b) companies showing signs of incipient sickness; and (c) companies having finalised modernisation/expansion programmes prior to the implementation of the Chore Committee recommendations might not be in a position to switch to the second method of lending recommended by the Tandon Committee (according to which the borrowers' contribution from owned funds and long-term resources to meet the working capital requirements should be at least 25.0 per cent of the total current assets), banks were instructed to assess the credit requirements of such borrowers without applying the second method of lending. Such relaxation was, however, to be permitted for a period not exceeding three years.

(ii) Banks were advised to adopt a flexible approach in respect of exporters who were unable to bring in additional contributions required under the second method of lending in respect of additional credit limits sanctioned for specific export transactions. In view of the concessional rate of interest applicable to export packing credits in the case of exporter-borrowers, banks may identify the working capital term loan where required on a notional basis and not carve it out from the relative account. Banks were also advised that additional interest of one per cent per annum on *ad hoc* temporary limits may be charged only on limits other than pre-shipment/post-shipment credit finance; as such finance was governed by ceiling rates of interest prescribed under the directives issued by the Reserve Bank from time to time.

(iii) To calculate the current assets/current liabilities and contributions to be made by borrowers, the net amount relating to income tax paid for the previous years, years for which assessments were pending and the corresponding provision may be taken into account. The advance tax paid for the current year and the corresponding provision may be taken as current assets and current liabilities, respectively, for the purpose of assessment and not the net position.

(iv) To compute permissible bank finance, banks were advised to include under current assets the amount of excise duty levied on the permissible level of inventory to be held by the borrower. Such amounts of excise duty may, however, be shown under other current assets and should not be treated as cost of production. Further, where the receivables of the borrower included an element of sales tax paid, banks could include such element of sales tax under other current assets.

COMMITTEE ON REHABILITATION OF SICK INDUSTRIAL UNDERTAKINGS

The Reserve Bank constituted a committee on May 14, 1981 to examine the legal and other difficulties faced by banks and FIs in rehabilitating sick industrial undertakings and suggest remedial measures. The terms of reference were:

(i) to review the policy framework within which banks/FIs could bring about a change in the management of assisted industrial units, and recommend changes;

(ii) to review the existing criteria adopted by banks/FIs for determining the suitability of a sick unit for revival and recommend appropriate modifications;

(iii) to identify the main constraints in the rehabilitation of sick units and suggest remedial measures including amendments to statutes;

(iv) to suggest measures for facilitating the restructuring of the capital base of the assisted units;

(v) to identify concessions that should normally be made by various agencies for reviving sick units and consider whether sick units should be burdened

with obligations like payment of minimum bonus and implementation of wage awards; and

(vi) to identify the factors inhibiting expeditious merger of sick units with healthy ones and suggest measures for expediting such mergers.

The committee submitted its interim report in November 1981 on the issue of special legislation for creating a special authority, *i.e.*, the Board for Industrial Revival, with an indicative draft legislation suggesting suitable legal measures for expeditious rehabilitation of sick industrial undertakings. The interim report was examined by the Reserve Bank and its views were forwarded to the Government for its consideration.

COMMITTEE TO REVIEW THE WORKING OF CAS

In pursuance of the decision taken at the meeting between the Governor, Reserve Bank and the chairmen of major banks on October 25, 1982, the Bank appointed a committee in November 1982 to review the working of CAS from the point of view of its operational aspects. The terms of reference of the committee were:

(i) to examine the objectives, scope and content of the scheme and suggest modifications, if any, given the changing economic situation;

(ii) to examine the adequacy of credit appraisal machinery/procedures in commercial banks and suggest modifications, if any, in their modalities;

(iii) to study the existing set up for compliance with the requirements of the scheme within the commercial banks, both at the head and regional office levels, and suggest necessary modifications to facilitate proper appraisal and expeditious disposal of applications and monitoring;

(iv) to examine the existing database used by banks to make recommendations to the Reserve Bank for authorising a given level of credit for a particular party and suggest modifications/simplifications;

(v) to examine the existing format used by banks to submit applications to the Reserve Bank in respect of seeking authorisation, and suggest necessary modifications;

(vi) to study the desirability of introducing time-bound guidelines to be observed by commercial banks and the Reserve Bank to speed-up the processing and disposal of applications; and

(vii) to make any other relevant recommendations.

The committee submitted its report in July 1983.

COMMITTEE ON FINANCING OF THE TEA INDUSTRY

The Reserve Bank of India constituted a committee on October 3, 1980 to examine problems relating to the financing of the tea industry. The terms of reference were:

(i) to review the existing norms for providing working capital to the tea industry recommended by the Reserve Bank to SCBs in March 1972 on the basis of the report of the study group under the chairmanship

of Shri B.K. Dutt and suggest suitable modifications in the changed circumstances;

(ii) to examine the credit requirements of the tea industry (both working capital and term loans) in the wider context of the need to expand output to meet the sustained rise in domestic consumption without impinging on the exportable surplus;

(iii) to enquire into the problems faced by the industry in obtaining finance (both working capital and term loans) from commercial banks, OFIs and the Tea Board;

(iv) to consider other problems faced by commercial banks in providing credit to the tea industry; and

(v) to make recommendations on these and any other related matters.

Based on the recommendations of the working group, guidelines were issued to banks in June 1982 for assessing the working capital requirements of borrowers. For this purpose borrowers were classified into four categories:

Large borrowers:[1] Cash credit/bills limits should not exceed 75.0 per cent of the peak deficits as reflected in the cash budgets of borrowers. Banks were required to fix the limits for the entire season/year on the basis of monthly cash budgets.

Small borrowers:[2] Working capital limits should be fixed on the basis of per acre scale of finance as determined by area committees (to be constituted by the Tea Board). No minimum contribution by way of net working capital was stipulated, but banks had to take into account the owned funds that could be brought in by the more affluent among the tea planters and determine the limits accordingly.

Bought-leaf factories:[3] Advances to factories holding registration certificates as SSI units should be eligible for classification as priority sector advances. The working capital needs should continue to be assessed on the basis of Tandon/Chore Committee discipline.

Tea traders:[4] Need-based finance should continue to be extended to tea traders, keeping in view the Tandon/Chore Committee discipline, except where specially relaxed by the Reserve Bank, as in the case of *ad hoc* increase in packing credit limits to meet large unforeseen export orders.

STANDING COMMITTEES FOR SELECTED INDUSTRIES

The Reserve Bank appointed standing committees on co-ordination of institutional finance for four major industries, *viz.*, jute, tea, sugar and fertilisers

1. Units having their own processing factories, and those which did not have processing factories but whose holdings were over 100 hectares.
2. Units with holdings up to 100 hectares and which did not have processing factories of their own.
3. Units which buy green leaves from neighbouring small planters for processing.
4. Those engaged in buying tea at auctions in bulk and eventually selling/exporting it.

to study their financial problems on an on-going basis. The standing committees for the jute and tea industries were set up on November 20, 1982 and those for the sugar and fertiliser industries on January 8, 1983. The members of the committees were drawn from the Reserve Bank, term-lending institutions, the concerned industries, the Central Government and experts/technologists. Each committee was to discuss financial and other problems of the respective industries that were referred to it.

STANDING COMMITTEE ON CO-ORDINATION OF INSTITUTIONAL FINANCE

Sugar

The SCCIF for the sugar industry, which had been in existence for the past few years, was set up to take a co-ordinated view on credit requirements and related problems of the sugar industry. The committee met as and when the need arose to discuss problems affecting the sugar industry. A sub-committee headed by the chairman of IFCI was also set up to suggest broad measures for the rehabilitation of the sugar industry. The recommendations of the sub-committee were considered at the final meeting of the SCCIF held on May 20, 1986 and follow-up action was initiated.

Based on the recommendations of the sub-group constituted by the standing committee, banks were advised by the Reserve Bank in October 1986 to classify the sugar mills financed by them into four categories according to the norms evolved, *viz.*, viable, potentially viable, marginally viable and non-viable. Based on the data provided by banks, detailed instructions for working out rehabilitation packages and giving concessions to potentially/marginally viable and non-viable sugar mills were issued to banks in July 1987.

Tea

The standing committee for the tea industry in its sixth meeting held in September 1986 discussed, among others, issues relating to the allotment to tea estates of land rendered surplus under the Land Ceiling Act in Assam and West Bengal, the classification of small tea growers under the priority sector, overdues of sick tea gardens and norms for financing the tea industry. There had been complaints that there was no uniformity among banks in applying the prescribed norms, resulting in the adoption of divergent assessment methods by banks. Therefore, a small sub-group comprising representatives of the Reserve Bank, commercial banks, the Tea Board and the tea industry was formed to study the problem in its entirety and suggest necessary modifications. The sub-group submitted its report.

Textiles

In pursuance of the textile policy statement announced by the Government in June 1985, a standing advisory committee on modernising the textile industry

was constituted by the Government. The committee, comprising representatives from the textile industry, textile machinery manufacturers, handlooms, power looms and exports, the Reserve Bank and officials from the Government, was to give its recommendations on planning and implementation of modernisation of the textile industry. The committee held two meetings. Further, the Government constituted working groups to review the position of closed/sick cotton textile mills in the country. The Government also created a nodal agency to look into the problems of closed/sick textile mills and consequently the earlier working groups were disbanded.

Export Finance

The standing committee on export finance, a high-powered policy-making body, set up by the Bank in 1975 to periodically discuss problems and policies relating to export finance, held frequent meetings. In December 1983, the Bank issued detailed guidelines to banks based on the suggestions made by the sub-group appointed by the standing committee for elongated suppliers' credit facilities for certain categories of goods to promote exports to various African countries. Also pursuant to the sub-group's recommendations, a working group was constituted consisting of representatives of the Reserve Bank, Exim Bank, ECGC, the concerned banks and a government nominee to consider proposals to extend credit terms beyond 180 days for targeted African countries as well as other countries for the export of selected commodities.

The committee met on November 15, 1985 and discussed problems faced by the export community. Important decisions taken by the committee included the following:

(i) Although the sub-group had recommended that the banks' practice of resorting to rediscounting/acceptance facilities abroad to raise resources was accepted in principle, it was decided that, in view of the liquidity in the banking system, the Reserve Bank might review the position.

(ii) The commerce ministry agreed to the Reserve Bank's proposal to make available an enhanced subsidy at 3.0 per cent to banks on rescheduled instalments of deferred payment exports, on a conditional case-by-case basis, where an agreement at the government-to-government level existed.

(iii) Post-supply credit facilities at a concessional rate of interest were granted for 'deemed exports' up to 30 days and a circular to this effect was issued.

INTEREST RATE ON EXPORT CREDIT

The committee to study the structure of interest rates on export credit comprising members from the NIBM, the SBI, Exim Bank, the Government of India (Ministry of Commerce) and the Reserve Bank was set up on January 11, 1986.

To provide a fillip to exports by extending the period for which concessional interest was offered and also to simplify the prevalent structure, the rates of interest for pre-shipment credit were fixed uniformly for all commodities as below:

(Per cent per annum)

Period	*March 1, 1986*	*August 1, 1986*
(i) Up to 180 days	12.0	9.5
(ii) Beyond 180 days but not exceeding 270 days (with prior RBI approval)	14.0	11.5
(iii) Beyond 270 days	Not exceeding 16.5	

The interest rate on post-shipment credit up to 180 days was brought down from 12.0 per cent to 9.5 per cent. Consequent to these changes, the Reserve Bank reduced its interest rate on export refinance from 10.0 per cent to 9.0 per cent, with effect from the same date.

ALL-INDIA EXPORT ADVISORY COMMITTEE

The AIEAC Committee had been constituted by the Reserve Bank in October 1983 in order to have a continued dialogue and receive feedback from the export community on problems of export credit and foreign exchange. The export advisory committee, consisting of Reserve Bank officials, representative from banks and people from all-India export promotion councils/organisations, met at frequent intervals. Various recommendations of the committee were brought to the notice of the standing committee on export finance for information/decisions.

COMMITTEE ON TOBACCO EXPORTS

A consultative committee was set up with officials drawn from the Reserve Bank and commercial banks, tobacco exporters, representatives of the Tobacco Board and Indian Tobacco Association to look into the export credit requirements of tobacco exporters. The committee held its first meeting at Guntur on January 27, 1984.

STANDING CO-ORDINATION COMMITTEE

The standing co-ordination committee, appointed in January 1979 to consider issues pertaining to co-ordination between banks and term-lending institutions following the recommendations of the inter-institutional group, was reconstituted in August 1983. The reconstituted committee was expected to provide a standing forum to sort out inter-institutional problems relating to term lending based on past experiences. It would also review the involvement of banks and term-lending institutions in extending term credit besides dealing with compilation and sharing of information on term credit and other issues that may be referred to it.

The committee, which served as a standing forum to consider co-ordination between banks and term-lending institutions in project finance and allied matters, met in August 1985 and April 1986. It considered the following issues:

(i) detection of sickness at the incipient stage and proper co-ordination between commercial banks and term-lending institutions in formulating and implementing rehabilitation programmes;
(ii) parameters for providing relief/concessions by banks under rehabilitation packages evolved for potentially viable sick units;
(iii) sharing of expenses for protection, preservation and disposal of security where a receiver was appointed;
(iv) operational issues with regard to implementing the provisions of the SICA, 1985; and
(v) adoption of a common definition for a 'sick industrial unit'.

Necessary instructions were issued to banks on the decisions taken by the committee.

WORKING GROUP TO REVIEW THE NORMS FOR CONSORTIUM ADVANCES

In accordance with the suggestion made by the NFCC in its meeting in December 1986, a working group was set up by the Reserve Bank in January 1987 to examine the system and formulate norms for advances made to both healthy and sick units by banks in consortium, with or without the participation of FIs, to make appropriate recommendations to speed up the decision-making process and to provide timely and adequate credit to borrowers. Based on the first report of the group, detailed instructions were issued to banks in June 1987 which, envisaged a major role to be played by the lead bank and the second largest financing bank or two major banks (under a multiple financing arrangement) and covered issues such as carrying out viability studies, formulating and implementing rehabilitation packages within a specified time frame, adhering to the commitment there under, exchange of information between banks and FIs, carrying out joint reviews, adopting a unified stand on recall of advances, vesting bank officials with larger discretionary powers, upgrading skills and training staff. These measures were expected to ensure greater co-ordination between banks and FIs in financing sick and weak industrial units to expedite decisions on measures for their rehabilitation and implementation.

RURAL SECTOR

HIGH LEVEL STANDING COMMITTEE TO REVIEW THE FLOW OF INSTITUTIONAL CREDIT TO THE RURAL SECTOR AND RELATED MATTERS

A high level standing committee was appointed in 1985 under the chairmanship of a Deputy Governor of Reserve Bank to review the flow of institutional credit to the rural sector and related matters. The committee was also asked to suggest

measures to improve the credit delivery system for the greater benefit of farmers, artisans, landless labourers and other weaker sections, particularly SCs/STs. The committee comprised representatives from the Reserve Bank, the Government of India, NABARD, the IBA, SBI, GIC, Agricultural Finance Corporation Ltd, Planning Commission, State Governments, National Federation of State Co-operative Banks Ltd, National Co-operative Land Development Banks Federation Ltd, Indian Council of Agricultural Research, Indian Institute of Science, Punjab Agricultural University, National Co-operative Development Corporation, KVIC and the Indian Agricultural Research Institute.

At its second meeting held on March 6, 1986, the committee decided to constitute a working group: (i) to consider problems relating to non-availability of credit to new and non-defaulting members of co-operative credit institutions and to suggest measures to ensure smooth flow of credit to these borrowers; and (ii) to recommend measures to assist the co-operative credit structure in areas susceptible to repeated natural calamities to insulate itself and its members from the increasing burden of overdues. Accordingly, a working group was constituted under the chairmanship of a former Union Minister for Agriculture.

The committee at its fourth meeting held in May 1987 considered the recommendations of the study team on banking development in the north-eastern region. For rapid economic development of this region along the lines suggested by the study team, it was decided to set up a separate task force in each state in the region and the SLBCs in these states would constantly review the performance under action plans. It was decided that an integrated plan for developing at least one block would drawn up on a pilot basis for each state.

WORKING GROUP ON THE MODALITIES OF IMPLEMENTATION OF PRIORITY SECTOR LENDING AND TWENTY-POINT ECONOMIC PROGRAMME BY BANKS

The working group constituted by the Reserve Bank on implementation of priority sector lending and the twenty-point programme submitted its report, and its recommendations were accepted by the Government and the Reserve Bank. The group, which identified the beneficiaries who required assistance from the banking system in pursuance of the twenty-point programme, spelt out ways in which such assistance could be rendered. As most of the beneficiaries under the programme fell in the relatively under-privileged groups within the priority sector, the group suggested changes in the approach to priority sector lending, including refining the definition of 'priority sector'. In particular, it introduced the concept of 'weaker sections' within the priority sector and recommended separate sub-targets for lending to such weaker sections in the two main categories within the priority sector, namely, agriculture and SSIs. The total enhanced target of 40.0 per cent for lending to priority sector was to be reached by the end of the Sixth Plan period. Consumption loans and housing loans for the poor were also brought within the priority sector lending. The need for a schematic and integrated approach to assisting the beneficiaries in consultation with state development

agencies was emphasised. At the field level, the DCPs prepared by banks had to explicitly provide for the beneficiaries under the twenty-point programme. With the large number of borrowers involved, the group recommended routing credit to the weaker sections through state-sponsored corporations/agencies (besides functional co-operatives) specifically set up for the benefit of such persons.

Based on the recommendations by the group, the Reserve Bank issued detailed instructions in October 1980 to all commercial banks for their implementation. In particular, the targets for lending to weaker sections and priority sector, placed before the banks, were: (i) The overall assistance to the priority sector should constitute 40.0 per cent of total advances by March 1985. (ii) At least 40.0 per cent of the advances to the priority sector should be extended for agriculture and allied activities; in other words this sector would account for at least 16.0 per cent of total advances by 1985. (iii) Direct advances to 'weaker sections' in agriculture and allied activities should constitute at least 50.0 per cent of total direct lending to agriculture (including allied activities) by March 1983. 'Weaker sections' in this sector comprised small and marginal farmers and landless labourers. Persons engaged in allied activities whose borrowing limits did not exceed ₹ 10,000 were also included in 'weaker sections'. (iv) Advances to 'weaker sections' in SSIs, *i.e.*, those with credit limits up to and inclusive of ₹ 25,000, should constitute 12.5 per cent of total advances to SSIs by 1985.

The state governments were separately advised by the Reserve Bank, indicating the vital role they had to play in facilitating banks' assistance under the twenty-point programme. The main areas where supportive action from the state government was required related to identification of beneficiaries, provision of infrastructure and technical facilities, input supply and marketing, training support and assistance for recovery of loans.

A new information system for monitoring the implementation of the DCPs and financing of twenty-point programme at the district and state levels was introduced by the Reserve Bank in January 1981, based on the recommendations of the working group.

In pursuance of the guidelines issued by the Reserve Bank, commercial banks took measures to implement the recommendations for assisting beneficiaries under the programme. These included arranging seminars for branch managers/ staff to impress on them the importance of the programme, discussions and lectures at training centres, setting-up special cells for monitoring performance, arranging credit camps and mass loan programmes and co-ordinating activities with government agencies at the district and state levels for integrated action.

WORKING GROUP ON MODALITIES OF IMPLEMENTATION OF THE NEW TWENTY-POINT PROGRAMME

Consequent upon the announcement of the new twenty-point programme by the Prime Minister in January 1982, it was decided at the Finance Minister's meeting with the chief executives of PSBs on February 15, 1982 that the Reserve

Bank would appoint a working group to formulate the modalities for banks to implement the new twenty-point programme. Accordingly, on March 11, 1982, the Bank appointed a working group under the chairmanship of Shri A. Ghosh, Deputy Governor, comprising senior officers of banks, the Ministry of Finance, Ministry of Rural Development, ARDC, AFC and the Reserve Bank. The terms of reference of the working group were: to identify the tasks for the banking system for effective implementation of the new twenty-point programme; to review the targets and sub-targets within the priority sector with special reference to the needs of the weaker sections; to examine the scope for modifications in the definitions of priority sector; to review the reporting and monitoring system regarding the flow of credit to the new twenty-point programme with a view to simplifying and expediting the flow of information and making evaluation more effective; and to make any other recommendations that were incidental or related to the terms of reference.

WORKING GROUP ON PROBLEMS OF BANK CREDIT IN THE NORTH-EASTERN REGION

Major banks operating in the north-eastern region were advised in December 1980 to take immediate steps to strengthen their existing set up in the region, so as to enable them to undertake, besides conventional functions, development banking to supplement the efforts of the central and state governments. Such development banking would imply not only granting term loans more liberally, but also assisting in project identification, formulation and appraisal. These banks opened or upgraded their regional offices at Guwahati so that they could be proactive in accelerating the flow of credit for implementation of the development schemes for the region.

In the fifth meeting of the regional consultative committee for nationalised banks, it was decided that the state governments and the lead banks in the states would co-ordinate their efforts to increase the flow of credit in the north-eastern area, particularly for the implementation of IRDP and DCPs. It was also decided that all states in the region would bring in legislation to empower village councils to borrow from banks and that all banks would adopt the procedures of the SBI for extending agricultural credit to farmers in areas where land was vested in the community; the SBI had decided to grant advances up to ₹ 10,000 to individual cultivators against hypothecation of agricultural machinery and/or crops and group guarantee of not less than three persons.

NABARD continued its efforts to effect various recommendations of the committee on agricultural productivity in eastern India (Chairman: Shri S.R. Sen). Some of the decisions taken and conveyed to the banks/state governments for implementation as also the follow-up action taken were:

(i) The need for preparing normal credit limit statements for all members by the PACS (including non-borrowers and defaulters) was emphasised.

(ii) State governments were advised to prepare a list of selected dealers/suppliers of agricultural inputs, such as fertilisers, pesticides and farm equipment, so that the credit societies would be in a position to introduce a voucher system for disbursement of the in-kind component as recommended by the committee.

(iii) The committee's recommendation to use the services of local voluntary organisations on a commission basis in the special drive to collect overdues was accepted and recommended for implementation, subject to the banks bearing the entire operational costs.

(iv) The Planning Commission was requested to keep in view the recommendations of the committee on problems of irrigation, drainage and water management during the formulation of the Eighth Five Year Plan and also to help states initiate a systematic action programme and make provisions for it in their budgets when approving their annual plans. It was decided to discontinue the practice of appointing expert group/state-wise consultants. Various development efforts were, henceforth, to be spearheaded by the regional offices of NABARD.

Considering the general backwardness of the north-eastern region and the need for accelerated development in view of its vulnerable position, it was decided to undertake a study of the steps needed for banking development in the region. Accordingly, a study team chaired by an Executive Director of the Reserve Bank was deputed to the region in May 1986. The study team met the representatives of banks, state governments and other institutions and held discussions. The recommendations of the study team in the report submitted in October 1986 covered four major aspects, *viz.*, provision of infrastructure facilities, banking facilities, extension facilities, and monitoring and follow-up of the action programme.

WORKING GROUP ON DATA COLLECTION RELATING TO CREDIT SUPPORT TO RETAIL OUTLETS OF THE PDS

The Ministry of Food and Civil Supplies considered it expedient to have detailed information on the extent of credit support to retail outlets of the PDS, comprising mainly private retail traders dealing in essential commodities (fair price shops), consumer co-operative stores, and suggested that the Reserve Bank set up a small group to look into the data sources and suggest improvements. Accordingly, the Reserve Bank set up a working group in December 1984 to examine the issue with the following terms of reference:

(i) To look into the available data under the existing reporting system and estimate the credit support to retail trade and distribution of essential commodities.

(ii) To formulate suitable format for making available adequate data on the above aspects to the Reserve Bank and the Government.

(iii) Any other relevant matters.

WORKING GROUP ON BANK CREDIT TO THE STATE HANDLOOM DEVELOPMENT CORPORATION

The working group appointed by the Reserve Bank in June 1984 to study operational problems of the State Handloom Development Corporations in relation to bank credit met three times and also undertook field visits to Karnataka, Tamil Nadu, West Bengal and the north-eastern region during early 1985. The field visits helped the working group understand various operational problems, such as supply and distribution of yarn to weavers, marketing of handloom products and raising finance for production and marketing under local conditions.

STUDY GROUP ON FLOW OF CREDIT TO IRDP BENEFICIARIES

A study group was set up by the Reserve Bank in November 1985 headed by the chairman of NABARD, with the objective of streamlining arrangements for the flow of credit and supply of inputs and assets to IRDP beneficiaries so that they would draw the full benefit of the anti-poverty programmes. Based on the recommendations of the study group in its interim report, which were accepted by the Government, banks were advised to implement, on an experimental basis, a system of cash disbursement of IRDP assistance for specified purposes in 22 selected blocks all over the country with effect from April 1, 1986, *viz.*: (i) when the asset was of a standard type, make or brand name marketed by reputed suppliers; (ii) when the loan was for Industries, ISB sector activities and a number of sundry items were to be bought, disbursement up to ₹ 3,000 may be made in cash in such cases; and (iii) to purchase animals. In all these cases, the borrowers were to provide documentary evidence to the bank for having purchased the asset/s, and banks were to verify the acquisition of the same by inspection.

STUDY GROUP ON THE FLOW OF INSTITUTIONAL CREDIT TO THE SSI SECTOR AND RELATED MATTERS

The study group appointed by the Reserve Bank under the chairmanship of a Deputy Governor of the Reserve Bank submitted its report in 1987. The report set out the background and features of the SSIs, analysed the causes of its sickness, identified the problems of credit institutions in nursing sick SSI units, reviewed the available facilities, explored the need to set up another fund in view of the existing gap and discussed the resources for such a fund. The recommendations of the group were forwarded by the Reserve Bank to the Government.

COMMITTEE TO CONSIDER PROBLEMS IN IDENTIFYING AND REHABILITATING SICK SSI UNITS

In February 1986, the Reserve Bank appointed a committee under the chairmanship of an Executive Director to consider problems in identifying and rehabilitating sick SSI units. The committee was to examine the following and make recommendations:

(i) Definition of a sick SSI unit.
(ii) Identification of incipient sickness in SSI units.
(iii) Establishment of a suitable machinery for identifying sickness, preparing rehabilitation packages in the case of potentially viable units, and follow-up and monitoring of implementation.
(iv) Formulation of parameters to provide relief/concessions by commercial banks, SFCs, state governments and other agencies under rehabilitation packages evolved for sick SSI units considered as potentially viable.

Based on the recommendations of the committee, guidelines stressing the need for adequate and intensive relief measures and their speedy application were issued to banks in 1987. An illustrative list of working signals of incipient sickness and a list of reliefs/concessions that could be extended to sick units according to certain norms were issued along with the guidelines.

The standing advisory Committee reviewed the flow of bank credit to the SSI sector and also the measures taken by the Reserve Bank to improve co-ordination between banks and term-lending institutions that were found to be satisfactory. The committee, however, expressed concern over the increasing number of SSI units falling sick and made the following recommendations:

(i) The state government and federations/associations concerned with the development of SSIs may take up sample studies of SSI units to identify problems/causes leading to industrial sickness and to make suitable arrangements to improve the information system.
(ii) Measures should be taken to popularise customer service centres to reduce delays in the flow of credit.
(iii) SLIICs should be used to sort out policy issues concerning the flow of credit to the SSI sector.

In connection with the financing of the SSI sector in the north-eastern region, the committee felt that the relatively low credit absorption capacity of the region should be gradually increased by providing infrastructure facilities, entrepreneurial development, assured supply of inputs and technology and adequate marketing support.

STUDY GROUP ON NORMS FOR INVOLVEMENT OF RESOURCES BY STATE AND CENTRAL CO-OPERATIVE BANKS IN AGRICULTURAL LENDING

The study group constituted by NABARD in June 1983 to recommend norms for involvement of resources by state co-operative banks/CCBs in agricultural lending submitted its report in June 1984. The important recommendations of the committee included, inter alia, fixing the minimum involvement of ILR of state co-operative banks and CCBs in short-term agricultural lending (25.0 per cent for state co-operative banks and 40.0 per cent for CCBs) and modifying the scheme of linking borrowings from NABARD with efforts at deposit mobilisation by CCBs. The recommendations of the study group were accepted by NABARD and implemented from 1985–86.

COMMITTEE TO EXAMINE ISSUES RAISED BY THE NATIONAL FEDERATION OF URBAN CO-OPERATIVE BANKS AND CREDIT SOCIETIES

The committee set up to examine the issues raised by the National Federation of Urban Co-operative Banks and Credit Societies submitted its report in February 1987. Almost all the recommendations of the committee were accepted and the Reserve Bank took the necessary follow-up action. A significant outcome of these recommendations was the decision to accord scheduled status to select UCBs. The Government issued orders to publish the notification in the official gazette describing UCBs that were licensed and whose demand and time liabilities were not less than ₹ 50 crore as FIs under sub-clause (iii) of clause (a) of sub-section 6 of section 42 of RBI Act, 1934. Other recommendations related to relaxing the norms for reckoning advances towards priority sector/weaker sections, enhancing the ceiling on housing loans by UCBs and increasing the limit on advances in certain categories.

The terms of reference of this group included, to identify the main market segments that banks should concentrate on and work out a plan for the immediate future, to assess and estimate their assigned capital, provisioning and infrastructure requirements and suggest modalities for raising such capital, to study personnel policy and suggest norms for selection, placement, transfer and training in respect of overseas branches, and to review the control and monitoring systems and suggest suitable changes wherever required.

WORKING GROUP TO EXAMINE THE SCOPE AND FUNCTIONS OF SLDBs

A high level working group was constituted by NABARD on January 2, 1985 to study the problems of LDBs, suffering from structural, financial and legal disabilities that tended to impede their growth, and to suggest measures for their orderly growth.

STANDING ADVISORY COMMITTEE FOR UCBs

The standing advisory committee for UCBs, after considering the views expressed by the state governments/co-operation departments on the uniform norms suggested by the Reserve Bank for audit classification of UCBs, recommended the adoption of standard norms for classifying UCBs in the country. It also suggested that the audit of bigger banks with working capital of ₹ 2 crore and above be entrusted to qualified auditors/chartered accountants to improve the quality of audit. As suggested by the standing advisory committee, urban banks with working capital of ₹ 25 crore and above were advised to ensure that at least 10.0 per cent of the liquid assets required to be maintained by them under SLR were held in the form of government and other trustee securities with a view to involving larger UCBs in the development activities of the Government. The committee also discussed the revised proposals on norms of viability of UCBs/

branches and recommended that a committee be constituted to conduct an in-depth study and suggest suitable norms of viability for its consideration.

The seventh meeting of the standing advisory committee for UCBs held on May 31, 1988 discussed, among others, the appointment of chief executives and other key personnel in UCBs, the rationalisation of recruitment procedures, the desirability of chartered accountants conducting the audit of UCBs, the supersession of the board of directors, selection of administrators, and progress in the rehabilitation of 'weak' and 'non-viable' banks.

COMMITTEE ON TERM LENDING THROUGH CO-OPERATIVES

The COTELCOOP met on six occasions after its formation; the final meeting was held on April 4, 1985. The committee continued to review the progress in implementing the rehabilitation of weak CCBs (evaluation studies). A sub-committee of COTELCOOP was set up in June 1983 to study the problems of rehabilitating primary units in the LDB structure and prepare broad guidelines for various state governments, which they could follow for drawing up individual rehabilitation plans. The sub-committee submitted its report to the committee for its consideration in its meeting held on October 29, 1984. The recommendations of the sub-committee, as approved by the COTELCOOP, were communicated to all SLDBs and the state governments for consideration and implementation.

APPENDIX 6.2

Banking and Allied Laws

BANKING LAWS (AMENDMENT) ACT, 1983

The banking laws (amendment) bill, 1983 proposing amendments to the laws affecting banking, mainly contained in the RBI Act, 1934 and the BR Act, 1949 was passed by both houses of Parliament in December 1983, and consequent on the President giving his assent to the bill, it became the Banking Laws (amendment) Act, 1983. The provisions of the Act, except sections 6, 7, 21, 26, 37 and clauses (V) and (IX) of section 42 came into force from February 15, 1984 in terms of Government of India notification No.F.1/15/83-B.O.I. dated February 14, 1984. The important amendments related to:

(i) Imposing restrictions on individuals, firms and unincorporated associations in accepting deposits from public to protect the interests of the vast multitude of small and uninformed depositors.

(ii) Enabling banks to undertake innovative measures, such as leasing and factoring business.

(iii) Providing nomination facilities to depositors/persons keeping articles in safe custody and those hiring lockers with banks to save legal heirs from hitherto cumbersome and expensive legal procedures to get deposits of the deceased depositors/parties from banks.

(iv) Changing the weekly return showing demand and time liabilities of a bank into a fortnightly return for computing CRR and basing SLR to be maintained by banks on demand and time liabilities as on the last Friday of the second preceding fortnight to which it related, so as to give banks time to visualise their liabilities and arrange for proper maintenance of CRR and SLR.

(v) Imposing a penalty for non-compliance with SLR.

(vi) Authorising the Reserve Bank to determine the mode of valuation of approved securities (one of the components of SLR) in accordance with the monetary policy.

(vii) Protecting the rates of interest charged by banks in pursuance of Reserve Bank of India directives from being challenged in courts as usurious.

(viii) Restricting the tenure of directors of banks to eight continuous years.

(ix) Widening the scope of consideration, which the Reserve Bank may take into account while examining applications for opening of banks.

(x) Giving statutory backing to the arrangements made by PSBs regarding nomination of directors on the boards of assisted units.

(xi) Raising the authorised capital of the DICGC to ₹ 50 crore.

(xii) Enabling the amalgamation of private sector banks with nationalised banks.

The concept of average daily balance, as per the Banking Laws (Amendment) Act, 1983, came to be linked to balances held at the close of business on each day of a fortnight instead of a week, and scheduled banks were required to file fortnightly returns on alternate Fridays of a month instead of each Friday of the month as hitherto. This would give banks more time to visualise their liabilities and arrange for proper maintenance of cash reserves. The change of periodicity for maintenance of average daily balance for CRR purposes from week to fortnight came into effect on March 29, 1985 (the first such fortnight commencing from March 30, 1985). Changes were made in the basis for calculating demand and time liabilities for the purpose of maintenance of SLR. The Reserve Bank was empowered to levy penalty for non-compliance with SLR. A special return in form A was to be filed if the alternate Friday was not the last Friday of the month. Section 7, which amended section 43 of the RBI Act, 1934 provided for the issue of a fortnightly (instead of weekly) press communiquй by the Reserve Bank.

Further, the definition of 'deposit' was widened to include any receipt of money by way of deposit or loan or in any other form, but specifically excluding certain types of deposits so as to enable individuals and unincorporated associations and firms to obtain funds or advances for their legitimate business. Earlier, there were no restrictions on acceptance of deposits by individuals or firms or unincorporated associations of individuals. In the larger interest of the public, and more particularly the vast number of small and uninformed depositors, it was felt necessary to curb the capacity of such unincorporated bodies to accept deposits from the public. Accordingly, the new provisions stipulated that no individual or firm or an unincorporated association of individuals should at any time have deposits from more than the specified number of depositors.

The amendment to the Banking Regulation Act applied to a wide range of provisions. It enabled banking companies to take up business activities specified by the Central Government in addition to those already undertaken as per the BR Act, 1949. It placed a limit on the tenure of directors of a banking company, empowered the Reserve Bank to decide if a change was permissible in the number of directors as also to appoint a chairman when a vacancy arose, if such an appointment was deemed necessary. It enabled the calculation of CRR of non-scheduled banks and SLR of all banks based on demand and time liabilities as on the last Friday of the second preceding fortnight. The amendment precluded granting loans to a company when the banking company's director was a director or any other office holder of such a company or its subsidiary or holding company in which he held a substantial interest. It enabled the Reserve Bank to raise the maximum SLR that it required a bank to maintain to 40.0 per cent and to call for a daily return from any banking company apart from other statutory returns. The Reserve Bank was further empowered to impose penal interest on banking companies that defaulted in maintaining SLR and to carry out a scrutiny of the affairs of a banking company in addition to regular inspections. The amendment

also provided for nomination facilities to bank customers for deposit accounts and articles kept in safe custody/safe lockers. Some of these amendments to the two Acts came into force with effect from February 15, 1984.

BANKING LAWS (AMENDMENT) ACT, 1985

The Banking Laws (Amendment) Act, 1985 amending various statutes, mainly the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980 and the Reserve Bank of India Act, 1934, was enacted in December 1985. Some of the provisions of the Act were brought into force with effect from December 30, 1985 and others with effect from May 1, 1986. The more important amendments were: the limit on the borrowing powers of the SFCs was raised from 90.0 per cent of the paid-up share capital to twice the paid-up capital; the ceiling on the paid-up capital and reserves of nationalised banks was raised from ₹ 15 crore to ₹ 100 crore to improve their debt-equity ratio and profitability; and the name of United Commercial Bank was changed to UCO Bank in view of the existence of a bank with the same name in Bangladesh.

By amendment to the relevant sections of the BR Act, 1949 (as applicable to co-operative societies), the above provisions were also made applicable to state co-operative banks/CCBs and RRBs. Further, loans taken by a scheduled state co-operative bank from the NCDC and by an RRB from its sponsor bank would be excluded from 'liabilities' for the purpose of calculating CRR. In terms of section 21, every non-scheduled bank was required to maintain on a daily basis a cash reserve, the amount of which should not be less than 3.0 per cent of its demand and time liabilities in India as obtaining on the last Friday of the second preceding fortnight.

Section 26 led to the amendment to section 24 of the BR Act, 1949. It provided for a change in the basis of calculating the demand and time liabilities for the purpose of maintenance of SLR. Before the amendment, advances, if any, taken by a bank from the Reserve Bank, the SBI and its associates, the IDBI, or the Exim Bank were excluded. After the amendment, the special status for borrowing from the SBI and its associates was removed. Banks now had to calculate the net liability to the banking system.

Several banks were making double use of cash balances — one to meet CRR and again to meet SLR requirements. Banks took advantage of SLR being monitored only on Fridays and computed the excess cash for the purposes of SLR as the difference between the average cash balance required to be maintained and the cash balance actually maintained on Friday, irrespective of the level of balances held on other days of the week, which were generally small. As per the amendment, banks were advised that average excess cash balance was to be computed as the difference between the average cash balance actually maintained and the average cash balance required to be maintained under CRR and this average excess cash balance figure was to be included in the daily SLR position.

The Reserve Bank was empowered to levy penalty for non-compliance with SLR requirements. The rate of penalty for non-compliance was fixed on the same basis as for CRR, that is, first default at 13.0 per cent (3.0 per cent over the Bank Rate) and subsequent continuous default at 15.0 per cent (5.0 per cent over the Bank Rate). The percentage of SLR above the statutory minimum of 25.0 per cent but not exceeding 40.0 per cent of the demand and time liabilities was henceforth governed by the issue of a notification in the official gazette by the Reserve Bank.

Section 37, which incorporated new sections 45Y and 45Z in the BR Act, 1949, provided for framing rules for the period of preservation of banks' records and nomination facilities to bank customers. A banking company was enabled to make payment to the nominee of a deceased depositor the amount of his deposits, to return the articles kept by a deceased person in safe custody to his nominee and to release the contents of a safety locker to the nominee of the hirer of such a locker.

BANKING LAWS COMMITTEE'S REPORT

The banking laws committee, appointed by the Government to review and codify commercial laws affecting banks, had submitted five reports. Of these, the recommendations contained in the committee's report on *hundis* were processed earlier but were not accepted by the Reserve Bank. The Bank's views on the draft warehouse receipts bill, contained in the report on documents of title of goods, were forwarded to the Government during the year. The bill intended to give the status of negotiability to warehouse receipts and, once passed, it was expected to facilitate liberal bank credit against the security of warehouse receipts. As regards the other three reports, the position was:

(i) Report on Negotiable Instruments Law

The report was examined by the Bank in consultation with the IBA. Since the recommendations contained in the report were mainly based on the uniform commercial code of the US, which was not suitable for India, it was decided to reject the report and to review the draft negotiable instruments bill, 1960 in light of the laws of the UK and other commonwealth countries, whose legal systems are similar to the Indian legal system. Accordingly, the draft bill *vis-à-vis* the recommendations of the banking laws committee in its report having a direct bearing on the bill were discussed at several meetings of the legal committee convened by the IBA. The draft negotiable instruments bill, 1960 was revised in light of the IBA's views and then forwarded to the Government for its consideration.

(ii) Report on Personal Property Security Law

The draft personal property security bill recommended by the banking laws committee in its report on this subject was examined by the informal group comprising representatives from the Reserve Bank and the IBA. As the proposed bill could bring about radical changes, a final decision by the Bank in the matter was envisaged to be taken in light of the reconsidered views received from the IBA.

(iii) Report on Real Property Security Law (RPSL)

The committee had submitted its report on the RPSL, examining lacunae in the law relating to credit and security of immovable properties and the special law relating to extension of rural credit by institutional agencies, the legal framework pertaining to investigation of title to immovable property and the scheme of registration.

SPECIAL LEGISLATION FOR RECOVERY OF BANKS' DUES

The Government accepted the recommendations of the Tiwari Committee to set up special tribunals to adjudicate on issues relating to the recovery of banks' dues. A committee of legal experts was constituted to prepare the draft of the legislation for this purpose. It was decided to vest special powers in favour of banks and FIs similar to those conferred on the IFCI and SFCs under their respective statutes.

BANKING, PUBLIC FINANCIAL INSTITUTIONS AND NEGOTIABLE INSTRUMENTS LAWS (AMENDMENT) BILL, 1988

The banking, public financial institutions and negotiable instruments laws (amendment) bill was passed by Parliament in December 1988 and received the assent of the President in December 1988. The provisions of the Act, except for three sections, were brought into force with effect from December 30, 1988. A notification was also issued by the Government on December 30, 1988 by which banks were required to close their accounts on the expiry of a period of 12 months ending March 31, instead of at the end of the calendar year as hitherto. Accordingly, banks closed their accounts on March 31, 1989, covering the 15-month period from January 1, 1988 to March 31, 1989. The other more important provisions which came into force on December 30, 1988 related to:

- (i) Uniform tenure for directors of nationalised banks, associate banks and other FIs, such as, the IDBI, NABARD, Exim Bank, DICGC and IRBI.
- (ii) Increase in the limit of paid-up capital of nationalised banks from ₹ 100 crore to ₹ 500 crore.
- (iii) Vesting authority in the Reserve Bank to direct special audits of banks.
- (iv) Increase in the rate of interest specified in sections 80 and 117 (C) of the Negotiable Instruments Act, 1881, from 6.0 per cent to 18.0 per cent.
- (v) Removal of legal lacunae in the Nationalisation Act to provide for the amalgamation of one nationalised bank with another nationalised bank and to enable transfer of part business.

Subsequently, the Government by issue of a notification gave effect to the provisions of section 4 of the Amendment Act. The section provided for penalties in the case of dishonour of cheques for insufficient funds in the drawer's account. With effect from April 1, 1989, where any cheque drawn by a person on any account maintained by him with a banker for payment to another person for discharge in whole or in part of any debt or liability was returned by the bank unpaid due to

insufficient funds in the account or because it exceeded the arrangements with the bank, such personnel were deemed to have committed an offence and were to be punished with imprisonment for a term that may extend to one year or with a fine that was to extend to twice the amount of the cheque or with both. The section also provided certain safeguards to save harassment to unwary drawers of cheques. It had been, *inter alia*, provided that the drawer could make payment within 15 days on receipt of the notice of return and only if he failed to do so could prosecution be launched. It was also provided that the complaint could be made only by the payee or holder in due course.

APPENDIX 7.1

Commercial Banks: Issues in Customer Service, Internal Control and Housekeeping

WORKING GROUP ON CUSTOMER SERVICE IN BANKS

The Government set up a group in 1975 to examine the recommendations of the working group on customer service in banks under the chairmanship of Shri R.K. Talwar (Chairman, SBI) and implement the recommendations expeditiously. The Government assessed the appraisal notes prepared by the Reserve Bank and took the following decisions:

(i) All banks should ensure that the customer should not be asked to go from counter to counter and as far as possible the waiting time should be curtailed.

(ii) All PSBs should take steps to introduce suitable arrangements to encash travellers' cheques issued by any PSB.

(iii) Bankers' cheques issued by PSBs should be freely used to make local inter-bank payments and these should be given the same status as cash for accounting purposes.

Further, the Government asked PSBs to implement 136 of the 176 recommendations of the working group. The Reserve Bank vigorously pursued with commercial banks the issue of improving customer service. The banks, in turn, took steps, such as extending the teller system to more branches, 10 banks introduced regional collection centres at the metropolitan centres for collection of outstation instruments and large-sized branches with poor customer service were allowed to be split on a functional or segment basis.

The performance of banks in the public sector was reviewed in respect of all 136 recommendations of the working group, including those contained in the interim report of the group. The review revealed that 85 recommendations had been implemented by more than 75.0 per cent of the PSBs (excluding the nationalised banks), *i.e.*, 17 banks. Further, progress reports from the banks revealed that the SBI and its associates had implemented more than 100 recommendations, while 14 nationalised banks had implemented more than 90 recommendations. In accordance with the decision of the group, private sector banks, that had implemented only 54 recommendations, were also advised to implement 136 recommendations.

In October 1982 the Reserve Bank called a meeting of the senior executives, in-charge of customer service cells in PSBs and the IBA to discuss critical areas of banking services where concerted efforts were needed to improve customer service. Banks were asked to pay special attention to introduction of the teller system; issue/payment of bank drafts; arrangements for payment of travellers' cheques; collection of outstation cheques and immediate credit against the

lodging outstation cheques for collection up to an amount of ₹ 2,500 (of only one cheque at a time), subject to charging normal collection charges. Salary cheques of up to ₹ 2,500 issued by government/quasi-government bodies were to be brought under the purview of the scheme, as were timely submission of statements of accounts to customers; attitude of the staff and general discipline; follow-up action on complaints/suggestions from bank users; and overseeing/monitoring the implementation of the recommendations of the working group on customer service at the bank's level. Banks were also instructed to issue demand drafts to all customers without insisting on their having an account with them, to ensure that teller counters were kept open throughout banking hours, and to ensure the implementation of nomination facilities to deposit holders in all their branches.

Further, all PSBs were advised in August 1987 to ensure that drafts drawn on their branches were paid immediately without waiting for the receipt of relative advice from the issuing branches. They were also advised to pay interest on delays in collection of instruments beyond 14 days from the date of receipt of the instrument for collection and to pay interest beyond a period of 10 days if the instruments lodged and drawn on state headquarters were not collected within 10 days. However, for state capitals in the north-eastern region and Sikkim, where two-way postal transit time was not less than 5 days, the earlier norms of 14 days would remain unchanged. Following the decision by the Government, banks were advised that they should not insist upon a succession certificate when settling the accounts of deceased depositors where the amount of credit did not exceed ₹ 25,000; nevertheless, while settling such claims, banks were advised to observe the usual safeguards, including obtaining an indemnity bond wherever required. All scheduled banks in the private sector, including foreign banks, were also to take appropriate action. Further banks were advised: (i) that payment of drafts should be made promptly, and a passport or postal identification could be accepted as evidence of identity; (ii) to issue cheque books with a larger number of leaves, if customers requested them and to maintain adequate stocks of such cheque books at branches; and (iii) that the Reserve Bank had no objection to their affording immediate credit to more than one outstation cheque to a customer at a time within the overall limit of ₹ 2,500.

From an institutional standpoint, many of the problems afflicting the banking industry, including deterioration in customer services, were traced to shortcomings inherent in the manual system of operations. The deficiencies in the system encouraged bank fraud, which had been growing fast.

To cater to the growing volume of transactions as well as to improve customer service, banks were making concerted efforts to install and operationalise ALPMs in identified larger bank branches. The banks also installed mini-computer systems in their regional/zonal offices to improve control over branches and to monitor their performance. To speed up mechanisation at various levels, industry-level AAPs were drawn for the years 1988 and 1989, and progress was closely monitored

by both the Reserve Bank and the Government. Further progress was made during the year in mechanised cheque processing and computerisation of clearing house settlement operations. Mechanised cheque processing at all four metropolitan centres, *viz.*, Bombay, Calcutta, Madras and New Delhi, was completed. The national clearing of MICR outstation cheques was in operation in the four metropolitan centres and one-way clearing of MICR outstation cheques was in operation at another four centres, *viz.*, Ahmedabad, Bangalore, Hyderabad and Nagpur.

CLEARING HOUSES

In the context of frequent disturbances and suspension of clearing house operations in the country on one pretext or another, causing inconvenience to trade and industry, a need was felt to assist the functioning of the clearing houses, with some statutory backing. As the clearing houses were autonomous bodies subject to the rules framed by their members, it was considered necessary to have uniform rules and regulations governing all the clearing houses in the country. With this in view, the IBA appointed a working group to frame draft model rules, with representatives from the DBOD and DGBA of the Reserve Bank.

The idea of a night clearing system or an additional clearing house offered only a short-term solution to the clearing problems. The IBA proposed the establishment of a national clearing authority.

INTERNAL CONTROLS AND SAFEGUARDS FOR PREVENTION OF FRAUD AND MALPRACTICES

The Governor, in a meeting with the chief executives of PSBs on February 25, 1983, expressed concern at the dwindling image of the banking system, the growing number of complaints about poor service, the prevalence of corruption/malpractice in banks and the increasing incidence of fraud. Banks were, therefore, advised to review and revamp the vigilance machinery, take urgent steps to tone control and supervision, strengthen the MIS, follow-up/inspection/audit arrangements, draw a time-bound programme to clear arrears in balancing of books and take up reconciliation of inter-branch and other accounts. Also, detailed guidelines were issued to the banks in April 1983 for prevention of fraud. Banks were advised to strengthen control mechanisms including the internal audit/inspection machinery, take note of warning signals, such as non-submission or irregular submission of control returns and arrears in housekeeping.

A special investigation cell was set up in the Reserve Bank in May 1983 to carry out, *inter alia*, special investigations into major frauds that came to its notice and to closely monitor the implementation of the guidelines to prevent fraud. The cell carried out investigations of frauds/complaints on a selective basis in banks' offices and findings were communicated to the concerned banks for corrective action and examination of the cases from the staff-angle. The outcome of the

scrutiny was also brought to the notice of the Government, wherever necessary. As a sequel to the follow-up action on the reports of the scrutiny/sample surveys, the cell issued instructions/guidelines to banks suggesting safeguards to prevent recurrence of such irregularities.

In terms of the guidelines, advances should not ordinarily be granted beyond the discretionary powers of the authorities or by verbal/telephone instructions. For unavoidable exigencies, a proper record of such sanctions/instructions should be maintained and confirmation from the competent authority obtained within a week. There should be proper investigation into the identity of borrowers, credit granted in accordance with the borrowers' requirements and frequent excess drawals in accounts should be prevented. There should also be supervision to ensure proper end-use of credit.

Regional/zonal offices should be made accountable for lapses by their branches. A system should be introduced to periodically review the working of controlling offices on the effectiveness of their control over branches, submission of periodic returns and the general working of branches.

In view of several complaints of fraudulent withdrawals from savings bank accounts, banks were advised to instruct branches to follow the rules and procedures regarding opening of accounts, withdrawals and maintenance of passbooks. The procedure for reporting instances of fraud from banks to the regional offices of the Reserve Bank and from the latter to the Bank's central office was specified. The banks' attention was drawn particularly to certain aspects of advances against merchandise/bills, which were fraud-prone.

APPENDIX 7.2

Review of the Working of PSBs for the 15-Month Period Ended March 31, 1989

The weak area in banks' functioning was identified as credit administration, resulting from poor or inadequate credit appraisal. Banks carried an increasing load of sticky advances. The incidence of industrial sickness was on the increase and so was the volume of bank advances made to sick units. Consequently, banks' profitability was constantly under strain.

Credit facilities were often extended without regard for the actual need for funds or a realistic assessment of the quantum. Extraneous considerations, such as the connections of the borrowers and the promise of deposit support, often influenced credit decisions. An equally inadequate or neglected area was post-disbursement supervision. Timely receipt and scrutiny of stock statements and periodic verification of securities charged to banks were also not attended to at several branches, particularly the larger ones, where there was the need for close monitoring was crucial.

Banks were continuously exhorted by the Reserve Bank to bring down the level of sticky advances. They were also advised to settle problem accounts on reasonable terms to the extent possible. The health code classification of advances that had almost stabilised was an important instrument for self-monitoring of advances by banks. The quality of the credit portfolio was continuously monitored, both during action plan discussions and also when bank executives called on the Deputy Governor/Executive Director of the Reserve Bank for discussions on inspection findings.

Another area causing concern was profitability. The overall deterioration in the profitability of PSBs is evident from the following table:

TABLE 7.2.1

Indicators of Profitability

(Annualised figures)

	1986	*1987*	*1988–89*
Percentage of gross profit to working funds	1.19	1.10	1.00
Percentage of profit after tax to working funds	1.01	0.89	0.80

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

Both indicators point to a fall in profitability. While the yield on investments were picking up (it was 7.7 per cent in 1986 and 8.7 per cent during 1988–89) and the average cost of deposits had marginally declined between 1987 and 1988–89, the

other two main indicators, *viz.*, average yield on advances and interest spread, did not show any encouraging signs and were declining. Yield on advances declined from 13.0 per cent in 1986 to 12.2 per cent in 1988–89. The average interest spread declined from 3.0 per cent in 1986 to 2.6 per cent in 1988–89. The increasing volume of NPAs was a major constraint on improving profitability.

As a result of heavy loan losses, as revealed by the Reserve Bank's annual financial review, the financial position of eight nationalised banks was considered unsatisfactory. In these cases, even a portion of their deposits had been eroded. In order to strengthen the net worth of nationalised banks, the Government was contributing substantial amounts to their capital. But it was primarily for the banks themselves to streamline their credit administration, improve the quality of their credit portfolio and strengthen their reserves.

A summary position showing the number of branches, domestic deposits (excluding inter-bank deposits), advances, working funds and published net profits of PSBs as at the end of 1987 and March 1989 is given below:

TABLE 7.2.2

Select Indicators of PSBs

(Amount in ₹ crore)

	No. of Branches		*Working Funds*	
	31.12.1987	*31.3.1989*	*31.12.1987*	*31.3.1989*
SBI and its associates	10,958	11,493	44,270	58,469
Nationalised banks	26,080	27,388	89,754	1,09,866
Total	37,038	38,881	1,34,024	1,68,335

	Domestic Deposits		*Domestic Advances*		*Published Net Profits*	
	*25.12.87**	*31.3.89**	*25.12.87**	*31.3.89**	*1987*	*1988–89*
SBI and its associates	32,786	39,923	20,987	26,770	54.83	110.74
Nationalised banks	74,136	91,820	39,983	51,633	206.99	254.16
Total	1,06,922	1,31,743	60,970	78,403	261.82	364.90

Note: * Last Friday of 1987 and March 1989.

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

The financial position for March 1989 of all PSBs based on the findings of AFRs is summarised below:

TABLE 7.2.3

Public Sector Banks (March 1989)

	Good (Paid-up capital & reserves intact)	*Satisfactory (Reserves affected)*	*Not Satisfactory (Paid-up capital affected)*	*Unsatisfactory (Deposits affected)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
State Bank Group	8	-	-	-
Nationalised Banks	2	3	7	8

Source: Reserve Bank of India, DBOD, internal records.

APPENDIX 8.1

Agricultural Review Committee (Chairman: Dr A.M. Khusro), August 1989: Key Observations and Recommendations Pertaining to Rural Credit

INTRODUCTION

The emerging agricultural technologies and secular shifts in the agricultural sub-sectors in favour of commercially-oriented activities were expected to create a robust agricultural economy in India. It was to these changes and the associated problems that the rural credit system was expected to effectively respond. Judging from the steep increase in the quantum of institutional credit over the past two decades and its coverage of the rural population, the objective of weaning away poor peasantry from money lenders had been achieved. The credit pattern that emerged in the process was, however, skewed in favour of larger farmers to the neglect of others. The future thrust had, therefore, to be on preserving the vitality of the credit structure, which showed signs of weakness in the very process of quantitative expansion. The only two structural changes visualised were: merger of RRBs with their sponsor banks and creation of a national apex co-operative bank. To correct regional imbalances, a comprehensive crop insurance scheme and a separate corporation to administer this as well as the ARDCs in certain states were also recommended. These were intended to reinforce the prevalent system of credit delivery.

In a poverty-ridden economy, financial institutions have a responsibility towards the weaker sections, but it was necessary to recognise the limitations of credit as the principal instrument of poverty alleviation. A sharper focus on the selection of beneficiaries and greater transparency in concessions and subsidies was important to avoid leakages. Better co-ordination between development planning and credit planning through a graduation of the 'service area scheme' into a more comprehensive 'development area scheme' became necessary. The 'multi-agency approach' needed to be sharpened where commercial banks and co-operatives supplemented and supported each other. The relative freeing of interest rates, a new and greater thrust on deposit mobilisation and more effective lending and recovery were meant to make the credit system more responsive to emerging development needs.

All these could be achieved only if greater autonomy was given to the credit institutions. The growing inroads into the commercial banking system through excessive directions, controls and interference with the democratic management of co-operatives, which debilitated these systems over the years, were disturbing trends. There was a need to reverse this trend.

COMMERCIAL BANKS AND RURAL CREDIT

With the introduction of social controls in 1967 and the nationalisation of major commercial banks in July 1969, commercial banks started to play a substantive role in dispensing rural credit and began opening branches in rural areas. After nationalisation, rural people came to be served quite extensively by commercial banks.

Commercial banks were mandated to achieve certain targets and sub-targets under priority sector lending. All these targets were achieved by banks by March 1988. The commercial banks' involvement in various poverty alleviation programmes such as IRDP, DRI, SEEUY and SEPUP increased substantially after nationalisation. There was a sharp increase in the number of branches of commercial banks in all states and regions of the country. Since the main objective of branch expansion was largely fulfilled within 15 years after nationalisation, there was a shift in policy from further expansion to consolidation and from quantitative to qualitative improvement.

With the rapid expansion of commercial bank branches in the rural areas, it was felt necessary to emphasise the deployment of deposits mobilised by rural branches locally in the rural areas. The banks were, therefore, advised to achieve a credit-deposit ratio of at least 60.0 per cent in rural and semi-urban branches. An analysis of the regional distribution of commercial bank deposits and advances showed a marked variation in the deployment of credit and mobilisation of deposits.

Commercial banks found that sanctioning and monitoring large numbers of small advances in rural branches was time-consuming and manpower-intensive, and hence a high-cost proposition. Partly because of this, banks were reluctant to post sufficient supervisory and other staff in rural branches. Consequently, supervision of rural advances was neglected. In addition, the staff in rural branches of the commercial banks lacked motivation to work in these areas for various reasons. In such a scenario, it was felt that monetary and non-monetary incentives were necessary to encourage staff to work in rural and semi-urban branches. It was found that efforts by commercial banks to gear up their organisational structure, adopt schematic lending, improve pre-lending appraisal of schemes and launch recovery drives had yielded results.

Under the LBS, 1969, the lead bank acted as a consortium leader to co-ordinate the efforts of all credit institutions in the allotted districts for branch expansion and met the credit needs of the rural economy. Various mechanisms designed under the LBS created better understanding of the problems at the ground level. However, many of the committees under the LBS tended to become more ritualistic than functional.

To improve the quality of rural lending by commercial banks, the Reserve Bank initiated a new approach called the 'service area scheme' in April 1989. The committee preferred to modify this 'service area approach' into a 'development

area approach', especially since the scheme had emerged out of the development plan and development-linked credit plan.

The overall profitability of commercial banks had been under strain due to a rise in the cost of deposits, declining yield on advances and rise in establishment expenses. Low interest rates on agricultural advances, lending under IRDP, relatively poor deposit mobilisation in rural branches and lower staff productivity contributed to declining profitability of rural business. However, commercial banks were able to absorb the losses of their rural branch operations through earnings from more profitable businesses. The bottom line was that commercial banks were the only system that was capable of lending to rural and weaker sections at concessional rates, and had the capacity for cross-subsidisation. A major problem associated with such rapid expansion was deterioration in the quality of lending due to various factors.

The committee sounded a note of concern on these issues, such as, tardy scheme preparation, particularly under the anti-poverty programmes; a heavy housekeeping workload without a commensurate increase in support staff; a tendency to rely on walk-in business or sponsoring of loan applications by the branch managers; lack of detailed instructions on several aspects of rural lending contributing to a decline in professionalism in rural branches; and insufficient discretion to the branch managers in taking credit decisions even within the overall framework of guidelines and for which they could be made accountable.

REGIONAL RURAL BANKS

The intent behind creating RRBs was to develop an institutional framework combining the local feel and familiarity with respect to the rural problems and the business organisation skills and modernised outlook of commercial banks. RRBs succeeded in taking banking services to very remote areas that were unbanked and made institutional credit available to weaker sections in these areas.

The working groups periodically set up on RRBs brought out the deficiencies in their working and, in particular, their inability to operate on a viable basis. A closer look at their performance to evaluate their impact on the rural credit structure revealed that the RRBs had developed serious organisational problems. These critical areas related to a steep decline in profitability, poor recoveries and problems relating to management and staff.

Major factors that contributed to erosion of RRBs' profitability included lending exclusively to weaker sections, low interest rate margins and high operating costs involved in handling small loans. In the absence of loans that could yield higher returns, they did not have any scope for cross-subsidisation. Further, wilful defaults, misuse of loans, lack of follow-up, wrong identification of borrowers, extension of *benami* loans, and staff agitations contributed to poor recoveries in RRBs. It was proposed that RRBs should be merged with the sponsor banks. The merger recommendation did not imply dilution of the concern for the common

man. On the contrary, the intention was to give the common man a stronger institution to serve his needs more efficiently. The proposed merger involved the question of absorbing the accumulated losses of the RRBs. It was recommended that net loss of each RRB should be shared between the Government of India, the sponsor bank and the state government in the same proportion as their shareholding.

CO-OPERATIVE BANKING SYSTEM

A major weakness of the co-operative credit system was the neglect of the base-level institutions and the tendency of higher-level institutions to look after their own interests, often at the cost of the primaries. The co-operative credit system had neglected its basic responsibility of mobilising deposits, with the lower tiers looking up to the higher tiers for refinance at all levels. Organisational and financial ties in the co-operative system had to be redesigned so that each tier strengthened the other. This meant larger reliance on resources mobilised locally and a lower dependence on higher credit institutions. Dependence on outside funds had made the members less vigilant on the one hand and led to greater outside interference and control on the other. The states had come to gain almost total financial and administrative control over the co-operatives and in the process stifled their growth. This trend had to be reversed.

Some of the results of politicisation were interference in the recovery of co-operative dues or promises to write-off the dues if elected to power and the determination of interest rates on considerations other than financial returns, *i.e.*, operating on populist appeal. Such actions generated a psychology of non-repayment, vitiating the recovery climate and jeopardising the financial interest of credit agencies. Another lever for greater politicisation was the incorporation of certain undesirable provisions in the Co-operative Societies Acts and Rules of various states. Paradoxically, state partnership, which was conceived as an effective measure to strengthen the co-operative credit institutions, paved the way for ever-increasing state control over co-operatives, virtually depriving the co-operatives of their democratic and autonomous character.

SHORT-TERM CO-OPERATIVE CREDIT STRUCTURE

The concept of a three-tier hierarchy in the short-term co-operative credit structure had been accepted and the committee did not see any advantage in abolishing any of the tiers. Although the co-operatives ceased to be the sole purveyor of agricultural credit with the entry of first the commercial banks and later RRBs, they continued to occupy a leading position in disbursing production finance for agriculture.

The profitability of the co-operatives caused considerable concern. The programme of re-organising the PACS based on viability norms had not been completed in some states. Unsatisfactory recovery of dues, low margins and

the non-viable nature of many societies were affecting the operations of PACS. The position of the DCCBs and the state co-operative banks was slightly better. Measures to remove the weaknesses of PACS and strengthen them in order that they could function effectively were grouped under: (i) viability; (ii) strengthening of share capital; (iii) mobilisation of deposits; (iv) improving lending policies and procedures; (v) management; (vi) office premises and godowns; (vii) loans for non-productive purposes; (viii) allocation of repayments; and (ix) audit of PACS.

The committee recommended the following lines of action:

(i) An action programme, not extending beyond five years, should be drawn for each of the PACS. All PACS that had not reached a loan business of ₹ 1 lakh should be taken up for specific attention. The programme of development for each PACS should deal with increasing loan business, enlarging its package of profitable non-credit activities, augmenting resources (deposits) and reducing overdues. The Eighth Five Year Plan should, in fact, become the period for the revival of PACS. The states of Maharashtra, Gujarat and Jammu & Kashmir must also undertake the programme or re-organisation at the earliest.

(ii) Each PACS must have at least one full-time, paid and properly trained official, to handle the business activities on a regular basis. Further, the managing committees of PACS must play an important role. The committees would determine the overall policy, appoint the secretary, decide on loans and credits and were accountable to the general body of the society for management of all its affairs.

(iii) The process of re-organisation was envisaged to be in tune with the dynamics of economic development. It was, however, not the intention to recommend another state-sponsored programme of re-organisation of PACS (except in the three states referred to earlier). Further, re-organisation was meant to be voluntary.

(iv) The share capital of PACS in many cases needed to be augmented to meet the growing responsibilities and challenges devolving on them. Most PACS were completely dependent on finance provided by the DCCBs and if the DCCBs were weak, the PACS were starved of finance. While the branches of commercial banks and RRBs were able to mobilise rural savings, the PACS largely failed in this area, with some exceptions, such as those in the states of Kerala and Punjab.

(v) The state co-operative banks/DCCBs could help build infrastructure facilities such as bank counters. As recommended by CRAFICARD, the state co-operative banks/DCCBs should create a co-operative development fund to help the PACS acquire bank counters and safe deposits.

(vi) The PACS should preferably mobilise low-cost deposits, such as savings bank deposits. The PACS should maintain 15.0 per cent (of deposits) liquidity with DCCBs in a special account.

(vii) The crop loan limits of members of PACS may be prepared once in three years, subject to certain precautions, to ensure that any subsequent changes in the crop acreage of members were taken note of. The existing scales of finance fixed by the district-level technical committees of the DCCBs and accepted by commercial banks were found to be inadequate.

Further, PACS should extend credit from their own resources for non-productive purposes, such as consumption loans, up to prescribed limits but only against tangible security. This would greatly help the poor who needed occasional consumption loans. The audit of the PACS should be done by the Registrar of Co-operative Societies free of cost or at a nominal fee.

The following areas were critical to the overall development of the state co-operative credit structure: (i) development of the leadership role of higher tiers; (ii) greater deposit mobilisation; (iii) development of project formulation and investment-planning capability for better and diversified project lending; and (iv) rehabilitation of weak banks.

LONG-TERM CO-OPERATIVE CREDIT STRUCTURE

The structure of the LDBs was not uniform across the country. In some states it was unitary, in other states it was federal, and in two states it was both unitary and federal. The overall performance of LDBs in reaching the plan targets was satisfactory and their progress in lending was steady. After the adoption of multi-agency approach in agricultural lending and the entry of commercial banks in the field, the share of LDBs in agricultural lending showed a decline. Like the short-term co-operative credit structure, this structure for rural lending faced problems that included: (i) overdues; (ii) restricted lending eligibility of units; (iii) inability of banks to become viable because of restricted lending; (iv) consequent deterioration of the profitability of the banks; (v) high cost of raising ordinary debentures and lower margins available on non-schematic lending; and (vi) external interference and government intervention in management.

Another problem that these banks faced was the uneconomical cost of interim finance required for issue of loans before debentures were floated. It was, therefore, recommended that NABARD should provide adequate interim finance at a concessional rate of interest. In most LDBs there was no definite policy with regard to recruitment, appointment, career planning and development of the staff, and they depended on transitory personnel sent on deputation.

THE OVERDUES SYNDROME

The high incidence of overdues in the agricultural credit system had become a major constraint on the expansion and smooth delivery of credit. However, the bulk of the overdues got recovered over time, leaving only a small proportion ultimately becoming irrecoverable. The overall position on recovery of loans

continued to be unsatisfactory in respect of all types of credit agencies, although it varied among the different agencies and different regions/states. Recoveries in aggregate were relatively better in the LDBs than in PACS, commercial banks and RRBs (which had the poorest rate). By state, the recovery of agricultural credit was consistently better in Punjab, Kerala and Haryana irrespective of the type of agency dispensing credit, whereas it was far from satisfactory in states such as Manipur, Tripura, Assam and Meghalaya. Similarly, recoveries were better in irrigated areas and where high-value crops were grown. Since recycling was as important as mobilisation of additional resources, effective measures were called for to bring down overdues to the minimum level within a definite time frame.

The dual legal framework for recovery, *viz.*, legislation along the lines recommended by the Talwar Committee in the case of commercial banks and RRBs and the Co-operative Societies Acts in various states for co-operative credit institutions suffered from various shortcomings. Administrative arrangements for recovery through legal measures, such as recovery staff, were inadequate, resulting in heavy arrears in disposal of recovery cases. Besides making the existing legal framework more effective and augmenting the government staff for effecting recoveries, a single common legal framework that covered both co-operatives and commercial banks for the country as a whole, special tribunals at the state level and a single government department in each state to execute the awards obtained through such tribunals were needed.

Providing loans to groups of persons or associations of farmers for a common purpose needed to be facilitated and in fact encouraged. Unlike individual loans, group loans besides being secured by the joint and several liabilities of those constituting the group/association, were also backed by their responsibility, including the moral one to discharge the loan liability. Similarly, there was an imperative need to educate borrowers about the correct use of bank credit and the commercial discipline that went with it.

There was a growing tendency to use agricultural credit as an instrument to achieve short-term populist objectives. Government measures such as write-off of agricultural dues, concessions/relief announced by political functionaries from public platforms, stay orders on legal processes of recovery and disbursement of loans/assets at the hands of political dignitaries in loan *melas* had vitiated the recovery climate. The need for a strong political will could not be over-emphasised if politicisation of the agricultural credit institutions was to be checked. A consensus was also needed among all political parties to ensure that agricultural credit was not used for political purposes. The Government of India and the state governments had to evolve a concrete long-term policy for recovery of agricultural dues and take a firm and objective view on wilful defaulters.

Factors internal to the credit system that directly affected recoveries included defective loan policies and procedures, inadequate supervision over credit and unsatisfactory management. These related to unrealistic scales of finance/unit

costs, delays in sanction and disbursement of loans, fixing defective repayment schedules, failure to provide working capital to borrowers under term credit and over-emphasis on the target approach. Several recommendations on streamlining the crop loan system were made by earlier committees and policy decisions taken, but these were not implemented. More attention and effort also needed to be given to linking credit with marketing and processing.

APPENDIX 12.1

Liberalisation Measures Introduced by the Reserve Bank: 1991–92 and 1992–93

TRADE LIBERALISATION

FINANCING OF IMPORTS: SPECIAL REGULATIONS

In view of the difficult foreign exchange reserves position, the Reserve Bank issued a series of instructions stipulating minimum cash margins against LCs and generally regulating the financing of imports. These included the requirements for obtaining prior approval from the Reserve Bank for remittances to be made against imports beyond certain limits or under certain other circumstances.

ROLL-OVER ON FORWARD COVER FOR DEFERRED PAYMENT OF EXPORTS AND IMPORTS

ADs were permitted to enter into forward purchase contracts on a roll-over basis in cases of exports on DPT and for forward sale contracts on a roll-over basis in cases of imports under import licenses issued on DPT as well as for repayment of foreign currency loans. The initial contract could be for six months and thereafter, as each deferred instalment was taken up, the outstanding balance of the forward contract could be extended for a further period of six months. It was decided to allow ADs, on specific requests from customers, to undertake roll-over at shorter intervals to reduce the costs payable by the customer.

DESPATCH OF SHIPPING DOCUMENTS DIRECT TO CONSIGNEES/OVERSEAS AGENTS OF CONSIGNEES

Exporters of precious/semi-precious stones and non-gold jewellery were granted general permission to dispatch shipping documents directly to consignees for consignments not exceeding US$ 25,000 or equivalent in value as against the earlier limit of US$ 15,000.

PERMITTED METHODS OF EXPORT PROCEEDS

Exporters were not normally permitted to receive payments for exports directly from overseas buyers in the form of bank drafts, pay orders, bankers' cheques, personal cheques, foreign currency notes or foreign currency travellers' cheques. The Reserve Bank permitted ADs to handle export documents in cases where their exporter customer had received payment, in the form of bank draft, pay order, banker's cheque or personal cheque drawn by the overseas buyer in favour of the exporter, not exceeding US$ 7,500 per shipment, directly from the overseas buyer, subject to the conditions: (i) the instrument was tendered to the AD within seven days from its receipt and was meant for payment for exports; (ii) export documents were routed through the AD/branch to whom the instrument was

presented for realisation; (iii) payment was received in an approved manner; and (iv) export was made only on realisation of the instrument. Applications involving amounts above US$ 7,500 or equivalent per shipment or applications for receiving payments in the form of foreign currency notes or foreign currency travellers' cheques tendered by overseas buyers while on a visit to India required a reference to the Reserve Bank for its consideration.

PROJECT EXPORTS

Between July 1, 1990 and June 30, 1991, the working group on project exports approved 104 proposals valued at ₹ 5,027 crore. These comprised 68 proposals for turnkey contracts valued at ₹ 4,089 crore, 25 proposals for civil construction contracts valued at ₹ 770 crore and 11 proposals for consultancy service contracts valued at ₹ 168 crore. The working group also cleared 33 proposals valued at ₹ 810 crore at the post-award stage.

SUBSIDIARIES/JVs ABROAD AND OPENING OF OFFICES IN INDIA/ABROAD

Between July 1, 1990 and June 30, 1991, five proposals allowing Indian companies to establish their subsidiaries abroad and 25 proposals enabling Indian companies to enter into JVs abroad were cleared. Indian companies were granted approval for opening 32 trading offices and 64 non-trading offices, and posting representatives abroad in 42 cases.

Approval for opening 70 liaison offices, 16 representative offices and 12 project offices in India were granted to foreign companies.

MEASURES TO ATTRACT NRI DEPOSITS

CREDIT TO NON-RESIDENT ORDINARY RUPEE (NRO) ACCOUNTS

The regulations governing operations on NRO accounts by non-residents of Indian nationality/origin and OCBs predominantly owned by such persons were revised as below:

(i) ADs were permitted to freely allow credit of rupee funds without any limit to NRO accounts maintained by NRIs/OCBs that were lawfully due to the account holder as against the previous limit of ₹ 4,000 a month, with individual credit not exceeding ₹ 1,500, up to which the ADs could allow such credits without prior approval from the Reserve Bank.

(ii) ADs were advised to call for documentary evidence for individual credits that exceeded ₹ 10,000 in order to ascertain that the transaction was bonafide.

(iii) ADs were also advised to get an undertaking from both existing and new account holders that they would not make available to any person in India any foreign currency against reimbursement in rupees or in any other manner.

NRO ACCOUNT HOLDERS

The limit up to which ADs were empowered to grant loans and overdrafts to their NRI constituents for purposes other than investment, against the security of fixed deposits held in NRO accounts, was increased from ₹ 2 lakh to ₹ 5 lakh.

NRE ACCOUNT HOLDERS

The limit for grant of loans/overdrafts to NRE account holders against the security of their fixed deposits held in NRE/FCNR accounts was raised from ₹ 2 lakh to ₹ 5 lakh and later to ₹ 10 lakh for purposes other than investment. Repayment in such cases was, however, to be made either by adjustment of the NRE/FCNR deposit or by fresh inward remittance from abroad.

ADs were empowered to grant, subject to certain conditions, rupee loans/ overdrafts up to ₹ 10 lakh to their NRI customers against security of fixed deposits held by them in NRE/FCNR accounts for the purpose of making direct investment in India on non-repatriation basis in the capital of Indian companies that were either engaged or proposed to engage in manufacturing/industrial activities, hospitals, hotels of three-star or higher grades, shipping, development of computer software and oil exploration services. Earlier, such applications were required to be referred to the Reserve Bank.

LOANS TO RESIDENTS AGAINST SECURITY OF NRE FIXED DEPOSITS

ADs were hitherto required to refer to the Reserve Bank applications for grant of loans/overdrafts to resident individuals/firms/companies in India against collateral of fixed deposits held in NRE accounts. Powers were delegated to ADs permitting them to grant such loans/overdrafts without any limit, subject to the following conditions:

- (i) There should be no direct or indirect foreign exchange consideration for NRI depositors who agreed to pledge their fixed deposits to enable the resident individual/firm/company to obtain such loans/overdraft.
- (ii) The period of loans should not exceed the unexpired period of maturity of NRE/FCNR fixed deposits accepted as security. In addition, the NRI depositor should furnish an irrevocable undertaking to the AD not to withdraw the deposit during the period of the loan/overdraft.
- (iii) The loan/overdraft to be granted should conform to the regulations relating to normal margin, rate of interest depending on the purpose of the loan as stipulated by the Reserve Bank from time to time.
- (iv) The loan could be used for personal purposes or for business activities other than agriculture/plantation and real estate.

TRANSFER OF FUNDS BETWEEN NRE ACCOUNTS OF NRIs

Hitherto, the Reserve Bank approval had been required to transfer funds from the NRE account of one person to the account of another person if the two people

were close relatives. Powers were delegated to ADs to undertake such transfers if the transfer was for genuine personal purposes, *e.g.*, education of children, gift or personal expenses and the transferor and transferee account holders were resident in the external group of countries or in the same bilateral group country.

If the funds were to be transferred from one bank to another, the transferor bank had to certify the NRE status of the account from which the funds were to be transferred. Transfer of funds as gifts were allowed subject to payment of gift tax, if applicable.

FCNR (A) DEPOSITS

ADs were permitted to pay commission not exceeding one per cent of the deposits mobilised under the FCNR (A) scheme with effect from November 26, 1990. The payment of brokerage was restricted to: (i) deposits mobilised under the pension scheme; and (ii) other deposits of US$ 25.0 million each under the FCNR (A) scheme. Such deposits were required to be kept for a minimum period of two years.

FCNR SPECIAL DEPOSIT SCHEME FOR THE MIDDLE EAST

To meet the requirements of NRIs/OCBs resident in countries of the Middle East, the FCNR special deposit scheme was introduced on August 20, 1990. Under the scheme, ADs were permitted to open accounts only in US dollars in the name of NRIs/OCBs resident in countries of the Middle East, provided the funds for the purpose were transferred to India in an approved manner from the country of residence of the prospective account holder or from any other country in the external group. The accounts could also be opened either by transfer of funds from the existing FCNR/NRE accounts of account holders or by tendering foreign currency notes and/or travellers' cheques, subject to conditions. No restrictions were placed on the number of withdrawals that could be made from these special accounts and, accordingly, no interest was payable on the balances in these accounts. Loans/overdrafts could not be granted against the security of the funds held in these accounts. The other provisions that applied to FCNR accounts were applicable, *mutatis mutandis*, to these special accounts.

Subsequently, it was decided that banks could pay interest on such deposits in cases where there were no further deposits or withdrawals in the same account and the deposits remained with the bank for a minimum period of six months. In other words, such deposit accounts were in the nature of term deposits. In such cases, the rates of interest were the same as was applicable to deposits denominated in US dollars for the period for which the deposits remained with the banks.

FOREIGN CURRENCY (ORDINARY NON-REPATRIABLE) DEPOSIT SCHEME

To provide further incentives and give wider options to NRIs and OCBs for making investments in India, the Reserve Bank introduced with effect from June 17, 1991 a new deposit scheme, *viz.*, the foreign currency (ordinary non-repatriable) deposit

scheme. Deposits accepted under the scheme were denominated in US dollars for a fixed period of five years. The rate of interest was one per cent above the ruling applicable rate for FCNR dollar deposits for three years. Certain benefits, such as availability of loans/overdrafts against the security of the deposit and tax exemptions under the Income Tax Act and the Wealth Tax Act, were also available to the depositors. The deposits were also free from gift tax for one-time gifts. Premature withdrawals of the deposit were permissible and the interest rate payable in such cases was the rate ruling on the date of deposit for the period for which the deposit remained with the bank. However, the rupee equivalent of the amount withdrawn or the maturity proceeds of the deposit including interest would be credited to the NRO account of the deposit holder.

INDIA EQUITY FUND UNIT SCHEME: 1990

The UTI was granted permission to enter into an agreement with India Equity Fund Inc. to raise funds abroad up to US$ 100.0 million for investing in units of UTI under its special unit entitled 'India Equity Fund Unit Scheme: 1990'.

NRI BONDS II SERIES BY THE SBI

The SBI was granted permission to issue a second series of NRI bonds to NRIs on non-repatriation basis. The special features of the scheme were:

(i) ADs in India were permitted to grant rupee loans for certain purposes to NRI bondholders against the collateral of the above bonds held by them.

(ii) These bonds could be gifted without restriction and without attracting the provisions of the Gift Tax Act only once, either by the original holder or an NRI transferee to any individual of Indian nationality or origin, whether or not he was resident in India, or to any charitable Trust in India that was recognised under the Income Tax Act, 1991.

(iii) Joint holdings were allowed between NRI and a resident Indian who was not a close relative.

INDIAN OPPORTUNITIES FUND

Indian Bank was granted permission to establish an off-shore fund, *i.e.*, the IOF in the Netherlands in collaboration with Perpetual Chescor, UK to raise funds abroad to the extent of US$ 200.0 million for investing in India in the units of Indbank (off-shore) Mutual Fund established by the Indian Bank.

IDBI CAPITAL BONDS

The IDBI was granted general permission to issue 3-year IDBI Capital Bonds to NRIs on non-repatriation basis, subject to the following conditions:

(i) Neither the capital invested nor the income earned was allowed to be repatriated outside India at any time in future; and

(ii) All interest accruals and maturity proceeds of the bonds were to be credited to the investor's NRO account maintained with a bank authorised to deal in foreign exchange in India.

RELAXATION IN REMITTANCES FOR MISCELLANEOUS PURPOSES

RELEASE OF FOREIGN EXCHANGE FOR VISITS TO BILATERAL GROUP OF COUNTRIES

Persons visiting the bilateral group of countries for business, study tour, or attendance at a conference, seminar/symposium were allowed to draw their entire exchange quota in free foreign exchange even though *per diem* scales of exchange and the permits issued by the Reserve Bank continued to be expressed in rupees. In the case of permits issued for medical treatment and higher studies, the conversion facilities on a limited scale allowed at that time were continued. Remittances for registration, admission, examination and membership fees continued to be allowed in rupees without any conversion facilities.

MCO FACILITY FOR TRAVELLERS VISITING MAURITIUS UNDER NTS

Indian residents visiting Mauritius under the NTS were permitted to avail of the facility of miscellaneous charges order (MCO) to cover expenses for surface transportation. This facility could be availed of by people travelling in a group of 15 or more, up to a limit of US$ 150 per person.

REFUND OF FOREIGN EXCHANGE CONSERVATION TRAVEL (FECT) TAX

In terms of sub-rule (1) of rule 5 of the FECT tax rules 1987, refund of FECT tax could be claimed within a period of one month from the date of return from foreign travel, for which exchange was released. This time limit for claiming the refund was increased to 90 days from the date of return from abroad.

FOREIGN EXCHANGE FOR HIGHER STUDIES

With effect from June 1, 1990 powers to release exchange for higher studies abroad were delegated to designated branches of PSBs. The total number of branches designated by these banks was 328.

SPECIALISED TRAINING

The period for release of exchange for advanced training in highly specialised medical fields at reputed overseas institutions for medical practitioners/specialists was enhanced from six months to a maximum of twelve months.

ENHANCEMENT OF RIFEE FACILITY AGAINST REPATRIATION OF MONTHLY PENSION

From April 1990, Indian nationals and persons of Indian origin receiving pension in foreign exchange from their erstwhile foreign employers and also regularly repatriating the entire pension amount to India were allowed to utilise up to 25.0 per cent of the pension amount drawn and repatriated to India for purposes specified under the Returning Indians Foreign Exchange Entitlement Scheme (RIFEES). The percentage of entitlement for pension amounts drawn prior to April 1990 and repatriated to India remained unchanged at 10.0 per cent under the scheme.

DEVELOPMENTS DURING 1992–93

FOREIGN EXCHANGE REGULATION (AMENDMENT) ACT OF 1993

To simplify and remove regulations that hindered the free flow of foreign capital into India as also investments by Indian companies in JVs overseas, comprehensive amendments were effected to FERA, 1973 under the following broad categories:

- (i) Some provisions governing the operations of FERA companies in India were amended, with the result that the restrictions placed on these companies under FERA, 1973 were removed. FERA companies were thus placed on par with domestic companies that did not have any foreign equity participation or had foreign equity participation up to a level of 40.0 per cent and did not attract the restrictive provisions of FERA, 1973.
- (ii) Several provisions that imposed restrictions, which hampered the move towards convertibility of the rupee, were amended or deleted. Two important developments were the deletion of the provision requiring foreigners to pay their hotel bills in India in foreign currency and deletion of the provision that required payment in rupees for travel to/from India by NRIs.
- (iii) Certain provisions relating to the enforcement of the Act were amended to prevent harassment of people suspected of having violated the provisions of the Act.
- (iv) Two new provisions, *viz.*, sections 18A and 73A, were introduced to provide better regulation of export of goods on lease or hire and to ensure better compliance by ADs of the directions issued by the Reserve Bank. Section 73A empowered the Reserve Bank to impose penalties on ADs without prejudice to the powers and jurisdiction of the Enforcement Directorate.

SIMPLIFICATION OF PROCEDURES UNDER FERA

In another important step, the authority to ADs was simplified in several areas of remittances, such as: (i) surplus collections of foreign airline companies operating

in India; (ii) remuneration payable to foreign technicians engaged by Indian companies; (iii) advance remittances for import of goods; and (iv) remittances for sundry purposes, such as advertisements, membership fees, examination fees and legal expenses. ADs were permitted to offer forward cover to their overseas investors for direct foreign investment in India, subject to certain conditions, and relaxations were given on dividends from their shareholdings and to residents on balances held in bank accounts with ADs in India, designated in foreign currencies. Remittance of dividend to foreign investors on their shareholdings in FERA companies, which earlier required authorisation by the Reserve Bank, were now permitted to be effected directly by ADs.

The regulations relating to travel abroad for business visits including travel abroad of delegations sponsored by trade bodies, such as the Associated Chambers of Commerce and Industry of India (ASSOCHAM) and Federation of Indian Chambers of Commerce and Industry (FICCI) for conferences/seminars, study tours, training and higher studies and for medical treatment were further liberalised and the procedures and documentation were simplified. ADs were empowered to deal with all these applications directly, without seeking approval from the Reserve Bank.

GENERAL PERMISSION IN SELECT AREAS

EXEMPTION FROM DECLARATIONS/SURRENDER OF FOREIGN CURRENCY ASSETS BY RETURNING INDIANS

Indian nationals and foreign nationals of Indian origin were required to declare to the Reserve Bank all their foreign currency assets, acquired while they were non-residents, on their return to the country permanently. They were also required to close their bank accounts aboard and were permitted to hold other forms of foreign currency assets only with the permission of the Reserve Bank subject to its terms and conditions. Where such persons desired to continue to maintain foreign currency accounts abroad, they had to obtain permission from the Reserve Bank. Non-residents with a minimum stay abroad for a period of one year were exempt from declaring their foreign currency assets to the Reserve Bank even after their return to the country permanently and were permitted to use them without any restrictions. The facility included switching of their foreign investments and investing abroad the income earned on their lawfully acquired foreign assets. As an incentive, such persons bringing foreign currency funds into the country were permitted to transfer their foreign currency funds into the country and maintain foreign currency accounts with banks in India (RFC accounts), and use the funds in such accounts freely without any exchange control restrictions.

LIBERALISED BAGGAGE RULES

The Government reduced the rate of customs duty applicable to 35 specified baggage items from 255.0 per cent to 150.0 per cent *ad valorem*. There was no prescribed condition relating to minimum stay aboard for availing of the concessional rates and the total value of goods eligible for these rates was fixed at ₹ 1.50 lakh.

DEVELOPMENTS IN THE DOMESTIC FOREIGN EXCHANGE MARKET

There were several developments in the domestic foreign exchange market. The regulations relating to the provision of forward exchange cover by ADs were relaxed. They were permitted to: (i) provide forward cover for all genuine transactions; (ii) provide cover for longer periods, *i.e.*, even beyond 180 days, on outright basis without going in for periodic roll-overs after obtaining the Reserve Bank's approval; (iii) undertake fully covered swaps in any convertible currency, against one of the FCNR currencies, with NRI depositors; and (iv) do such swaps between two FCNR currencies.

To ease the pressure on the rupee, banks were advised that the overnight oversold position in the rupee should not exceed US$ one million or its equivalent at the close of business each day. For the purpose of this limit, however, customer purchases and foreign currency purchase for *vostro* funding were excluded.

FOREIGN INVESTMENTS

During the year, foreign investment proposals in high-priority areas were freed of non-tariff restrictions embodied in export obligations to balance dividend repatriation (except for 22 consumer goods industries). Keeping in view the ever-expanding frontiers of global technology, a scheme was introduced that provided for 100.0 per cent foreign equity participation, duty-free import of capital goods and a 5-year tax holiday relating to corporate and income tax. One hundred per cent foreign equity participation in power generation units was also permitted. Indian firms/companies were free to engage the services of foreign technicians without seeking permission from the Reserve Bank, provided the terms of their engagement conformed to certain guidelines. Reservations for the public sector in the areas of mining and mineral extraction were done away with. The new national policy envisaged foreign equity participation up to 50.0 per cent in Indian companies engaged in mining activities and even beyond that in the case of non-captive mines, on a case-by-case basis.

GUIDELINES FOR INVESTMENTS IN PRIMARY AND SECONDARY MARKETS FOR FIIs

In continuation of the process of developing a market-friendly environment for foreign investment, guidelines were set out for FIIs, *i.e.*, pension and corporate or institutional portfolio managers. FIIs were allowed to invest in all the securities

traded in the primary and secondary markets, provided they were registered with SEBI, for which SEBI would seek general permission from the Reserve Bank before initial registration was granted. Simultaneously, the FIIs were to file an application, in a specified format, with the Reserve Bank seeking approvals under FERA. Further, the concerned FIIs had to hold a registration of Securities and Exchange Commission or the regulatory organisation for the stock market in the country of domicile/incorporation. SEBI's initial registration was valid for five years and could be renewed.

The general permission from the Reserve Bank, as per the guidelines, would enable FIIs to: (i) open foreign currency-denominated accounts in a designated bank; (ii) open a special non-resident rupee account to which all receipts would be credited; (iii) transfer sums from the foreign currency accounts to the rupee account and vice versa; (iv) make investments in securities in India out of the balances in the rupee account; (v) transfer/repatriate (after tax) proceeds from the rupee account to the foreign currency account; (vi) repatriate the capital, capital gains, dividends and interest income; and (vii) register FII holdings without any further clearance under FERA.

The guidelines also stated that there was no restriction on the volume of investment for the purpose of entry of FIIs in the primary/secondary market. In addition, there was no lock-in period prescribed for the purposes of such investments made by FIIs. Portfolio investments of FIIs in primary or secondary markets were, however, subject to a ceiling of 24.0 per cent of issued share capital for the total holdings of all registered FIIs in any one company, The holding of a single FII in any company was also subject to a ceiling of 5.0 per cent of total issued capital, and for this purpose the holdings of a group of FIIs was counted as holdings of a single FII.

According to the guidelines, disinvestment was permitted only through exchanges in India. All secondary market operations of FIIs were conducted only through recognised intermediaries on the Indian stock exchanges.

INTRODUCTION OF STOCKINVEST FACILITY IN PRIMARY CAPITAL MARKET FOR NRIs/OCBs

The stockinvest facility was provided by ADs to resident Indians. ADs were allowed to issue stockinvest with certain conditions to NRIs and OCBs predominantly owned by the non-residents. NRIs and OCBs could thus avail of the facility to apply for shares/debentures with repatriation benefits.

INVESTMENTS ABROAD BY ADs

The Reserve Bank permitted ADs from August 16, 1993 to invest their funds held in all foreign currency accounts in their books in Treasury Bills and with banks abroad rated for short-term obligations as A1+ by Standard and Poor's or P1 by Moody's. They were also allowed to lend the foreign currency amounts standing

in their EEFC and RFC accounts to residents towards their genuine foreign exchange requirements as in the case of funds mobilised under the FCNR (B) Scheme. However, ADs were advised to ensure that the maturities of such deposits and placements were taken into account, along with the maturities of foreign exchange transactions when computing gaps, and to make sure that aggregate gap limits were not exceeded. They had to ensure that investments were made such that the deposit liabilities were promptly met on maturity/demand. The details of investment in Treasury Bills and deposits placed abroad as well as the total balances held by customers in their foreign currency accounts were to be reported periodically.

FOREIGN EXCHANGE RATE QUOTATION SWITCHOVER TO DIRECT QUOTATION SYSTEM

The Reserve Bank and ADs had been using the indirect quotation system for their sale/purchase transactions in foreign exchange. The Reserve Bank decided to switch to the direct system of quotation of exchange rates. Accordingly, from August 2, 1993, the Reserve Bank started to express its exchange rates in terms of rupees per US dollar instead of US dollar per ₹ 100. Simultaneously, the inter-bank and merchant quotations of the ADs were changed to the direct quotation system.

EXTENSION OF FACILITY TO OPEN NRE/FCNR ACCOUNTS

In view of relaxations in the policies and in order to attract more foreign investment, it was decided to extend the facility to open NRE/FCNR accounts, making available the schemes relating to investments in shares and debentures of Indian companies under various investments account schemes to NRIs and their foreign-born spouses.

INVESTMENT BY NRIs IN HOUSING AND REAL ESTATE DEVELOPMENT

To encourage NRI investments, it was decided to allow existing or new private or public limited companies engaged or proposing to engage in the development of plots and construction of residential and commercial premises, including business centres and offices, development of townships, urban infrastructure facilities and manufacture of building materials to issue equity shares and convertible debentures to NRIs up to 100.0 per cent of the new issue with repatriation benefits. OCBs were, however, not eligible for this facility.

Persons of Indian nationality/origin, who were permitted to acquire residential properties only on non-repatriation basis, were now allowed to repatriate the original investment in equivalent foreign exchange in residential properties subject to a maximum of two houses, provided the properties were purchased on or after May 26, 1993, and the properties were not transferred or disposed of by way of sale for a period of three years from the date of purchase.

General permission was granted to NRIs and foreign citizens of Indian origin, whether resident in India or not, to acquire through purchase, inheritance and transfer or disposing of by sale commercial immovable property in India. Repatriation of the original investment in equivalent foreign exchange was also allowed, subject to certain conditions.

General permission was also granted under section 31(1) of FERA, 1973 to foreign citizens of Indian origin, whether resident in India or not, to acquire, transfer or dispose of residential properties (up to two houses) situated in India by way of gift from or to a relative who may be an Indian citizen or a person of Indian origin, whether resident in India or not, subject to the condition that gift tax, if any, will be paid. The above general permission, however, was not available for acquisition of agricultural land/farm house/plantation property situated in India.

SILVER IMPORTS

The Government of India notified on February 8, 1993 a scheme to allow import of silver into the country along the lines for gold imports. NRIs and Indians returning after a stay of six months abroad were allowed to bring in 100 kg of silver as personal baggage after paying duty of ₹ 500 per kg in foreign currency

APPENDIX 13.1

Liberalisation in Exchange Management and Exchange Control

The liberalisation process in the sphere of exchange management and control was continued with vigour during the period from 1993–94 to 1996–97. Simplification of procedures and delegation of authority to ADs were extended in many more areas of operation. There were a number of policy changes with far-reaching implications for the foreign investment, foreign currency non-resident account schemes, euro issues, and portfolio investment by FIIs, which are discussed briefly below.

TRADE LIBERALISATION

REDISCOUNTING OF EXPORT BILLS ABROAD

During 1993–94, ADs were permitted to negotiate BAF with the overseas banks and discounting agencies; or make a similar arrangement with other agencies, including a factoring organisation abroad, without the prior approval of the Reserve Bank for the purpose of rediscounting export bills abroad, provided the rate of interest on the BAF or similar arrangement did not exceed 1.0 per cent over the six-month LIBOR in the case of rediscounting with recourse and 1.5 per cent over the six-month LIBOR in the case of rediscounting without recourse. If the facility was availed of from an overseas factoring organisation, it could only be 'without recourse'. Similarly, exporters were permitted to arrange for lines of credit with overseas banks or any other agency abroad with whom their export bills were discounted without the prior approval of the Reserve Bank, provided the rate of discount did not exceed the spread indicated above and the exporter undertook to get the export bills discounted from the overseas bank or agency only through the branch of an AD in India designated by him for this purpose. ADs were, however, required to advise the Reserve Bank about the terms and conditions of such lines of credit as soon as they were finalised. If the export bills were not paid on the due date, ADs were permitted to remit the amount, equivalent to the value of the bill earlier discounted, to the overseas bank or agency that had discounted the bill, without the prior approval of the Reserve Bank.

REGULATIONS RELATING TO FORWARD CONTRACTS

The regulations governing forward exchange cover were further liberalised during 1993–94. The decision on the period and extent to which an exposure in genuine permissible transactions was to be covered was left to customers. ADs were permitted to book roll-over forward cover as necessitated by the maturity period of underlying transactions, market conditions and the need to reduce the cost to the customer. They were also permitted to substitute orders after satisfying themselves with the circumstances under which the original sale/purchase

contracts could not be performed by the customer. In cases where the foreign currency amounts to be covered could not be quantified, ADs were permitted to book forward contracts based on reasonable estimates.

ACU TRANSACTIONS

Settlement of payments towards the import of sugar, fertiliser and pulses from any ACU country was allowed to be made outside the ACU mechanism in any permitted currency. During 1994–95, Indian exporters were permitted to accept payment in free foreign exchange in respect of their exports to ACU countries, provided such payment was voluntarily offered by the importer in the ACU country.

EXPORT FACTORING SERVICE

In 1994–95, the ECGC was permitted to provide non-fund-based export factoring services to exporters holding its policies. The Reserve Bank also approved the scheme evolved by the SBI Factors and Commercial Services Pvt Ltd, Bombay, for providing international factoring services on a 'with recourse' basis.

UTILISATION OF FUNDS IN EXCHANGE EARNERS' FOREIGN CURRENCY (EEFC) ACCOUNTS

Export/trading/super-star trading houses were permitted, with the Reserve Bank's permission, to make advance payments to their overseas suppliers by utilising funds in their EEFC accounts up to 5.0 per cent of their export realisation of the previous year, through a branch of an AD to be designated by them for this purpose.

OVERSEAS JOINT VENTURES/WHOLLY OWNED SUBSIDIARIES

Until 1992–93, Indian companies that wanted to establish JVs/subsidiaries abroad were required to approach the Government for clearance of their proposals. While applications involving equity in the form of cash and/or capitalisation of export proceeds/other receivables up to certain ceilings were cleared by the Ministry of Commerce under the automatic route, the remaining applications were considered in the inter-ministerial committee constituted for the purpose. The Government decided to transfer the work to the Reserve Bank and the procedural details and modalities in this regard were worked out.

CROSS-CURRENCY OPTIONS

To provide greater flexibility to the corporate for managing their foreign currency exposures, it was decided to selectively permit banks to write cross-currency options on a fully covered basis from January 3, 1994. The operational guidelines were laid down by the FEDAI in consultation with the Reserve Bank.

LOANS/OVERDRAFTS BY INDIAN BANKS

The limit for grant of loans/overdrafts in the rupee accounts (*vostro* accounts) maintained with ADs by overseas branches was raised from ₹ 50 lakh to ₹ 150 lakh. Simultaneously, the limit of ₹ 50 lakh for availing of loans and overdrafts by ADs from overseas branches was raised to US$ 5,00,000.

PROJECT EXPORTS

The value limits up to which ADs and Exim Bank could grant approvals at the pre-bid and post-award stages for proposals for project exports were enhanced from ₹10 crore to ₹ 25 crore for the former and from ₹ 50 crore to ₹ 100 crore for the latter.

DELEGATION OF POWERS TO ADs

The broad areas of simplification and delegation of greater autonomy to ADs during the year 1993–94 were as under:

TRAVEL

(i) ADs were permitted to release exchange for higher studies abroad in all cases where the student had secured admission in an overseas educational institution.

(ii) Powers were also delegated to full-fledged moneychangers to release foreign exchange to Indian businessmen going abroad on business.

(iii) The FTS and NTS under which Indian nationals could avail of exchange facilities up to US$ 500 and US$ 250, respectively, for private visits abroad once in three years were replaced by a scheme of basic travel quota of US$ 2,000 in a year, which could be availed of for one or more visits abroad for private purposes.

OTHER CURRENT ACCOUNT TRANSACTIONS

(i) Powers were delegated to ADs to write-off outstanding export bills that could not be realised for reasons beyond the exporters' control, subject to certain limitations.

(ii) The monetary ceiling up to which ADs were allowed to make remittances on behalf of their constituents towards cost of services rendered by overseas parties was increased substantially.

(iii) A new scheme for providing non-fund-based export factoring service to exporters who were ECGC policyholders was introduced by ECGC with the approval of the Reserve Bank.

(iv) Value limits for allowing remittances by ADs towards advance royalty or lump-sum royalty on books was enhanced from US$ 500 to US$ 3,000.

(v) ADs were permitted to allow remittance of commission to buying agents

abroad who had been appointed by Indian companies. The scope of powers delegated to ADs to allow remittance of surplus freight collections by airline/shipping companies was widened.

(vi) The scope of powers for ADs to allow remittances towards remuneration of foreign nationals engaged by Indian companies was widened and the *per diem* rates as well as annual ceilings were dispensed with.

(vii) ADs were permitted to allow remittance facilities for maintenance of non-trading overseas offices of Indian exporters who complied with the stipulated criteria.

(viii) The value limits of ₹ 250 for dispatch of samples of journals and periodicals by airfreight, ₹ 200 for dispatch of other goods by airfreight and postal packets not involving foreign exchange transactions were raised to ₹ 10,000.

(ix) Powers were also delegated to ADs to allow remittances of gifts/donations up to US$ 500 a year.

(x) Foreign citizens of Indian origin (whether resident in India or not), holding residential/commercial properties, were granted general permission to let out their properties, subject to the condition that the rental income or proceeds of any investment from such income would not be repatriable.

During 1994–95, the process of delegation of authority by the Reserve Bank to ADs regarding the release of foreign exchange was carried forward and the existing ceilings on various categories of outward remittances were raised. These were: (i) Release of exchange at the rate of US$ 500 *per diem* under the special scale for senior executives and US$ 350 *per diem* under the general scale for others. (ii) The limit for the release of exchange to Indian firms/companies for participation in trade fairs/exhibitions abroad was raised from ₹ 2 lakh to US$ 20,000 or its equivalent. This was also applicable to private printers and publishers. (iii) The limit on remittances by Indian shipping companies towards solicitor's fees/ average adjuster's fees was raised from US$ 5,000 to US$ 10,000. (iv) Remittance for accessing information from international databases up to US$ 10,000 to foreign data service vendors was permitted. With effect from July 5, 1995, ADs were permitted to release exchange for visits abroad for business, participation in overseas conferences/seminars, specialised training, medical treatment and studies, even beyond the scales and the duration prescribed by the Reserve Bank, provided that they were satisfied about the bonafide of the applicant and the need for releasing exchange at the higher rates.

During 1995–96, ADs were permitted to export their surplus stocks of foreign currency notes and coins for realisation of proceeds to private moneychangers abroad in addition to their overseas branches or correspondents. They were allowed to remit commission in cases where an Indian exporter secured an export order through an overseas agent for which payment was made from an escrow account designated in US dollars under the counter-trade arrangement. The ceiling of ₹

15 crore of the aggregate overnight open position to be maintained by ADs was removed with effect from January 1, 1996 and ADs were given the freedom to fix their own open exchange positions, subject to approval from the Reserve Bank. ADs were permitted to renew NRNR deposits along with the interest accrued with effect from October 1, 1994 for a further period ranging from six months to three years. ADs were permitted to allow EEFC account holders to utilise funds held in such accounts for making remittances in foreign exchange connected with their trade and business-related transactions of a current account nature. Banks were accorded the freedom to fix their own aggregate gap limit (AGL) for more efficient management of their assets/liabilities. It was decided to permit select banks with adequate dealing expertise and infrastructural facilities to initiate positions overseas in cross-currency transactions. ADs were now permitted to offer forward cover for interim dividend due to overseas investors on account of direct foreign investment in India and provide forward cover for a period not exceeding two months in respect of new remittable freight collections due to foreign shipping companies. ADs were also permitted to allow the corporate to substitute orders under forward contracts, irrespective of whether or not the original order against which the cover was offered was cancelled.

The process of liberalisation in the external sector that focused on giving greater freedom to banks and the corporate in respect of current account transactions was continued during 1996–97. Besides, ADs were permitted to offer various hedging products to the corporate for hedging loan exposures without prior reference to the Government/Reserve Bank. ADs were permitted to offer cost-effective and risk-reduction option strategies like range forwards and ratio range forwards, subject to the condition that there was no net inflow of premium to the customers. ADs were permitted to use FCNR(B) funds to lend to their resident constituents for meeting their foreign exchange as well as the rupee needs. ADs were also allowed to remit dividend/interest on shares/debentures/bonds held by non-residents on repatriation basis, subject to fulfilment of certain conditions. They were empowered to release exchange/allow remittances on actual basis without the prior approval of the Reserve Bank for: (i) legal expenses; (ii) postal imports; (iii) imports of design and drawings; (iv) establishment of overseas offices; (v) electronic database costs; (vi) maintenance expenditure for journalists stationed abroad; (vii) advertisement costs; and (viii) solicitors' fees. ADs were permitted to (a) borrow up to US$ 10.0 million from their overseas offices/correspondents without any conditions on end-use and repayment of such borrowings, and (b) invest funds in overseas money market instruments up to US$ 10.0 million. To impart flexibility to the corporate and improve liquidity in the forward markets for longer periods (beyond six months), ADs were permitted to book forward cover for exporters and importers based on a declaration of an exposure by the customer. They were allowed to arrange forex-rupee swaps between the corporate and run a swap-book within their open positions/gap limits.

FACILITIES FOR NRIs AND OCBs

INVESTMENT IN INDIAN COMPANIES ENGAGED IN DEVELOPMENT OF HOUSING AND REAL ESTATE

OCBs predominantly owned by NRIs were permitted to invest up to 100.0 per cent in the new issues of equity shares/convertible debentures of Indian companies engaged or proposing to engage in housing and real estate development. Repatriation of the proceeds on disinvestment was permissible after the lock-in period of three years to the extent of the original investment in foreign exchange with the Reserve Bank's approval. In addition, they were permitted to repatriate net profit up to 16.0 per cent arising from the sale of such investment. Repatriation of dividend/interest on equity shares/debentures was permissible without any lock-in period. Earlier, this facility had been available to persons of Indian nationality/origin outside India for whom the repatriation of proceeds on disinvestment continued to be restricted to the original investment.

INVESTMENT IN SHARES AND BONDS

NRIs and OCBs were allowed to: (i) invest in the schemes of all domestic public sector and private sector mutual funds and also to invest through the secondary market on a repatriation basis after complying with certain conditions; (ii) invest in the bonds issued by PSUs in India with repatriation of both the principal and interest; and (iii) purchase shares of Indian public sector enterprises on a repatriation basis after complying with the necessary stipulations. Also, NRIs in Nepal were permitted to invest in India for which the funds needed to be remitted in free foreign exchange through banking channels. The repatriation or otherwise of such investments was, however, not subject to the existing terms and conditions.

RAISING OF FOREIGN EQUITY THROUGH PREFERENTIAL ALLOTMENT

The Reserve Bank issued revised guidelines in June 1995 for determination of the issue price in respect of shares issued to non-residents by existing Indian companies through preferential allotments, to bring them in line with those issued by the Government of India and SEBI. Accordingly, every preferential allotment of shares by listed companies to foreign investors was to be made at the market price of the shares. As per the revised guidelines, the valuation of such shares, effective 30 days prior to the shareholders' general meeting, was required to be at least the higher of the average of the weekly highs and lows of the closing share prices quoted on a stock exchange for the preceding fortnight or an average of the weekly highs and lows of the closing prices on a stock exchange during the previous six months. For this purpose, the share prices of the stock exchange on which the highest trading volume in respect of the shares of the company were recorded were to be taken into account. The shares allotted on preferential basis were not transferable in any manner for a period of five years from the date of their allotment.

WORKING GROUP ON NRI INVESTMENTS

Six recommendations of the working group on NRI Investments (Chairman: Shri O.P. Sodhani) were implemented during the year 1995–96 to further facilitate NRI/OCB investments: (i) General permission for sale of shares acquired under the portfolio investment scheme was extended to OCBs. (ii) The general permission to NRIs for subscribing to the memorandum and articles of the association of Indian companies engaged in industrial activities was extended to cover other permissible activities. (iii) General permission was granted to ADs to remit sale proceeds of shares kept under pledge for liquidation of outstanding loans. (iv) Housing loan to NRI staff of Indian companies was granted under the staff housing loan scheme. (v) General permission was given for crediting interest on delayed refunds of share application money. (vi) The scope of safe custody of securities on behalf of NRIs was extended to institutional custodians.

NRIs were permitted to invest funds on non-repatriation basis in MMMFs floated with prior authorisation from the Reserve Bank/SEBI.

The following recommendations of the working group on NRI investments were accepted for implementation during 1996–97 to further liberalise investment by NRIs/OCBs: (i) liberalisation of the scheme for 100.0 per cent investment by NRIs in sick units; (ii) general permission for interest free non-repatriable loans from NRI relatives for personal purposes and for business activities; (iii) permission for fund transfers between NRE account holders; (iv) permission to NRIs/OCBs to establish schools and colleges on the same terms and conditions as a resident individual/corporate body; (v) permission for NRIs/OCBs to invest in unlisted companies in non-annexure III industries with full repatriation benefits; (vi) permission for NRIs/OCBs to remit income/interest on investments and deposits in India subject to clearance from the income tax authorities; (vii) permission for NRIs to participate in venture capital activities on the same terms and conditions as foreign investment; (viii) grant of housing loans to NRIs for acquisition/improvement of existing houses on the terms and conditions applicable to residents; and (ix) placing all information relating to NRI/foreign investment on the internet.

JVs/WHOLLY OWNED SUBSIDIARIES ABROAD

The Reserve Bank commenced functioning as the single-window agency for receipt and disposal of proposals for overseas investments by Indian companies from December 1, 1995. Subject to certain conditions, the Reserve Bank processed and cleared, under the fast track route (FTR), within 21 days from the date of receipt of application, proposals involving Indian investment up to US$ 4.0 million contributed through cash remittance and/or capitalisation of exports and the technical know-how fees. Proposals that did not qualify under the FTR were processed by a special committee constituted by the Reserve Bank.

The guidelines for Indian direct investment in JVs and wholly owned subsidiaries abroad under the FTR clearance scheme were further modified in 1996–97. Foreign exchange earnings other than from exports and export/foreign exchange earnings (track records) of parent/subsidiary companies were also to be taken into account for determining eligibility under the FTR. The other conditions regarding fulfilment of prudential norms, eligibility criteria and feasibility reports, were, however, kept in view while considering proposals under the FTR.

REMITTANCE OF INCOME ON INVESTMENTS

The remittance of current income/interest earned by NRIs and OCBs on investments made in India and deposits with Indian companies and banks, which was of non-repatriable nature, was permitted in a phased manner over a three-year period.

REMITTANCE OF SURPLUS PASSAGE COLLECTION

Off-line carriers and their general sales agents in India, with appropriate permission from the Reserve Bank, were permitted to stock and sell their tickets to travellers in India and also remit surplus fare collection without limit.

OTHER RELAXATIONS

CAPITAL ACCOUNT TRANSACTIONS

(i) The limit up to which the Reserve Bank permitted repatriation of capital assets at the time of retirement of foreign nationals who were resident in India on grounds of employment was raised from ₹ 5 lakh to ₹ 10 lakh. The ceiling on annual instalments for remittance of the remaining assets was increased from ₹ 2.5 lakh to ₹ 5 lakh.

(ii) The monetary ceilings on proposals for project exports and export of services on cash terms by Exim Bank and ADs were revised substantially.

(iii) The limit of US$ 1.0 million or its equivalent on oversold position of rupees against foreign currencies was raised to ₹ 15 crore. The ceiling was also applicable to over-bought positions.

HOLDING OF FOREIGN CURRENCIES BY RESIDENTS

The Government of India on January 5, 1994 granted general permission to persons resident in India to hold for personal purposes, in addition to the amount allowed to be held for numismatic purposes, foreign currencies up to an equivalent of US$ 500 held or acquired by them. Accordingly, the Reserve Bank granted general permission to residents to take out of India foreign currencies equivalent to US$ 500.

INTER-BANK FOREX CLEARING SYSTEM

The Reserve Bank initiated the process of establishing a clearing house for inter-bank foreign exchange transactions that initially took up transactions in US dollars for clearing followed by other major currencies. Trial runs for the clearing system, based on actual data, commenced in September 1995 with initial participation by six ADs.

MARKET INTELLIGENCE CELL

The Reserve Bank set up a market intelligence cell to study and closely monitor developments in the Indian foreign exchange market. The cell received from the ADs, on a daily basis, information on forex transactions, which were analysed and followed up.

APPENDIX 13.2

Features of United Exchange Rate System

LERMS, which came into effect from March 1, 1992, was replaced by unified exchange rate system with effect from March 1, 1993. The salient features of the new arrangement were:

(i) Effective March 1, 1993, all foreign exchange transactions (receipts/payments), both under current and capital accounts of the BoP, would be put through by ADs at market-determined rates of exchange. Foreign exchange receipts/payments would, however, be subject to exchange control regulations; foreign exchange receipts should be surrendered by residents to ADs except where residents had been permitted, either under a general or special permission of the Reserve Bank, to retain them either with banks in India or abroad. Foreign exchange would be sold by ADs for permissible transactions.

(ii) The regulations laid down in the exchange control manual, as amended from time to time, would continue to remain in force. In terms of the instructions contained in paragraph 8.2 of the exchange control manual (volume I), ADs should maintain, at the close of business each day, square or near-square positions in each foreign currency. Further, ADs should not have an oversold position in rupees against foreign currencies in excess of US$ 1 million or its equivalent (subject to the relaxations related to customer purchases and purchases for funding *vostro* accounts) at the close of business on each day. If any AD was observed to have violated these provisions or had built up balances in his *nostro* accounts in violation of the provisions of paragraph 8.3 of the manual, the Reserve Bank would take appropriate action.

(iii) The Reserve Bank's sale of foreign exchange to ADs was to be only for purposes approved by the Government. ADs would be free to retain the entire foreign exchange receipts surrendered to them for being sold for permissible transactions and were not required to surrender to the Reserve Bank any portion of such receipts.

(iv) The Reserve Bank would sell US dollars to any authorised person at its offices/branches for meeting foreign currency payments at its exchange rate based on the market rate only for purposes that were approved by the Central Government. The Central Government had approved the following purposes for sale of US dollars by the Reserve Bank:
   (a) Debt-service payments on government account.
   (b) As an arrangement in transition:
      - to meet 40.0 per cent of the value of imports under advance licences, imprest licences and replenishment (REP) licences for the import of raw materials for gem and jewellery exports, as per

instructions to be issued by the Department of Economic Affairs (DEA), and

- to meet the full value of imports under Exim scrips and REP licences and other licences treated on par with Exim scrips.

(v) The Reserve Bank would buy spot US dollars from any authorised person at its offices/branches referred to in the aforesaid order at its exchange rate. The Reserve Bank would not ordinarily buy spot pound sterling, deutsche mark (DM) or Japanese yen. It would not ordinarily buy forward any currency. Any offer of foreign currency to the Reserve Bank would be governed by the provisions of paragraph 9.6 of the exchange control manual. If the offer was not covered by the aforesaid provisions, the AD could approach the Department of External Investments and Operations (DEIO) at Bombay.

(vi) No forward sale in any currency would be made by the Reserve Bank to ADs. It would, however, be prepared to enter into swap transactions under which it would buy US dollar spot and sell forward for two to six months.

(vii) The purchases/sales of US dollars would be made by the Reserve Bank in multiples of US$ 5,000 with a minimum of US$ 25,000. The procedure for such sales/purchases would be the same as was being followed, except that for purchases from the Reserve Bank, a revised format had to be used.

(viii) Forward commitments/swaps: All outstanding forward commitments and swap liabilities in respect of transactions in the inter-bank market and with the Reserve Bank as on February 27, 1993, would be honoured at the contracted rates. Customer forward contracts would also be honoured at the contracted rate unless cancelled by the customer.

(ix) FCNR accounts: There was no change in the regulations relating to FCNR deposits. The Reserve Bank would continue to provide exchange risk cover.

(x) Other non-resident accounts: There was no change in the regulations relating to these accounts. The operations on these accounts would be at market-determined exchange rates.

(xi) RFC accounts: The existing instructions in terms of which foreign currency accounts with banks in India were allowed to be maintained would continue. No rupee finance was admissible on the security of funds in these accounts.

(xii) Exim scrips/REP licences/Advance licences: The purchase of Exim scrips and other eligible licences valid for import from Caucasus and Central Asia (CCA) at a reasonable premium might be considered.

(xiii) Asian Clearing Union (ACU): The rates of exchange for transactions with countries belonging to the ACU would be at rates announced by the

Reserve Bank. Such rates would be determined based on the prevailing market rates.

(xiv) Bilateral trade arrangements: Rupee trade and payment arrangements, wherever they existed, would continue for the period announced by the Reserve Bank from time to time.

(xv) Market intervention: The Reserve Bank might also undertake, at its discretion, purchases/sales of foreign exchange in the market.

APPENDIX 17.1

Constitution of the Board for Financial Supervision

I. COMPOSITION

Chairman	*Governor*
Full-time Vice-Chairman	Deputy Governor
Ex officio members	Other Deputy Governors
Four full-time members of the rank of Executive Directors	(i) Two from the Reserve Bank. (ii) Two from the fields of finance, banking, law or audit.

The BFS[1] was to be assisted by the newly set up Department of Supervision (DoS), an independent department within the Reserve Bank that would report directly to the BFS. The department would draw its personnel from the Reserve Bank, but also take personnel from outside to the extent necessary, either on deputation or through direct recruitment. This way, the expertise available within the Reserve Bank as also outside could be blended and taken advantage of.

The BFS would undertake supervision over different segments of the financial sector comprising commercial banks, FIs, NBFCs and para-banking organisations, such as subsidiaries and mutual funds of banks.

II. SUPERVISION

(i) Prepare independent inspection programmes for different institutions.

(ii) Undertake scheduled and special onsite inspections and offsite surveillance, and ensure follow-up and compliance.

(iii) Determine the criteria for the appointment of statutory and special auditors and appoint them, and also assess audit performance.

(iv) Undertake special studies, write reports, analyse data and provide resource support.

(v) Collect, process and disseminate market trends and developments (business intelligence).

(vi) BFS would have the powers to inspect a gamut of activities of banks, FIs and NBFCs. It would be expected to comment on their compliance with the laws, rules, regulations, policies, directives, guidelines and instructions applicable to them. It would, however, carry out supervisory intervention only in the implementation of the regulations in the areas of credit management, asset classification, income recognition, provisioning, capital adequacy, treasury operations and financial viability

1. As approved by the Central Board of Directors, Reserve Bank of India on February 12, 1993.

of banks, institutions and other segments of the financial sector. It would also deal with financial sector fraud. After inspection on matters other than these, the relevant points would be conveyed to other departments of the Reserve Bank for information and necessary action.

III. SUPERVISORY POWERS

(i) Removal of managerial and other persons excluding top personnel, such as the chairman, managing director, executive director and director, under section 36 AA of the BR Act, 1949.
(ii) Recommend suspension of business.
(iii) Recommend to the Reserve Bank about amalgamation, merger or winding up.
(iv) Call for information and returns.
(v) Issue directives and impose penalties in areas referred to in [II(vi)] above.
(vi) These supervisory functions, however, would not include powers of rescheduling, de-licensing and other matters not listed in (III) above. These shall continue to be exercised by the concerned departments of the Reserve Bank.
(vii) The supervision would not extend to co-operative banks. In the case of the exchange control functions of the Reserve Bank, however, the BFS might conduct inspection but would not, on its own, exercise the power of supervisory intervention.
(viii) The BFS, being only a supervisory body, shall deal only with supervision and not with credit and monetary policy or the regulatory and development functions of the Reserve Bank as also monitoring, thereof.
(ix) The Reserve Bank would frame regulations regarding the conduct of business of the BFS.
(x) The Annual Report on the functioning of the BFS would be submitted to the Central Board of Directors of the Reserve Bank. Supervision by such a quasi-autonomous Board, exclusively dedicated to supervision, was proposed to be undertaken with greater professional expertise, paying focused attention to compliance.

APPENDIX 17.2

Statement on Irregularities and Fraudulent Transactions in Banks and Other Financial Institutions During 1991-92: Chronology of Events

March 20, 1991	The Governor, Reserve Bank of India, orders scrutiny of operations of certain banks with reference to the practice of dealing in securities through pieces of paper — Bankers' Receipts — without actually holding securities against them.
April–May 1991	The Reserve Bank inspectors carry out scrutiny in these banks and recommend issuing guidelines to banks to ensure that the practice of Bankers' Receipts is not misused. The Governor orders immediate issue of instructions.
July 26, 1991	Detailed guidelines for securities transactions are issued. The circular, among other things, calls on banks to form an internal investment policy, keeping in view the Reserve Bank guidelines. Banks are also asked to confirm compliance with the guidelines after getting the policy approved by their Board.
July–December 1991	Banks, including Standard Chartered Bank and the SBI, indicate compliance with the Reserve Bank guidelines. Standard Chartered Bank issues three letters (August 26, 1991, September 4, 1991 and December 20, 1991) indicating its Board's acceptance. The SBI confirms compliance on October 8, 1991. (It is normal practice for the Reserve Bank of India to follow up compliance of circulars during the course of annual inspection or through annual statutory audit. In fact, individual banks are expected to have their own internal control systems to ascertain, *inter alia*, compliance with the Reserve Bank circulars). By December 1991 as many as 51 banks acknowledge and 24 banks forward their investment policies to the Reserve Bank. Ten more banks formalise their investment policies, but do not forward their compliance to the Reserve Bank.
January 27–February 4, 1992	Reports are received regarding possible violations of the Bankers' Receipts circular. Investigations are undertaken, at the Governor's instance, of the Bank of Karad, Bank of Madura and Andhra Bank.

February 1–29, 1992	BSE Sensitive Index goes up from 2302 to 3017.
March 1–9, 1992	BSE Sensitive Index further goes up from 3017 to 3547.
March 3, 1992	Investigations indicate continuance of practice of Bankers' Receipts in these three banks. The Governor expresses displeasure and suggests drastic action. A decision is taken to issue a final warning to the erring banks.
March 9, 1992	The Governor expresses concern at a meeting in Hyderabad at the sharp rise in share prices.
March 10, 1992	Against the background of the information available on banks' wrongdoings, the Governor holds a meeting of the chief executives of financial institutions and the SBI. He urges them to consider appropriate steps to identify the sources of funds that were fuelling speculation.
March 13, 1992	The Governor reiterates, in Madras, the need for corrective measures to cool the overheated market due to excessive speculation.
March 16, 1992	At the Governor's instance, the Executive Director, Kum. V. Visvanathan obtains from the Chairman, SBI, a statement of the current account of Shri Harshad Mehta maintained at the SBI's Bombay main branch. Kum. Visvanathan informs the Governor, who, in turn, advises the SBI Chairman to monitor the transactions of Shri Harshad Mehta. The Chairman places Mehta's account under continuous monitoring.
March 30, 1992	Bank of Karad, Bank of Madura and Andhra Bank, where irregularities of Bankers' Receipts and securities operations were uncovered, are cautioned. They are given a final opportunity to improve their position.
April 1, 1992	Shri Harshad Mehta meets the Governor. He mentions certain difficulties he has been facing with the SBI. The SBI Chairman explains that the difficulties were because he had not allowed roll-over to Mehta. The Governor concurs with the SBI's stand.
April 2, 1992	The Reserve Bank deputes an officer to the SBI, to investigate, *inter alia*, the purchases of government securities by SBI on the eve of the hike of coupon rates. The officer asks for the reconciliation statement for the bank's investments as at March 31, 1992. The

	bank indicates that investments were reconciled only up to January 1992. The SBI is asked to reconcile accounts as on March 31, 1992 and furnish the statement to the Reserve Bank. The Chairman and his officers arrange for the reconciliation, as a result of which a gap of nearly ₹ 1,022 crore is uncovered between the books in the PDO and the SBI. Shri Harshad Mehta is summoned by the officers of the SBI to reconcile the account. He pays ₹ 622 crore between April 13 and April 24, 1992.
April 23, 1992	The press breaks the story on irregularities in securities transactions relating to the SBI and the broker Shri Harshad Mehta.
April 23–May 4, 1992	The Reserve Bank trails the cheques through which Shri Harshad Mehta paid the SBI and finds that the funds had come via ANZ Grindlays Bank. On examining further, the Reserve Bank finds that the cheques were issued by the National Housing Bank (NHB).
April 30, 1992	The Governor appoints a committee under the Deputy Governor, Shri R. Janakiraman, to look into the securities irregularities. The Finance Minister announces the same.
May 4 and 5, 1992	The Reserve Bank's follow-up of cheques reveals that in 1992, the NHB had engaged in arbitrage transactions. The Chairman, NHB declares that he was unaware of these transactions on May 4, 1992. The NHB submits details of the transactions, which indicate that Shri Harshad Mehta was to deliver certain securities or pay a corresponding amount on May 5, 1992. Roll-over was not permitted to the broker.
May 18 and 19, 1992	The Reserve Bank convenes a bankers' roundtable for Bankers' Receipts reconciliation.
May 31, 1992	Janakiraman Committee submits its first interim report.
April 1993	Janakiraman Committee submits its final report.

APPENDIX 17.3

Prudential Norms for NBFCs

In pursuance of the recommendations of Shah Committee, 1993, the following prudential norms for NBFCs were put in place.

INCOME RECOGNITION

The policy on income recognition to be objective, it had to be based on a record of recovery. Income from NPAs might not be recognised merely on the basis of accrual. An asset would become non-performing when it ceased to yield income. Income past due but not received within a period of six months was not to be booked until income was actually received. Assets were to be classified as non-performing based on recovery record. Interest on NPAs should not be booked as income if the interest had remained outstanding for more than six months on and from March 31, 1995. The basis of treating a credit facility as NPA should be as under:

TERM LOAN BEYOND ONE YEAR

If the interest amount remained past due for six months, the term loan was to be treated as an NPA. Where the instalment was overdue for more than six months, the entire outstanding loan inclusive of unpaid interest, if any, should also be treated as an NPA.

LEASE RENTAL, HIRE-PURCHASE INSTALMENT

Where lease rentals/hire-purchase instalments were past due for six months, the entire dues from the lessee/hirer were to be treated as an NPA. A bill was to be treated as an NPA if it remained overdue and unpaid for six months. All other credit facilities in the nature of short-term loans were to be treated as NPAs if any amount to be received in respect of such a facility remained past due for a period of six months,

ACCOUNTING FOR INVESTMENTS

All investments in securities were to be bifurcated into current investment and long-term investment. Current investment was readily realisable and intended to be held for not more than one year from the date on which the investment was made. Current investment was to be valued at the lower cost and market value for each individual investment. A long-term investment was defined as one other than current investment, which should be valued at cost. However, provision for diminution should be made to recognise a decline other than temporary. In the value of long-term investment, such reduction should be determined for each individual investment. Unquoted shares were to be valued at cost or break-up

value of the share as per the last audited balance sheet of the company concerned, whichever was less. Investments in units of mutual funds that were not quoted in the market should be valued at the lower cost or the latest NAV declared by the mutual fund for each scheme. Commercial paper and Treasury Bills should be valued at carrying cost. Unquoted debentures, depending on the tenor, were to be treated as long-term loans or other credit facilities for the purpose of income recognition and asset classification.

CAPITAL ADEQUACY

The ratio of capital to risk-weighted assets and off-balance sheet items should be a minimum of 6.0 per cent by March 31, 1995 and 8.0 per cent by March 31, 1996.

CREDIT RATING

The NBFCs and RNBCs were required to get rated at least once every year for fixed deposits by one of the following three credit rating agencies and secure a minimum rating as indicated below:

Name of the Credit Rating Agency	*Minimum Rating*
CRISIL	FA –
ICRA	MA –
CARE	CARE BBB(FD)

Source: Reserve Bank of India, Department of Non-Banking Supervision (DNBS).

While companies with NOFs of ₹ 2 crore and above had to get the rating by March 31, 1995, those having NOFs below ₹ 2 crore had the option to get the rating by March 31, 1996.

As per the instructions issued by the Reserve Bank, the capital of these companies would comprise two tiers. Tier I would consist of paid-up equity capital and free reserves, and tier II capital of preference shares, revaluation reserves, general provisions and loss reserves in excess of the required amounts, and hybrid debt capital instruments/subordinated debts, if any. Preference shares had characteristics similar to equity capital, as the shareholders' funds were subordinated to the claims of creditors. Revaluation reserves served as a cushion against unexpected losses, but these were less permanent and could not be considered as core capital. Revaluation reserves arose from revaluation of assets, such as premises and marketable securities. The extent to which the revaluation reserves could be relied upon as a cushion for unexpected losses depended only upon the estimates of the market value of the relevant assets, subsequent deterioration in the market value or forced sale. Therefore, the Reserve Bank thought it prudent to consider revaluation reserve at a discount of 55.0 per cent for inclusion in tier II capital. It was advised by the Reserve Bank that if general

provisions and loss reserves were not attributable to actual diminution in the value of specific assets and were available to meet unexpected losses, they could be included in tier II capital. However, general provisions and loss reserves would be admitted up to a maximum of 1.25 per cent of weighted risk assets. Hybrid debt capital instruments comprised a number of capital instruments that combined certain characteristics of equity and debt, and they could be included in tier II capital.

SUBORDINATED DEBT

To be eligible for inclusion in tier II capital, the instrument should be fully paid-up, unsecured, subordinated to the claims of other creditors and not redeemable without the consent of the supervisory authority of the NBFCs. These instruments carried fixed maturity; they should be subjected to progressive discount in tier II capital as under:

Where the date of maturity is beyond 5 years	50.0 per cent
Beyond 4 years but does not exceed 5 years	60.0 per cent
Beyond 3 years but does not exceed 4 years	70.0 per cent
Beyond 2 years but does not exceed 3 years	80.0 per cent
Beyond 1 year but does not exceed 2 years	90.0 per cent
Where date of maturity does not exceed one year	100.0 per cent

Source: Reserve Bank of India, Department of Non-Banking Supervision.

Subordinated debt capital would be limited to 50.0 per cent of tier I capital and tier II capital would not exceed Tier I capital.

Assets classified as NPAs were based on recovery record and needed to be classified as standard assets, sub-standard assets, doubtful assets and loss assets. Norms had been prescribed for provisioning of the last three categories of assets.

RISK-WEIGHTED ASSETS AND OFF-BALANCE SHEET ITEMS

Risk-weighted assets mean the weighted aggregate of funded and non-funded items as furnished below. The degree of credit risks expressed as percentage weights was assigned to the balance sheet and conversion factors to off-balance sheet items. The value of each asset item was to be multiplied by the relevant weights to arrive at risk-adjusted assets and off-balance sheet items as detailed below:

On-Balance Sheet Items	*Percentage Weights*
Cash and bank balance including FDs and CDs	0.0
Investment in government and approved securities	0.0
Shares, debentures, bonds, units of mutual funds	100.0

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Current assets	
Stock on hire, inter-corporate deposits, other secured loans and advances considered good, bills purchased/discounted and others to be specified	100.0
Loans and advances fully secured by company's own deposits, loans to staff	0.0
Fixed assets net of depreciation	
Assets leased out, premises, and furniture and fixtures	100.0
Other assets	
Income tax deducted at source, advance tax paid	0.0
Interest due on government securities, and others to be specified	0.0

Source: Reserve Bank of India, Department of Non-Banking Supervision.

OFF-BALANCE SHEET ITEMS

The credit risk exposure attached to off-balance sheet items had to be calculated by multiplying the face amount of each item by the credit conversion factor as indicated in table below.

Nature of Item	*Credit Conversion Factor*
Financial and other guarantees, partly-paid shares and debentures, bills discounted/rediscounted, lease contracts entered into but yet to be executed	100
Shares, debenture underwriting obligation, other contingent liabilities	50

Source: Reserve Bank of India, Department of Non-Banking Supervision.

APPENDIX 17.4

Reserve Bank of India (Amendment) Act, 1997: Major Features

In pursuance of Khanna Committee recommendations, the Reserve Bank of India (Amendment) Act, 1997 with regard to the NBFCs was characterised by:

(i) NBFCs were clearly defined. Institutions carrying on agricultural or industrial activity as their principal business were excluded from the definition.

(ii) The minimum NOFs of ₹ 25 lakh and Reserve Bank registration were prescribed as entry point norms.

(iii) Existing NBFCs had to apply for registration by July 8, 1997. Their business could, however, be carried on, unless registration was refused.

(iv) NBFCs with NOFs of less than ₹ 25 lakh were given three years to reach that level; the three-year period was extendable by three more years at the Reserve Bank's discretion.

(v) The Reserve Bank had powers to cancel registration, but NBFCs had the right to appeal to the Central Government.

(vi) NBFCs had to maintain liquid assets in specified securities on a daily basis; liquid assets were to be maintained as per the existing norm of 5.0 and 10.0 per cent of their deposits outstanding as at the end of the last working day of the second previous quarter, depending on the category and regulatory status of NBFCs. The Reserve Bank penalised NBFCs for any shortfall. The percentages were increased in a phased manner to 10.0 and 15.0 per cent effective January 1 and April 1, 1998, respectively.

(vii) NBFCs had to create a reserve fund and transfer not less than 20.0 per cent of their net profit to the reserve fund every year.

(viii) The Reserve Bank could direct NBFCs on issues such as disclosures, prudential norms, credit and investments.

(ix) For violation of any provisions of the RBI Act, the Reserve Bank not only could prohibit NBFCs from accepting deposits, but also ask them not to sell or, transfer their properties and assets without its prior permission for a period of six months.

(x) The Reserve Bank could file a winding-up petition against an NBFC if it failed to pay its debt or was disqualified from carrying on business.

(xi) The Company Law Board could adjudicate and pass orders in case of non-repayment of deposits/interest by NBFCs.

(xii) Nomination facility was made available to depositors of non-banking institutions.

(xiii) Unincorporated bodies engaged in financial activities could not accept deposits from April 1, 1997. They could, however, accept deposits from their relatives and borrow from specified institutions. Existing deposits were to be repaid within three years from April 1, 1997 extendable by one more year on merit.

(xiv) Unincorporated bodies could not issue advertisements for soliciting deposits.

(xv) NBFCs could be penalised for carrying on business without a registration certificate and non-compliance with directions/orders of the Reserve Bank and Company Law Board. Similarly, unincorporated bodies could also be subjected to pecuniary penalty and imprisonment for committing a breach of the provisions of the Act.

Enclosures

ENCLOSURE 1

The Reserve Bank of India (1981–1997)

I. GOVERNORS

Name	*Period*	
	From	*To*
Dr I.G. Patel	01–12–1977	15–09–1982
Dr Manmohan Singh	16–09–1982	14–01–1985
Shri A. Ghosh	15–01–1985	04–02–1985
Shri R.N. Malhotra	04–02–1985	22–12–1990
Shri S. Venkitaramanan	22–12–1990	21–12–1992
Dr C. Rangarajan	22–12–1992	22–11–1997

II. DEPUTY GOVERNORS

Name	*Period*	
	From	*To*
Shri P.R. Nangia	29–12–1975	15–02–1982
Shri M. Ramakrishnayya	02–01–1978	31–01–1983
Shri A. Ghosh	21–01–1982	20–01–1992*
Dr C. Rangarajan	12–02–1982	20–08–1991
Dr M.V. Hate	12–03–1982	11–03–1985
Shri R.K. Kaul	01–10–1983	30–09–1986
Dr P.D. Ojha	29–04–1985	28–04–1990
Shri P.R. Nayak	01–04–1987	31–03–1992
Shri R. Janakiraman	16–05–1990	15–05–1993
Shri S.S. Tarapore	30–01–1992	30–09–1996
Shri D.R. Mehta	11–11–1992	21–02–1995
Shri S.P. Talwar	07–11–1994	30–06–2001
Shri R.V. Gupta	02–05–1995	30–11–1997
Dr Y.V. Reddy	14–09–1996	31–07–2002
Shri Jagdish Capoor	01–01–1997	30–06–2001

* From 15–01–1985 to 04–02–1985 Shri A. Ghosh was Governor.

III. DIRECTORS OF THE CENTRAL BOARD

Name	*Date of first nomination*	*Date of retirement*
Shri S.L. Kirloskar	15–01–1969	18–03–1983
Shri M.P. Chitale	06–09–1972	18–03–1983
Dr V. Kurien	06–09–1972	18–03–1983
Prof M.L. Dantwala	23–02–1973	21–07–1981
Shri A.N. Haksar	23–02–1973	18–03–1983
Dr Bharat Ram	23–02–1973	18–03–1983
Dr D.P. Singh	13–11–1975	18–03–1983
Shri Akbar Hydari	13–11–1975	18–03–1983
Dr B. Venkatappiah	22–07–1977	18–03–1983
Shri Jehangir P. Patel	22–07–1977	18–03–1983
Air Chief Marshal P.C. Lal (Retd.)	22–07–1977	21–07–1981
Shri M.V. Arunachalam	22–07–1977	28–03–1994
Shri Chhedi Lal	02–04–1979	01–04–1983
Dr K.N. Raj	02–04–1979	01–04–1983
Shri R.N. Malhotra	19–04–1980	12–10–1982
Shri M. Narasimham	12–10–1982	01–07–1983
Shri Jaharlal Sen Gupta	18–03–1983	28–03–1994
Dr S.R. Sen	18–03–1983	28–03–1994
Shri Ashok Kumar Jain	18–03–1983	28–03–1994
Shri R.P. Goenka	18–03–1983	28–03–1994
Dr A.S. Kahlon	18–03–1983	28–03–1994
Shri Raghu Raj	18–03–1983	28–03–1994
Shri A.V. Birla	18–03–1983	28–03–1994
Shri R. Ganesan	18–03–1983	28–03–1994
Shri P.N. Devarajan	18–03–1983	28–03–1994
Shri P.K. Kaul	11–07–1983	08–02–1985
Dr K.A. Naqvi	29–11–1983	23–04–1984
Shri S. Venkitaramanan	11–03–1985	06–04–1989
Shri S.S. Marathe	16–01–1986	28–03–1994
Shri M.S. Patwardhan	16–01–1986	28–03–1994
Shri G.K. Arora	06–04–1989	08–01–1990

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Name	*Date of first nomination*	*Date of retirement*
Dr Bimal Jalan	09–01–1990	02–01–1991
Shri S.P. Shukla	03–01–1991	05–11–1991
Shri Montek Singh Ahluwalia	06–11–1991	31–08–1998
Shri Y.H. Malegam	28–03–1994	Continuing
Dr J.J. Irani	28–03–1994	27–11–2000
Shri P.N. Dhar	28–03–1994	27–11–2000
Shri E.A. Reddy	28–03–1994	27–11–2000
Shri R.N. Tata	28–03–1994	27–06–2006
Shri K.L. Chugh	28–03–1994	27–11–2000
Shri Mumtaz Ahmad	28–03–1994	27–11–2000
Dr Sardara Singh Johl	28–03–1994	27–11–2000
Dr C.H. Hanumantha Rao	28–03–1994	27–11–2000
Dr Bhai Mohan Singh	28–03–1994	27–11–2000
Dr M.L. Shahare	28–03–1994	27–11–2000
Dr Amrita Patel	28–03–1994	27–06–2006
Shri Gopala Ramanujam	28–03–1994	29–07–1994
Shri Vipin Malik	28–03–1994	27–11–2000
Shri G. Ramachandran	10–05–1995	27–11–2000

Source: Reserve Bank of India, internal records.

IV. MAJOR PORTFOLIOS HELD BY DEPUTY GOVERNORS

Name	*Period of office*	*Major portfolios held*
Shri P.R. Nangia	29–12–1975 to 15–02–1982	Department of Administration, Personnel Policy Department, Exchange Control Department, Bank's Training Establishments, Inspection Department, Legal Department, Management Services Department, DICGC and Premises Department.
Shri M. Ramakrishnayya	02–01–1978 to 31–01–1983	Agricultural Credit Department, Agricultural Refinance and Development Corporation, Rural Planning and Credit Department, Department of Currency Management, Department of Government and Bank Accounts (excluding Foreign Currency Accounts), Department of Expenditure and Budgetary Control and Management Services Department.
Shri A. Ghosh[1]	21–01–1982 to 20–01–1992	Department of Banking Operations and Development, Industrial Credit Department, Department of Administration, Personnel Policy Department, Exchange Control Department, Inspection Department, Legal Department, Premises Department, Department of Financial Companies, Management Services Department, DICGC, Secretary's Department and Department of Expenditure and Budgetary Control.

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1. From 15–01–1985 to 04–02–1985, Shri A. Ghosh was Governor.

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Name	*Period of office*	*Major portfolios held*
Dr C. Rangarajan	12–02–1982 to 20–08–1991	Department of Economic Analysis and Policy, Credit Planning Cell, Department of Statistical Analysis and Computer Services, Secretary's Department, Department of Government and Bank Accounts (Foreign Accounts Division), Department of External Investments and Operations, Rural Planning and Credit Department, Urban Banks Department, Management Services Department and DICGC.
Dr M.V. Hate	12–03–1982 to 11–03–1985	Rural Planning and Credit Department, Urban Banks Division of DBOD, Premises Department, Inspection Department, Department of Government and Bank Accounts (except Foreign Accounts Division), Department of Expenditure and Budgetary Control, Department of Non-Banking Companies, DICGC and Department of Financial Companies.
Shri R.K. Kaul	01–10–1983 to 30–09–1986	Department of Currency Management and Management Services Department.

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Name	*Period of office*	*Major portfolios held*
Dr P.D. Ojha	29–04–1985 to 28–04–1990	Rural Planning and Credit Department, Urban Banks Department, Department of Financial Companies, DICGC, Department of Expenditure and Budgetary Control, Inspection Department, Premises Department, Department of Government and Bank Accounts (except Foreign Accounts Division) and Department of Currency Management.
Shri P.R. Nayak	01–04–1987 to 31–03–1992	Department of Currency Management and Rural Planning and Credit Department.
Shri R. Janakiraman	16–05–1990 to 15–05–1993	Department of External Investments and Operations, Industrial and Export Credit Department, Exchange Control Department, Department of Expenditure and Budgetary Control, Department of Government and Bank Accounts, Inspection Department, Management Services Department, Department of Financial Companies, Urban Banks Department, Rural Planning and Credit Department, Premises Department, DICGC, Department of Currency Management, Personnel Policy Department and Department of Administration (including Training).

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Name	*Period of office*	*Major portfolios held*
Shri S.S. Tarapore	30–01–1992 to 30–09–1996	Department of Economic Analysis and Policy, Credit Planning Cell, Department of Statistical Analysis and Computer Services, Internal Debt Management Cell, Department of Financial Companies, Secretary's Department, Legal Department, Department of External Investments and Operations, Financial Institutions Cell, Bank's Training Establishments, Rural Planning and Credit Department, Department of Expenditure and Budgetary Control, Industrial and Export Credit Department, Premises Department, Management Services Department, and Urban Banks Department.
Shri D.R. Mehta	11–11–1992 to 21–02–1995	Department of Banking Operations and Development, Industrial and Export Credit Department, Urban Banks Department, Premises Department, Rural Planning and Credit Department, Management Services Department, DICGC, Setting-up of the Board for Financial Supervision, Financial Sector Reform Cell, Exchange Control Department, Inspection Department, Central Security Cell,

contd...

contd...

Name	*Period of office*	*Major portfolios held*
		Supervision, Department of Administration, Personnel Policy Department, Department of Currency Management and Premises Department.
Shri S.P. Talwar	07–11–1994 to 30–06–2001	Department of Banking Operations and Development, Department of Banking Supervision, Industrial and Export Credit Department, Department of Information Technology, Department of Administration and Personnel Management, Human Resources Development Department, Inspection Department, Management Services Department, Urban Banks Department, Premises Department, Department of Currency Management, DICGC, Central Security Cell, Department of Financial Companies, Financial Institutions Cell, and Legal Department.
Shri R.V. Gupta	02–05–1995 to 30–11–1997	Rural Planning and Credit Department, Exchange Control Department, Legal Department, Department of Information Technology, Department of Currency Management, DICGC, Premises Department, Central Security Cell, Urban Banks Department, Department of Administration

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concld.

Name	*Period of office*	*Major portfolios held*
		and Personnel Management, and Human Resources Development Department.
Dr Y.V. Reddy	14–09–1996 to 31–07–2002	Department of Economic Analysis and Policy, Credit Planning Cell (later known as Monetary Policy Department), Department of Statistical Analysis and Computer Services, Internal Debt Management Cell, Department of External Investments and Operations, Department of Government and Bank Accounts, Department of Expenditure and Budgetary Control and Secretary's Department.
Shri Jagdish Capoor	01–01–1997 to 30–06–2001	Industrial and Export Credit Department, Central Security Cell, Department of Administration and Personnel Management, Human Resources Development Department (including Training), Rural Planning and Credit Department, Exchange Control Department, Urban Banks Department, Department of Currency Management and DICGC.

Source: Reserve Bank of India, internal records.

ENCLOSURE 2

Ministry of Finance (1981–1997)

I. FINANCE MINISTERS

Name	*Period*	
	From	*To*
Shri R. Venkataraman	14–01–1980	15–01–1982
Shri Pranab Kumar Mukherjee	15–01–1982	31–12–1984
Shri Vishwanath Pratap Singh	31–12–1984	24–01–1987
Shri Rajiv Gandhi	24–01–1987	25–05–1987
Shri N.D. Tiwari	25–05–1987	25–06–1988
Shri S.B. Chavan	25–06–1988	02–12–1989
Prof Madhu Dandavate	06–12–1989	10–11–1990
Shri Chandra Shekhar	10–11–1990	21–11–1990
Shri Yashwant Sinha	21–11–1990	21–06–1991
Dr Manmohan Singh	21–06–1991	16–05–1996
Shri Jaswant Singh	16–05–1996	01–06–1996
Shri P. Chidambaram	01–06–1996	21–04–1997

Source: Government of India, Ministry of Finance.

II. MINISTERS OF STATE FOR FINANCE

Name	*Year/s*
Shri Jagannath Pahadia	1980–81
Shri S.S. Sisodia	1980–81
Shri Maganbhai Barot	1980–82
Shri R.B. Pattabhi Rama Rao	1982
Shri Janardhana Poojari	1982–88
Shri S.M. Krishna	1984
Shri B.K. Gadhvi	1986–89
Shri Brahm Dutt	1987
Shri Ajit Panja	1988–89
Shri Edwardo Faleiro	1988–89
Shri Rameshwar Thakur	1991
Shri Dalbir Singh	1991
Shri Shanta Ram Potdukhe	1991
Dr Abrar Ahmed	1993–94
Shri M.V. Chandrashekara Murthy	1993–95
Dr Debi Prosad Pal	1995–96
Shri M.P. Virendra Kumar	1997
Shri Satpal Maharaj	1997–98

Source: Government of India, Ministry of Finance.

III. FINANCE SECRETARY/SECRETARY (EA)

Name	*Year/s*
Shri R.N. Malhotra, Finance Secretary	1980–82
Shri M. Narasimham, Finance Secretary	1982–83
Shri P.K. Kaul, Finance Secretary	1983–85
Shri S. Venkitaramanan, Finance Secretary	1985–89
Shri G.K. Arora, Finance Secretary	1989
Dr Bimal Jalan, Finance Secretary	1990
Shri S.P. Shukla, Finance Secretary	1990–91
Shri Montek Singh Ahluwalia, Secretary (EA)	1991
Shri Montek Singh Ahluwalia, Finance Secretary	1993–98

Source: Government of India, Ministry of Finance.

IV. CHIEF ECONOMIC ADVISER

Name	*Year/s*
Dr Bimal Jalan	1986–88
Shri Nitin Desai	1988–90
Dr Deepak Nayyar	1990–91
Dr Ashok Desai, Chief Consultant and Secretary	1991–93
Dr Shankar N. Acharya	1993–98

Source: Government of India, Ministry of Finance.

ENCLOSURE 3

Chronology of Major Events (1981–1997)

1981

March	The committee to review arrangements for institutional credit for agriculture and rural development (CRAFICARD) in its report recommended establishment of a National Bank for Agriculture and Rural Development (NABARD).
July 11	Bank Rate revised from 9.0 per cent to 10.0 per cent, forming a package of anti-inflationary measures.
August 24	Central Records Documentation Centre (CRDC) set up in Pune.
November	Government of India negotiated with IMF for a loan facility of SDR 5 billion under the EFF to tide over the balance of payments crisis.
November 7	New central office building (NCOB) of the Reserve Bank at Bombay (now Mumbai) was inaugurated by the Union Finance Minister, Shri R. Venkataraman.

1982

March	The new bank branch licensing policy for three fiscal years, *i.e.*, from 1982–83 to 1984–85, came into operation.
July 12	NABARD was established.
September 15	Dr I.G. Patel relinquished office as Governor.
September 16	Dr Manmohan Singh assumed charge as Governor.
December	A committee to review the working of the monetary system set up by the Reserve Bank (Chairman: Prof Sukhamoy Chakravarty).

1983

May	A special investigation cell was constituted in the Reserve Bank to facilitate speedy investigation of major frauds/ complaints which came to its notice.
September	Detailed guidelines were issued to commercial banks by the Reserve Bank regarding their role in implementation of the scheme for providing self-employment to the educated unemployed youth (SEEUY).

November	National Clearing Cell (NCC) was set up.
December	The expert committee on exports and imports appointed by the Reserve Bank submitted its final report.

1984

January 1	The system of prescribing a sterling rate schedule was abolished. ADs were permitted to quote exchange rates for merchant transactions in pound sterling on the basis of market conditions as in the case of other currencies.
February 1	Urban Banks Department (UBD) was set up in the Reserve Bank.
February 15	Various provisions of the Banking Laws (Amendment) Act, 1983 came into effect. The remaining provisions came into effect from March 29, 1985.
May 1	Government of India terminated the extended fund facility (EFF) borrowal arrangement with the IMF, six months ahead of its date of expiry.
August 24	DNBC renamed as the Department of Financial Companies (DFC).
August	The committee on mechanisation in banking industry submitted its report.
December 31	The committee on agricultural productivity in Eastern India set up by the Reserve Bank in March 1983 submitted its report.

1985

January 14	Dr Manmohan Singh relinquished office as Governor on his being appointed as the Deputy Chairman of the Planning Commission.
January 15	Shri A. Ghosh took over charge as Governor and relinquished charge on February 4, 1985.
February 4	Shri R.N. Malhotra assumed the office of Governor. Shri A. Ghosh reappointed as Deputy Governor.
March 31	Reserve Bank of India completed 50 years of service to the nation.
April 10	The committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty) submitted its report.

June 1	The golden jubilee celebrations of the Reserve Bank of India inaugurated by the Prime Minister, Shri Rajiv Gandhi.
December 19	The long term fiscal policy (LTFP) announced by the Government.
December 30	Some provisions of the Banking Laws (Amendment) Act, 1985, were brought into force. The other provisions were made effective from May 1, 1986.

1986

June 2	Central Security Cell (CSC) established in the Reserve Bank.
November	The first auction of 182-days Treasury Bills held.

1987

January 13	Working group on money market (Chairman: Shri N. Vaghul) submitted its report.
June	Magnetic ink character recognition (MICR) technology introduced in Bombay (now Mumbai).
December 28	Indira Gandhi Institute of Development Research (IGIDR) set up and started functioning.

1988

April 12	Securities and Exchange Board of India (SEBI) constituted by the Central Government.
April 25	Discount and Finance House of India Ltd (DFHI) commenced business operations.
July 9	National Housing Bank (NHB) set up.
October 8	Credit authorisation scheme (CAS) replaced by credit monitoring arrangement (CMA).

1989

April 1	A new strategy of rural lending, namely, service area approach (SAA), became operational.
August	The agricultural credit review committee (ACRC) submitted its report.
August 29	The Reserve Bank signed a wage settlement with the AIRBEA (class III employees).

September 30	Committee on currency management (Chairman: Shri P.R. Nayak) submitted its report.
November 27	The Reserve Bank signed a wage settlement with the AIRBWF (class IV employees).

1990

January 16	The Reserve Bank announced its decision to introduce a pension scheme in lieu of CPF on an optional basis for serving employees. The scheme came into effect from November 1, 1990.
August	The financial institutions cell was set up to function as a nodal unit for matters pertaining to financial institutions.
July-September	An amount of SDR 487 million in the reserve tranche of the IMF was drawn in three instalments on July 20, August 14, and September 4, 1990.
October 17	Gold held by the Reserve Bank as its assets revalued closer to international market price in contrast with the erstwhile statutory price of ₹ 84.39 per 10 fine grammes.
December 22	Shri R.N. Malhotra relinquished charge of the office of the Governor.
	Shri S. Venkitaramanan took charge as Governor with effect from the same day.

1991

January 23	As part of concerted efforts towards liquidity management, India negotiated with the IMF a drawal of SDR 717 million under the CCFF and SDR 552 million under the first credit tranche of IMF's stand-by arrangement.
May	Government of India sold 20 tonnes of gold with a repurchase option to the Union Bank of Switzerland (UBS) to enable it to borrow US$ 200.0 million for six months.
July onwards	The Government and the Reserve Bank initiated far-reaching policy initiatives to achieve macroeconomic stabilisation through fiscal correction, structural adjustment and financial sector reforms. The Centre's regular budget for 1991–92 laid the foundation for the process of fiscal adjustment, including a number of non-fiscal reform measures.

July	India shipped 47 tonnes of gold to the Bank of England (BoE) to raise US$ 405.0 million.
July 1	BCCI (Overseas) Ltd, Bombay, suspended all its banking operations in India.
July 1 and 3	The exchange rate of the rupee was adjusted downwards in two stages. In terms of pound sterling (*i.e.*, the intervention currency) it worked out to 17.38 per cent and 18.7 per cent in US dollar terms.
July 3	Bank Rate revised to 11.0 per cent from 10.0 per cent.
August	Government of India appointed a high level committee on the financial system (Chairman: Shri M. Narasimham).
August 21	The Government of India entered into a 20-month stand-by arrangement with the IMF for an amount equivalent to SDR 1,656 million.
October	Government negotiated a structural adjustment loan (SAL) with the World Bank for US$ 500.0 million, and a hydrocarbon sector loan for US$ 250.0 million with the ADB.
October 8	Bank Rate revised to 12.0 per cent.
November	The committee on the financial system (Chairman: Shri M. Narasimham) submitted its report.

1992

January 1	A scheme of post-shipment export credit denominated in foreign currency (PSCFC) was introduced.
February	SEBI reconstituted as a Board with statutory powers by the Government.
March 1	The liberalised exchange rate management system (LERMS) (*i.e.*, a dual exchange rate system) was introduced.
April	Internal Debt Management Cell (IDMC) was created within the Secretary's Department in the Reserve Bank.
April	The Reserve Bank announced detailed guidelines on a phased introduction of norms for capital adequacy, income recognition and provisioning for banks.
April 21	Credit policy circular for the first half of the year 1992–93 enunciated adoption of an active internal debt management policy.

April 30	The Reserve Bank set up a committee (Chairman: Shri R. Janakiraman) to investigate the irregularities in funds management and securities transactions by commercial banks and financial institutions, and in particular, in relation to their dealings in government securities, public sector bonds, UTI units and similar instruments. In all, the committee on securities operations of banks and financial institutions submitted six reports, the last one being in April 1993.
May 5	Memorandum of agreement signed between India and the Russian Federation for rupee-rouble debt retirement.
May 20	The committee on licensing of new co-operative banks (Chairman: Shri S.S. Marathe) submitted its report.
August 1992	Joint Parliamentary Committee (JPC) constituted to look into the irregularities in the securities operations of banks and financial institutions.
October 1	IDMC became an independent policy-making unit within the Reserve Bank.
November	A system of electronic clearance settlement and depository (ECSD) introduced by the Reserve Bank.
December 10	Repos auctions of central government securities commenced.
December 21	Shri S. Venkitaramanan relinquished office as Governor.
December 22	Dr C. Rangarajan took over as Governor.

1993

January	The Reserve Bank issued guidelines for grant of licences for opening new banks in the private sector.
January 8	The Foreign Exchange Regulation Act (FERA), 1973, was amended through an ordinance promulgated on January 8, 1993, which was replaced on April 2, 1993 by the Foreign Exchange Regulation (Amendment) Act, 1993.
March 1	A unified exchange rate system was introduced by merging dual exchange rates under the LERMS.
March 15	The gold bond scheme, 1993, (introduced by the Government of India) opened for public subscription and it closed on June 14, 1993.
April	The high level committee on the balance of payments (Chairman: Dr C. Rangarajan) submitted its report.

June 13	Guidelines were issued to NBFCs on prudential norms, income recognition, accounting standards and provisioning for bad and doubtful debts.
July 17	The Supreme Court in its judgment upheld the validity of the Chit Funds Act in its entirety.
December 22	A new department, *i.e.*, Department of Supervision (DoS), was set up in the Reserve Bank.

1994

January 17	Government of India floated zero coupon bonds of five-year maturity on auction basis.
June 1	Reserve Bank set up a committee on technology issues relating to payments system, cheque clearing and securities settlement in the banking industry (Chairman: Shri W.S. Saraf).
June 27	In order to develop a vibrant secondary market in government securities, the Securities Trading Corporation of India Ltd (STCI) was set up.
June 30	National Stock Exchange (NSE) commenced trading operations in debt securities.
August	India's external current account convertibility was formalised through declaration of Article VIII status in the IMF.
September 9	The first supplemental agreement between the Government of India and the Reserve Bank signed on September 9, 1994 placed a limit on the former's access to the Reserve Bank for accommodation through issue of *ad hoc* Treasury Bills. This agreement also envisaged discontinuation of the automatic monetisation of budget deficit through issue of *ad hoc* Treasury Bills over a period of three years.
November	An expert group on foreign exchange market (Chairman: Shri O.P. Sodhani) set up to recommend measures for the growth of an active, efficient and orderly foreign exchange market and to suggest introduction of new derivative products.
November 16	The Board for Financial Supervision (BFS) was constituted under the aegis of the Reserve Bank, with the Governor as the chairman, for an integrated and efficient supervision over banks, financial institutions and financial companies.
December	RBINet was inaugurated.

1995

January 1	Two new departments, namely, Human Resources Development Department (HRDD) and Department of Information Technology (DIT), were formed in the Reserve Bank.
February	Department of Supervision (DoS) introduced an offsite computerised monitoring system (OSMOS) as a first step towards a new strategy of strengthening supervision of banks under the direction of BFS.
February 3	Bharatiya Reserve Bank Note Mudran Private Ltd (BRBNM) was established as a fully-owned subsidiary of the Reserve Bank, with registered office at Bangalore (now Bengaluru). It commenced printing of currency notes at the Mysore press on June 1, 1996 and December 11, 1996 at Salboni (West Bengal).
March 1	DFHI and STCI started functioning as PDs in government securities market.
April 12	BFS took up supervisory responsibility for all-India financial institutions.
June 1	Four more PDs became operational. These were, the SBI Gilts Ltd, PNB Gilts Ltd, Gilts Securities Trading Corporation Ltd, and ICICI Securities.
June 14	Banking Ombudsman Scheme was introduced by the Reserve Bank under the provisions of the Banking Regulation Act, 1949 for an expeditious and inexpensive resolution of complaints about deficiency in banking services.
July 7	BFS with the assistance of DoS started supervising NBFCs.
July 14	The share capital of NABARD was increased from ₹ 330 crore to ₹ 500 crore, with contribution of ₹ 85 crore each from the Government of India and the Reserve Bank.
July 17	A system of delivery *versus* payment (D*v*P) for transactions in government securities was introduced in Mumbai to synchronise the transfer of securities with cash payment.
September 20	The expert group to review internal control and inspection/audit system in banks (Chairman: Shri Rashid Jilani) submitted its report.
November 23	Private sector was allowed to set up MMMFs to provide greater liquidity and depth to the money market.

1996

January 7	Banks were granted freedom to decide their own foreign exchange overnight open position limits subject to approval by the Reserve Bank. Earlier, a uniform limit of ₹ 15 crore was applicable for each bank irrespective of the nature and volume of business and the structure of the bank's owned funds.
January 18	The committee on electronic fund transfer system (Chairperson: Smt. K.S. Shere) submitted its report.
April 3	The Reserve Bank set up a foreign exchange market technical advisory committee.
July 1	The Institute for Development and Research in Banking Technology (IDRBT) was established at Hyderabad by the Reserve Bank as an autonomous centre.
July 2	Banks were given the choice to fix their own interest rates on domestic term deposits with a maturity of over one year with a view to provide them greater flexibility in determining their term deposit rates.
July	Measures were initiated to address the problem of Y2K both within the Reserve Bank and banking industry as a whole.
October	Reserve Bank became a shareholding member of the Bank for International Settlements (BIS), Basel, Switzerland.
October 9	A market intelligence cell was started in the Exchange Control Department of the Reserve Bank to closely study and monitor the developments in the foreign exchange market.
December 31	Guidelines for setting-up satellite dealers (SDs) announced with the aim of strengthening the infrastructure in the government securities market, enhancing liquidity and turnover and providing a retail outlet.

1997

January 27	A technical advisory committee on government securities market was constituted by the Reserve Bank.
January 30	Government decided to permit foreign institutional investors (FIIs) to invest in government dated securities.
March 26	In terms of the second supplementary agreement signed between the Reserve Bank and the Government of India,

the system of *ad hoc* Treasury Bills to finance budget deficit was discontinued from April 1, 1997.

March 31 Government of India introduced (from April 1, 1997) 14-day Intermediate Treasury Bills to provide state governments, foreign central banks and special bodies with an alternate arrangement for investment of their temporary cash surpluses.

Documents

List of Documents

(1) D.O. letter No. 295-SSEA/82 dt. 14/2/82 from Ministry of Finance to the Governor Dr. I.G. Patel

(2) Telex message no. COF (CPC)11969 dt. 25/5/85 from Dy. Governor Dr. C. Rangarajan to Shri S. Venkitaramanan, Finance Secretary.

(3) D.O. letter No. DEIO.4149/177(25-88/89) dt. 10/9/88 from the Governor Shri R.N. Malhotra to Shri S. Venkitaramanan, Finance Secretary, Utilisation of Gold Reserves.

(4) Letter No. G.Sec.158/88 dt. 23/12/88 from the Governor, Shri R.N. Malhotra to Hon. Shri S.B. Chavan, Minister for Finance.

(5) D.O. letter No. CPC. 1880/279A-89 dt. 7/1/89 from the Governor, Shri R.N. Malhotra to Hon. Shri S.B. Chavan, Minister for Finance, Government Budget Deficit and Monetary Policy.

(6) D.O. letter No. CPC. 1368/279A-89 dt. 6/6/89 from the Governor, Shri R.N. Malhotra to Shri G.K. Arora, Finance Secretary, Introduction of Commercial Paper in the Indian Money Market.

(7) D.O. letter No. G Sec 115/89 dt. 18/12/89 from the Governor, Shri R.N. Malhotra to Shri Madhu Dandavate, Hon. Minister for Finance, Measures

for Preventing Automatic Monetisation of the Government Budget Deficit.

(8) D.O. letter No.RPCD.No.791/NB3 (J)-89/90 dt. 28/4/90 from the Governor, Shri R.N. Malhotra to Dr. Bimal Jalan, Finance Secretary, Report of the Agricultural Credit Review Committee.

(9) Letter No. G. 20/561/90 dt. 18/5/90 from the Governor, Shri R.N. Malhotra to Dr. Bimal Jalan, Finance Secretary, Legislation on the Securities and Exchange Board of India (SEBI)-Regulation of Capital Market.

(10) IMF document dt. 27/8/91-Stand-By Arrangement-Letter of Intent.

(11) Letter dt. 11/11/91 from Dr. Manmohan Singh to Mr. I.T. Preston, President, The World Bank.

(12) Suo moto Statement by the Prime Minister in Parliament dated July 9, 1992.

(13) Supplemental Agreement between the Reserve Bank of India and the Government of India dated September 9, 1994.

(14) D.O. letter No. 1855 (I)/FS/95 dated February 24, 1995 from Shri M.S. Ahluwalia to the Governor, Dr. C. Rangarajan.

(15) D.O. letter No. 2739/FS/96 dated April 5, 1996 from Shri M.S. Ahluwalia to the Governor, Dr. C. Rangarajan.

(16) Supplemental Agreement between the Reserve Bank of India and the Government of India dated March 26, 1997.

SECRET/BY BAG

GOVERNMENT OF INDIA
MINISTRY OF FINANCE
DEPARTMENT OF ECONOMIC AFFAIRS
NEW DELHI

D.O.No.295-SSEA/82

February 14, 1982

Dear Dr. Patel,

I am writing this in response to a letter dated February 4, 1982 addressed to me by Tambe suggesting certain changes in interest rates for fixed deposits with maturities of one to three years. The Finance Minister has no objection to the Reserve Bank giving effect to these proposals.

2. While considering the Report of the Working Group on foreign remittances into India by Indian nationals resident abroad and foreign nationals of Indian origin, the Finance Minister has approved the Group's proposal that deposits with maturities of one year and above held in the two non-resident external accounts should carry interest at 2 per cent above the rates permissible on local currency deposits of comparable maturities. The higher rates would apply only to fresh deposits and on renewals of maturing deposits. In this connection, I had mentioned to the Finance Minister the reservations of the Reserve Bank and its suggestion that the Government should subsidiese the banks for the extra cost they would incur in paying additional interest on this account. While the Finance Minister did not favour the payment of the proposed subsidy to the commercial banks, he agreed that the banks could be compensated by a somewhat higher return on Government borrowings under the SLR.

3. It is suggested that the changes in the interest rates referred to above may be brought into effect from March 1, 1982. An announcement in this behalf could be made by the Reserve Bank immediately after the Finance Minister presents his Budget.

With best regards,

Yours sincerely,

Sd/- R.N. Malhotra

Dr. I.G. Patel,
Governor,
Reserve Bank of India,
Bombay.

Pl.see what follow-up action is necessary. I tried to reopen our old idea of going all the way. But Econ. Secy.was not prepared to change his view and F.M. though let us see how far the present proposal works. We may have to be clear about what Govt. would do on 'A' - and whether we also should in any case raise the return on impounded segment.

Id. IGP.
17/2

E.D.(T)

P. see this. We will discuss tomorrow at 12.30 noon along with CO(DBOD) and C.E.

Ad(M)

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FROM DR.C.RANGARAJAN, DEPUY GOVERNOR, RBI BOMBAY
FOR (1) SHRI S.VENKITARAMANAN, FINANCE SECRETARY
ECOFAIRS
ND
REPEAT
(2) DR. BIMAL JALAN, SECRETARY(BANKING) AND CHIEF ECONOMIC ADVISER, MINISTRY OF FINANCE, NORTH BLOCK, GOVT. OF INDIA
ND

WE TELEX BELOW THE TEXT OF GOVERNOR'S LETTER TO SCHEDULED COMMERCIAL BANKS ISSUED TO-DAY. YOU MAYLIKE TO BRING THIS TO THE NOTICE OF THE FINANCE MINISTER.

QUOTE:

WITH EFFECT FROM APRIL 8,1985 SCHEDULED COMMERCIAL BANKS WERE GIVEN THE DISCRETION TO FX++ FIX INTEREST RATES ON DEPOSITS OF MATURITIES OF LESS.THAN ONE YEAR WITHIN A CEILING OF 8 PER CENT. IT WAS EXPECTED THAT WITH REASONABLE RATES OF INTEREST, ON SUCH MATURITIES, BANKS WOULD BE ABLE TO MOBILISE HITHERTO UNTAPPED RESOURCES AND THEREBY WIDEN THEIR DEPOSIT BASE. A SUITABLE INCREASE IN INTEREST RATES FOR SHORTER MATURITIES WAS ZL++ALSO EXPECTED TO ACHIEVE A BETTER DISTRIBUTION OF TERM DEPOSITS INSTEAD OF THE PRESENT HIGHLY SKEWED DISTRIBUTION WITH CONCENTRATION AROUND THE LONGER MATURITIES AT RELATIVELY HIGHER COSTS.

2. IT WAS HOPED THAT IN THE EXERCISE OF THE DISCRETION GIVEN TO THEM, INDIVIDUAL BANKS WOULD SO FIX THE RATES AS TO SAFEGUARD THEIR CURRENT AND SAVINGS ACCOUNTS AND AT THE SAME TIME BRING ABOUT BETTER PORTFOLIO MANAGEMENT. HOEWEVER, THE APPROACH OF BANKS HAS BEEN SUCH AS TO PREVENT THE EMERGENCE OF SUCH EFFICIENT PORTFOLIO MANAGEMENT. THE MAJOR BANKS INITIALLY FIXED UNIFORM RATES FOR FIVE MATURITIES BELOW ONE YEAR ++ YEAR AT A LEVEL OF ONE PERCENTAGE POINT ABOVE THE RATES PREVAILING PRIOR TO APRIL 8, 1985. HOWEVER, WHEN A FEW BANKS STARTED OFFERING A RATE OF 8 PERCENT EVEN FOR MATURITIES OF 15 DAYS, ALL BANKS SIMPLY

FOLLOWED SUIT AND, 'WITHOUT REGARD TO CONSIDE-RATION OF PROFITABILITY, SET A SINGLE RATE OF 8 PERCENT FOR MATURITIES STARTING FROM 15 DAYS AND BELOW ONE YEAR. SOME OF THE BANKS ARE MANAGING THEIR 15-DAY DEPOSITS ALMOST LIKE CURRENT ACCOUNTS. MOREOVER, RESORT TO MATURITIES ABOVE 15 DAYS BUT BELOW ONE YEAR HAS GREATLY DIMINISHED. THE CONSQEQUENCE HAS BEEN A SHIFT OF DEPOSITS FROM 'CURRENT ACCOUNTS AND, TO A LESSER EXTENT, FROM SAVINGS ACCOUNTS TO 15-DAY DEPOSITS.

3. IN VIEW OF THESE DEVELOPMENTS, WE HAVE REVIEWED THE POSITION. WITH EFFECT FROM MAY 27, 1985, THE RATES FOR MATURITIES UPTO 90 DAYS ARE BEING RESORTED TOTHE LEVELS PREVAILING PRIOR TO APRIL8,1985, THE RATE FOR MATURITIES OF 91 DAYS TO LESS THAN 6 MONTHS IS FIXED AT 6.5 PERCENT AND THE RATE FOR 6 MONTHS TO LESS THAN ONE YEAR IS FIXED AT 8 PER CENT. THE REVISED STRUCTURE OF INTEREST RATE ON DEPOSITS WILL BE AS FOLLOWS:

SCHEDULED COMMERCIAL BANKS1 INTEREST RATES ON DEPOSITS

	EXISTING (EFFECTIVE APRIL 8,1985	NEW (EFFECTIVE MAY 27,1985)
	(PER CENT PER ANNUM)	
1. CURRENT ACCOUNTS	NIL	NIL
2. SAVINGS ACCOUNTS	5.0	5.0
3. TERM DEPOSITS		
(A) 15 DAYS TO 45 DAYS		3.0
(B) 46 DAYS TO 9Q DAYS		4.0
(C) 91 DAYS AND ABOVE BUT LESS THAN 6 MONTHS	Not Exceeding 8.0	6.5
(D) 6 MONTHS AND ABOVE BUT LESS THAN 1 YEAR		8.0
(E) 1 YEAR AND ABOVE BUT LESS THAN 2 YEAR	8.5	8.5
(F) 2 YEARS AND ABOVE BUT LESS THAN 3 YEARS	9.0	9.0
(G) 3 YEARS AND ABOVE BUT LESS THAN 5 YEARS	10.0	10.0
(H) 5 YERARS AND ABOVE	11.0	11.0

NOTE: BANKS WHICH ARE AUTHORISED DEALERS IN FOREIGN
EXCHANGE AND WHO ACCEPT TERM DEPOSITS HAVING
A MATURITY PERIOD OF ONE YEAR AND ABOVE UNDER
THE FOREIGN CURRENCY(NON-RESIDENT. ACCOUNTS
SCHEME (FCNR) AND THE NON-RESIDENT(EXTERNAL)
RUPEE ACCONTS SCHEME(NRE) SHALL PAY, ON SUCH
DEPOSITS, INTEREST AT RATES 2 PERCENTAGE POINTS
PER ANNUM ABOVE THE RATES PERMISSIBLE ON. LOCAL
CURRENCY DEPOSITS OF COMPARABLE MATURITIES.

THE RELEVANT DIRECTIVE IS BEING ISSUED SEPARATELY

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(2) DR. BIMAL JALAN, SECRETARY (BKG) AND CHIEF
ECONOMIC ADVISER MINISRY OF FINANCE, NORTH
BLOCK, GOVT.OF INDIA ND.

FROM NXIOX DR.C.RANGARAJAN, DY GOVERNOR RBI BOMBAY

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DATED 25TH MAY 1985. KINDLY ADD IN PARAGRAPH 1 LINE
NO.8 XX AFTER DISTRIBUTION “0F TERM DEPOSITS INSTEAD
OF THE PRESENT HIGHLY SKEWED DISTRIBUTION".
AND PARA 2 LINE NO.6 AFTER MANAGEMENT 11THE MAJOR
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SECRET

D.O.DEIO.NO.4149/177(25)-88/89 10th September 1988.

Utilisation of Gold Reserves

You may recall that during the course of our review of deployment of foreign exchange reserves by the Reserve Bank on 5th July 1988, I had made a suggestion that a part of our gold reserves, which as of now do not earn any income, could be leased out to earn an income. Both you and Bimal agreed that it was a good idea. My detailed proposal in this behalf is described in the following paragraphs.

2. The practice of gold lending is not uncommon with central banks, a large number of whom have arrangements with Bank of England, Federal Reserve Bank of New York, Swiss National Bank, and also some private institutions to store a proportion of their gold reserves which are deployed in international gold markets. The most convenient and expedient method of utilising gold reserves would be to lease out certain proportion of the reserves and earn a return thereon. This, however, requires physical shifting of gold to an acceptable depository abroad. In terms of Section 33(5) of the RBI Act , 1934, out of the gold held by the Bank, not less than 17/20th, i.e., 85 per cent shall be held in India. The Bank's official gold holdings are 324.988 tonnes (10,449 million ounces troy), all of which are held in India itself. It is thus permissible for the Bank to transfer about 48.7 tonnes of gold out of the country within the existing parameters of the law. Such a movement would, however, be reflected in the weekly statement of affairs of the Bank whose format requires the Bank to show separately the gold held in India and outside India. Any shifting of gold from India will, therefore, automatically come to the knowledge of the public and Government will have to be prepared to explain the reasons.

3. The gold acceptable in international markets has to conform to specifications of good delivery bars weighing approximately 400 ounces troy (12.5 kgs.)

and of minimum assay 995 from acceptable Melters and Assayers. The physical possession of gold has to be given by the Bank to the lessee/s' ex-vault, say, Bank of England or any gold depository. (The title to the gold will continue to vest with Reserve Bank of India). We are ascertaining the quantity of good delivery gold bars held by the Bank and, if necessary, the India Government Mint standard bars may have to be reassayed at a nominal cost.

4. In return for use of gold for a specified period, the lessee will pay a lease fee which, historically, has been around 0.5 per cent per annum but varies on demand and supply conditions obtaining in international markets. Lease fee is calculated on spot value of the quantity of gold deployed on the lease date and is payable in either US dollar or in gold. At the end of the lease period, an equivalent quantity of gold in fine ounces/grams is returned to the Bank's account with its depository. The only risk involved in this transaction is that of a default by the lessee. Such risks, even otherwise, exist for currency deposit transactions and can be minimised by spreading out gold deposits amongst institutions in our approved list within the overall exposure limits that have been/may be assigned to them. We can also utilise the services of the Bank for International Settlements, Basle for the purpose of placement of deposits since they have developed the requisite expertise over the years.

5. The physical movement of gold from Bombay to say, London, would involve a one time cost which would decline asymptotically over the period during its employment and retention in.-London. The cost of transportation and insurance from Bombay airport to "in vault" Bank of England is estimated at about 40 cents (US) per ounce, or say $12,900 (approximately) per metric tonne. The 1987 average London. P.M. fix works out to $446.41 per troy ounce. The 1988 half year average is $452.80 per troy ounce. Assuming a conservative price of $400 per troy ounce, one tonne of gold will have a deployable value of $12,860,400,

say, $12.86 million which will yield an income stream of $64,300 per tonne per annum.

6. Taking into account the absorbtive capacity of the markets, their logistics and the practical difficulties involved, it is deemed advisable to shift about 40 tonnes to Bank of England, London. Depending upon the actual amount leased, the annual income that would accrue to us would be about $2.5 million or say Rs. 3.5 crores.

7. The proposal set out above may kindly be examined by the Government. I shall be glad to have Government's approval in principle before proceeding further in the matter.

With regards,

Yours sincerely,

(R.N. Malhotra)

Shri S. Venkitaramanan,
Finance Secretary,
Government of. India,
Ministry of Finance,
New Delhi

गवर्नर
GOVERNOR

भारतीय रिज़र्व बैंक
केन्द्रिय कार्यालय,
बंबई
RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

SECRET
G.Sec.158/88

23rd December 1988

Dear Shri Chavan,

Kindly recollect the brief discussion we had on developments in the balance of payments when I called on you recently in Delhi. This letter sets out in some detail the position as it has evolved in the current fiscal year against the background of developments in recent years. A note on the "External Debt Position as on March 31, 1988" is also enclosed.

The balance of payments has been under severe strain during the current financial year. Foreign exchange reserves comprising foreign currency assets of Reserve Bank of India, gold and SDRs during the current financial year upto December 9, 1988 declined by Rs.1064 crores, as compared with a fall of Rs.1025 crores in the corresponding period of 1987-88. However, excluding valuation changes, i.e., net appreciation in the value of foreign currency assets of RBI and SDRs, reserves would show a larger fall of Rs.1966 crores as compared with a fall of Rs.1383 crores in the corresponding period of 1987-88 (Table 1). The present level of reserves at Rs.6623 crores is quite low, constituting less than 2.8 months of imports. This is the first time since 1974-75 that the level of reserves is less than 3 months of imports, the earlier low being at the end of 1974-75, when reserves level was equivalent of 3 months of imports.

The real loss in reserves is much higher than is indicated above. If special transactions (that is, funds brought in, receipts from India Supply Mission, Washington and Indian Embassy, Tokyo and sales of foreign currencies to RBI by ICICI/IDBI/IFCI out of their commercial borrowings) are .excluded, the fall in

reserves this fiscal year so far upto December 9, 1988 works out to Rs.3752 crores. This is more than twice the fall of Rs.1714 crores (after excluding special transactions) in the corresponding period of 1987-88. Besides, we increased our resort to the use of short-term credits, the outstandings of which went up by Rs.1441 crores to Rs.2855 crores between end March 1988 and December 2, 1988, nearly twice the rise of Rs.767 crores in April-November 1987.

The main factor for the sharp fall of reserves this year was larger net sales of foreign currencies to Authorised Dealers by RBI, reflecting mainly higher import payments. Although aid receipts were somewhat higher, the debt service payments were much more than in the last year. Repurchases from the IMF under External Fund Facility were also higher this year. On the other hand, net inflow of funds under Foreign Currency Non-resident Account (FCNRA) Scheme was much stronger (Table 2).

Detailed balance of payments data for the current financial year are not yet available. According to provisional DGCIS data, during April to September 1988, while exports went up by 21.3 per cent over April to September 1987, this was more than offset by a sharp rise of 26.6 per cent in imports over the same period. It is disquieting to note that the export growth this year in rupee terms was lower than the growth of 26.5 per cent achieved during April to September 1987, while the import growth was substantially higher than the growth of 12.6 per cent in April to September 1987. In terms of SDRs, while the growth in exports during April-September 1988 was only 9.1 per cent as compared with a growth of 13.1 per cent in April-September 1987, the rise in imports during the two reference periods was 13.9 per cent and 0.6 per cent respectively. Because of a larger rise in imports than in exports, the trade deficit in rupee terms widened sharply by 39.8 per cent from Rs.2988 crores in April to September 1987 to Rs.4177 crores during April to September 1988. The estimated current account deficit during April-November 1988 worked out from known capital transactions would be over Rs.7250 crores, about 70 per cent higher than that estimated for the same period of 1987-88 (Table 3).

The balance of payments has been under considerable pressure since the beginning of the Seventh Plan. Foreign Exchange reserves, excluding valuation changes, declined continuously during the first three years of the Seventh Plan by Rs.707 crores, Rs.732 crores and Rs.954 crores, respectively despite a sharp increase in aid flows and commercial borrowing. In SDR terms, foreign exchange reserves steadily declined from SDR 6,004 million at the end of March 1985 to SDR 3443 million by the end of December 9, 1988, about SDR 750 million lower than the level a year ago (SDR 4196 million). The order of current account deficits experienced during the Seventh Plan has been very large. The current account deficit more than doubled from Rs.2852 crores in 1984-85 to Rs.5927 crores in the first year of the Seventh Plan. Although it came down somewhat in 1986-87, it went up once again in 1987-88. The available indicators, as stated above, show that the current account deficit in 1988-89 would be even more than in 1987-88. It is clear that the current account deficits have been running at a much higher rate than postulated in the Seventh Plan document. The annual average ratio of current account deficit to GDP of over 2 per cent in the first three years of the Seventh Plan, as against the targeted average of 1.6 per cent for the Plan period, underscores the pressure on balance of payments.

The large order of current account deficits has been financed partly by drawing down reserves, but mainly through a larger inflow of capital both on concessional and commercial terms and by way of NRI deposits. As a result, India's medium` and long-term debt has reached high proportions. As can be seen from the note on the External Debt Situation (Appendix), India's medium and long-term external debt which was around Rs.13300 crores at the end of March 1980, increased to nearly Rs.55000 crores by end-March 1988 (vide Annexure I of Appendix). In addition, we have also contracted short-term debt which is estimated to have gone up from Rs.750 crores at end-March 1980 to Rs.3700 crores by the end of March 1988. India's external debt (short,medium and long term) as a proportion of exports and current invisible receipts has consequently gone up from 135 per cent at the end of 1979-80 to 240 per cent at the end of

1987-88. Even if allowance is made for the increase in debt due to exchange rate factors, there has been a substantial rise in external debt over the last few years. At the same time, NRI deposit liabilities have gone up from Rs.855 crores at end-March 1980 to Rs. 3819 crores by the end of the Sixth Plan and to Rs. 11775 crores by the end of September 1988.

Some estimates place the external debt at an even higher level than the figures indicated above. According to the September 1988 Report of the Institute of International Finance (IIF), India's outstanding external debt (medium and long-term) at the end of March 1988 is $45.1 billion (as against our figure of $42.3 billion) and inclusive of short-term debt and NRI deposits, the external debt is placed by the IIF at $57.6 billion as against our figure of $53.0 billion (Annexure V of Appendix). The higher figure of external debt given by the IIF seems. to be mainly due to exchange rate adjustments under IBRD, IDA and bilateral credits as well as due to a higher estimation of short-term debt.

Consequent to increase in external debt, the debt service obligations have steadily gone up over the last few years. India’s debt service ratio on medium and long-term debt rose from 8 per cent in 1980-81 to 13.6 per cent in 1984-85, 21.6 per cent in 1986-87, in 24 per cent in 1987-88 and in expected to rise further to nearly 26 per cent in 1988-89. In this context, it may be mentioned that if debt service payments (on economic credits) and exports to rupee payment area countries are excluded from the calculations, the debt service ratio would be higher. If the instalment payments on defence credits from the USSR which are financed by way of export of goods but not included under debt service, are also considered, the ratio would be even still higher. Even without making these adjustments, if interest payments on NRI deposits and short-term debts are taken into account under debt service, India’s debt service ratio in 1988-89 would go up to 30.8 per cent. The country’s debt service ratio is now fast approaching a level of the "countries with recent debt servicing problems" as a group according to IMF World Economic Outlook, 1988, whose debt service ratio was

30.4 per cent and is expected to touch 32.4 per cent in 1988. It is necessary to reverse as quickly as possible the rising trend in debt service ratio.

The present level of reserves in SDR terms (SDR 3443 million) is the lowest reached since March 1978 and there is hardly any scope for further drawdown on the reserves. Our debt service liabilities are mounting. Over the next two years, we have to make repayments to the Fund amounting to SDR 1698 million (SDR 1486 million under EFF and SDR 212 million against Trust Fund loans).

The pressure on balance of payments and the mounting burden of external debt can be contained only through a reduction in current account deficit in absolute terms quickly. The Department of Economic Affairs of the Finance Ministry had drawn up an action plan sometime in July this year to reduce the deficit. However, looking to the developments and trends, since then, more efforts need to be made not only to `attain a higher volume growth in exports but to carefully examine the scope for containment, of imports in the areas of defence, POL and edibIe oils. There has been some softening in crude oil prices, but the situation is uncertain and the scope for limiting the growth rate in oil consumption may have to be explored. There has been a fairly sharp increase in non-bulk OGL imports. The possibilities of raising duties on products covered by the OGL as a means of restricting their imports may be considered. The current account deficit on the external account is intimately related_ to the budgetary deficit. The reduction of budgetary deficit would help to contain the current account deficit.

With kind regards,

Yours sincerely,

(R.N. Malhotra)

Hon. Shri S.B.Chavan,
Minister for Finance,
Government of India,
New Delhi.

Encls : 1 Note and 4 Tables.

गवर्नर
GOVERNOR

भारतीय रिज़र्व बैंक
केन्द्रिय कार्यालय,
बंबई
RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

SECRET

D.O.No.CPC.1880/279A-89 7th January 1989

Dear Shri Chavan,

Government Budget Deficit
and Monetary Policy

Monetary Policy has to ensure the twin objectives of maintaining reasonable price stability and meeting the genuine credit requirements necessary to support the growth of output. The large and recurring Government budget deficits have been contributing to strong monetary expansion and, over time, there has been a serious erosion in the effectiveness of monetary policy instruments. In the context of the large budget deficits it is difficult to control monetary expansion which, in turn, contributes to inflation. Government's market and other borrowings have also been rising rapidly and interest payments are now very large. A disturbing trend has been the steep increase in the ,Government's revenue deficit which has grown from Rs.384 crores in 1981-82 to Rs.4,224 crores in 1984-85 to Rs.9,842 crores in 1988-89(BE). This means that Government has been borrowing heavily to meet current expenditure. While the need for corrective action is well recognised, effective measures have not yet materialised. Postponement of the needed adjustment would, however, lead to more acute problems.

2. The overall budgetary deficit of the Government of India has been growing over the years. Between 1977-78 and 1987-88, the overall budgetary deficit of the Government of India grew at an annual compound rate of over 20 per cent. The deficit is budgeted to increase by another 23 per cent during 1988-89. Upto December 16, 1988, however, the deficit is already 36 per cent more than the budget estimate for the full financial year and

also over a fourth more than the comparable deficit at this point of time last year. On current indications, the actual deficit during 1988-89 is likely to exceed the budget estimate unless immediate measures are taken to contain the deficit.

3. Over the years the practice has grown by which the entire budget deficit of the Central Government is taken up by the Reserve Bank of India through the acceptance of ad hoc Treasury Bills issued in its favour. Since these budget deficits are not temporary, the huge amount of Treasury Bills outstanding is being continuously rolled over. A part of the outstandings has recently been converted into long-term securities at the rate of interest applicable to Treasury Bills. In addition, the Reserve Bank continues to provide support to the Central Government's market borrowing programme. The automatic monetisation of large and growing budgetary deficits has led to excess liquidity in the system with serious inflationary implications.

4. Treasury Bills are meant to provide short-term accommodation but this has become a permanent form of financing the Government. The longer term requirements of the Government should, quite properly, be met from the market and not the Reserve Bank. I hardly need mention that automatic monetisation of the budgetary deficit by the central bank is not a healthy practice and it would be desirable, over a period of time, to move away from such monetisation. As a first step, this calls for reducing the budget deficit, in a phased manner, from the level of 2.3 per cent of GDP in 1988-89 to 1 per cent of GDP say by 1992-93. The eventual aim should be that only temporary accommodation to the Government is provided by the Reserve Bank, the long term needs being met from the market.

5. Over the years, the expansionary impact of the large budget deficits has been partly neutralised and the consequent inflationary impulse moderated through the pursuit of a cautionary monetary policy. The main instrument Of monetary restraint has been the use of the cash reserve ratio which has virtually reached its statutory limit of 15 per cent of Bank's net demand and time liabilities. This statutory limit would not

have posed much of a problem if the fiscal deficit had remained low. As the currently high deficits can be brought down only in a phased manner we have been constrained to suggest to the Government an enhancement of the statutory limit for the cash reserve ratio from 15 per cent to 20 per cent. We have already written to the Ministry of Finance in this context and an early action in the matter is urged.

6. The use of the interest rate instrument for monetary control has limitations in our context because of substantial concessional lending to the priority sectors and the below-market rates at which Government borrows from the market. The insulation of Government borrowing from market rates also prevents the Reserve Bank from undertaking open market operations to mop up excess liquidity.

7. I would like to point out that the large current account deficit in the balance of payments has had a moderating impact on monetary growth and prices. This deficit, however, has considerably increased our external indebtedness and sharply raised the debt service ratio. A reduction in the current deficit which is urgently needed, would, however, put pressure on both money supply and prices. Under the circumstances, a substantial moderation of the fiscal deficit has become inescapable. In the absence of such moderation, the inflationary situation could become serious and there could be further pressures on the balance of payments.

8. While the monetary targetting and borrowing programme exercise for 1989-90 is being worked out separately, I thought it would be useful to set out the broad framework for this exercise. On the assumption of a 5 per cent rate of real growth and an objective of containing the inflation rate to within 5 per cent, we should ensure that the growth of M3 in 1989-90 does not exceed 15.0 per cent as against a projected 16.3 per cent increase in 1988-89. Consistent with this would be a growth of aggregate deposits of scheduled commercial banks. in 1989-90 of Rs.23,300 crores (16.8 per cent) as against a working estimate of Rs.20,500 crores (17.4 per cent) for 1988-89. To contain the growth of liquidity within the abovementioned limits, the overall market borrowing programme of the Centre, States and institutions would

need to be limited to Rs.12,200 crores in 1989-90 as against Rs.11,721 crores in 1988-89. This itself would require Reserve Bank support to dated securities of Rs.1,200 crores. The overall growth of liquidity can be contained within a limit of 15 per cent in 1989-90 only if the RBI net credit to Central Government is limited to an increase of Rs.8,200 Crores. Since the support to the borrowing programme would be of the order of Rs.1,200 crores, the budget deficit of the Centre in 1989-90 should not exceed Rs.7,000 crores.

9. To sum up, may I suggest that the following broad parameters be accepted as part of a programme to adjust the budgetary gap:

(i) The Government of India should ensure that its deficit during 1988-89 does not exceed the budget estimate of Rs. 7,484 crores.

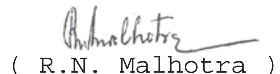
(ii) The budget deficit for 1989-90 should not exceed Rs.7,000 crores (equivalent to 1.9 per cent of GDP) and net RBI credit to the Central Government should be limited to Rs.8,200 crores. The overall borrowing programme of the Centre, States and institutions should be limited to Rs.12,200 crores in 1989-90; this would mean an increase of about Rs.500 crores over 1988-89.

(iii) There should be a programme for a phased reduction in the absolute size of the budget deficit so that by 1992-93 it is reduced to 1.0 per cent of GDP, which could approximate to Rs.5,000 crores.

10. I do appreciate that these suggestions imply the beginning of an adjustment process calling for action on controlling expenditures and raising revenue. I would like to discuss these matters with you at an early date.

With kind regards,

Yours sincerely,



(R.N. Malhotra)

Shri S.B. Chavan,
Finance Minister,
Government of India,
New Delhi.

CONFIDENTIAL

D.O.NO.CPC.1368/279A-89 6th June 1989

My dear Gopi,

Introduction of Commercial Paper
in the Indian Money Market

As you are already aware, the question of introducing Commercial Paper (CP) in the Indian money market had been under consideration for quite some time. The CP would enable highly rated corporate borrowers to diversify their sources of short-term borrowing and also provide an additional instrument to investors. You would recall that I had discussed this matter with the Finance Minister and yourself and in March 1989, as part of the credit policy for the first half of 1989-90, I had announced the decision to introduce Commercial Paper together with the salient features of the new instrument. We are at present finalising detailed guidelines in consultation with the Indian Banks' Association (IBA) and others concerned and the detailed scheme is expected to be ready for implementation very shortly.

2. While announcing the salient features of the scheme, we had set out that certain exemptions would have to be obtained from the Government before CPs can be issued. In the scheme of things, CP would be in the form of unsecured promissory notes with the maturity period ranging from three months to six months. However, under the Companies (Acceptance of Deposits) Rules 1975, framed by the Government of India under Section 58A of the Companies Act, 1956, companies are prohibited from accepting deposits which are repayable on demand or on notice or repayable after a period, except where such deposits are repayable after the expiry of six months from the date of acceptance of deposits.

3. To enable companies to issue CPs, it would be necessary to either (i) exempt CPs from the provisions of Section 58A of the Companies Act or (ii) the Companies (Acceptance of Deposits) Rules 1975 could be amended to exempt deposits raised through CPs from the

definition of deposits. In our view, the first alternative seems preferable. It is therefore requested that the Government of India may kindly agree to grant exemption for the issue of Commercial Papers from the provisions of Section 58A(8) of the Companies Act, 1956. I am forwarding a copy of the draft exemption order for the consideration of the Government and it would facilitate the introduction of CPs if the exemption order could be issued by an early date. (draft 1 attached). If for some reason the second alternative is preferred a draft for giving effect to that is also attached. (draft 2).

With Regards,

Yours sincerely,

(R.N. Malhotra)

Shri G.K. Arora,
Finance Secretary,
Ministry of Finance,
Government of India,
New Delhi.

गवर्नर
GOVERNOR

भारतीय रिज़र्व बैंक
केन्द्रिय कार्यालय,
बंबई
RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

SECRET

D.O.No.G SEC 115/89 18th December 1989

Dear Shri Dandavate

Measures for Preventing Automatic Monetisation of the Government Budget Deficit

As you are well aware, an important objective of monetary policy is to ensure price stability. With the large and recurring budget .deficits of the Government, and their monetisation by virtue of these deficits being automatically financed by the Reserve Bank of India, the efficacy of monetary policy has been greatly attenuated. It is, therefore, desirable to move away from such monetisation. While the longer term needs of the Government should be met from the. market, the Reserve Bank should provide only temporary accommodation to the Government. This question was also addressed in the Report of the Central Board of Directors on the working of the Reserve Bank of India for the year ended June 30,1989, wherein it was argued that an effective monetary policy Would require the avoidance of the automatic monetisation of the budget deficits and that over the medium term, beyond a mutually agreed Ways and Means accommodation from the Reserve Bank, Government should aim at placing its entire debt in the market at appropriate interest rates (extracts from the Report are attached as Annexure I for ready reference). In this letter I am setting out the genesis of the existing practice of monetisation of the budget deficit by the Reserve Bank of India and make certain specific proposals for avoiding this in future.

Genesis of the Problem

2. Before considering measures to prevent automatic monetisation of the Government budget deficit it may be useful to briefly recapitulate the genesis of the existing procedures of financing the budget deficit. In terms of Section 17(5) of the Reserve Bank of India Act, 1934, the Bank is authorised to grant to the Central and State Governments, advances repayable in each case not later than three months from the date of making the advance. These "Ways and Means" advances were granted to the Central Government to ensure that the balances of the Government did not fall below the agreed minimum level to be kept with the Bank. The provisions of Section 17(5) are enabling and not mandatory, and they do not require the Reserve Bank to finance unlimited deficits of the Government. While the Central Government did not avail of Ways and Means advances during the period 1944-54, from 1954-55 onwards the Central. Government sought accommodation through sale of ad hoc Treasury Bills under Section 17(8) of the Act which authorises the Reserve Bank to undertake purchase and sale of securities of the Central Government. In January 1995, the Government and the Reserve Bank agreed that if the balances of the Government fell below the stipulated minimum of Rs.50 crores, the Reserve Bank would create ad hocs to replenish the cash balances of the Government. While the practice of creating ad hocs for replenishing the balances with the RBI commenced only in 1955, right from the inception of the Bank, the Reserve Bank purchased ad hocs from the Government for providing eligible assets to facilitate currency expansion; however, such expansion was very modest and as late as 1948 the total outstanding Treasury Bills were only Rs.99 crores of which the holdings by the Reserve Bank amounted to a mere Rs.6 crores.

3. I may draw your attention to the fact that as far back as 1957, the then Governor, the late Shri H.V.R. Iengar, expressed concern at the prevailing arrangement regarding automatic creation. of ad hocs to finance the Government deficit and in his letter dated July 5, 1957 to the then Finance Minister, the late Shri T.T. Krishnamachari, he said:

> "Ever since I came to the Reserve Bank, I have been exercised over the fact that under the arrangements in force for the last five years or thereabouts, currency is expanded against the creation of ad hoc Treasury Bills as a merely mechanical process depending on the weekly closing balance of the Central Government. There is no check against the volume of currency that could be so expanded. If Government want to go on increasing their expenditure without regard to the available resources, there would be nothing to stop them, so far as ways and means are concerned; the currency would be provided automatically. The process is in fact so mechanical that it is operated by my Calcutta Manager and I hear about this action subsequently ..... The reason I am exercised in my mind is that the present arrangement, as a standing arrangement, is defective The Reserve Bank, under the Statute, is charged with responsibility of regulating the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India. (Please see the preamble to the Act). As matters now stand, with an automatic expansion of currency at the will of Government, the Bank, in my judgement, is not really in a position to discharge its responsibility."

In reply, the Finance Minister vide his letter No.8340/PSF/57 dated July 27, 1957 said:

> "What to my mind is necessary is to ensure that Government policy is formulated in this respect after very full discussion with the Reserve Bank and that the latter is kept informed from time to time of any changes that Government feel called upon to make before they are made. Thus, it would be the duty of the Finance Ministry to formulate their proposals for borrowing as also for deficit financing in consultation with the Reserve Bank. These programmes of borrowing and deficit financing are incorporated in the Budget and placed before the Parliament for its approval. The subsequent creation of ad hoc Treasury Bills when the

> Government's cash balances fall below a certain level is done within the limits thus prescribed. If in the course of the year it is found that these limits are likely to be exceeded, revised arrangements may become necessary and these would certainly also be formulated in consultation with the Reserve Bank. The Reserve Bank thus would have every opportunity of discharging its responsibility of regulating the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India."

It will thus be seen that what started off as a mechanism for providing temporary accommodation to the Central Government to enable it to maintain a minimum balance with the Reserve Bank became an open-ended monetisation of budgetary deficits, thus substantially undermining the role and effectiveness of monetary policy. What is more, the Treasury Bill which is a short term instrument for meeting temporary needs has been used for financing the long-term requirements of the Government.

Impact of Monetisation of the Deficit in Recent Years

4. In recent years, the budget deficit has been large and apart from monetising this deficit, the Reserve Bank has also had to provide support to the Government's market borrowing programme through purchase of long-term bonds. As a result, the pace of monetary expansion has been unduly high and this has put inevitable pressures on prices. It is pertinent to note that as on December 1, 1989 the outstanding reserve money (i.e. the money created by the Reserve Bank) amounted to Rs.69,462 crores of which the net claims of the Reserve Bank on the Central Government accounted for Rs.70,948 crores. The overall liquidity in the system (M3) as on December 1,1989 was Rs.215,318 crores and this M3 expansion is almost exclusively the secondary impact of the increase in net Reserve Bank credit to the Central Government. As on December 1, 1989, the Reserve Bank's holdings of Treasury Bills amounted to Rs.24,435 crores and its holdings of other securities was Rs.46,522 crores; of the holdings of other securities, as much

as Rs.36,000 crores of holdings relate to three large fundings of Treasury Bills undertaken in the current decade (Rs.3,500 crores in March 1982, Rs.15,000 crores in March 1987 and Rs.17,500 crores in March 1988) at a low rate of 4.6 per cent. At the end of March 1989 the net Reserve Bank credit to Central Government was equivalent to 51.2 per cent of the net domestic debt of the Central Government. This epitomises the impact of the automatic monetisation of the .Central Government budget deficit.

5. Despite the large automatic monetisation of the budget deficit the expansionary impact has been partly neutralised, and inflation moderated, particularly in the 1980's, by a strong regime of monetary restraint which was only possible because of the frequent use of the instrument of the cash reserve ratio (CRR). But this instrument is no longer available to us as the statutory ceiling of 15 per cent of banks' net demand and time liabilities has already been reached. I had, over a year ago, urged the Ministry of Finance to initiate early action to raise this statutory ceiling from 15 per cent to 20 per cent. I would urge immediate action to amend the Reserve Bank of India Act so that we are in a position to impound a part of the excess liquidity whenever necessary. I must, however, stress that the cash reserve ratio cannot be effective for very long if the Government continues the present arrangement of automatic monetisation of the budget deficit. This is because high cash reserve ratios entail payment of interest to banks to maintain their profitability and such interest payments materially reduce the effectiveness of the CRR instrument. Besides, a situation is created where resources tend to move away from banks to non-bank financial intermediaries which are not subject to such reserve requirements. What the cash reserve ratio would provide (if the ceiling is raised) is breathing time until a fundamental restructuring is undertaken of the arrangements for financing the budget deficit.

6. The trends in the budget deficit in the current financial year have been, to say the least alarming. As against an estimated budget deficit of Rs.7,337 crores for 1989-90, the deficit as on December 1, 1989 was

Rs.13,025 crores and the budget deficit has been above Rs.10,000 crores for the past 22 consecutive weeks. The increase in the net Reserve Bank credit to the Central Government in 1989-90, as on December 1, 1989, was Rs.12,748 crores. The growth of overall liquidity (M3) in 1989-90 between March 24, 1989 and December 1, 1989 was Rs.23,244 crores (12.1 per cent) as against Rs.18,377 crores (11.3 per cent) in the comparable period of last year. The growth of M1 (demand deposits and currency) was Rs.9,233 crores (13.9 per cent) this year as against Rs.3,907 crores (6.8 per cent) last year. The Cabinet Committee on Economic Affairs had approved an M3 target of 16.1 per cent as against last year's expansion of 17.3 per cent (on March 31 basis); current trends indicate that we could well exceed even last year's high monetary growth. Wholesale prices on a point-to-point basis in the current financial year upto December. 2, 1989 indicate an increase of 6.2 per cent as against 4.6 per cent last year. Unless some measures are taken to bring about a drastic reduction in the budget deficit, prices would show a sharp upsurge in the remaining months of the year. If the administered price adjustments, which are overdue, are put through we could well have a double digit inflation rate in 1989-90.

Financing of the Government in Other Countries

7. Before setting out a specific scheme for financing the budget deficit of the Central Government, I thought it would be pertinent to mention that in developed countries the central banks do not automatically monetise the budget deficit. A limited amount of the government's borrowing is in the form of Treasury Bills and these bills are placed in the market outside the central bank at market related interest rates. The central bank in the course of its open market operations freely buys or sells government securities bearing in mind its objectives of controlling liquidity in the system. In such a milieu, the central bank is able to have a far better control over liquidity as it can determine how much of primary liquidity to inject into the system. A basic precondition for such operations necessarily has

to be flexible interest rates on Government securities. In some countries, as part of a conscious policy, a budget surplus is planned so as to enable a net repayment of the outstanding public debt. In some other countries plans are afoot to direct the central bank, by an Act of Parliament, to hold inflation within a low rate of say two per cent and the central bank has the freedom to take such action as may be necessary to achieve this objective. Several developing countries have also moved away from automatic monetisation of the budget deficit.

8. A perusal of the provisions, in various countries, on central bank statutes on lending to Government reveal a common strand: (i) that the provisions are enabling and not mandatory, (ii) that the advances are essentially of a short-term nature to be repaid within clearly specified periods, (iii) that there are ceilings on outstanding borrowings from the central bank.

Legislative Aspects on Monetisation of the Budget Deficit in India

9. As already indicated in paragraph 2 above, the provisions in the RBI Act regarding the financing of the Government are enabling and not mandatory. At the present time, however, a practice has evolved under which the budget deficit is automatically monetised by the Reserve Bank. In view of the prevailing practice it is necessary to consider an explicit amendment to the Reserve Bank of India Act whereby the Reserve Bank shall not be subject to any directions by the Central Government regarding the Bank's holdings of Government securities (including Treasury Bills). This must be so notwithstanding any powers the Central Government may have to give_ directions to the Reserve Bank under Section 7 of the Act. Incidentally, to underpin the autonomy of the Reserve Bank, it is necessary to provide that any directive under Section 7 of the Reserve Bank of India Act would be issued with the consent of the Cabinet and that a copy thereof, along with a statement setting out the circumstances leading to the issue of the directive, shall be placed before Parliament within a stipulated time. If these proposals are agreed to in principle, a suitable amendment to the Act can be drafted.

Proposed Scheme for Financing
the Central "Government

10. In pursuance of the objective of phasing out the current system of automatic monetisation of the budget deficit, an understanding needs to be worked out between the Central Government and the Reserve Bank. The main ingredients of such an understanding could be as follows:

(i) The Central Government should adopt a medium-term strategy of bringing about a decisive turn-around in the overall budget deficit. As part of a phased programme, the overall budget deficit in 1990-91 should not exceed Rs.6,000 crores. During the subsequent three years the overall budget deficit should be progressively reduced till the budget deficit, as presently defined, comes close to zero. The longer term resource requirements of the Government should be met through floatation of dated securities and not Treasury Bills. The needs of the Government to cover temporary requirements for mismatches within the year between revenue receipts and expenditures could be met through Ways and Means advances from the Reserve Bank and Treasury Bills raised from the market. A limit must be set on the outstanding level of Ways and Means advances and once this limit is reached, further utilisation will be possible only to the extent of repayments. The arrangements regarding Ways and Means advances should be put in place from 1993-94 when the budget deficit is expected to reach the level close to zero.

(ii) The Reserve Bank of India should not be required to provide any support to the Government market borrowing programme starting from 1990-91. The Government should move towards a system of market related rates on Government securities and the rates of interest on bonds should be so adjusted as to enable the Government to place the entire debt in the market.

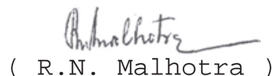
(iii) As part of the progressive effort towards placing the Treasury Bills outside the Reserve

Bank, the rate of interest on 182-day Treasury Bills should be allowed to move up from the present level. When the budget deficit reaches a point close to zero as envisaged earlier, the 182-day Treasury Bills auctions can be replaced by 91-day Treasury Bills auctions with market determined interest rates. At that point, the existing stock of 91-day Treasury Bills held by the Reserve Bank could be entirely funded into longer term securities.

11. I do recognise that the scheme I am recommending implies a fundamental change in the present system of financing of the Government. If, however, we are to keep inflation under control, you will kindly appreciate that there is an urgent need for an early cessation of automatic monetisation of the budget deficit. If the proposals set out above meet your broad agreement, the Ministry of Finance and the Reserve Bank could draw up a detailed programme of action. I would be glad to discuss this matter with you at your earliest convenience.

With best regards,

Yours sincerely,



(R.N. Malhotra)

Shri Madhu Dandavate,
Hon'ble Finance Minister,
Government of India,
New Delhi.

ANNEXURE I

Extracts from the Report of the Central Board of Directors on the Working of the Reserve Bank of India for the year ended June 30, 1989

11.37 Broadly, the three major objectives of economic policy are growth, social justice which implies a more equitable distribution of income, and price stability. While all of these objectives are relevant for monetary policy, price stability has to be its chief focus. This does not, however, mean that it cannot contribute to the attainment of other objectives. Credit and bank¬ing policy, particularly during the past two decades, through the various schemes of direct credit allocation and interest rate changes, has helped to promote such objectives as the promotion of the weaker sections of society and balanced regional development. Nevertheless, monetary policy is able to make a more effective contribution towards the objective of price stability than to the other objectives. The importance of price stability as an objec¬tive of economic and monetary policy is not, always, well appreciated. In some situations there is perhaps a trade-off between growth and inflation in the very short run. Over a longer time period growth cannot however be bought with the aid of higher prices and there is no evidence to show that a higher growth rate is associated with a higher inflation rate. In India quite the contrary is the case. In fact, it is price stability which provides the appropriate environment in which healthy and sustainable growth can occur. In an economy where a predominant proportion of the population operates in the unorganised sector with little protection against inflation, maintenance of price stability is intimately linked with social justice.

11.38 For regulating money supply, which in conjunction with real out¬put, determines the general price level, there has to be a reasonable degree of control over the creation of reserve money. Over the years, the practice has grown under which the entire budget deficit

of the Central Govern¬ment has been financed by the Reserve Bank leading. to an automatic monetisation of the deficit. This is in addition to whatever support the Reserve Bank may provide to the market borrowing programme. The Reserve Bank has, therefore, to address itself continually to the task of neutralis¬ing, to the extent possible, the expansionary impact of deficits. The increasing liquidity of the banking sector resulting from rising levels of reserve money has to be mopped up on a continuous basis. The task of absorbing the ex¬cess liquidity in the system has been done in the past mainly by increasing the cash reserve ratio. With the frequent and sharp increases, the cash reserve ratio has now reached its statutory limit.

11.39 An effective monetary policy would require the avoidance of the automatic monetisation of the budget deficits. As a step in this direction, the level of fiscal deficits as a proportion of GDP needs to be much lower than what it is now. This would enable better control over the regulation of money supply. Over the medium. term, however, beyond a mutually agreed ways and means accommodation from the Reserve Bank, Government. should aim at placing its entire debt in the market at appropriate interest rates. The attainment of this objective would be greatly facilitated by a substantial reduction of the Centre's revenue deficit. The overall economic policy framework would then improve and it would give to the Reserve Bank the necessary freedom to determine the level of reserve money creation and therefore the money supply depending on how the real factors in the economy are evolving, thus enabling it to play a more effective role in con-tributing to the objective of growth with price stability.

SECRET

D.O.RPCD.No.791/NB3(J)-89/90 28th April 1990

Report of the Agricultural
Credit Review Committee

Please refer to your D.O.letter No.7(60)/89-1N, dated 21st March 1990. A Task Force constituted under the Chairmanship of Dr.Ojha, Deputy Governor which included three representatives of Government of India (Additional Secretary, Banking and two Joint Secretaries from the Departments of Rural Development and Agriculture) had examined the draft final report of the Agricultural Credit Review Committee. The final report has been submitted by the Committee after taking into account the observations made by the Task Force. The major issues dealt with in the final report requiring priority considerations are (a) greater autonomy to the banks in financing anti-poverty programmes, (b) interest rates on agricultural advances, (c) the merger of the Regional Rural Banks with the sponsor banks, and (d) the suggestions for the setting up of the National Co-operative Bank of India, Agricultural and Rural Development Corporations for the Eastern and North Eastern Regions and a Crop Insurance Corporation. We have had the major recommendations examined in the Reserve Bank and your comments are contained in the statement enclosed. On some of the important issues we have the following views to offer.

2. Autonomy of banks in financing anti-poverty programmes

The Committee has observed progressive deterioration in the autonomy of commercial banks particularly in regard to financing of anti-poverty programmes. The commercial banks have been subject to several external pressures in the form of loan melas etc. According to the committee, mandatory credit by commercial banks which entails target setting, should not result in dilution of the accountability of the banks and to this end it is necessary that once policies have been laid down and targets set, there should be no interference by any

external authority in decision making so far as appraisal and sanction of projects and steps initiated for recovery of loans are concerned. It is also necessary to ensure that the targets set to subserve social objectives are within the bank's financial capacity to bear the risk involved. We are in agreement with the observations made by the committee. We must ensure greater autonomy to the banks in their lending decisions. Banks have already over-fulfilled the target of 40 per cent of their outstanding credit to the priority sectors. It is important that new targets for such lending are not fixed and that the tendency to require banks to lend under new special programmes at the highly unremunerative rate Of 10 per cent is eschewed. Practices like loan melas need to be eliminated. The present arrangements regarding recovery of bank dues are unsatisfactory inasmuch as State Governments' machinery for recovery is inadequate. Further, periodical announcements by various governments regarding across-the-board write-offs/reductions of dues vitiate the environment for recovery. Unless effective steps are taken to reverse these trends the viability of the rural lending system will remain under serious threat. It is also necessary to improve legal and administrative arrangements for recovery of dues.

3. Interest rates

The Committee has estimated the financial and transaction costs and the income realizable in agricultural lending by commercial banks, RRBs and co-operatives based on the interest rates existing before the budget of 1988 (when the interest rates were reduced to a minimum of 10 per cent on crop loans) and has recommended the gross margins required by each type of institution to provide for risk costs and a minimum surplus. These are summarised at item 2 of the statement enclosed herewith.

4. The deficit in the margins available in the case of commercial banks has been estimated by the Committee at 2.86 per cent on their agricultural advances (this would have risen by about 1.5 per cent after the March 1988 reduction in the minimum short term interest rate from 11.5 per cent to 10 per cent and the increase in

guarantee fee charged by the Deposit Insurance and Credit Guarantee Corporation). The Committee's approach is that the gross margin recommended by it is necessary for the institutions to attain viability in their agricultural credit operations. They also feel that the institutions capable of cross-subsidisation from other operations should be able to live with somewhat lower gross margins. The Committee has, therefore, recommended raising the interest rates and in doing so has stated that there should only be two sets of rates of interest as far as agricultural loans are concerned. The concessional rate of interest for small and marginal farmers should be at 1.5 per cent above the highest rate of interest on deposits allowed by scheduled commercial banks (this would work to a minimum rate of interest of 11.5 per cent) and that the higher rates of interest with a ceiling of 15.5 per cent (which is the existing maximum rate of interest for short-term agricultural advances) be charged to other borrowers. It is to be presumed that the Committee expects a substantial reduction in the deficit in the margins by raising the interest rates as above and also that the remaining deficit, if any, will be made good through cross-subsidisation from other than agricultural advances. If the Committee were aware that the deficit in the gross margin would in the event turn out to be higher, they might have suggested further jacking up of. the interest. The present interest rate structure for Short-term agricultural advances varies from 10. per cent to 15.5 per cent. The rates of interest for term loans for agricultural advances are 10 and 12.5 per cent. In the case of DRI loans the rate of interest is four per cent per annum.

5. In the light of the detailed examination made by the Committee we agree with it that interest rates on agricultural advances have to be raised to improve the viability of lending institutions. We also agree that under our conditions a degree of concessionality in interest rates to the weaker sections is unavoidable. The World Bank staff who have had discussions on the report with the RBI and NABARD in December 1989 also seem to have taken this view, though they have expressed reservations on some rates which they regard too far

below market rates on the ground that they might result in excessive demand and diversion of credit to unproductive purposes. They seem to feel that the minimum rate should not be below 12.5 per cent, provided the overall margin in agricultural lending could be protected through higher rates for other borrowers. We, however, feel that the World Bank's reservations could be substantially overcome, if the concessional rate is fixed at 11.5 per cent, as recommended by the Committee. This was the rate applicable to the lowest slab of short-term agricultural advances till it was reduced to 10 per cent in March 1988. We are of the opinion that the proposed interest rate structure would reduce to some extent the losses suffered by the banks in their lending to the weaker sections.

6. We also feel that the benefit of concessionality in interest rates should be extended not only to small and marginal farmers but also to all categories of small borrowers including artisans. Accordingly, all advances both short-term and term loans, granted to all categories of borrowers including those assisted under special programmes like IRDP,SEEUY and SEPUP upto an amount of Rs.25,000 could carry a rate of. interest of 11.5 per cent.

7. In my detailed D.O. letter NO.CPC.2197/279A-90 dated 16th February 1990 addressed to you on the restructuring of scheduled commercial banks' lending rates we have suggested an alternative system of administered lending rates wherein the present practice of prescribing specific rates for specific programmes/ lending would be discontinued and the element of concessionality would be directly and exclusively linked to the size of the loan while determining the structure of lending rates. In that letter too a uniform rate of 11.5 per cent has been suggested for loans upto Rs.25,000. You would recollect that this matter was subsequently discussed by us and we came to the tentative conclusion that if Government find it difficult to raise the present rate of 10 per cent to 11.5 per cent, one way could be to charge 10 per cent on loans upto Rs.7,500 and 12 per cent on the next slab upto Rs.25,000. Another conclusion was that on higher slabs

the interest rates suggested by us could be prescribed. The adoption of such rates would generally be less than those proposed by the Khusro Committee but could, nonetheless, afford a reasonable basis for discussion of future World Bank/IDA loans to NABARD.

8. The Committee has recommended the abolition of the DRI Scheme because of the anomalous situation under which commercial banks are required to lend to weaker sections under two parallel programmes, one at the higher rate of 10 per cent under IRDP with subsidy and the other at the lower rate of four percent under the DRI Scheme. The banks sustain a loss of about Rs.50 crores per annum on their DRI loans. The DRI Scheme has outlived its utility and we may accept the recommendation of the Committee to discontinue it. The beneficiaries eligible under DRI Scheme may be assisted under IRDP in rural areas and the SEPUP in other areas.

9. The Committee has recommended that if the interest rates for any category of borrowers are fixed, in pursuance of Government policy, at below the financial costs plus transaction costs, the shortfall in the interest actually charged and the economic rate should be made good to the institutions by the Government. While there may be no need to provide a subsidy to the commercial banks under the proposed interest rate structure, the subsidy to be provided by the Government, assuming no change in the pre-March 1988 deficit level of 2.86 per cent in the margin on outstanding direct agricultural advances of Rs.13,500 crores would be of the order of Rs.400 crores.

10. In the case of RRBs the deficit in margin available is high at 5.45 percent. As the RRBs lend exclusively to the weaker sections, their ability to cross-subsidise is practically non-existent and according to the Committee, the RRBs' economic rate of lending would be 16.45 per cent. Since this will not be possible, the RRBs would hardly ever become viable.

11. The Committee has estimated the deficit in the gross margin available to the primary agricultural credit co-operative societies at 3.81 per cent and the primary land development banks at 2.61 per cent. The

short-term co-operative credit structure represented by the State Co-operative banks, the District Central Co-operative Banks and the Primary Agricultural Credit Societies depends largely for their resources on the refinance provided by RBI through NABARD. Over the years the general line of credit extended by the RBI to NABARD has increased -- from Rs.1,200 crores in 1982-83 to Rs.3,350 crores in 1989-90 -- and nearly 40 per cent of the outstanding short-term loans of the primary agricultural credit societies is out of the refinance availed of by them from NABARD. In March 1988 when the interest rates on short-term agricultural advances were reduced by 1 to 2.5 percentage points, as desired by the Government of India, the Reserve Bank/NABARD had to reduce the rate of interest on the general line of credit to the State Co-operative Banks from seven to three per cent for compensating the losses incurred by the short-term co-operative credit structure.

12. As the rate of interest to the ultimate borrowers, whether they borrow from the commercial banks or co-operative banks or RRBs, is uniform, the modification in the interest rate structure now proposed by us would also apply to the co-operatives. The raising of the lending rate to 11.5 per cent for loans upto Rs.25,000 would make it possible for the co-operatives to increase their involvement in agricultural loans because of better return and our estimate is that their involvement in the short-term agricultural loans could go up by Rs.750 crores to Rs.1000 crores(However, if only 10 per cent is charged on loans upto Rs.7,500 the return to the co-operative institutions will get considerably reduced). As a substantial portion of the loans in the case of co-operative banks would come within the range of Rs.25000, their ability to cross-subsidise by charging higher rates of interest on larger advances is limited. Hence, the deficit in the interest margin in their case even after raising the rate of interest to 11.5 per cent would be around Rs.300 crores on the present level of their advances. It would be around Rs.200 crores in the case of the RRBs. It would be necessary for the Central and State Governments to make good the deficit by way of subsidy to these institutions. The quantum of

subsidy would go up with the increase in agricultural advances which are growing at about 15 per cent per annum in the case of co-operatives.

13. Regional Rural Banks

The financial viability of a vast majority of RRBs has been seriously eroded and they are increasingly unable to deliver credit to the target groups. The accumulated losses of RRBs have been going up every year. They have increased from Rs.133 crores at the end of' December 1987 to Rs.180 crores in respect of 183 reporting RRBs out of a total of 196 RRBs at the end of 31st March 1989. As a result, the paid up capital and reserves of 153 RRBs amounting to Rs.59 crores and deposits of 103 RRBs amounting to Rs.121 crores have been eroded. Besides, but for a few RRBs which have worked well the functioning of most such banks leaves much to be desired. In this context we had urged an early decision in regard to the merger of RRBs with the sponsor banks (vide copies of my D.O.letters RPCD.No.NB.799/RRB.10-88/89 dated 10th April 1989 addressed to Shri S.B.Chavan, the then Finance Minister and RPCD.No,NB.273/RAB.10-89/90 dated 19th October 1989 addressed to Shri G.K.Arora, the then Finance Secretary). Although the initial cost to the commercial banks would go up as a result of the merger, the quality of operations will improve and the sponsor banks would be able to provide a measure of cross-subsidisation.

14. Setting up of new Institutions

We do not accept the Committee's recommendations for establishing the National Co-operative Bank of India and the Agricultural and Rural Infrastructure Development Corporations and the concept of only one commercial bank branch for each block. Our detailed comments on these and other major recommendations of the Committee are given in a statement enclosed.

15. The World Bank/pre-appraisal mission which had held discussions with NABARD in December 1989 had given the impression that they would be willing to consider a funding arrangement of approximately $ 700 million for three years. They seem to have left hints that their main concern would be for viable interest

rates which they would prefer to be not less than 12.5 per cent at the minimum. Although it may be difficult for the Government at this stage to give any advance assurance of a minimum interest rate for agricultural and rural development lending, Government may like to inform the World Bank that it is confident of arriving at a mutually acceptable position regarding this issue when the appraisal mission enters into discussions with Government. I suggest that an invitation may be extended to the World Bank for a pre-appraisal mission.

With best regards

Yours sincerely,

(R.N. Malhotra)

Dr. Bimal Jalan,
Finance Secretary,
Government of India,
New Delhi.

गवर्नर
GOVERNOR

भारतीय रिज़र्व बैंक
केन्द्रिय कार्यालय,
बंबई
RESERVE BANK OF INDIA
CENTRAL OFFICE
BOMBAY

G.20.561/90 18th May 1990

My dear Bimal,

Legislation on the Securities
and Exchange Board of India (SEBI)-
Regulation of Capital Market

With a view to ensuring the growth of the capital market along healthy lines the Government has been considering measures to strengthen the regulatory framework relating to Stock Exchanges and the Securities industry. Some time back, the Securities and Exchange Board of India (SEBI) was set up as a non-statutory body. I understand it is now proposed to convert this Board into a statutory body. Meanwhile, the question of the regulation of the financial system including the securities market has also been engaging the attention of the Reserve Bank of India and I would like to share with you some of our views on the subject.

2. In recent years, the Indian financial market has been undergoing significant and rapid changes. The financial sector is emerging as a key sector of the economy and the market, from the short end to the long end, is developing into a continuum. Though the sector is loosely divided into (a) the banking sector, (b) non-banking financial companies (including leasing, hire purchase and investment companies, most of which are deposit takers) and (c) the capital market (including stock exchanges, brokers, market makers and other intermediaries), financial institutions are no longer confined to operations in any one segment of the market. Banks and their subsidiaries have extended their activities into new areas such as merchant banking, underwriting, investment, leasing, mutual funds, portfolio management

and venture capital funds. Some subsidiaries of banks have become corporate members in the stock exchanges. The interface of banks with the capital market, whether directly or through subsidiaries or associates, is increasing. I have no doubt that as the capital market develops iris size and sophistication, the number and role of institutional members of stock exchanges - mainly banks or their subsidiaries or other associated companies - will grow. At the same time, non-banking financial institutions such as the Unit Trust of India, the Life Insurance Corporation, the General Insurance Corporation etc. have also become lenders, usually in combination with term lending institutions, but also on their own, particularly in the money market. Insurance companies too have entered activities like mutual funds and housing finance through their subsidiaries. Private sector financial companies offering a variety of services are also springing up. These developments which are increasingly characterized by desegmentation of the financial market have important implications for the kind and structure of the regulatory system which we should build.

3. The regulatory systems for overseeing the financial markets in various countries have traditionally developed in the context of the rigid segmentation of financial institutions and activities. For instance, in the United States the Glass Steagall Act provided for almost total separation of commercial banks from investment and securities companies. This separation was also replicated in Japan in the post-war period. It is therefore not surprising that in these countries there are different regulators for the securities businesses and banks. In the United Kingdom the stock exchanges were the concern of the Department of Trade while the Bank of England and the commercial banks were associated with the Treasury. This again appears to have influenced the dichotomy in regulatory institutions for the banking sector and the securities businesses. In several countries the regulation of capital markets has been left essentially to stock exchanges acting as self regulating organisations. There have been, however, conflicts between different regulatory agencies necessitating resort to coordination mechanisms such as

the development of the concept of lead regulator for the Bank of England in respect of bank subsidiaries and deposit taking companies. The conflicts have, however, not been easy to resolve and in any case entail confusion and delays. Perhaps some difficulties have already been encountered in devising the scope and role of SEBI.

4. The need to regulate the securities market in the interest of investors, to specify and enforce disclosure requirements and to prevent insider trading and fraudulent and unfair trade practices, is well recognised. In setting up an appropriate regulatory system, however, we must take into account the fast changinq nature of the financial markets, particularly the multiplicity of financial services which financial institutions are increasingly undertaking and the blurring of distinctions between institutions and market segments. More integrated markets would call for integrated supervision and avoidance of multiplicity Of regulatory agency. It is desirable that the entire market, including the constituents in the capital market, is subject to regulation and supervision by a common authority which appropriately is the central bank of the country. Multiple authorities exercising supervision independent of each other, over various overlapping segments of the market will inevitably lead to conflict of jurisdiction and confusion which can be avoided.

5. While the supervision and control of the banking sector has been the major pre-occupation of the Reserve Bank of India, it has also been given wide powers under Chapter IIIB, Section 45L, of the Reserve Bank of India Act to enable it to exercise a comprehensive oversight over the financial system. I enclose a copy of Section 45L ibid for ready reference. According to that Section, if the Reserve Bank is satisfied that for the purpose of enabling it to regulate the credit system to its advantage it is necessary so to do, it may require financial institutions to furnish statements, information or particulars relating to the business of such financial institutions and to give such institutions directions relating to the conduct of business by them. In issuing such directions to any financial

institutions, the Reserve Bank shall of course, have due regard to the conditions in which, and the objects for which, the institution has been established, its statutory responsibilities, if any, and the effect the business of such financial institution is likely to have on trends in the money and capital markets. Section 45L empowers the Reserve Bank to carry out inspection of any non banking institution, including a financial institution, if it is necessary or expedient to do so. The expression "Financial Institutions" has been defined in Clause (C) of Section 45(1) of Reserve Bank of India Act. A copy of the aforesaid clause (C) is also enclosed for ready reference. It will be seen therefrom that the expression "Financial Institutions" has been widely defined and covers any non-banking institution carrying on the activities, inter alia, of financing by way of making loans or otherwise of any activity other than its own, the acquisition of shares, stocks, bonds, debentures, letting goods on hire purchase and insurance business.

6. The statement of objects and reasons for the amendment introducing Chapter IIIB in the Reserve Bank of India Act inter alia states:

> "The Reserve Bank of India should also be empowered to give to any financial institution or institutions directions in respect of matters, in which the Reserve Bank, as the central banking institution of the country, may be interested from the point of view of the control of credit policy."

While moving the Bill in the Lok Sabha on December 19, 1963, the then Minister of Planning observed:

> "We also intend that the activities of loan, investment and hire-purchase companies or firms, or other financial institutions, which grant loans and advances for a variety of purposes, or purchase securities or shares and thereby influence or affect the money and capital markets, should be controlled by the central bank of the country, so far as these activities are concerned.....".

(emphasis supplied)

Clearly the intention of the law has been that the central banking authority of the country should exercise comprehensive oversight over the financial system as a whole. Since the Reserve Bank authorised the establishment of bank subsidiaries carrying out merchant banking, investment and other financial services, it has been exercising its powers of supervision under Section 45L ibid through inspections. There is a growing consensus among bank supervisers the world over that banks and their subsidiaries or associates should be subjected to consolidated supervision and the Reserve Bank of India has already initiated steps in that direction. As regards other financial institutions the Reserve Bank of India has so far confined itself to informal discussions with them. However, considering the large size of operations of several financial institutions and their impact on the credit and monetary area and the capital market, it has become essential to exercise a more structured supervision over them. A committee of the Reserve Bank is currently devising formats for calling periodical information from selected financial institutions. These formats will be discussed with the heads of _the institutions concerned shortly. I also intend to have consultations with the heads of these institutions on a structured basis at suitable intervals. The quality of assets of many financial institutions, the cost of their funds and rates of interest charged by them also call for a close look for assessing their financial health so that they continue to perform their functions under the relevant statutes effectively. For this purpose, we intend to institute a system of annual financial reviews of important institutions. Another objective would be. to improve, where necessary, co-ordination of these institutions with commercial banks.

7. Considering the scope of the Reserve Bank's powers over commercial .banks as well as financial institutions (as explained above) two different authorities laying down prescriptions in relation to securities industry and financial institutions providing various services can create areas of conflict. Thus, from the point of view of overall credit policy as well as the need to avoid supervisory overlap, it is my view that the regulation of the security industry as envisaged under

the contemplated legislation of SEBI should become a direct responsibility of the Reserve Bank. Even from the operational point of view, there is an advantage in the Reserve Bank of India being entrusted with this responsibility. The Offices of the Reserve Bank of India are located at all important State capitals and there is already a well developed machinery for inspection operating in the Bank which can easily handle the additional tasks with some limited re-organisation. Instead of creating a new institution, it will be economical to use the facilities that now exist in the Reserve Bank. With the authority of the Reserve Bank behind it, there would be greater compliance of the directives and regulations issued. As I have already indicated, in countries where different supervisory authorities have evolved over time, there is a conscious effort now to bring about greater co-ordination among them. The Indian situation is different. In relation to some segments of the financial is system like the securities markets, there is as yet no comprehensive supervisory authority. Instead of creating a new one and then finding ways and means for achieving co-ordination among different authorities, it will be advisable to let the central bank exercise directly this power. The Reserve Bank is in a position to undertake this work soon. It can also absorb whatever trained manpower has been developed in the SEBI. I suggest that the Government may consider these recommendations early. I would like to discuss the matter with yourself and the Finance Minister.

With kind regards,

Yours sincerely,

(R.N. Malhotra)

Dr.Bimal Jalan,
Finance Secretary,
Ministry of Finance,
Government of India,
Department of Economic Affairs,
New Delhi.

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AGENDA

EBS/91/143

CONFIDENTIAL

August 27, 1991

To: Members of the Executive Board

From: The Secretary

Subject: India - Request for Stand-By Arrangement - Letter of Intent and Memorandum on Economic Policies

Attached for consideration by the Executive Directors is the letter of intent from the Indian authorities requesting a stand-by arrangement equivalent to SDR 1,656 million, together with a memorandum on economic policies for 1991/92-1992/93. The staff report for the 1991 Article IV consultation with India and its request for a stand-by arrangement will be circulated later.

Mr. Neiss (ext. 7604) or Mr. Goldsbrough (ext. 4735) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

Att: (1)

New Delhi, India
August 27, 1991

Dear Mr. Camdessus,

The attached Memorandum on Economic Policies sets out the economic program of the Government of India for the period 1991/92-1992/93. In support of this program, the Government requests an 18-month stand-by arrangement in an amount equivalent to SDR 1,656 million. The Government also intends shortly to request an additional purchase under Section V of the decision on the compensatory and contingency financing facility (CCFF) with respect to any remaining excess in oil import costs or shortfall in merchandise and remittance earnings for the shortfall year that ended July 31, 1991. At a later stage, the Government intends to enter into discussions on a comprehensive medium-term structural adjustment program, supported by an arrangement under the extended Fund facility.

The following quarterly performance criteria for 1991/92 are proposed to monitor progress under the program (Table 1): (a) ceilings on the overall borrowing requirement of the Union Government; (b) ceilings on the net domestic assets (NDA) of the Reserve Bank of India (RBI); (c)a subceiling on RBI credit to the Union Government; and (d) floors on net official international reserves. Indicative magnitudes of these variables for 1992/93 are also proposed and, at the time of the first review, quarterly performance criteria for 1992/93 will be established. During the course of the program, the Government will refrain from imposing new or intensifying existing restrictions on payments and transfers for current international transactions, or introducing or modifying multiple currency practices, or concluding bilateral payments arrangements with Fund members inconsistent with Article VIII, or imposing new or intensifying existing import restrictions for balance of payments reasons.

Three reviews of the program will be conducted. The conclusion of the first review, which is to be completed by March 31, 1992, will depend, inter alia, on the reaching of understandings on the 1992/93 budget, on the establishment of quarterly performance criteria for the remainder of the program period, as well as understandings on: (i) the formulation of a program for tax reform, including concrete measures proposed for the 1992/93 budget and a timetable of action for the medium term; and (ii) the introduction of a detailed tracking system for all categories of expenditures and a system of quarterly expenditure reviews. The second and third reviews of the program will be completed by September 30, 1992 and March 31, 1993, respectively.

The Government of India believes that the policies set forth in the Memorandum are adequate to achieve the objectives of the program, but will take any additional measures appropriate for this purpose. In addition, the Government will consult with the Fund on the adoption of any measures that may be appropriate in accordance with the policies of the Fund on such consultations.

Sincerely yours,

Manmohan Singh
Minister of Finance

Attachment

Mr. Michel Camdessus
Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Memorandum on Economic Policies for 1991/92-1992/93

1. The new Government that took office on June 21, 1991 inherited an economy in deep crisis. The balance of payments situation was precarious, with reserves at a low level and the weakening of international confidence having resulted in a sharp decline in capital inflows through commercial borrowing and nonresident deposits. Inflation had reached double digits, hurting most the poorer sections of our society; and there were signs that economic growth had begun to slow somewhat as the shortages of imports and political uncertainty began to affect production and investment. The origins of these problems are directly traceable to large and persistent macroeconomic imbalances, most notably the unsustainably large fiscal deficits, and to the low productivity of past investments. The crisis in the Middle East had exacerbated the situation by contributing to a higher oil import bill in 1990/91 and the temporary loss of export markets and remittance earnings.

2. The new Government, recognizing that there was no time to lose, immediately adopted a number of stabilization measures that were designed to restore internal and external confidence. Thus, monetary policy was tightened further through increases in interest rates, the exchange rate of the rupee was adjusted by 18.7 percent, and a major simplification and liberalization of the trade system was announced. It is the Government's intention, as announced in the Budget speech to Parliament on July 24, 1991, to complement these initial measures by a comprehensive program of economic adjustment. The centerpiece of the economic strategy will be a substantial fiscal correction in the remainder of the current fiscal year and in 1992/93, to be followed by continued fiscal consolidation thereafter. The reduction in fiscal imbalances will be supported by reforms in economic policy that are essential to impart a new element of dynamism to growth processes in the economy. The thrust will be to increase the efficiency and international competitiveness of industrial

production, to utilize foreign investment and technology to a much greater degree than in the past, to improve the performance and rationalize the scope of the public sector, and to reform and modernize the financial sector so that it can more efficiently serve the needs of the economy. During the inevitable period of transition, it is the Government's firm intention that the poorest sections of society are protected to the maximum extent possible from the costs of adjustment.

3. Key macroeconomic objectives (Table 2) will be (i) economic growth in the range of 3-3 1/2 percent in 1991/92 followed by a gradual recovery in 1992/93; (ii) an inflation rate of no more than 9 percent by end-1991/92 and no more than 6 percent by end-1992/93; indeed, the Government will strive for an even more rapid reduction in inflation during the course of 1991/92; and (iii) an easing of the present critical payments situation and a rebuilding of gross international reserves from the extremely low level of about three weeks of imports at end-July to over 1 1/2 months by the end of 1992/93. 1/ In particular, there is an urgent need to rebuild foreign exchange reserves from their current critically low level ($1.3 billion) to about $2.2 billion by end-1991/92.

4. Taking account of the sizable new investments and related imports that will be needed to support the restructuring of the economy, the external current account is targeted to decline from about 3 1/2 percent of GDP in 1990/91 to about 2 1/2 percent of GDP in 1991/92 and 1992/93. 2/ In order to provide room for an expansion in private investment to take advantage of the new opportunities created by the structural reforms, and to allow for a likely

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1/ According to the IMF definition, i.e., including SDR holdings and with gold valued at SDR 35 per ounce.

2/ These targets refer to the IMF definition of the external current account. According to the official Indian definition, the external current account would decline from 2.5 percent of GDP in 1990/91 to about 2.1 per¬cent in 1991/92 and 2.0 percent in 1992/93.

temporary decline in the private savings ratio, the reduction in the public sector deficit, which will initially be brought about by a reduction in the fiscal deficit of the Central Government, will be larger than the adjustment in the external current account.

Fiscal policy

5. Our medium-term objective is to progressively reduce the overall public sector deficit 3/ from an estimated 12 1/2 percent of GDP in 1990/91 to about 7 percent of GDP in the mid-1990s, a level that we judge to be consistent with external viability and the goal of ensuring adequate private sector resources to respond dynamically to the opportunities created by the structural reforms. In line with this objective, we aim to reduce the Union Government deficit 4/ to 6.5 percent of GDP in 1991/92 and 5 percent in 1992/93, which will include a substantial decline in Union Government net transfers to the rest of the public sector, most notably to central public enterprises.

6. The interim budget presented to Parliament in March 1991 aimed for a deficit of about 6.5 percent of GDP, but a number of the measures needed to attain this target were not formulated. Consequently, the postponement of the regular budget has made fiscal adjustment in 1991/92 even more difficult because almost four months of the financial year have elapsed without a comprehensive fiscal correction effort. The required adjustment is about 2 1/2 percentage points of GDP. We expect a swing from deficit to surplus in the accounts of the Oil Coordination Committee as a result of higher domestic petroleum prices to contribute about 0.4 percentage points of GDP. About half of the remaining adjustment will be achieved by

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3/ Defined to include the Union Government, the Oil Coordination Committee (O.C.C.), States, Union Territories and internal and extrabudgetary resources of central and state enterprises for financing their capital expenditure.

4/ Including the balance in the accounts of the Oil Coordination Committee.

lowering expenditures and about half from higher tax and nontax revenues.

7. Total expenditures and net lending are targeted at a little over 19 percent of GDP in 1991/92--a decline of about one percentage point. The bulk of the savings are to be achieved from lower expenditures on subsidies, moderation in defense spending, cuts in transfers to public enterprises, and restraint on other current and capital spending. Cash export subsidies on new shipments were eliminated with effect from July 3, 1991; fertilizer prices were raised by 30 percent in August (with special arrangements to cushion the impact on small and marginal farmers); the subsidy on sugar was eliminated by raising the issue price under the public distribution system by about 16 percent; and subsidies on foodgrains will be held broadly unchanged as a share of GDP. In all, these measures will reduce the major subsidy payments from 1.9 percent of GDP in 1990/91 to 1.5 percent of GDP in 1991/92; on a full-year basis, the savings will be considerably greater (about 1 percent of GDP). Budgetary support to central public enterprises is budgeted to decline from 1.5 percent of GDP in 1990/91 to 1.2 percent of GDP in 1991/92. Two considerations will guide our approach to expenditure policy. First, no area of government spending should be exempt from scrutiny in the effort to achieve fiscal correction. Second, the benefits of the recent exchange rate adjustment should not be eroded by inflation. At the level of the departments, no additional budgetary provision has been made for cost-of-living increases ("dearness allowance"); any increases will have to be financed from savings on departments' other expenditures.

8. During the remainder of the financial year, there will be no net additions to expenditures through supplementary appropriations, other than those supported by matching savings or additional receipts. Beyond this, we plan to have strengthened expenditure monitoring and control procedures in place by the time the 1992/93 budget is presented to Parliament.

9. Total revenue as a share of GDP is targeted to rise by over one percentage point (to about 12 1/2 percent) in 1991/92. Additional tax measures with an estimated gross revenue yield equivalent to 0.5 percent of GDP have been adopted in the 1991/92 budget. Important new measures include a 5 percentage point increase in the corporate tax rate; a reduction in generous depreciation allowances that have tended to encourage capital-intensive methods of production; a tax on the gross interest receipts of banks; and increases in excise duties, especially for consumer durables and other products that are purchased primarily by the affluent sections of society. At the same time, we have taken some initial steps to rationalize the structure of import tariffs and to broaden the base and strengthen the collection of direct taxes. The ad valorem rate of basic plus auxiliary customs duties has been reduced to a maximum of 150 percent; many of the increases in auxiliary customs duties introduced in December 1990 have been partially or fully rolled back; and rates of import duty on general capital goods and their components have been reduced by 5 percentage points (to a range of 65-80 percent). To strengthen tax collection, the system of deduction at source is being extended to cover interest income, commissions,and withdrawals from the National Savings Scheme; and a major loophole in the wealth tax has been plugged. With regard to nontax receipts, Rs.25 billion (0.4 percent of GDP) will be generated from the planned sale to mutual funds of shares in a number of public enterprises (paragraph 30).

10. In order to ensure that the objective of reducing the fiscal deficit of the Central Government to 6.5 percent of GDP in 1991/92 is achieved, notwithstanding any unanticipated adverse developments during the course of the year, the Government intends to take additional measures, on both the revenue and expenditure sides, resulting in an estimated adjustment of Rs 20 billion (0.3 percent of GDP). These additional measures will be implemented in stages, in the light of budgetary developments, and

will be in place by December 31, 1991. The nature of the additional measures will be in keeping with the Government's policy of achieving a sustainable fiscal deficit reduction.

11. Our target for reducing the fiscal deficit of the Union Government to 5 percent of GDP in 1992/93 is an ambitious one, but we are determined to take all possible measures to achieve this objective. Reduction of the fiscal deficit would yield desired results only when the method of bringing about such reduction is in harmony with reforms in economic policy and economic management. We intend, therefore, to formulate policy proposals in a number of areas. We intend to initiate a process of comprehensive tax reform with the object of broadening the base of taxation, reducing levels of and dispersion in import duties, improving compliance and modernizing the entire system of tax administration. We will take a fresh look at the whole area of expenditure, and no major category should be exempt from scrutiny. Particular emphasis would be given to transfers and loans to public enterprises. The aim is to tighten their budget constraint and improve their efficiency and viability. We hope that norms of fiscal discipline being set by the Central Government would find acceptance by the State Governments as well. There is need for further rationalization and reduction of subsidies. Our aim should be to move to a more objective system of administered prices, as indicated in paragraph 16, that takes into account world market developments and domestic supply conditions. We would have a major thrust for a more efficient expenditure control system. With this end in view, a thorough review of the existing system will be undertaken to remove existing deficiencies and to significantly strengthen its effectiveness. Thus, fiscal adjustment in 1992/93 will not only be of a substantial magnitude, but will also be anchored to measures and policies that would have a sustainable impact on future fiscal consolidation.

12. In consonance with the fiscal consolidation of the Union Government, it is our hope that the State Governments will move in a similar direction

to correct their fiscal imbalances. We will encourage them to take steps to improve their fiscal performance and streamline the working of their enterprises. In particular, renewed efforts will be made to address the financial difficulties of the State Electricity Boards through improved efficiency and a rationalized tariff structure. This would also enable them to ensure prompt payment of dues to central public sector undertakings, especially the power generation companies. Our overall strategy for the central public enterprises is outlined in paragraph 29. As a result of these efforts to improve efficiency and profitability, we expect the internal resource generation of the central public sector enterprises to improve significantly in 1991/92. This will permit a reduction in budget support even while their capital spending is expected to increase. The aggregate deficit of all central public enterprises is projected to fall from 3 1/2 percent of GDP in 1990/91 to 3 percent in 1991/92. As part of our endeavor to introduce a hard budget constraint for the enterprises, no increase in budget support 1/ during 1991/92 beyond the budget figures will be considered, barring exceptional circumstances where matching savings would be found.

Monetary policy

13. A restrictive monetary policy will be pursued in order to reduce inflationary pressures and support the targeted balance of payments improvement. Such a policy, in conjunction with the lowering of the public sector's claims on resources, is both an essential corollary of exchange rate stability and the only way to achieve a lasting reduction in interest rates. Monetary policy has already been tightened considerably during 1991. Thus, in April a number of interest rates were increased, the incremental nonfood credit-deposit ratio was lowered, and an additional 10 percent cash reserve requirement was imposed on increases in deposits. A further across-the-board

1/ Net of the impact of exchange adjustments on the rupee value of aid receipts.

increase of one percentage point in deposit interest rates was implemented in July, and the minimum loan rate for nonpreferred credits was also raised from 17 percent to 18 1/2 percent. For 1991/92, broad money (M3) growth of 13 percent has been targeted, consistent with the output and inflation targets. Taking account of the impact of the new incremental cash reserve requirement, reserve money has been targeted to rise by 15 1/2 percent. A further slowdown in the growth of broad and reserve money (to 11-12 percent) will be sought in 1992/93. The monetary program for 1991/92 specifies quarterly ceilings on the net domestic assets (NDA) of the Reserve Bank of India (RBI) as well as on net RBI credit to the Union Government (Table 1). The projected NDA levels are consistent with a targeted improvement of about $1 billion in gross official foreign exchange reserves between end-June 1991 and end-March 1992. Quarterly floors for net official international reserves in 1991/92 have also been established.

14. In implementing its monetary and credit policies, the, RBI uses both indirect, market-oriented mechanisms that operate through their effect on reserve money growth and commercial bank liquidity as well as the existing instruments that influence more directly the overall magnitude and composition of credit growth. In line with the overall thrust of financial sector liberalization, described in paragraph 32, the RBI intends to rely increasingly on indirect policy instruments. Therefore, interest rate policy will be used flexibly to manage the balance of payments and to achieve the desired deceleration in inflation. In particular, the RBI will act decisively to tighten monetary policy should net official international reserves fall below the targeted floors.

Pricing policies

15. With a view to reducing budgetary subsidies and promoting a more flexible price structure, the Government recently announced increases in a number of administered prices including for important inputs (petroleum products and fertilizer); for services (such as railway fares); and for agricultural

commodities (such as sugar). Beyond this, our pricing policies will aim at imparting greater flexibility in all areas, and public enterprises will be given greater freedom in setting prices according to market forces--a step that will need to be coordinated with the phasing of trade liberalization and the promotion of increased domestic competition. Detailed plans will be announced at the time of the first review.

16. Average domestic petroleum prices were increased by a cumulative 38 percent in 1990 and were not lowered again as world market prices fell in early 1991. Further price changes were announced at the time of the presentation of the 1991/92 Budget to Parliament: a 20 percent increase for motor spirit (gasoline), aviation fuel, and LPG for nonindustrial use; no change for diesel; a 10 percent reduction for kerosene for nonindustrial uses; and a 10 percent increase for all other petroleum products. The reduction in kerosene prices reflects the importance of this item in the consumption basket of the poor and the Government's determination to cushion the impact of the adjustment process on this segment of Indian society. On a weighted average basis, the price changes amount to a 7 percent price increase and are sufficient to ensure that, at prevailing world market prices, total oil-related fiscal receipts, 1/ will not be reduced as a result of the recent exchange rate action. The accounts of the Oil Coordination Committee are now projected to record a small surplus. In line with the general policy described in paragraph 15, the Government intends to evolve a system for the pricing of petroleum products that provides for periodic adjustments in the light of developments in the world market and domestic supply conditions.

External policies

17. An exchange rate policy that safeguards competitiveness is a crucial element of our economic program. Shortly after the new Government assumed office, the RBI adjusted downward in two steps the

1/ Accruing to the Union budget and the Oil Coordination Committee.

value of the rupee by 18.7 percent against the U.S. dollar in order to improve the international competitiveness of exports and to bring about a more orderly compression of imports. This adjustment will help check the flight of capital, encourage the repatriation of outstanding export receipts and remittances, and thereby help to stabilize the balance of payments. Following this realignment of the rate, the Government intends to hold the nominal effective exchange rate stable by relying primarily on monetary and fiscal policy to maintain competitiveness and ensure the balance of payments objectives.

18. The Government's stabilization and import compression measures are expected to reduce the external current account deficit to 2.7 percent of GDP in 1991/92. 1/ Import volumes would decline by about 5 percent, while export earnings are expected to gradually resume the growth that was interrupted in 1990/91, in reflection of the improvement in competitiveness, the resumption of exports to the Middle East, and better demand conditions in industrial countries. The capital account, however, is expected to deteriorate substantially in 1991/92 because of the curtailment in access to commercial capital markets and the outflow of nonresident deposits and short-term capital that took place during the first quarter of the fiscal year. As a result, despite the improvement in the current account, an exceptional financing need of about $4 billion is expected for 1991/92. 2/ Part of this amount ($870 million) has already been covered from various sources, including

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1/ To 2.1 percent of GDP according to the official Indian definition.

2/ The size of the remaining compensable amount under the CCFF, and hence the size of the requested purchase, are larger than anticipated at the time of the discussion on the program (SDR 468.9 million compared with an earlier estimate of SDR 314.4 million). Under the program, the difference, amounting to $220 million, has been added to the targeted gross reserve accumulation, with a corresponding increase in total exceptional financing.

the recent CCFF drawing from the Fund, and exceptional assistance already disbursed by multilateral and bilateral creditors. The remainder of about $3 billion is expected to be covered by a further CCFF drawing, purchases under the stand-by arrangement, and by additional financing from multilateral and bilateral sources, including a Structural Adjustment Loan and two sector loans from the World Bank as well as additional quick-disbursing support from the Asian Development Bank and bilateral donors. A meeting of the aid donor's consortium is scheduled for mid-September.

19. The current account deficit is expected to remain broadly unchanged in 1992/93, at 2.6 percent of GDP. Export growth is projected to continue its recovery (with an 11 percent volume increase) as a result of improved competitiveness and a further pickup of demand in world markets. However, imports are also expected to rise significantly (by about 7 percent in volume terms) from the low level of 1991/92 as the special import compression measures are removed. The capital account is expected to register a significant improvement (from a surplus of $2.8 billion in 1991/92 to about $4.4 billion in 1992/93) as a result of a moderate reversal of the previous year's net outflow of nonresident deposits, some increase in normal net aid disbursements, and a reversal in net short-term flows. Given the need for a further restoration in official reserves, there would still be a need for exceptional financing from the Fund and other multilateral and bilateral creditors, but we estimate that the need (about $2.8 billion) would be considerably smaller than in the current year. A further sizable adjustment in the external current account will be needed over the medium term. The pace at which India's external viability can be restored would depend, however, on how quickly access to normal commercial borrowing can be resumed. In this respect, the Government envisages that, in 1993/94¬-1994/95, covering the external financing gaps would continue to require some additional assistance from multilateral sources, including the Fund, as well as access to

financing from official bilateral and commercial sources. We also expect a significant expansion in foreign direct investment inflows as a result of the new policy measures discussed in paragraph 25. Our aim is to eliminate the need for exceptional financing by the mid-1990s.

20. The targeted buildup in gross official reserves to about 1 1/4 months of imports at end-1991/92 and a little over 1 1/2 months of imports at end-1992/93 would still leave reserves at a low level in comparison with earlier years. Hence, India's external position will remain vulnerable to adverse shocks or to any unexpected slippages. Therefore, the Government will act quickly and decisively to correct any shortfall from the targeted path for reserve increase through a further tightening of monetary policy. The Government intends to pursue prudent debt management policies, and higher-than-anticipated commercial borrowings will be used for an additional rebuilding of reserves. Specifically, any unanticipated borrowing from commercial markets by the public sector will be matched by a corresponding increase in the floors for net official international reserves.

Social policies

21. The Government is aware that the process of macroeconomic adjustment is bound to be painful. All sections of the community have to make sacrifices to preserve our economic independence and to restore the health of the economy. Our endeavor would be to minimize the burden of adjustment on the poor. We are committed to adjustment with a human face; therefore, a steadfast adherence to the objective of poverty alleviation is an integral part of our conception of the adjustment process. We expect the structural reforms that have been initiated to generate long-lasting benefits in the reduction of poverty by promoting greatly increased employment opportunities. In the interim, any adjustment process that widened social and economic disparities would, in our view, be self-defeating. With this principle in mind, the Government has provided in the 1991/92 budget for

higher outlays on elementary education, rural drinking water supply, assistance to small and marginal farmers, programs for women and children, programs for the welfare of scheduled castes and scheduled tribes and other weaker sections of the society, as well as for increased spending on infrastructure and employment-creation projects in the rural areas.

22. India continues to have a deep commitment to environmental conservation, drawn both from her ethos and traditions as well as her experience in the last two decades. We share the global concern for adverse environmental changes induced by economic and technological activities. Our commitments and concerns are reflected in our present and projected policies and legislation relating to air and water pollution control, forestry, and to conservation of natural resources, including wasteland and water resource development. We shall endeavor to obtain a greater quantum of peoples' involvement and association of nongovernment organizations in their implementation. The objective will be to attain ecologically sound and sustainable development.

Structural policies

23. Our adjustment strategy is predicated upon a comprehensive program of structural reforms that are designed to promote faster economic growth. The broad thrust of these reforms as well as the initial concrete policy measures are described below. In the areas of industrial deregulation, trade policy, public enterprises, and aspects of financial sector reform, we expect that policy changes already introduced, combined with further action to implement and strengthen policy reform, would also form the basis for World Bank support in the context of a structural adjustment loan.

24. While over the years a well-diversified industrial structure was established, barriers to entry and limits on growth in the size of firms led to a proliferation of licensing arrangements and an increase in the degree of monopoly. There was inadequate emphasis on reduction of costs, upgradation

of technology, and improvement of quality standards. With a view to fostering increased competition between the firms in the domestic market so that there are adequate incentives for raising productivity and reducing costs, a major deregulation of the domestic industrial sector was introduced in the Industrial Policy announced on July 24, 1991. The thrust of the new policy is to enable entrepreneurs to take investment decisions based on their own commercial judgement with a greatly reduced regulatory role of Government. These measures are complementary to those taken in the areas of trade policy, exchange rate management, fiscal policy, and financial sector reforms.

The first stage of the reform was announced in July and includes the following key measures:-

(i) Industrial licensing has been abolished for all projects except for a list of 18 industries related to security, strategic, or environmental concerns and certain items of luxury consumption that have a high proportion of imported inputs. The exemption from licensing also applies to the expansion of existing units. Notifications spelling out the new procedures were issued on August 2.

(ii) The Monopolies and Restrictive Trade Practices (MRTP) Act will now be applied in a manner which eliminates the need to seek prior governmental approval for expansion of present undertakings and establishment of new undertakings by large companies. The changes also apply to merger, amalgamation, and takeover. These changes will be introduced with immediate effect through appropriate administrative notifications under the Act.

(iii) The system of phased manufacturing programs, which required the progressive reduction in the import content of certain projects over time, has been discontinued for all new projects.

(iv) Industrial location policies have been streamlined so that only the 23 cities with a population of over 1 million (within a radius of 25 kilometers) will be subject to industrial location rules. Further¬more, these rules will not apply

for specified nonpolluting industries or in already designated industrial zones.

(v) The set of activities henceforth reserved for the public sector is now much narrower than before, and there will be no bar to the remaining reserved areas being opened up to the private sector selectively.

Beyond this, it is the Government's intention to review the prior approval requirements that still exist for capital goods imports, with the aim of rapidly reducing their scope. As a first step, all capital goods imports where foreign exchange availability for the imported equipment is assured through foreign equity have now been given automatic clearance. Effective April 1, 1992, imported capital goods that represent less than 25 percent of a project's total plant and equipment costs will also be given automatic approval, up to a value of Rs. 20 million (about $800,000). The Government expects further liberalization during the course of 1992/93.

25. In conjunction with industrial deregulation, the Government intends to provide greatly increased opportunities for foreign investment. Such investment would bring the attendant advantages of technology transfer, marketing expertise, and the introduction of modern managerial technique as well as promoting a much-needed shift in the composition of external private capital inflows toward equity and away from debt-creating flows. In addition, restrictions on technology agreements will be relaxed. With these broad objectives in mind, the following steps have already been announced.

(i) Automatic approval will be given for direct foreign investment up to 51 percent foreign equity ownership in a wide range of approved industries. Previously, all foreign investment was subject to approval, and foreign equity participation was generally limited to 40 percent.

(ii) Other foreign equity proposals will continue to need prior clearance, but procedures will be streamlined and made mare transparent. A special

empowered Board will be established to negotiate with large international firms that would provide access to high technology and world markets.

(iii) Automatic permission will be given for foreign technology agreements in the list of industries referred to in item (i) for royalty payments of up to 5 percent of domestic sales or 8 percent of export sales or for lump-sum payments of up to Rs 10 million (about $400,000). Automatic approval for all other royalty payments will also be given if the projects can generate internally the foreign exchange required. All other payments will continue to require approval under existing procedures.

The necessary changes in the application of the Foreign Exchange Regulation Act (FERA) will be introduced by end-October through administrative notifications. It is our intention to explore further options for attracting foreign direct investment and technology.

26. As part of our strategy to promote the international integration of our economy, it is necessary to phase out the excessive and often indiscriminate protection provided to industry which has weakened the incentive to develop a vibrant export sector. An important element of this strategy will be a transition from a regime of quantitative restriction to a price-based system. Our medium-term objective is to progressively eliminate licenses and quantitative restrictions, especially for capital goods and raw materials, so that these items could be increasingly placed on open general license. The shift is proposed to be achieved over a period of three to five years. A high-level committee will work out the modality of achieving this transition, keeping in mind the balance of payments position, in order to provide Indian industry with an appropriate environment to develop international competitiveness. Based on the Committee's recommendations, we will formulate policy proposals by the time of the 1992/93 budget. (See also paragraph 34.)

27. The first step in rationalizing the trade regime was implemented in July. Cash export subsidies

were eliminated at the time of the exchange rate adjustment, and an expanded system of import entitlements, linked to export earnings, has replaced a large part of the administered licensing of imports. The new entitlements, called EXIM scrip, are generally provided at a rate of 30 percent of gross export earnings (with special arrangements for gems, jewelry, and a few other industries), and are freely tradeable; the premium on the scrip, set in the market, represents a further incentive for exporters and a means of allocating imports according to market forces. The arrangement is intended as a transitional one that will serve as a vehicle for further trade liberalization through expansion of import entitlements in the next several years, and it is our intention to administer the system in a manner that prepares Indian industry for a more uniform set of incentives.

28. In addition to the trade reform measures already taken, the Government plans additional action along the following lines:-

(i) Greater transparency will be introduced into the trade regime through the adoption, from September 1, 1991, of a harmonized system of customs classification.

(ii) A high priority will be the earliest possible elimination of the temporary exchange restrictions imposed earlier in the year in response to the foreign exchange crisis--including the limitations on the availability of foreign exchange for capital goods imports, the prior approval by the RBI for certain foreign exchange transactions exceeding specified amounts, and the high cash margin requirements (ranging up to 200 percent) on letters of credit. The first priority will be to eliminate the restrictions that affect exporters. Recently, the RBI has reduced the cash margins on imports by certain exporters and has also relaxed prior approval requirements for exporters. A timetable for eliminating any remaining restrictions will be discussed at the time of the first review.

(iii) Over the years, a number of import and export items had to be exclusively channelled ("canalized") through specified public sector agencies. It has now been decided to reduce sharply the scope of this public sector monopoly, including most export items and a significant number of import items. The Government recognizes that there is a strong case for freeing trade in more items, especially imports of raw materials. Therefore, additional items will be progressively decanalized; for this purpose, a further review of the remaining items will be made in March 1992 and a suitable decision taken with effect from April 1, 1992.

(iv) Actual user requirements, which require that imports be undertaken by the final users, have already been relaxed as a result of the EXIM scrip scheme. Proposals for the removal of the remaining requirements will be formulated.

(v) The 1991/92 Budget began the process of tariff reform, with a reduction in peak tariff rates to a maximum of 150 percent (from as much as 300 percent or more) and a moderate across-the-board reduction in tariffs on capital goods imports. A more broad-based effort to streamline and reduce tariff rates will be proposed in the 1992/93 budget.

29. The public enterprise sector has not generated internal surpluses on a large enough scale and, because of its inadequate exposure to competition, has contributed to a high-cost structure. To address these problems, the Government has decided to adopt a new approach, key elements of which will be: (1) the existing portfolio of public investments will be reviewed with a greater sense of realism to avoid areas where social considerations are not paramount or where the private sector would be more efficient; (2) enterprises in areas where continued public sector involvement is judged appropriate will be provided a much greater degree of managerial autonomy; (3) budgetary transfers to public enterprises will be progressively reduced; (4) to provide further market discipline for public enterprises, competition from the private sector will be encouraged and part of the

equity in selected enterprises will be disinvested; and (5) chronically sick public enterprises will not be allowed to continue incurring heavy losses.

30. Several important measures initiating the new strategy have already been taken. (1) The number of industries reserved for the public sector has been reduced from 17 to 8. Even in these areas, private sector participation will be allowed selectively. Thus, joint ventures with foreign companies in oil exploration and production are now possible. (2) Public enterprises that are chronically sick and unlikely to be turned around will be referred to the Board for Industrial and Financial Reconstruction (BIFR) for rationalization. We expect to have the new procedures in place by end-December 1991. A safety net will be created to protect the interests of workers. (3) The existing system of monitoring enterprises through Memoranda of Understanding (MOU) will be strengthened, with primary emphasis on profitability and the rate of return on capital. (4) Up to 20 percent of government equity in selected public sector enterprises will be disinvested through mutual funds. The objective is that the mutual funds would seek a listing for the shares on the stock market and would have the freedom to dispose of them after a specified time period. Additional sales are expected in 1992/93, by which time proposals for encouraging broader disinvestment options could also be developed.

31. Appropriate exit policies are needed to capture the efficiency gains from policy reform and, at the same time, it is imperative that workers should be protected from the adverse impact of the adjustment process to the maximum extent feasible. Keeping in view the need for a rapid improvement in the efficiency of the economic system and of preserving social cohesion, so vital for ensuring political and social acceptability of the adjustment process, effort is under way to formulate a policy that would facilitate the process of industrial re-structuring, including a suitable framework for reducing barriers to exit. This process will take some time, since it will be essential to build the political consensus

necessary for ensuring durability of policy reform. We expect that specific policies in this area will be formulated by the time of the submission of the 1992/93 budget to Parliament. An important component of these policies is the establishment of a National Renewal Fund (NRF) introduced in the 1991/92 budget. The NRF will provide a social safety net to protect workers from the adverse consequences of adjustment and technical transformation, most importantly through the provision of retraining so that they are in a position to remain productive participants in economic activit. We visualize the NRF also being supported by contributions from the States and the private sector. It is also intended to strengthen the Board for Industrial and Financial Reconstruction (BIFR), which was established in 1987 to recommend action--rehabilitation, merger, or exit--for private sector firms with negative net worth and meeting certain eligibility requirements; in addition, its scope will be widened to include public sector units.

32. Far as the financial system has come in terms of market widening and deepening, there remain a number of structural rigidities--notably related to interest rates and the allocation of credit--that have contributed to inefficient financial intermediation. Important measures have been taken recently to address these problems, particularly on the side of liberalizing interest rates. Thus, bank lending rates on larger loans have been set free, the short-term money market has been allowed to function without hindrance, interest ceilings on loans by term-lending institutions have been abolished, and all restrictions on private debentures interest rates have been eliminated. These steps, implying an elimination of controls at the short and long end of the maturity spectrum, have made for a considerably more flexible structure of interest rates. While the process of interest rate liberalization will be continued over the next 18 months, the Government will focus attention on three other key priorities: promoting a more market-oriented allocation of credit, implementing policies to further the development of capital markets, and enhancing the soundness of the

banking system. The recently constituted Committee on the Financial System (Narasimhan Committee) will formulate detailed recommendations in these areas. In addition, the Committee has been requested to make recommendations relating to banks and term-lending financial institutions specifically on (a) their organizational structure, (b) composition and adequacy of the capital structure, and (c) supervisory arrangements. The Committee has been asked to submit its proposals by November 15, and it is the intention of the Government to spell out a timetable for implementation by the time of the first review. Beyond this, as the process of fiscal consolidation takes hold, bank profitability can be expected to improve, thus setting the stage for the extension of interest rate liberalization to bank deposits as well as for a phased reduction, beginning in 1992/93, in the statutory liquidity requirement, under which banks must presently hold selected government and other public sector securities against 38 1/2 per cent of their deposits.

33. To continue the process of developing more competitive capital markets, the Government has decided to promote the development of private sector and joint-venture mutual funds; a comprehensive set of policies and guidelines that will apply equally to both public and private sector mutual funds is being developed. The Government also intends to introduce legislation in the forthcoming winter session of Parliament that would allow the Securities and Exchange Board of India to function as an autonomous body with full statutory powers to regulate equity markets. Two expert committees have also been established to examine the question of trading reforms and institutional improvement of the stock exchanges.

34. In order to make the tax system more elastic, broaden the base of taxation, reduce its dependence on customs revenue, and simplify the existing procedures, the Government intends to implement a major tax reform over the next few years. The major emphasis will be on increasing the share of revenue from direct taxes, so that resources are raised from those most able to

pay; rationalizing domestic indirect taxes including further expansion in the existing MODVAT system; and reducing the level and dispersion of import tariffs. The time available for the new Government before presenting the 1991/92 budget was simply not enough to formulate basic structural changes, but several measures were adopted consistent with our medium-term strategy. Thus, peak import tariffs were reduced and major efforts were made to strengthen tax compliance, including a much increased role for deduction of tax at source. Beyond this, the Government will appoint a committee of experts to prepare a study advising how best our agenda of tax reform can be pursued. The first steps of the tax reform will be introduced in the 1992/93 budget.

Table 1

India: Performance Criteria for Domestic and Financial Policies in 1991/92 and Indicative Targets for 1992/93

	Prel. Actual	Performance Criteria, 1991/92			Indicative Targets 1992/93
	end-July	End-Oct. 1991	End-Dec. 1991	End-Mar. 1992	End-March 1993
		(In billions of rupees)			
Domestic sector (ceilings)					
Overall borrowing requirement of the Union Government 1/	160 2/	275	305	390 3/	325 4/
Net domestic assets (NDA) of the RBI 5/	818.7	865.6	899.1	943.5	1,048
Of which : Net credit to Union Government	973.4	987.6	987.6	955.6	1,018
		(In millions of U.S.dollars)			
External sector (floor)					
Net official international reserves 6/	-1,131	-943	-1,156	-1,195	-703
Memorandum item:		(In billions of rupees)			
Indicative target (ceiling) for bank credit to general Government 7/	1,535	1,546	1,564	1,551	1,675

1/ Cumulative from March 31 of the previous financial year.

2/ End-June figure.

3/ The ceiling for end-March 1992 will be raised (lowered) by the excess(shortfall)of the OCC surplus from Rs.8 billion.

4/ Including projected OCC surplus.

5/ The ceilings will be adjusted for (i) unexpected valuation effects arising from changes in exchange rates and the price of gold; (ii) changes in reserve requirements; and (iii) changes in the net international reserve floor arising from factors described in footnote 6 below.

6/ The floors will be adjusted upward (downward) to the extent that gross commercial borrowing by or guaranteed by the public sector (medium and long¬-term borrowing from commercial banks plus bond issues to foreigners plus any change in the short-term external debt of the State Bank of India) plus exceptional financing exceeds (falls short of) $590 million for the period August 1-October 31, 1991, $840 million for the period August 1-December 31, 1991, and $1,484 million for the period August 1, 1991-March 31, 1992. However, the downward adjustments in the floors will be limited to no more than $300 million by October 31, 1991, $200 million by December 31, 1991, and $400 million by March 31, 1992. The floors will also be adjusted upward (downward) by any increase (decrease) in foreign exchange deposits held by the RBI with the State Bank of India from the level of $600 million.

7/ General Government comprises the Union Government, the States, and Union territories.

Table 2

India: Key Macroeconomic Objectives, 1991/921-1992/93

(In percent unless otherwise indicated)

	1990/91	1991/9211	1992/93
	Est.	Program	
Real GDP growth	5	3-3 1/2	4
Inflation (end-period)	12.1	9	6
Overall public sector deficit/GDP	12.5	10.0	8.5
Union Government deficit/GDP	9.0	6.5	5.0
Broad money growth	15.3	13.01	11-12
Reserve money growth	13.1	15.5 1/	11-12
External current account/GDP	3.4	2.7	2.6
Gross official reserves (in months of imports) 2/	1.3	1.3 1.7	
Official foreign exchange reserves (in billions of U.S.dollars)	2.2	2.2 3.2	

1/ Excluding the impact of the incremental cash reserve ratio, reserve money growth would be 13 percent.

2/ According to the IMF definition, i.e., including SDR holdings and gold valued at SDR 35 per ounce.

November 11, 1991

Pear Mr. Preston,

1. The Government of India has adopted a package of major policy reforms aimed at macro economic stabilisation and restoration of the growth momentum to the economy. These initiatives are being implemented at a time when the Indian economy faces a serious Balance of Payments crisis. The strategy consists of measures aimed at achieving a sharp reduction in the fiscal deficit, combined with reforms in the key areas of trade policy, industrial policy, the public sector and the financial sector. The effectiveness of these measures in bringing about the desired structural adjustment in the economy while maintaining the momentum of growth depends critically upon the availability of adequate external finance. Accordingly, we are requesting a Structural Adjustment Loan/Credit from the World Bank. We believe that the policies outlined by us are adequate and sufficient to meet the objectives of the programme.

2. It is also our intention to seek IBRD/IDA support for our medium term reforms strategy through a series of Structural/Sectoral Adjustment loans/credits including fast disbursing support for establishing and strengthening the social safety net to mitigate the social burden of the transition process.

3. We have no doubt that with continued support from multilateral financing institutions, particularly the Bank and the Fund, and given the resilience of our economy as well as the support of the international community as a whole, witnessed at a recent meeting of the Aid India Consortium, India would be able to overcome the present economic difficulties and return it to a path of sustained high growth. 1 greatly look forward to your continued support in our endeavour to achieve these objectives.

4. The medium term reform programme of Government is described in the attachment to this letter.

Kind regards,

Yours sincerely,

(Manmohan Singh)

Mr. I.T. Preston,
President,
The World Bank,
Washington D.C.

SUO MOTO STATEMENT BY THE PRIME MINISTER

(made on July 9, 1992 in Parliament)

The events that have unfolded in the last few months in the financial sector of the country have caused grave anxiety to me and the country at large. The ramifications of this matter have to be thoroughly probed and effective measures taken so that the basic integrity of the financial institutions of the country is not jeopardized and the new economic initiatives taken by the Government to strengthen and accelerate the economic growth are in no way inhibited. My Government has been taking concrete and effective steps at every stage in the last few months as required in the circumstances. The inquiry by the CBI and action by the Special Court will be pursued and whatever is required to be done as a consequence thereof, shall be done.

While this aspect is being fully attended to, I feel that there is need for a comprehensive inquiry through the instrument of Parliament which not only fully establishes Parliamentary supremacy but also provides an effective safeguard to protect the country's interests. We have had consultations with all political parties in Parliament and there is consensus on the desirability of setting up a Joint Parliamentary Committee in this regard. I am, therefore, requesting the Hon'ble Speaker to proceed with the formation of a Joint Parliamentary Committee and entrust it with the task I have mentioned which may be completed within a reasonable time.

I would like to assure this august House that my desire and purpose remain, as they have been so far, to unravel the truth, and ensure the smooth transformation to a vibrant economy in the larger interests of the nation.

POLICY ENVIRONMENT

Box 1.1

Supplemental Agreement between the Reserve Bank of India and the Government of India

An Agreement made this ninth day of September 1994 between the President of India acting through the Ministry of Finance, Government of India (hereinafter referred to as "the Government") of the one part and the Reserve Bank of India (hereinafter called "the Bank") of the other part.

2. Whereas the erstwhile Secretary of State for India in Council and the Bank have entered into an agreement dated fifth day of April 1935 (hereinafter referred to as "the principal agreement").

3. Whereas under clause 5 of the principal agreement it is provided that the Bank shall not be entitled to any remuneration for the conduct of ordinary banking business of the Governor General in Council (now Government of India) other than such advantage as may accrue to it from the holding of his cash balance free of obligation to pay interest thereon.

4. Whereas it has been further agreed in November 1937 and January 1955 by enchange of letters that the Government shall maintain with the Bank a cash balance of not less than Rs. 50 crore on Fridays and Rs. 4 crore on other days free of obligation to pay interest thereon and further whenever the balance in the account of the Government falls below the minimum agreed to, the account be replenished by the creation of *ad hoc* Treasury Bills in favour of the Bank.

5. Whereas it has been announced by the Union Finance Minister in his budget speech for financial year 1994-95 the intention to phase out the Government's access to *ad hoc* Treasury Bills over a period of three years beginning financial year 1994-95.

6. Whereas it has been agreed between the parties that at the end of the financial year 1994-95, the net issue of *ad hoc* Treasury Bills should not exceed Rs. 6,000 crore, it has also been agreed that the net issue of *ad hoc* Treasury Bills should not exceed Rs. 9,000 crore for more than ten continuous working days at any time during the financial year 1994-95. It has further been agreed that, if the net issue of *ad hoc* Treasury Bills exceeds Rs. 9,000 crore for more than ten continuous working days at any time during the year, the Bank will automatically reduce only the excess beyond the prescribed level of *ad hoc* Treasury Bills, by auctioning Treasury Bills or flotation of Government of India dated securities. Similar ceilings for the net issue of *ad hoc* Treasury Bills will be stipulated for 1995-96 and 1996-97. From 1997-98 the

system of *ad hoc* Treasury Bills will be totally discontinued.

7. Whereas it has been agreed between the parties that a suitable monitoring mechanism would be put in place by the Bank so as to furnish the Government up-to-date position about the net issue of *ad hoc* Treasury Bills.

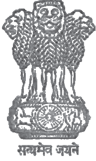
8. Whereas the parties have agreed on certain changes in the matters referred to above, it is now hereby agreed and declared as follows:

(1) This agreement shall be supplemental to the principal agreement and the subsequent letters exchanged and shall come into force with effect from the date of this agreement.

(2) The Bank would monitor, on a daily basis, the position in regard to the net issue of *ad hocs* over the level at the end of the financial year 1993-94; similar monitoring will be provided for each of the financial years 1995-96 and 1996-97. The Bank will advise the Government of the net increase in *ad hocs* on a daily basis; and furthermore, the number of consecutive working days when the net issue of *ad hocs* exceeds the limit prescribed in paragraph 6 hereof. Central Government holidays at New Delhi and bank holidays at Nagpur will be excluded from the computation of the number of consecutive working days. On receipt of the advice, Government could convey to the Bank its views and instructions in regard to regularisation or the extent to which the Bank may raise market borrowing on behalf of Government.

9. In witness whereof Finance Secretary to the Government of India acting for and on behalf of and by the order and direction of the President of India has hereunto set his hand and the common seal of the Reserve Bank of India has been hereunto affixed in the presence of its subscribing officials the day and year first above written.

Signed by the said Shri Montek Singh Ahluwalia, Finance Secretary, Government of India for and on behalf of President of India in the presence of Shri N.P. Bagchee, Additional Secretary (Budget) to the Government of India.	Sd. Montek S. Ahluwalia) Sd. (N.P. Bagchee)
The Common seal of the Reserve Bank of India was affixed hereto in the presence of its Governor Dr. C. Rangarajan who has signed in the presence of Shri S.S. Tarapore, Deputy Governor of Reserve Bank of India.	Sd. (C. Rangarajan) Sd. (S.S. Tarapore)



वित्त सचिव
FINANCE SECRETARY

भारत सरकार
वित्त मंत्रालय
आर्थिक कार्य विभाग
GOVERNMENT OF INDIA
MINISTRY OF FINANCE
Department of Economic Affairs
नई दिल्ली / New Delhi

DO.NO.1855(I)/FS/95 February 24, 1995

Dear Governor,

I enclose a copy of an Article in TIME magazine about the crisis of the banking system in Venezuela in the wake of the privatisation and deregulation of banks in recent years. The article reveals that many new private banks which came into existence were merely divisions of larger financial or industrial groups, which meant that when the parent companies were strapped for money they frequently turned to their in-house banks for loans. Laissez-faire took on a new meaning as bankers used their institutions as personal "cajas chicas" or petty cash-drawers. The article provides examples of banker-extravagance only weeks before their collapse with very minimal regulatory oversight. According to later investigations, regulatory officials were paid to look the other way or lacked the authority or manpower to intervene.

2. It is important that we should draw appropriate lessons from the experience of Venezuela. The Finance Minister has asked me to convey to you that RBI should have a separate and strong division to monitor and supervise the performance of the newly established banks. In licensing new banks, it must also be ensured that the new entities are not an extension or a front for big industrial houses.

3. I would be grateful if you could give us your response to these concerns. The Finance Minister has

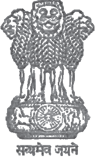
indicated that he would like to discuss this with you soon after the presentation of the Budget.

With regards,

Yours sincerely,

(Montek Singh Ahluwalia)

Dr. C. Rangarajan,
Governor,
Reserve Bank of India,
Central Office,
BOMBAY.



वित्त सचिव
FINANCE SECRETARY

भारत सरकार
वित्त मंत्रालय
आर्थिक कार्य विभाग
GOVERNMENT OF INDIA
MINISTRY OF FINANCE
Department of Economic Affairs
नई दिल्ली / New Delhi

DO.NO.2739/FS/96 Friday, April 05, 1996

I am writing to share some thoughts on how we should handle the problem posed by some banks not achieving their capital adequacy norms. The conventional, and possibly unavoidable approach, would be to give the banks a limited relaxation for a specified period. Some discussions have already taken place between RBI and Banking Division along these lines.

2. An alternative would be to insist on capital adequacy norms being met by non complying banks shifting their asset portfolio from risk assets to risk-free assets i.e., government securities. In practice this would mean that banks which do not meet the capital adequacy norms would have to restrict, or even reduce, their commercial lending portfolio in favour of government securities thus achieving compliance with the capital adequacy norms by reducing these risk weighted assets. I recognise that this poses problems especially for the banks and even their clients, but on the other hand it sends the right signal, and it also helps in marketing government securities. To the extent that it reduces the burden on RBI of picking up government securities it extinguishes one source of reserve money expansion and thereby increases the flexibility of the RBI in reducing the CRR. To some extent the reduction in commercial credit by defaulting banks is offset by the enhanced credit made available by other banks because of lower CRRs. It can be argued that this approach would lead to a healthier banking system in the medium term, even if it puts a greater strain on weak banks in the short term.

3. I would like to emphasise that I retain an open mind on this issue and am only making this suggestion with the request that it be given a full examination before a view is taken on how to resolve the problem. I look forward to a discussion of RBI's response on this issue.

4. I am sending a copy of this letter to Deputy Governors, Shri S.S.Tarapore and Shri S.P.Talwar.

With regards,

Yours sincerely,

(Montek Singh Ahluwalia)

Dr. C. Rangarajan,
Governor,
Reserve Bank of India,
Central Office,
BOMBAY.

Copy to:

1. Shri S.S.Tarapore, Deputy Governor, RBI.
2. Shri S.P.Talwar, Deputy Governor, RBI.

(Montek Singh Ahluwalia)

ECONOMIC REVIEW

Box 1.2

Supplemental Agreement between the Reserve Bank of India and the Government of India

An Agreement made this twenty sixth day of March 1997 between the President of India acting, through the Ministry of Finance, Government of India (hereinafter referred to as "the Government") of the one part and the Reserve Bank of India (hereinafter called "the Bank") of the other part.

A. WHEREAS the erstwhile Secretary of State for India in Council and the Bank have entered into an agreement dated fifth day of April 1935 (hereinafter referred to as "the principal agreement").

B. WHEREAS it has been agreed in November, 1937 and January, 1955 by exchange of letters that the Government shall maintain certain minimum cash balance and fürther that whenever the balance in the account of the Government falls below the minimum agreed to, the account be replenished by the creation of ad hoc Treasury Bills, in favour of the Bank.

C. WHEREAS the President of India and the Bank have entered, into a Supplemental. Agreement dated ninth day of September 1994 (First Supplemental Agreement) regarding phasing out of ad hoc Treasury Bills, and, in terms of paragraph 6 of First Supplemental Agreement, the system of ad hoc Treasury Bills to replenish the balance of the Government to the agreed minimum level as laid down is to be totally discontinued with effect from 1997-98.

D. WHEREAS the Union Finance Minister in his budget speech for Financial Year 1997-98 has presented concrete propoals setting out modalities for phasing out ad hoc Treasury Bills from April 1, 1997.

E. WHEREAS it has been agreed between the parties that a suitable mechanism would be put in place so as to enable the Government to manage its cash balance position with the Bank.

F. AND WHEREAS the parties have agreed on certain changes in'the matters referred to above.

NOW IT IS HEREBY AGREED AND DECLARE AS FOLLOWS:

(1) This agreement shall be supplemental to the principal agreement. and the First Supplemental Agreement dated September 9, 1994.

(2) The practice of issuing ad hoc Treasury Bills to replenish the cash balance of the Government to the agreed minimum level will be discontinued with effect from April 1, 1997.

(3) The outstanding ad hoc Treasury Bills as on March 31, 1997 would be funded into special securities, without any specified maturity, at an interet rate of 4.6 per cent per annum on April 1,1997. The outstanding Tap Treasury Bills as on March 31, 1997 will be paid off on maturity with an equivalent creation of special securities without any specified maturity, at an interest rate of 4.6 per cent per annum.

(4) From April 1, 1997, the Bank shall make Ways and Means Advances to the Government, if so required, at such rate of interest, as may be mutually agreed from time to time, provided such advances outstanding at any time shall not exceed the limit, as may be mutually agreed upon from time to time. The advances shall be fully paid off within a period not exceeding three months from the date of making such advance. Interest shall be calculated on daily balances and debited to the account of the Government with the Bank at such intervals, as may be decided by the Bank.

(5) In the event of Government's account as at the close of business on any working day emerging and remaining overdrawn beyond the agreed limit for Ways and Means Advances, the Bank may charge interest on the daily balances overdrawn at such rate or rates, as may be mutually agreed upon from time to time, by debit to the account of the Government with the Bank at such intervals, as may be decided by the Bank.

(6) When 75 per cent of the Ways and Means Advances is utilised, the Bank would trigger fresh floatation of Government securities.

(7) Ways and Means Advances and Overdraft would be monitored and regulated on such terms, as may be mutually agreed from time to time.

(8) If the Government runs surplus cash balances beyond an agreed level, the Bank will make investments, as may be mutually agreed from time to time.

(9) Subject to the terms hereinabove, the arrangements for the

fiscal year 1997-98 have been mutually agreed as under:

(i) The limit for Ways and Means Advances will be Rs.12,000 crore for the first half the year (April to September) and Rs.8,000 crore for the second half of the year (October to March).

(ii) The interest rate on Ways and Means Advarices and Overdraft for the Government will be the following:

(a)	Up to the Ways and Means Advance Limits	: "Calculated Rate" **minus** 3 per cent
(b)	For Overdraft beyond the Ways and Means Advances limits.	: The rate at (a) **plus** 2 per cent on the Overdraft amount.

NOTE: The "Calculated Rate" for any quarter beginning April ti 1997, will mean the average of the implicit yield at the cut-off price of 91-day Treasury Bill auctions held during the previous quarter.

(10) The arrangement for the fiscal year 1998-99 With regard to limits for Ways and Means Advances, as also interest rate on Ways and Means Advances and Overdraft will be through exchange of letters.

(11)(a) The arrangements after fiscal year 1998-99 in respect of limits for Ways and Means Advances and interest rate on Ways and Means Advances and Overdraft will be through exchange:of letters.

(b) Overdraft will not be permissible for periods exceeding ten 'consecutive' working days,after March 31, 1999.

NOTE: For the purpose of computation of the number of 'consecutive' working days, Central Government holidays at New Delhi and bank holidays at Nagpur will be excluded.

12) In witness whereof Finance Secretary to the Government of India acting for and on behalf of and by the order and direction of the President of India has hereunto set his hand and the common seal of the Reserve Bank of India has been hereunto affixed in the presence of its subscribing officials the day and year first above written.

Signed by the said	}	
Shri Montek Singh Ahluwalia,	}	
Finance Secretary,	}	
Government of India for	}	
and on behalf of	}	Sd/-
President of India in	}	26.3.97
the presence of Shri J.S. Mathur,	}	
Additional Secretary (Budget)	}	Sd/-
to the Government of India	}	26.3.97
The Common seal of	}	
the Reserve Bank of India	}	
was affixed hereto in the	}	
presece of its Governor	}	Sd/-
Dr. C. Rangarajan who has	}	
signed in the presence of	}	
Dr. Y.V. Reddy,	}	Sd/-
Deputy Governor of	}	
Reserve Bank of India	}	

This Agreement has far reaching implications for monetary policy and debt management. With the elimination of ad hoc Treasury Bills from April 1, 1997, the 91-day tap Treasury Bills also lost their relevance and were accordingly discontinued simultaneously.

1.9 As regards instruments of monetary policy, the Reserve Bank has been making conscious efforts to reduce the reliance on direct instruments of monetary control, such as administered interest rates with the objective of moving over to indirect methods. Open market operations (OMO), including repo operations, have been emerging as the principal indirect instrument. The interest rate instrument is sought to be developed by reactivating the Bank Rate (BR) as a signalling mechanism to the market, alongside a provision for a general refinance facility. The op it procedures of monetary\pcTc2talta close -c1561-dirration between liquidity management and debt management, as well as institutional developments for widening and deepening securities and money markets along with evolution of risk management strategies for efficient functioning of the financial system.

1.10 The year 1996-97 was significant in many ways in relation to the con uct o monetary policy in India. It

was the first-time that the CRR was reduced sharply by 4 percentage points within a financial year. and net sales of Central Government securities under OMO registered the record level of Rs.10,435 crore during a financial year. CRR to be maintained by scheduled commercial banks (excluding RRBs) was gradually reduced during April 1996