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Monetary Management

INTRODUCTION

For the most part of the 1980s, credit policy and monetary management by the Reserve Bank had to contend with the task of neutralising the inflationary impact of persistently rising deficit in the Government's budgetary operations. A significant part of the widening fiscal deficit following expansionary fiscal policy, especially in the later part of the decade had perforce to be monetised automatically by the Reserve Bank through issuance of *ad hoc* Treasury Bills. This resulted in high inflation rates and culminated in the acute balance of payments (BoP) crisis of 1991. In such a milieu, the two main objectives of credit and monetary policy of the Reserve Bank were to maintain a reasonable degree of price stability by moderating money supply (M_3) growth and to ensure adequate credit flow to the productive sectors of the economy by using essentially direct instruments such as the cash reserve ratio (CRR), administered interest rates and directed credit with stringent use of refinance facilities. A defining event that had a far-reaching impact on the conduct of monetary policy for years to come was the implementation of wide-ranging recommendations of the committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty). The later part of the 1980s was also marked by early measures for liberalisation of the money market and the introduction of new instruments. The Reserve Bank experimented with interest rate deregulation in April 1985 by giving banks freedom to fix short-term deposit rates, but the move had to be reversed quickly since it failed to evoke the expected competitive response from the banking system. These developments have been chronicled at length in chapter titled: Monetary and Credit Policy.

The early economic liberalisation measures pursued in the 1980s were carried forward more vigorously as a cohesive and detailed framework of economic reforms from about the middle of 1991–92. The trigger, as discussed elsewhere in this volume, came from the critical BoP crisis of 1991. The liberalisation measures were comprehensive and meant to bring about stabilisation and structural changes in the economy. Initially, the focus was on real, external and fiscal sector reforms, with monetary and financial sector reforms following in relatively quick succession. The focus of monetary policy as a result was transformed in the 1990s, with emphasis accorded to progressive and prudential regulation in the banking operations.

The main objectives of the monetary policy of the Reserve Bank during this eventful period (beginning in 1992) continued to be multi-dimensional, with emphasis being placed as much on growth as on price stability. Towards this end, the perception within the Reserve Bank was that monetary growth had to be consistent with the expected growth in output and a tolerable rate of inflation. In pursuit of the given objectives, monetary policy was rendered flexible enough to make strategic adjustments to any market disequilibria as also the surge in foreign capital inflows. Consequently, monetary management was also vested with the additional responsibility of maintaining orderly conditions in the money, credit, securities and foreign exchange markets.

Growth with moderate or tolerable level of inflation continued to be the primary goal of monetary policy in India. Broad money (M_3), also referred to as the aggregate monetary resources (AMR), was adopted as an intermediate target, with the level of bank reserves serving as the operating target. What was more important was the progressive rationalisation and deregulation of the interest rate structure as an integral part of financial liberalisation. The flexibility that it provided in policy formulation was expected to improve the functioning of the financial markets as well. In the process, interest rates would eventually be closely aligned and markets progressively got integrated. As a corollary, this required a marked shift in emphasis from direct to indirect instruments of credit control. Open market operations (OMOs) and its derivative, namely, repurchase agreements or repos, were actively utilised from 1993–94 to influence the level of reserves with commercial banks and thereby the liquidity in the economy. This mechanism also helped to bring about discreet changes in the volume of primary liquidity in the system and served to communicate to market participants in a subtle manner the perceptions of the monetary authority about the conditions in the money and financial markets.

The year 1991–92 was a landmark in terms of expeditiously overcoming the BoP crisis through fiscal correction, exchange rate adjustment and reform, industrial delicensing and reaffirmation of the need for introducing flexibility in monetary policy with a view to fostering inflation control together with growth sustainability. Framing monetary policy that would be in sync with the economic and fiscal policies took the form of a consultative process through dialogues between the Reserve Bank and the Government, taking the fiscal outlook into account. This co-ordination strengthened over the years, and was formalised with the signing of the historic agreement in September 1994 to phase out automatic monetisation of the budget deficit, which gave the Reserve Bank a relatively high degree of manoeuvrability in monetary management as well as in public debt management.

The Reserve Bank pursued financial sector reforms (including the strengthening of the banking sector) to enable smooth and orderly functioning of markets even while deepening the financial sector to give support to real sector growth. The report of the committee on the financial system (Chairman: Shri M. Narasimham) came in handy to bring about changes in the monetary policy framework and processes. However, this did not totally eliminate the challenges that the Reserve Bank had to face in addressing the economic uncertainties often associated with unpredictable international economic and financial developments and weaknesses in the transmission channels of domestic economic policies.

This chapter unfolds the developments in and challenges to monetary management from 1989–90 to 1996–97 with a focus on monetary and credit policy responses. The chart that accompanies the chapter summarises the policy measures in the context of the relevant macroeconomic backdrop, objectives and stance of monetary policy.[1]

MONETARY POLICY RESPONSES DURING THE RUN-UP TO THE BALANCE OF PAYMENTS CRISIS

By the beginning of the year 1989–90, there were distinct signs of several macroeconomic imbalances that caused concern to policymakers

1. The other inter-related policy areas, namely, public debt management and financial market developments are covered in separate chapters (15 and 16) in this volume, as their functions attained much significance in the post-reform period.

in the Reserve Bank as well as the Ministry of Finance. These were the deterioration in budget deficits and the widening of the current account deficit (CAD) in the BoP leading to excess liquidity in the economy and pressure on the price level. Inflation as measured by the wholesale price index (WPI) showed unmistakable signs of hardening. The inflation rate in 1988–89 at 5.7 per cent, which was already unacceptably high, had begun to move upwards in 1989–90. Inflation turned out to be a generalised phenomenon mainly due to sectoral demand-supply mismatches in some essential commodities, additional budgetary imposts, escalation in import costs and, above all, high liquidity growth caused by fiscal imbalances.

At the time the Reserve Bank took up the exercise of framing credit policy for the first half of 1989–90, it was against the backdrop of the encouraging performance of the economy in 1988–89 and the prospect of growth in real national income of about 9.0 per cent in 1989–90. However, there were other disconcerting developments. Expansion in M_3 up to March 10, 1989 was 18.3 per cent as against 15.1 per cent in the previous year. There was a larger increase in net RBI credit to the Central Government as also in reserve money, which forewarned a large expansion in liquidity. Under the circumstances, the basic feature of credit policy for the first half of 1989–90 (announced on March 27, 1989) was one of caution. The package of measures was designed to moderate growth in liquidity, rationalise reserve requirement prescriptions, and realign the maturity structure of term deposits. The policy also attempted to promote more efficient operations in the financial system by bringing about structural changes and introducing new instruments such as certificates of deposit (CDs) and commercial paper (CP).

The CRR structure as it had evolved was characterised by multiple prescriptions. Banks were required to maintain with the Reserve Bank a CRR of: (i) 11.0 per cent of their deposits (excluding foreign currency non-resident (FCNR) and non-resident (external) rupee [NR(E)R] deposits); (ii) an additional 10.0 per cent of their incremental domestic deposits; (iii) 10.0 per cent of FCNR deposits; and (iv) 3.0 per cent of NRE deposits. All these limits were subject to an overall statutory ceiling of 15.0 per cent. The Reserve Bank simplified the structure by stipulating a CRR of 15.0 per cent on the entire deposit liabilities of commercial banks from July 1, 1989.

The interest rate on term deposits of 46 days to 90 days was raised from 4.0 per cent to 6.0 per cent, and simultaneously the category of term deposits of 15 days to 45 days (at an interest rate of 3.0 per cent) was abolished with a view to aligning short-term interest rates with other interest rates and improving the rate of return on short-term surplus funds.

In July 1989, the Reserve Bank, concerned about the buoyant growth in primary liquidity and the continued build-up of inflationary pressures, which presaged 'loss of monetary control' and the banks overextending themselves, contemplated taking tough counter-measures. These included reduction in export finance limits, withdrawal of the stand-by refinance against the collateral of government securities, reduction in interest payable on eligible cash balances maintained by commercial banks with the Reserve Bank and the prescription of incremental non-food credit-deposit ratio.[2] There are, however, no official papers to show why the Reserve Bank did not take the contemplated measures. One may have to, therefore, surmise that it preferred to wait for the scheduled busy season credit policy due in October 1989, instead of fostering market expectations that might not be in line with the aim of promoting balanced financial development.

The above surmise appears to be justified since the economic and financial situation did not show any improvement in the subsequent months. By August/September 1989, the Reserve Bank came around to the view that the rate of expansion of non-food credit had been excessive in the context of developments in the real sector. Increases in M_3 and net bank credit to the Central Government were above the projected paths and, even though the growth in reserve money was somewhat lower, there was an overhang of large monetary expansion. Similarly, the build-up in aggregate deposits and non-food credit was above the anticipated levels. For the Reserve Bank, these disquieting trends underscored the need for further tightening of credit policy.

Against this background, the overriding consideration of the credit policy measures for the second half of 1989–90 (announced on October 9, 1989) was one of containing inflationary pressures without jeopardising the growth potential of the economy. The Reserve Bank's perception was that while banks should necessarily extend 'appropriate' credit support for all productive activities, the extent of 'additional' support need not be as large as in the previous year. Further, it was envisaged that large-sized companies would moderate their dependence on the banking system since they already enjoyed large recourse to the capital market.

2. Reserve Bank of India, Credit Planning Cell (CPC), office notes dated July 4 and 6, 1989.

From November 4, 1989, the Reserve Bank reduced the proportion of export refinance entitlement from 100.0 per cent to 75.0 per cent of the increase in export credit over the monthly average for 1987 so that banks could finance a larger proportion of exports out of their own resources rather than from the Reserve Bank. Banks were at the same time advised that this should not be viewed as a disincentive to extending credit to the export sector and not lead to curtailing overall export credit as exports continued to enjoy preferred status. It was pointed out (in the credit policy circular) that the policy mix of concessional refinance, subsidy, attractive exchange margins, and a lower degree of bad debts in export credit ensured that export credit provided a reasonable yield to banks. However, this decision had to be reversed on December 31, 1990 on the grounds that the growth of export credit was not commensurate with the overall growth rate in net bank credit. Moreover, in view of the developments in the Gulf region and the consequent pressure on the BoP, it was considered that more efforts were needed to support exports.

To improve the return on short-term deposits, the rate for the period of 46 days to 90 days was hiked from 6.0 per cent to 8.0 per cent from October 11, 1990 which, in effect, meant that the rate for deposits for 46 days to less than one year became 8.0 per cent. To impart further flexibility to the administered structure of interest rates and also to promote efficiency in the use of term loans, all term loans which carried a rate of interest of 15.0 per cent 'fixed' were to carry a 'minimum' of 15.0 per cent, thereby doing away with the prescription of a ceiling. Banks were asked to use this discretion to charge differential rates judiciously so that the interest charged remained within reasonable levels. The Economic Times dated October 10, 1989, in its editorial: Fighting the Wrong Fire bemoaned that the focus of credit policy was invariably on bank credit to the non-government sector. It pointed out that the real culprit was the unrestrained budget deficit, but trade and industry were called on to help control inflation even though the expansion in non-food credit to this sector was proportionately no larger than that in the previous year.

Another area where the Reserve Bank took pre-emptive action was on window dressing by banks. The data on monetary aggregates for the end of each financial year (*i.e.*, March 31) got distorted since banks regularly resorted to window dressing. Therefore, the Reserve Bank announced that the facility of discretionary refinance without its prior sanction stood temporarily withdrawn during the fortnight beginning from March 24 to April 6, 1990.

To counter the tendency of banks to draw refinance from the Reserve Bank and simultaneously lend it in the call money market (*i.e.*, over-night call money and short notice money for periods up to and including 14 days), the Reserve Bank decreed that on any day when banks had outstanding borrowing from it under the stand-by and/or discretionary refinance entitlements and a lending position in the call money market, an additional interest charge would be levied on such borrowings. Banks were also cautioned that in case of flagrant violation of this stipulation, refinance facilities to the errant banks could even be withdrawn.

INCREMENTAL NON-FOOD CREDIT-DEPOSIT RATIO

Recognising that with large reserve money expansion there could not only be substantial growth in bank deposits but also excessive credit expansion, the Reserve Bank considered it necessary for banks to adhere to the stipulation of 60.0 per cent incremental non-food credit-deposit ratio (INFCDR) for the year 1989–90. This was different from the 'guidelines' for expansion in overall credit that were in vogue until 1981–82, in as much as any increase in credit over the stipulated level entailed an escalation in the cost of refinance from the Reserve Bank, namely, an additional interest charge of 3 percentage points on the refinance drawn by the concerned bank under all facilities to the extent of net non-food credit over the stipulated ratio or the refinance drawn, whichever was lower. The rationale was that given the statutory reserve pre-emptions as they stood, banks would be able to achieve an incremental non-food credit-deposit ratio of only 40.0 per cent on the strength of their own deposit resources, and that even after availing of any refinance from the Reserve Bank, term-lending institutions and money market borrowings, they would find it extremely difficult to reach the 60.0 per cent limit in the course of the remaining months of 1989–90. Thus, the measure operated on the cost of refinance linked to actual credit expansion by a bank. According to the Annual Report of the Reserve Bank for 1989–90, the stipulation essentially ensured that credit expansion was commensurate with deposit growth and available refinance facilities and that the individual banks did not over-extend themselves.

The imposition of INFCDR was, however, not taken kindly by the industrial sector. In an attempt to allay the misgivings of the industry, the Deputy Governor, Dr C. Rangarajan, clarified[3] that since the non-food

3. Rangarajan, C. (1989). *Recent Credit Policy Measures*. Address at Gujarat Chamber of Commerce and Industry. Ahmedabad. December 9.

credit-deposit ratio of banks in the first half of 1989–90 was only 35.0 per cent, the stipulation of 60.0 per cent for the whole year in fact implied that in the second half of the year, the banks could go to the extent of providing 85.0 per cent of the increase in deposits as credit and there was no ground to fear that the working capital requirements of industry would not be met adequately. He drove home the point that monetary and credit expansion that was excessive could only result in further increase in prices without any benefit to industry.

What was interesting was that the Ministry of Industry in the Government too represented against the new prescription of the Reserve Bank. In its letter dated October 26, 1989 to the Finance Secretary, the Ministry expressed apprehension that this method of checking inflation through a 'credit squeeze' on industry and trade might further aggravate stagnation in industrial production and thereby adversely affect the growth of industry, impact the price level of manufactured products and thus defeat the very purpose of controlling inflation through selective credit control. Further, it feared that reduction in export finance could result in lower off-take by exporters and higher inventory levels in industry. The Governor, in his letter dated November 23, 1989 to the Finance Secretary, responded that taking into account the prevailing statutory liquidity ratio (SLR) and CRR prescriptions, the INFCDR could not in any case be 100.0 per cent and that this ratio was only 35.0 per cent in the first half of the year. The letter concluded that banks were under no restriction to provide non-food credit beyond 60.0 per cent of their incremental deposits, but that only in case the ratio was breached, refinance and its costs would become important considerations for banks and industry.

The policy measures taken during the year could be broadly classified under three heads. The first were the measures aimed at imparting greater discipline and prudence in the functioning of banks. These included imposition of additional charge in the event of banks lending in the call money market simultaneously when they had a borrowed position with the Reserve Bank; prescription of a shut-out period for discretionary refinance facility; strict observance of the instructions for use of the bill mechanism in order to inculcate a bill culture; reduction in interest rate on cash balances maintained with the Reserve Bank; revisions in the scheme of graduated penalties for CRR shortfalls (effective December 29, 1990); and an increase in interest rate charged on 182-day Treasury Bill refinance. Under the second category, several measures that were already in place were carried forward with a view to imparting greater flexibility and reducing rigidities in general, and promoting a competitive environment in the money and financial markets. Third, the functioning of financial markets was strengthened by allowing a larger number of participants as lenders in the money market and liberalising the existing guidelines for issue of CDs and CP with a view to broad-basing the primary market and giving a fillip to development of secondary markets for these instruments. Besides, changes were made in selective credit control (*i.e.*, modifications in minimum margin levels and ceilings on bank advances against select commodities) in response to price-output developments relating to sensitive commodities.

Reflecting the Bank's concerns towards monetary stability, the Annual Report of the Reserve Bank for the year 1989–90 postulated that if the Centre's overall budget deficit in 1990–91 was kept within the budgeted figure (which implied that the ratio of deficit to gross domestic product (GDP) at current market prices would fall from 2.4 per cent in 1989–90 to about 1.5 per cent in 1990–91), the aim of monetary management would be to bring about a reduction in the expansion of M_3 in 1990–91 by about 4.0 percentage points over that in 1989–90.

The year 1990–91, however, turned out to be an exceptionally difficult one for the Indian economy. All the components of M_3 recorded lower growth rates compared to the previous year, mainly due to a large and unplanned drawdown of external reserves. A memorandum to the Central Board of Directors of the Reserve Bank (dated January 8, 1990) stated that the central bank would continue to explore ways of controlling liquidity and that a more consistent framework of monetary projections would have to be evolved taking into account the trends in net RBI credit to the Government and the borrowing programme of the Government. The memorandum envisioned an active role for internal debt management if monetary policy was to play its assigned role, which again depended on the initiative of the Government to place the entire debt-raising on the market and eliminate the automatic monetisation of budget deficit.

MACROECONOMIC CRISIS OF 1990–91 AND ITS IMPACT ON MONETARY MANAGEMENT

The main thrust of the credit policy of 1990–91 was to bring about a sharp break in inflationary expectations by initiating measures to achieve a sizeable reduction in overall monetary expansion, which was backed by the Government's declaration to effect a cut-back in the overall level of budgetary deficit. However, a sudden turn of events — both external and internal — set in motion a further set-back to the already fragile macroeconomic situation. The high external CAD owing to the sharp spurt in crude oil prices exerted the maximum adverse impact on the economy. Notwithstanding a fairly satisfactory performance in the real sector, inflationary pressures did not slacken and instead took a turn for the worse in the early part of 1990–91. The immediate concern of both the authorities in the Reserve Bank and the finance ministry was to arrest the precipitous flight of foreign reserves and to restore the confidence of investors abroad in creditworthiness of the country. In the absence of a regular budget for the year 1991–92 and a credible medium-term stabilisation programme for correcting the macroeconomic imbalances, the immediate burden of economic management fell considerably on the monetary and credit policy of the Reserve Bank, particularly from July 1991. The Governor, Shri S. Venkitaramanan, initiated several contractionary demand management measures. At the peak level, a cash margin of 200.0 per cent was imposed on the import of goods under the open general licence (OGL) and 150.0 per cent under specific import licences.

As an integral part of overall demand management, on one hand the deposit rates were raised to boost deposit mobilisation and, on the other, lending rates were increased to restrain and dampen demand for credit. Within a restrictive policy environment, credit for exports was protected from the rigour of credit control and interest on post-shipment credit beyond certain maturities was raised to encourage faster realisation of export proceeds. Other instances were the relaxation made in the Reserve Bank's export credit finance entitlement and also exclusion of export credit from computation of the INFCDR prescription for banks during 1991–92.

The credit policy formulation for the first half of 1990–91 was accordingly influenced by the need to address the large expansion in reserve money, its impact on the economy and the attendant pressure on the price level. This was because over the five-year period ended 1989–90, overall liquidity increased by 17.6 per cent per annum, while the annual average growth of real GDP was recorded at 5.6 per cent. However, with strong deposit growth, despite heavy statutory pre-emptions, the resources of banks to meet credit demand from industry were adequate. The Government, on its part, made known its intention to cut back the overall budget deficit in 1990–91 to ₹ 7,206 crore as against ₹ 11,750 crore (RE) in 1989–90. Taking all these factors into account as well as the resurgence of inflationary tendencies in 1989–90, the Reserve Bank decided that the objective of monetary management was to bring about a sharp reduction in the pace of overall monetary expansion (M_3) in 1990–91 by about 4.0 percentage points below the figure of 19.9 per cent.

The gulf crisis of August 1990 dramatically altered the underlying macroeconomic fundamentals and induced far-reaching changes in the economic and monetary policies. The need for immediate measures to stave off from default in repayment of maturing external obligations, which needed current account adjustment in the BoP, took centre-stage and became the priority for policymakers in the Government and the Reserve Bank in the early stages of the crisis. However, carefully designed plans of long-term macroeconomic adjustment were announced only in July 1991.

RESTRUCTURING OF CRR FOR EFFECTIVE CREDIT CONTROL

One proposal considered was that of restructuring CRR, which had served well as an important and flexible instrument of monetary control until it reached its operational statutory ceiling of 15.0 per cent on July 1, 1989. There was also the requirement on the part of the Reserve Bank to pay interest to commercial banks on the reserves maintained with it in excess of the minimum of 3.0 per cent. This had the unintended effect of augmenting the stock of reserve money and thereby diluting the effectiveness of CRR as a monetary policy tool. Since the Government took time to initiate steps to raise CRR ceiling, the Reserve Bank, in March 1990 explored the possibility of restoring this initiative by restructuring CRR in combination with changes in other credit control instruments. The office note dated March 10, 1990 called for two-pronged action. The Reserve Bank was not to pay any interest on the eligible balances of banks from a cut-off date (say, end of March 1990) but instead, the interest rate to be paid on balances prior to the cut-off date was to be increased from 10.5 per cent to 12.0 per cent. Under the arrangement, banks were expected to benefit overall in the first year after the change, but lose heavily in subsequent years. For the Reserve Bank, the outgo on interest payments on cash balances could be maintained at a reasonable level. The Deputy Governor, Dr C. Rangarajan, however, envisioned that this could evolve into a complex structure if interest rates had to be lowered later for some reason.

Another novel but complex proposal was a reduction in CRR to be offset by either reducing the entitlement of export credit refinance or by an increase in SLR. The intention was to slowdown the accretion of non-interest bearing cash balances and thereby give banks the much needed time for adjustment to the interest income foregone and correspondingly reduce access to export credit refinance from the Reserve Bank or even eliminate it completely. The Reserve Bank's Executive Director reasoned in his office note dated March 10, 1990 that a CRR reduction accompanied by a reduction in the existing export credit refinance limit was a somewhat difficult proposition as it presupposed an unchanged export base, even though for an effective monetary policy, it was highly desirable to totally abolish the export refinance facility. He also had reservations about the possible adverse implications in the event of its sudden withdrawal and therefore favoured an increase in SLR with a corresponding reduction in CRR, provided there was no change in the Government's borrowing programme. The Deputy Governor saw merit in the second option as it offered the Reserve Bank manoeuvrability in regulating monetary expansion in future. The matter was referred to the Governor, Shri R.N. Malhotra for a decision, who in turn passed the following order on March 28, 1990:

> Considering the strain on bank profitability, it will not be feasible to deny them [banks] interest altogether on their future cash reserve deposits. Raising the rate of interest for a year would not be the signal. At a time when liquidity is ruling high, dropping the CRR by 2 per cent even if it were feasible, and to raise the SLR by 2 per cent without at the same time agreeing to increase Government's borrowing from the market is not desirable.
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> A via media would be to reduce the rate of interest on future accretions to deposits under CRR to, say, 8 per cent. SLR could perhaps be raised by 1/2 per cent to accommodate the large borrowing of Rs. 1,100 crore to which we agreed at the time of budget preparation. This could be supplemented by an increase in SLR on NRI deposits from 25 per cent to 30 per cent.

REFINANCE FACILITIES

In March 1990, the policy on refinance facility was reviewed, keeping in view the need to restrain monetary expansion. The review suggested that: (i) the base for determining the export credit refinance could be shifted from the monthly average level of export credit for the calendar year 1987 to the monthly average for the financial year 1988–89, thus reducing the overall limits by about ₹ 1,000 crore; (ii) the less-used discretionary stand-by refinance be abolished; and (iii) refinance against holdings of

Treasury Bills by banks be introduced. As regards food credit refinance, even though no bank was eligible to draw refinance (at the limits it stood then), the thinking in official circles was that it would not be advisable tactically to withdraw this facility at a time when food credit was expected to rise sharply. Another proposal was to bring forward the base year for discretionary refinance to 1988–89. This would have resulted in an increase in such refinance limits, but it did not find favour for several reasons. First, it would run counter to the Reserve Bank's long-term objective of encouraging banks to do more business with the Discount and Finance House of India Ltd (DFHI), for which they had to hold eligible money market assets. Second, the Reserve Bank contemplated offering the market in the near term about ₹ 1,000 crore securities through DFHI. Third, as in the past, the Reserve Bank could increase the discretionary limit in individual cases based on merit. Last, the Reserve Bank was seriously contemplating an increase in the rate of interest on the 182-day Treasury Bill Refinance facility from 10.75 per cent to 11.25 per cent, since the cut-off yield on this instrument had risen from 9.42 per cent at the end of March 1989 to 9.93 per cent by early March 1990. These suggestions were approved by the Governor, except for the one relating to stand-by refinance against excess holding of liquid assets.

CONTINUATION OF THE INCREMENTAL NON-FOOD CREDIT-DEPOSIT RATIO

In yet another review done in March 1990, the staff proposed that due to the prevailing difficult money and credit situation, the INFCDR might be continued during the first half of 1990–91 at a reduced ratio of 40.0 per cent with a penalty for infringement, so that credit expansion in the first half did not turn out to be so excessive as to make any correction in the second half difficult. The Governor, however, opted to continue the 60.0 per cent ratio for the entire duration of the year.

INCREASE IN SLR ON NON-RESIDENT DEPOSITS

The Reserve Bank felt that SLR on FCNR (A) and NR(E)R deposits should be raised from 25.0 per cent to 30.0 per cent, which would, in turn, require banks to invest an additional ₹ 900 crore in government securities. A drawback was that it might have an uneven impact on banks due to concentration of such accounts in the deposit portfolio of some banks. Therefore, to give the affected banks time to adjust to this change and taking into account the likely bulge in food credit requirement that might surface during the first quarter of 1990–91, it was proposed in March 1990 that it might be made effective four months later, *i.e.*, towards the end of July 1990. The Executive Director, Shri S.S. Tarapore, in his note dated March 22, 1990, advocated the increase on the following grounds:

> The external payments position and the fact that interest rates on non-resident deposits vary from domestic deposit rates have been factors which have been taken into account while continuing to prescribe lower reserve requirements on non-resident deposits. With the blunting of the cash reserve requirements, it is necessary to use some other instrument to immobilise liquidity. Although the SLR increase implies a shift in lending from the commercial sector to the government sector, with an unchanged borrowing programme it results in a reduction in net RBI credit to Government. There has to be a trade-off between external balance of payments concerns and domestic monetary concerns and to the extent that these are inter-related, it would appear desirable to undertake this measure.

However, the Deputy Governor was in favour of a cautious approach and effecting the change at a later date to avoid an adverse impact on the attractiveness of these deposits to non-resident Indian (NRI) account holders. Moreover, with the interest rates ruling at a high level in the international financial markets, even though the rates of interest paid on FCNR deposits were equal to or higher than the domestic rates — particularly in the case of dollar-denominated deposits — any increase in SLR could lead to erosion in the attractiveness of these deposits. The Governor indicated that 'tentatively' he would like to raise SLR to 30.0 per cent on non-resident deposits, which was given effect to in the credit policy announcement of April 12, 1990.

RATIONALISATION OF INTEREST RATE STRUCTURE OF NRE DEPOSITS

The Reserve Bank tried to remove the anomaly between the interest rate on short-term NRE deposits and domestic deposits for corresponding periods by abolishing the maturity range of 15 days to 45 days in respect of NRE term deposits (which carried an interest rate of 3.0 per cent), introducing a new maturity of 46 days to 1 year at a uniform rate of 8.5 per cent and abolishing the facility for withdrawal or early repayment after a notice period (as in the case of domestic deposit maturities). The proposal was approved.

SALIENT CREDIT POLICY MEASURES

The credit policy for the first half of the year 1990–91 reflected the above-mentioned internally formulated suggestions, *viz.*, continuation of the INFCDR at 60.0 per cent, an increase in SLR from 38.0 per cent to 38.5 per cent and an increase in SLR in the case of NRE and FCNR deposits from 25.0 per cent to 30.0 per cent effective July 28, 1990.

The eligibility conditions for export credit refinance were modified. From August 25, 1990 banks were provided refinance equivalent to 75.0 per cent of the increase in export credit (instead of 100.0 per cent). It was to be over the monthly average level for the calendar year 1987. Although the banks' access to export credit refinance was reduced, it was expected to be quickly recouped as they expanded export credit in the busy season. The interest rate on refinance against 182-day Treasury Bills was enhanced from 10.75 per cent to 11.25 per cent per annum, in line with the rise in cut-off yields on these bills in regular auctions. The maturity range of 15 days to 45 days was abolished in the case of NRE accounts and a uniform rate of 8.5 per cent was made applicable on term deposits of maturities of 46 days to less than one year from April 16, 1990.

For payment of interest on banks' cash balances with the Reserve Bank, a two-tier formula was introduced. On the eligible cash balances held as on March 23, 1990, interest was paid at 10.5 per cent and on the increase in deposits after March 23, 1990 interest was paid at 8.0 per cent. As a corollary, modifications were made under the scheme of graduated penalties for shortfalls in the maintenance of CRR.

LENDING RATE REFORM OF SEPTEMBER 1990

Over the years the lending rate structure had become complex and was characterised by a multiplicity of rates. The element of concessionality in interest rates depended on disparate criteria, such as the size of the loan, the priority status of the beneficiary, the location of economic activity, the nature of the lending programme and the level of income of the borrower. For the Reserve Bank, administering such a complex rate structure, turned out to be difficult and cumbersome. Therefore, a rationalisation of the interest rate structure was overdue. At the same time, it was accepted that some element of cross-subsidy within the interest rate structure was inescapable, since societal considerations warranted continuation of concessions in the case of small borrowers and weaker sections. In the proposed structure, all sector-specific and programme-specific lending rate prescriptions were discontinued except for the differential rate of interest (DRI) scheme and export credit. Moreover, the distinction between short and long-term credit was abolished, except in the case of term loans for agriculture, small scale industry and road transport operators owning up to two vehicles. Banks were asked to use 'judiciously' the discretion given to them to determine the rate of interest for advances over ₹ 2 lakh. In the case of public sector procurement/distribution agencies, the new lending rates involved an increase in the cost of interest on their bank borrowings. This presaged the interest rate reform subsequently recommended by the Narasimham Committee.

CREDIT POLICY FOR THE SECOND HALF OF 1990–91

The Reserve Bank announced the credit policy measures for the second half of 1990–91 on October 8, 1990. A new category of deposits of three years and above at a rate of 11.0 per cent was introduced from October 10, 1990, thus raising the maximum rate on term deposits by one percentage point. The objective was to assist banks in their deposit mobilisation efforts by offering attractive rates on longer-term deposits. To prevent unwarranted increases in deposits and non-food credit of commercial banks during the last few days at the end of March (which in fact turned out to be dependent on refinance from the Reserve Bank), the facility to draw discretionary refinance without the Reserve Bank's prior sanction was not made available from March 9, 1991 to April 19, 1991. Moreover, banks were asked to repay the amount outstanding under this facility before March 9, 1991 and they were to plan their operations well in advance on the basis that the discretionary refinance facility without prior sanction of the Reserve Bank would not be available during the shut-out period.

To encourage a bill culture, the Reserve Bank had prescribed in March 1987 that the credit limits sanctioned by a bank to borrowers under the credit authorisation scheme (CAS) against book debts should not be more than 75.0 per cent of the aggregate limits sanctioned to such borrowers for financing inland credit sales. On a review of its working, the Reserve Bank decided that in the case of fund-based working capital limits of ₹ 5 crore and above, from January 1, 1991 interest at 2.0 percentage points above the relevant cash credit interest rate should be levied on that portion of the book debt finance in excess of the prescribed norm of 75.0 per cent of the limits sanctioned to borrowers for financing inland credit sales.

It took some time for the Central Government to formulate short-term fiscal measures to achieve stability in its budgetary finances. For the full year 1989–90, the budgetary deficit, which was projected at ₹ 7,206 crore, had, by the middle of November 1990, deteriorated to ₹ 15,442 crore, but stood at ₹ 11,430 crore by the close of the year; this was nearly 60.0 per cent more than the original budgetary estimate. Despite the substantial growth in monetised deficit, M_3 expanded at a slower pace, mainly due to massive decumulation of foreign reserves. The real sector of the economy also experienced some sluggishness on account of transport and other infrastructure bottlenecks. Bank deposit growth slackened as a result of lower real income caused by rise in prices and emergence of other attractive avenues of financial savings, such as mutual funds.

By the second half of 1990–91 and early 1991–92, with the precipitate and substantial decline in foreign exchange reserves, financing the CAD of the BoP became a serious problem, and more so because the short-term and long-term sources of commercial finance had practically dried up. Under these circumstances, the management of the BoP became the overriding and immediate preoccupation of the economic policy administration in the short run. To tide over the situation, exceptional methods of financing were sought and obtained from multilateral and bilateral agencies, especially the IMF. Gold transactions also provided an important source of bridge finance. The strains on the economy were compounded by the inability of the Central Government to present a regular budget in Parliament. In this grim situation, the responsibility for short-term economic management had to be borne by monetary and credit policy. The Reserve Bank deployed unconventional instruments of credit control, which helped ease the strains considerably within a short time.

INSIGHT INTO THE CREDIT POLICY FORMULATION FOR THE FIRST HALF OF 1991–92

In response to the instructions of the Governor, Shri S. Venkitaramanan, who assumed office on December 22, 1990, three analytical notes were prepared in February, March and April 1991 that outlined the policy measures that could be considered for inclusion in the April 1991 credit policy statement.

In an office note titled: Issues for Discussion (February 1991), the Executive Director, Shri S.S. Tarapore proposed that credit policy should continue to be tight in view of the major problems facing the economy and the uncertain outlook for future, but with some rationalisation. He, therefore, suggested increasing SLR from 38.5 per cent to 40.0 per cent and gradually phasing out the export credit refinance facility. On the former proposal, the Governor took the view that such an increase in SLR would convey a contradictory signal to the 'reformers', and on the latter he felt that, while it was the best option operationally, export credit refinance would look 'optically' reduced.

An 'Exploratory' note (March 1991) also prepared by the Executive Director, forewarned that the economy might enter an extremely critical phase during April–June 1991 that might need to be addressed by unusual remedies. The first line of action was to curb the effective drawing power of large borrowers (*i.e.*, all non-food credit cash credit limits of ₹ 1 crore and over) for the period from April 9, 1991 to September 20, 1991 by limiting it to 60.0 per cent of the peak level of actual utilisation reached in the three-year period ending March 31, 1991. Any drawal in excess of the reduced drawing power but within the existing limit would attract an interest rate surcharge of 25.0 per cent. Moreover, on advances above ₹ 2 lakh for all non-priority sector personal loans, loans for purchase of consumer durables and loans to individuals against shares and debentures an interest rate surcharge at 25.0 per cent was to be made applicable on the entire amount of the advance.

Perhaps the most stringent proposal was an increase in the Bank Rate by 2.0 percentage points and no segment was to be spared from the impact. Carrying the analogy further, all interest rates (*i.e.*, deposit and lending rates, coupon rates on government securities, the rate on Treasury Bills and refinance rates on drawals from long-term operations [LTO] funds) were to be raised by 2.0 percentage points without any exception. All discretionary refinance limits sanctioned that exceeded the limits where prior sanction was not required were to be phased out by the end of April 1991. In the case of imports, the existing margin was to be raised from 50.0 per cent to 100.0 per cent, and all exemptions given in the immediate past were to be withdrawn. Last, there was to be no further allocations out of long-term operations [LTO] funds during 1991–92 and no drawals were to be permitted during the period April–September 1991. There were indications in the file notings that the Deputy Governor had perused this note and the Governor was apprised of its contents. It redounds to the credit of the official concerned that within three months (*i.e.*, July 1991) events so unfolded that the authorities were forced to implement some of the strong measures envisaged above, though with some modifications.

The third and final office note prepared in early April 1991 summed up the economic scene as it was evolving. M_3 recorded subdued growth, which was attributable to factors, such as the slackening of deposit growth on the components' side, as also lower non-food credit and a decline in the foreign exchange assets of the banking sector on the side of sources. Competition from mutual funds as well as inflation impacted bank deposit growth. The macroeconomic fundamentals and the continuing uncomfortable BoP situation left the authorities with little option but to pursue a restrictive credit policy during 1991–92 too. However, the silver lining on the horizon was the prospect of success in fiscal correction, a factor that would provide considerable manoeuvrability to the Reserve Bank in formulating its monetary policy. Growth in M_3 was expected to be fairly close to the projection of 15.5 per cent in 1990–91, much better than the sharp rise of 19.9 per cent in 1989–90.

Besides these principal policy notes, another subsidiary note considered the implications if there was a hike in the maximum bank lending and deposit rates, including the rates on overdrafts to state governments. Concurrently, there was a proposal that if the lending rates were to be raised by 1.5 percentage points, no interest needed be paid to banks on their incremental cash balances beyond March 1991. The rationale was that the package would not entail a loss to banks, while for the Reserve Bank, the effectiveness of CRR as an instrument of monetary policy would stand enhanced.

The hard posturing, however, concealed the fact that while the Reserve Bank was overtly committed to promoting exports through provision of export credit refinance on favourable terms to banks, it was rather uneasy about its impact on reserve money creation. The Bank contemplated three options: (i) bringing forward the base for determining export credit refinance entitlement from the year 1988–89 to 1989–90; (ii) provision of refinance to the extent of only 50.0 per cent outstanding export credit; and (iii) introduction of a two-tier refinance formula, namely, 50.0 per cent on 1988–89 base and 100.0 per cent on 1989–90 base level. The first option, although perceived to be best suited for restraining reserve money growth, did not find favour because it was construed to adversely affect export promotion. The second course of action was expected to impart an element of rigidity since the authorities could find it difficult to reduce the limits in future when needed and, more importantly, it could result in enhancing the prevailing export finance limit to banks, an outcome that the Reserve Bank was trying to avoid. The last option of a two-tier formula on balance found favour, since it combined a partial relaxation of the existing practice of bringing forward the base year with the absence of any difficulty if it had to be withdrawn in future. The dilemma facing the Reserve Bank was clearly brought out by the Deputy Governor in his noting dated March 24, 1991.

The feasibility of withdrawing export credit limits conjointly with some reduction in CRR was examined internally in the above context. But it was felt that such a measure would have varying effects on the concerned banks. To elaborate, banks that had a relatively higher share in export refinance limits than in their deposits (*i.e.*, the base for CRR) would stand to lose and *vice versa.* The Governor's perceptive comment that banks, which did more for exports; a national priority, should be helped, consciously settled the issue. Notwithstanding the differences in these internal perceptions, the Reserve Bank was clear that it should continue to explore avenues for rationalisation to the point where CRR could be brought down to a lower level, thus doing away with the payment of interest on impounded CRR balances and, in the process, adapting it as an effective instrument of credit control. As a first step in this direction, the Reserve Bank decided to partially reduce the existing export finance level together with an appropriate reduction in CRR. The Deputy Governor recommended a CRR reduction of 1.5 per cent and simultaneously bringing forward the base year for determining export refinance entitlement from 1988–89 to 1989–90. This would augment the resource position of banks on one hand and exporters would get 100.0 per cent refinance over the new base year on the other. The Deputy Governor, Dr C. Rangarajan summed up the proposition in a subtle manner: "We need to present the case as a rationalisation of CRR and not a signal for further credit expansion." The Governor assented.

TIGHTENING OF CREDIT POLICY FOR THE FIRST HALF OF 1991–92

The credit policy measures for the first half of 1991–92, which the Governor announced on April 12, 1991, were formulated more in the context of the precarious BoP position than the emerging macro trends in growth in M_3, prices and output. Its overriding objective was to conserve the country's foreign exchange by slowing the pace of imports and aiding export promotion efforts and, therefore, its stance was one of caution. Banks were advised in the circular that although there were several imponderables in making a forecast of the real rate of growth of the economy for the year 1991–92, they should ensure that their incremental non-food credit (excluding export credit)-deposit ratio did not exceed 45.0 per cent.

To help export promotion efforts, export credit was excluded from the computation of the non-food credit-deposit ratio. From April 20, 1991, for defaults in maintaining the prescribed ratio, the errant banks were to be charged additional interest of 3.0 percentage points on the refinance drawn from the Reserve Bank under all facilities on the amount of excess credit over the stipulated level or the refinance drawn, whichever was lower. Banks that chronically breached the ratio faced the prospect of total withdrawal of all refinance facilities.

Recognising the need to provide continued support to the export sector without unduly resulting in a large increase in created money, a two-tier refinance formula was introduced. From July 27, 1991, banks were provided export refinance to the extent of 50.0 per cent of the increase in export credit over the monthly average level of export credit in 1989–90. To restrain monetary expansion, the lending rate on limits of over ₹ 2 lakh was raised from April 13, 1991 by one percentage point to 17.0 per cent (minimum). Term deposit rates for three years and over were raised by one percentage point, from 11.0 per cent to 12.0 per cent to achieve better alignment between the maximum deposit rate and the yield on alternative saving instruments and to reflect the prevailing inflation rate. Rates of interest on NR(E)R deposits of maturities of three years and above were enhanced by one percentage point.

The foreign exchange position continued to cause serious concern to the authorities, and, therefore, it became necessary to further contain overall demand pressures by moderating monetary expansion. The Reserve Bank tightened further its credit policy by imposing an incremental CRR of 10.0 per cent of the increase in deposits over the level on May 3, 1991. To mitigate its effect on banks, the Reserve Bank decided to pay interest at the rate of 8.0 per cent on these additional cash balances. This measure was considered essential to meet the short-term exigencies of the situation and was a prelude to activating the monetary policy measures in July 1991.

NEED FOR REGULATION OVER PORTFOLIO MANAGEMENT SERVICES OFFERED BY BANKS

The Credit Planning Cell (CPC), in an office note dated March 22, 1991, made a strong case for imposing strict control over portfolio/funds management services provided by banks on the rationale that these activities undermined monetary and credit discipline. These were treated as off-balance sheet items and hence did not strictly form part of the liabilities of banks. Even though a Reserve Bank circular dated January

18, 1991 had advised banks that the funds deployed under their clients' portfolio account would attract CRR and SLR, policymakers surmised that banks might manipulate these funds to circumvent the reserve requirements. The office note suggested that the minimum period for funds involved under portfolio/funds management services should be three years and subject to reserve requirements. However, in the case of funds handled by subsidiaries of banks for these purposes, the reserve prescription was to apply for a temporary period. The Executive Director felt that instead of imposing conventional reserve requirements, some kind of quasi-reserve rule could be devised to achieve the objective of prudent management of these funds by banks and their subsidiaries. Under this proposal, banks would hold 25.0 per cent of the funds in government and other approved securities, and to avoid the volatile churning of funds and venturing into the call money market by errant means on days other than reporting Fridays, investment in any single instrument was to be for a minimum period of six months and such investments purchased must be transferred in the name of the client for whom the portfolio management services were being provided. With a touch of humour, the Executive Director, Shri S.S. Tarapore, remarked: "To have to impose such curbs soon after the pioneering portfolio management is indeed distressing... That economists have been awarded Nobel Prize for Economics [for doing pioneering research on this topic] is a painful reminder of the harshness of the realities of the Indian financial system."

However, the Deputy Governor preferred a pragmatic approach to this issue, which was approved by the Governor. He reasoned that the Reserve Bank had 'wrestled' with this problem for the past two years since it was widely believed that the basic motivation of the scheme was to earn a rate of return well above the prevailing interest rate on bank deposits, and portfolio management was only a 'facade' to provide a higher rate of return on short-term funds. According to him, the existing regulations over these transactions were adequate, that it was only a matter of ensuring that banks — particularly the foreign banks — abided by the regulations, and adding further conditions would not take the Reserve Bank far. Finally, he suggested that a mechanism should be devised to ensure strict compliance with the existing regulations in the form of submission of quarterly returns by banks relating to these activities.

SWIFT RECOVERY AND ON THE ROAD TO GROWTH

THE NEW ECONOMIC POLICY OF JULY 1991

As discussed earlier, the overriding consideration in the policy actions of the Reserve Bank in the second half of 1990–91 and the first quarter of 1991–92 was to contain aggregate demand and, in particular, the demand for imports. The terms of export credit were adjusted in order to accelerate realisation of export proceeds. The efforts at reducing the overall monetary demand and inflation in the economy had over time led to an improvement in the BoP. As the foreign exchange situation improved and the rate of inflation showed signs of slackening, there was gradual withdrawal of the stipulation relating to cash margins on imports and some moderate lowering of lending rates applicable to large borrowers (October 1991).

The strategy for correcting serious imbalances in the internal and external sectors of the economy was two-pronged, namely, strong macroeconomic stabilisation on one hand and structural reforms on the other. The former included fiscal correction, monetary tightening, inflation control, exchange rate adjustment and strengthening the competitiveness of India's exports. These were supported by long-term structural reforms, such as, industrial deregulation, liberalisation of foreign direct investment (FDI), trade liberalisation, overhauling of public sector enterprises and financial sector reforms. The determined efforts made by the Government and supported by the Reserve Bank to bring the external liquidity crisis under control and restore the confidence of foreign creditors succeeded. The country's foreign exchange assets (FCA) recorded a remarkable turnaround from less than US$ 1.0 billion in the middle of July 1991 to US$ 5.6 billion by the end of March 1992. Nonetheless, the Reserve Bank in its Annual Report for the year 1991–92 sounded a note of caution that immediate stabilisation measures and the long-term structural reforms could pose problems of prioritisation of measures, such as between the goals of fiscal correction and fiscal consolidation and between monetary control measures and financial sector reforms.

SYNCHRONISED APPROACH

In the very first year of the reform, the conduct of monetary policy underwent transformation concurrently with the presentation of the reform-oriented Central Government budget in July 1991. The key macroeconomic assumptions underlying monetary targets for 1991–92, namely, real GDP growth of 3.0 to 3.5 per cent, inflation of around 9.0 per cent and a significant slowdown in M_3 expansion to about 13.0 per cent, became irrelevant by the first half of 1991–92, since building up foreign exchange reserves emerged as an overriding objective by the middle of 1991. Severe import compression, credit curtailment and fiscal adjustment measures adversely impacted the industrial sector and thus the overall growth rate of the economy. Expansion in M_3 accelerated to a high of 18.5 per cent in 1991–92, mainly due to a sharp increase in primary liquidity. In response to these developments, the Reserve Bank took a series of measures in co-ordination with the finance ministry to restore macroeconomic stability and bring in structural adjustment.

The foremost measure was a two-step downward adjustment in the exchange rate of the rupee by 17.38 per cent in terms of pound sterling and about 18.7 per cent in US dollar terms, which was effected by the Reserve Bank with the objective of promoting competitiveness in exports, reducing inessential imports, minimising incentives for flight of capital, stabilising the current account of BoP and restoring the viability to the country's BoP. To ensure that the gains of exchange rate adjustment were not dissipated by inflation, the Reserve Bank tightened monetary policy with sharp increases in the Bank Rate and lending and refinance rates. These measures were in accord with the Government's adjustments in fiscal, trade, industrial licensing and foreign investment policies, and formed part of a radical shift in the economic policy regime.

ACTIVATING THE MONETARY POLICY FOR CRISIS MANAGEMENT AND ECONOMIC RECOVERY

The Union Budget for 1991–92 launched the programme of fiscal adjustment for rapid macroeconomic stabilisation. It was to be followed up with fiscal consolidation over a medium-term perspective of about three years. Hence, the budget proposed concrete measures to reduce the gross fiscal deficit (GFD) from about 8.4 per cent of GDP in 1990–91 to 6.5 per cent in 1991–92 and to contain the revenue deficit and monetised deficit at relatively low levels. The budget also included several non-fiscal reform measures related to the financial sector, such as, an increase in interest rates on small savings, granting freedom to financial institutions to charge interest in accordance with their perception of the creditworthiness of their borrowers subject to a floor rate of 15.0 per cent, removal of restrictions on the interest rate offered on debentures, strengthening the capital market, transfer of control over capital issues to the Securities and Exchange Board of India (SEBI) and permitting mutual funds activity in the private sector.

Finally, the Government announced its intention of strengthening the role of the financial sector as an essential adjunct to promoting economic growth and competitive efficiency, as well as improving the health of the financial institutions.

To ensure adjustment of the imbalance in external payments, the Bank raised the Bank Rate by one percentage point, *i.e.*, from 10.0 per cent to 11.0 per cent, from the close of business on July 3, 1991, as well as other rates on accommodation from the Reserve Bank specifically linked to the Bank Rate (by one percentage point). Simultaneously, the Reserve Bank realigned refinance rates with the enhanced Bank Rate. Discretionary refinance rate was raised by 3.0 percentage points, food credit refinance by 2.5 percentage points, stand-by refinance by 1.0 percentage point and export credit refinance by 0.5 percentage points. The decision to raise the Bank Rate was taken by the Governor based on the statutory powers derived under section 7(3) of the Reserve Bank of India (RBI) Act, 1934, without going through the normal course of obtaining the prior approval of the Central Board of Directors or its Committee.[4]

Interest rates on term deposits (excluding FCNR/NRE accounts) were enhanced across the board by one percentage point; this was, however, made applicable only to fresh deposits and on renewals of maturing deposits. To curtail aggregate demand and following the change made in deposit rates, the lending rate on limits over ₹ 2 lakh was marked-up by 1.5 percentage points from 17.0 per cent (minimum) to 18.5 per cent (minimum). The effective interest rate on discounting bills of exchange for this category of borrowers was one percentage point below the corresponding lending rate charged to borrowers in this category. There was no change in the existing rates in the case of term loans to agriculture, small scale industry and transport operators owning up to two vehicles.

The measures announced by the Bank attracted interesting reactions from the media. For example, under the caption A Deflationary Policy, the Economic Times in its editorial dated July 8, 1991 postulated that given the devaluation of the rupee, it was only natural that the Reserve Bank followed it up with the announcement of new measures to prevent monetary overheating of the economy and to dampen inflationary pressures and that the logic and the need for these steps were understandable. It added that

4. This action was based on earlier precedents of raising the Bank Rate during the tenures of the Governor, Shri S. Jagannathan (on July 22, 1974) and the Governor, Dr I.G. Patel (on July 11, 1981).

the proximate compulsion behind the changes in the interest rates was the fear that the rupee devaluation might fuel inflation. However, it sounded a note of caution that attempts to curb the growth in M_3 and credit might lead to a resource crunch and push up costs in the manufacturing sector and that the prime engine behind the monetary expansion in the economy was the Central Government, given its heavy dependence on the Reserve Bank credit.

CONTINUANCE OF TIGHT CREDIT POLICY IN THE SECOND HALF OF 1991–92

With inflation still hovering around double-digit figures by the second quarter of 1991–92 and given the need to comply with the performance criteria under the IMF stand-by arrangement, the Reserve Bank was left with no choice but to further tighten credit control. The Executive Director, in his note dated September 25, 1991, advocated the withdrawal of refinance facilities — in particular the discretionary refinance — which was expected to have a strong announcement effect and serve as a pre-emptive strike on larger drawal by banks.

A sharp rise in short-term deposit rates within the existing ceiling of 13.0 per cent was also envisaged, because with the high rate of inflation (*i.e.*, around 15.0 per cent), deposit rates turned out to be negative. In addition, changes in the lending rate structure became necessary for three reasons. First, the rates being charged by the Small Industries Development Bank of India (SIDBI) had to be placed on par with those of banks, by raising the rate from 14.0 per cent (fixed) to 15.0 per cent (minimum) in the case of term loans to agriculture, small scale industries and transport operators owning up to two vehicles. Second, an increase in lending rates at the lower end of the structure was seen as an 'ineluctable' necessity, because the co-operative banks were confronted with the anomaly of paying 13.0 per cent for deposits and charging 10.0 per cent for loans. Third, enhancing the lending rate for limits over ₹ 2 lakh was seen as an appropriate response to the rising inflationary trend. All lending rates up to ₹ 2 lakh were proposed to be enhanced by 1.5 percentage points, and term loans for agriculture, small scale industries and transport operators owning up to two vehicles for loans between ₹ 25,000 and up to ₹ 2 lakh were to be raised by one percentage point. For loans over ₹ 2 lakh, the rate was to be 15.0 per cent (minimum) as in the case of term-lending institutions. Policymakers placed faith in banks' monitoring the incremental non-food credit (excluding export credit)-deposit ratio, and favoured the imposition of stiff penalties for any infringement of the rules in this regard.

A post-shipment export credit facility denominated in foreign currencies at the prevailing international interest rates was proposed to be introduced. The Reserve Bank decided that all mutual funds, including the Unit Trust of India (UTI), should be asked to maintain in a phased manner 10.0 per cent liquidity requirement in government and other approved securities related to their asset value. However, this measure was to be implemented through issuance of guidelines and kept distinct from the October 1991 credit policy. During the last week of September 1991, these proposals were discussed by the Governor at a meeting with the Finance Minister, Finance Secretary and the Chief Economic Adviser to the Government of India. For obvious reasons, the hike in the Bank Rate, which formed the nodal feature of the credit policy announcement of October 8, 1991, was kept a well-guarded secret.

In the context of the proposals considered separately for raising the bank interest rates, a need arose to further reduce the payment of interest on eligible cash balances of banks with the Reserve Bank. From April 21, 1990, the Reserve Bank had been paying interest under a two-tier formula, *i.e.*, at 10.5 per cent on balances as on March 23, 1990 and at 8.0 per cent on balances maintained on increased deposits after March 23, 1990 (*i.e.*, incremental CRR). The option of non-payment of interest on the 10.0 per cent incremental deposits from March 1990 as well as on the incremental CRR balances after May 3, 1991 did not appeal to policymakers because of the comparatively larger loss in income to banks compared to the alternative, namely, a reduction in interest on eligible cash balances from 8.0 per cent to 6.0 per cent after March 1990 (*i.e.*, balances relating to the average as well as incremental prescription). The second method had the drawback that if at some stage the Reserve Bank decided to merge the average and incremental CRR, it might face the problem of determining the rate of interest to be paid on eligible cash balances after March 1990.

The Reserve Bank, however, was not unduly concerned about the loss of interest income to banks, as such income was in any case expected to rise very sharply because of other measures and there was a pressing need to reduce the created money in the system. As things stood at that time, there was a distinct possibility that if no corrective measures were taken, one-fourth of the cash balances impounded would return to banks as interest (on these balances) in 1992–93. Taking all factors into account, the Reserve Bank concluded that some reduction in interest paid on CRR balances was 'justified'. The Governor approved of the second proposition with the proviso that the rate of interest paid to banks should be 5.0 per cent instead of 6.0 per cent, thus making the prescription even more stringent.

SECOND INCREASE IN THE BANK RATE IN THREE MONTHS AND OTHER RESTRICTIVE MEASURES OF OCTOBER 1991

As internally envisaged, the October 8, 1991 credit policy announcement contained several restrictive measures. Table 14.1 provides the gist of these measures and their rationale.

TABLE 14.1

Important Credit Policy Measures Announced on October 8, 1991

Credit Policy measure	*Rationale*
Bank Rate revised from 11.0 to 12.0 per cent.	The inflationary pressures warranted a restrictive stance of credit policy. Consequent to the increase in the Bank Rate, all other rates on credit from the Reserve Bank that were specifically linked to the Bank Rate were correspondingly raised by one percentage point unless otherwise specified.
Lending rates of scheduled commercial banks (SCBs) raised across the board by 1.5 percentage points, which ranged from 11.5 per cent to 20.0 per cent (minimum) as against 10.0 per cent to 18.5 per cent (minimum). In the case of term loans to agriculture, small scale industries and transport operators owning up to 2 vehicles, however, the lending rate for loans between ₹ 25,000 and up to ₹ 2 lakh was raised by one percentage point.	In the context of the current inflation rate, several lending rates had become negative in real terms.
The rate on term deposits with a maturity of 46 days to less than one year was increased from 9.0 per cent to 11.0 per cent. For better alignment of the return on short-term deposits, the term deposit rate with a maturity of one year to less than two years was raised from10.0 per cent to 12.0 per cent.	With high inflation rates, deposit rates at the short end had become unattractive. The rates were increased to ensure the competitiveness of bank deposits and to provide a better rate of return on short-term surplus funds.
Interest rates on pre-shipment and post-shipment export credit were raised.	To provide greater incentive to banks and to enable them to provide credit support to the export drive.

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The export credit refinance formula was modified. Commercial banks would be provided export credit refinance to the extent of 60.0 per cent of the increase in outstanding export credit over the monthly average level of 1988–89 up to the monthly average level of 1989–90 plus 125.0 per cent of the increase over the monthly average level of outstanding export credit in 1989–90. The modified two-tier formula was implemented in two stages.	Major incentive to banks to extend export credit.
Cash margins on imports:	
The cash margin on OGL imports (at the time of opening of letters of credit or placement of order on overseas suppliers for import of other than capital goods) at a rate of 200.0 per cent was reduced to 150.0 per cent.	
From October 9, 1991, refinance facilities to SCBs were withdrawn for the remaining duration of the year. These included food credit refinance, stand-by refinance, 182-day Treasury Bills refinance and discretionary refinance.	The imperative need to contain reserve money expansion in the context of the severe inflationary pressures in the economy.
Banks that exceeded their incremental net non-food credit (excluding export credit)-deposit ratio of 45.0 per cent for 1991–92 for two successive fortnights faced the prospect of an automatic reduction in refinance limits for the next four fortnights and any excess credit in each subsequent fortnight would result in reduction in refinance limits for the following two fortnights.	To ensure strict compliance with the stipulated ratio.
From October 19, 1991: (i) on the eligible cash balances based on deposits (*i.e.*, net demand and time liabilities) as of March 23, 1990, interest was continued to be paid at a rate of 10.5 per cent; and (ii) on the increase in eligible cash balances based on deposits maintained after March 23, 1990 under the average 15.0 per cent CRR as well as eligible cash balances under the 10.0 per cent incremental CRR, interest was to be paid at a reduced rate of 5.0 per cent.	To curtail the increase in reserve money, the total interest payments made by the Reserve Bank to banks had to be moderated.

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concld.

Selective credit controls were reintroduced on bank advances against stocks of cotton and *kapas*, the minimum margins on advances against pulses raised and the level of credit ceiling on advances against wheat reduced.	On a review of the recent price-output developments in the respective commodities.
Banks were to ensure that there was no increase in the credit outstanding: (i) for purchases of consumer durables; (ii) to individuals against shares and debentures/ bonds; (iii) other non-priority sector personal loans; and (iv) real estate loans.	In the context of inflationary pressures and pressure on banks' resources.

Source: Reserve Bank of India, CPC circular.

POST-CRISIS RELAXATION IN MONETARY POLICY (FEBRUARY 1992)

The payments crisis was overcome within a short period. The Reserve Bank, therefore, decided to resume efforts at correcting the fundamental macroeconomic imbalances afflicting the economy.

An important mid-course policy announcement was made by the Reserve Bank on February 29, 1992, coinciding with the presentation of the Union Budget by the Finance Minister in Parliament for the year 1992–93. From the available records it appears that unlike in the past, there was no internal review note to suggest possible changes in credit policy measures. Apparently, there were close and frequent consultations between the Reserve Bank and the Government in order to integrate and harmonise the content of credit policy with the budget proposals. The measures announced related to lending rates, SLR and introduction of a new NRI rupee deposit scheme.

REDUCTION IN LENDING RATES

In view of the decline in the headline inflation from the peak of 16.7 per cent in the week ended August 24, 1991 to 11.8 per cent in the week ended February 8, 1992, the Reserve Bank reduced the lending rate on credit limits of over ₹ 2 lakh by one percentage point, *i.e.*, from 20.0 per cent (minimum) to 19.0 per cent (minimum). Banks were advised to reduce the rates for all borrowers under this category by a minimum of one percentage point over the rates being charged to them. The effective rate of interest on rediscounting of bills of exchange for this category of borrowers was reduced to 18.0 per cent (minimum) and the actual rate charged was one percentage point below the corresponding lending rate charged to borrowers in this category. The Reserve Bank impressed upon banks that while they were free to determine the actual lending rates, they should adopt objective and rational criteria to decide the range of rates between the minimum lending rate as stipulated by the Reserve Bank and the actual rates charged to different borrowers. Borrowers with the highest credit rating were normally to be provided credit at the minimum rate stipulated by the Reserve Bank and, depending on the credit risk, higher rates could be charged. However, banks were cautioned that it would be prudent to avoid an excessively large spread in rates. *Inter alia*, the lending rate for commodities within the purview of selective credit controls was reduced from 20.0 per cent (minimum) to 19.0 per cent (minimum).

LOWERING OF SLR

In the context of the fiscal adjustment and macroeconomic stabilisation undertaken by the Government, the Reserve Bank considered it feasible to moderate the existing levels of statutory pre-emptions. The Narasimham Committee had recommended in its report submitted in November 1991 that the SLR might be brought down in a phased manner. Considering the expected decline in the GFD of the Centre and keeping in view the recommendation of the Narasimham Committee, the Reserve Bank reduced SLR from its existing level of 38.5 per cent without disrupting the market borrowing programme of the Central Government. SLR remained 'frozen' at 38.5 per cent up to the level of outstanding deposits as on April 3, 1992 (excluding non-resident liabilities), and for any increase in deposits above the April 3, 1992 level, the applicable SLR was 30.0 per cent.

A NEW NON-RESIDENT (ORDINARY NON-REPATRIABLE) RUPEE DEPOSIT SCHEME

To provide further incentives and wider options to non-residents, including the overseas corporate bodies, a new non-resident (non-repatriable) rupee deposit scheme [NR(NR)RD] was introduced in June 1992. The scheme contained several attractive features to enable banks to mobilise substantial deposits and attract foreign exchange on a non-repatriable basis without any foreign exchange risk. Banks that were authorised to deal in foreign exchange could accept deposits under the scheme by way of transfer of foreign exchange funds from outside India or from the existing NRE/FCNR accounts, which would be converted into rupees at the prevailing exchange rate; these funds, were not repatriable. The deposits under the new scheme could be accepted for maturities of six months to three years and were not deemed as part of net bank credit for purposes of determining priority sector lending. These deposits (and the advances against such deposits) were exempt from interest rate stipulations and, thus, banks were free to fix the deposit and lending rates under this scheme.

SUSTAINED PROGRESS IN THE REFORM ERA

The first phase of crisis management was completed by the close of 1991–92. The Government at the Centre, which assumed office in June 1991, inherited a grave and deepening economic crisis. The BoP situation was precarious, with the foreign exchange reserves barely enough to meet two weeks of import payments. International confidence in the creditworthiness of India had collapsed so much that access to commercial borrowings was closed and non-resident deposits were being withdrawn at an alarming pace. Industrial growth had turned negative due to severe import squeeze, and inflation was on the rise. The new Government moved quickly to restore macroeconomic stability and, at the same time, initiated structural reforms that were designed to strengthen the growth capability of the economy in the medium-term. Although full results of the Government's adjustment policies took time to materialise, substantial progress was achieved even in the first nine months. By April 1992 international confidence in the Indian economy had been restored and the cushion of foreign exchange reserves had been rebuilt. Inflation was on a downtrend from a peak of about 17.0 per cent in August 1991 to less than 13.0 per cent by March 1992, which, however, was not adequate to meet the target.

Reforms in the area of fiscal correction formed the centre-piece of the wide-ranging reform measures.[5] The fiscal policy initiatives introduced in July 1991 greatly helped to reduce the GFD of the Central Government in relation to GDP, from 8.3 per cent in 1990–91 to 5.9 per cent in 1991–92 and further to 5.7 per cent in 1992–93. However, the revenue deficit of the Centre as a percentage of GFD continued to remain high at around 45.5 per cent. Unfortunately, the resource gap on revenue account was bridged by high-cost borrowed funds. As a result, interest payments accounted for 41.5 per cent of revenue receipts in 1992–93. However, progress in other areas was highly satisfactory. The macroeconomic outcomes from 1990–91 to 1996–97 are captured in Table 14.2.

5. Refer to chapter 15: Public Debt Management for a review of fiscal consolidation

TABLE 14.2

Indian Economy in the Post-Reform Period (1991–92 to 1996–97): Key Macroeconomic Growth Indicators

(Per cent unless otherwise indicated)

	1990–91	*1991–92*	*1992–93*	*1993–94*	*1994–95*	*1995–96*	*1996–97*
Real GDP Growth[@]	5.4	0.8	5.3	6.2	7.8	7.2	7.5
Inflation (average of weeks)[#]	10.3	13.7	10.1	8.4	10.9	7.7	6.4
Broad Money (M_3) growth	15.1	19.3	14.8	18.4	22.4	13.6	16.2
Reserve Money Growth	13.1	13.4	11.3	25.2	22.1	14.9	2.8
Net RBI Credit to Central Government	20.5	6.3	4.6	0.3	2.2	20.1	1.6
Net Domestic Assets (NDA) of RBI	1.1	9.5	9.3	-1.0	8.4	27.3	-12.6
Gross Fiscal Deficit (GFD/GDP)	8.3	5.9	5.7	6.9	5.6	4.9	4.7
Monetised Deficit as percentage of GDP[+]	2.7	0.9	0.6	0.03	0.2	1.6	0.1
External CAD/GDP	-3.2	-0.4	-1.8	-0.4	-1.0	-1.6	-1.2
Official Foreign Exchange Reserves (US$ billion) (end-March)	58.34	92.20	98.32	192.54	251.86	216.87	264.23
Gross Official Reserves (in months of imports)[&]	2.7	5.6	5.1	8.6	8.5	6.1	8.1

Notes: @: Real GDP growth rate at constant prices. GDP at factor cost (base = 1980–81).

#: Wholesale Price Index (WPI) (base = 1981–82).

+: In 1989–90, Monetised Deficit as percentage of GDP was 3.02, the highest on record.

&: According to the IMF definition and including SDR holdings and gold valued at SDR 35 per ounce.

Source: Reserve Bank of India, *Annual Report*, various issues; *Handbook of Statistics on the Indian Economy, 1999*; Government of India, *Economic Survey*, various issues.

FINANCIAL SECTOR REFORMS

The favourable outcomes of the strong and purposive policy measures in 1991–92 provided the launch pad for further financial sector reforms, which can be classified into three categories, namely: (i) removing the external constraints operating on the profitability of banks; (ii) improving the financial health of banks and introducing greater transparency in their balance sheets; and (iii) injecting a greater element of transparency in the financial system. The first category formed the plank of monetary management, given the fiscal dependence on the banking system's support and the need to ensure that the banks' ability to create credit was modulated to suit the economic circumstances of the time.[6] The external constraints in the form of high levels of SLR were required to be relaxed and the structure of interest rates to be simplified. The Economic Survey for 1992–93 stressed the need to phase out the distortion present in the financial system due to the very high levels of SLR and CRR, and suggested that CRR might be reduced over a five-year period to a level below 10.0 per cent. The Narasimham Committee had also, *inter alia*, recommended a phased reduction in SLR. The Government decided to reduce SLR to 25.0 per cent over the next three years and reduce CRR to 10.0 per cent over four years (Table 14.3).

TABLE 14.3

Phased Reductions in SLR and Changes in CRR

I. Reductions in SLR

Announcement date	*Effective date on domestic deposits of commercial banks*
February 29, 1992	30.00 per cent of the increase in deposits over April 3, 1992 level. However, 38.50 per cent of deposits up to April 3,1992 level was frozen.
October 8, 1992	38.25 per cent, 38.00 per cent and 37.75 per cent as on April 3, 1992, with effect from January 9, 1993, February 6, 1993 and March 6, 1993, respectively.
April 7, 1993	37.50 per cent and 37.25 per cent as on April 3, 1992 from August 21, 1993 and September 18, 1993.
October 11, 1993	34.75 per cent as on September 17, 1993 and 25.00 per cent on increase in deposits over the level as on September 17, 1993.
May 14, 1994	34.25 per cent and 33.75 per cent as on September 17, 1993 with effect from August 20, 1994 and September 17, 1994.
October 29, 1994	31.50 per cent as on September 30, 1994 and 25.00 per cent on increase in deposits over the level as on September 30, 1994.
April 15, 1997	Inter-bank liabilities were exempted from maintenance of SLR from April 26, 1997.

contd...

6. The last two categories do not strictly form part of monetary management; so they are discussed in the chapter 17: Reforms in Banking and Financial Institutions.

concld.

II. Changes in CRR

Effective date	*Changes in domestic deposits (per cent)*	*On incremental deposits*
May 4, 1991	15.00	10.00 per cent of the increase in deposits over the level as on May 3, 1991.
January 11, 1992		[The rupee equivalent of the funds mobilised under the India Development Bonds exempted.]
April 21, 1992 (announcement date)		(i) 10.00 per cent of the increase up to the level as on April 17, 1992 exempted. (ii) Increase in deposits over the level as on April 17, 1992 exempted.
October 8, 1992		One-third of impounded balances under incremental CRR based on deposit level as on April 17, 1992 was released in three equal instalments beginning from October 17, 1992, November 14, 1992 and December 12, 1992.
April 17, 1993	14.50	
May 15, 1993	14.00	
June 11, 1994	14.50	
July 9, 1994	14.75	
August 6, 1994	15.00	
November 11, 1995	14.50	
December 9, 1995	14.00	
April 27, 1996	13.50	
May 11, 1996	13.00	
July 6, 1996	12.00	
October 26, 1996	11.50	
November 9, 1996	11.00	
January 4, 1997	10.50	
January 18, 1997	10.00	

Source: Reserve Bank of India, CPC circulars.

Incidentally, the phased reduction of SLR to 25.0 per cent over a three-year period was part of the strategy to phase out the automatic monetisation of budget deficit in a three-year time frame (which, again, would help to reduce CRR over the medium term).[7] In effect, as the GFD came down and there was a move away from automatic monetisation of fiscal deficit,

7. The topic of phasing out automatic monetisation of budget deficit is discussed in chapter 15: Public Debt Management.

monetary policy came into its own. Thus the regulation of money and credit was determined by the overall perception of the country's monetary authority on what the appropriate level of expansion of money and credit should be, depending on how real factors in the economy evolved.

THE RESERVE BANK'S DILEMMAS IN REDUCING RESERVE REQUIREMENTS

The medium-term plan was to reduce CRR to 10.0 per cent by March 1997. However, the Reserve Bank was cognisant that temporary deviations might be necessary to restrain growth in excess liquidity. To counter the expansionary impact of the large fiscal deficit in 1993–94, CRR had to be raised by one percentage point, from 14.0 per cent to 15.0 per cent, in three phases between June 11, 1994 and August 6, 1994. Subsequently, the Reserve Bank, while reducing CRR, tried to counterbalance the consequent excess liquidity in the system by trimming export credit refinance.

By March 1993, the Reserve Bank noted that SLR for banks had reached such high proportions that they tended to be 'counterproductive' (office note dated March 17, 1993). This implied that the Bank recognised the need for a basic shift from reserve requirements to more flexible and active OMOs. In the case of CRR, the reduction had to be gradual, as a rapid pace of adjustment could aggravate the problem of excess liquidity. CRR reduction to a more realistic level could be considered only when there were clear signals of an enduring abatement of inflationary pressures as also containment of the fiscal deficit of the Central Government. The acute predicament faced by policymakers in this regard was well captured in the office note recorded (dated February 16, 1994) by the Deputy Governor, Shri S.S. Tarapore, "If we are to effectively move from direct monetary control to indirect monetary control, we need to move away from high CRR limits. The present time offers an opportunity for rationalisation under which the CRR and the refinance limits can both be reduced."

However, the Governor was not persuaded by this reasoning and instead remarked that lowering CRR simultaneously with a reduction in export credit refinance might send the wrong signal and, therefore, instructed that CRR might be raised by one percentage point to contain liquidity.

In the case of SLR, as an integral part of the financial sector reform, its reduction in a phased manner was envisaged to 25.0 per cent over a three-year period ending March 1996. Here again, the policy decision was contingent on a reduction in the GFD of the Central Government.

Unlike CRR, the need for a high level of SLR diminished perceptibly with the progressive move towards market-related interest rates on government borrowing after 1993–94. Although the quantum of SLR that banks were required to maintain was being progressively lowered, the demand from banks for holding government securities did not wane since their rate of return was very attractive and they carried zero risk weight under the capital adequacy norms for commercial banks. In other words, SLR as a statutory prescription became redundant as far as the Central Government was concerned. But the continued reliance of the state governments on SLR led to the pursuit of a cautious approach towards rapid declines in SLR.

Several policy measures were taken to usher in fundamental changes in the financial system. In particular, commercial banks underwent a time-bound structural transformation. The thrust of the reform was to improve the operational and allocative efficiency of the financial system as a whole. This was achieved by correcting several external and structural factors that were affecting its performance. Banks and financial institutions were encouraged to function as autonomous business units that were fully accountable for their performance. The structural reforms in the financial sector focused on easing external constraints, prescribing requisite prudential norms relating to provisioning against loan losses and capital adequacy, introducing transparency in accounting and reporting procedures, restructuring and recapitalising banks, and increasing the competitive element in the market through the entry of private participants. Legislative changes were made to strengthen the legal framework supporting the financial sector.

MONETARY MANAGEMENT IN THE FIRST FULL YEAR OF REFORM (1992–93)

During 1992–93, there was a sharp and welcome deceleration in the price level. Also, the pressure on the external sector eased, allowing for a build-up of the FCA of the Reserve Bank. Besides, the Government decided to reduce the GFD-to-GDP ratio from 6.5 per cent in 1991–92 to 5.0 per cent in 1992–93.

The major objective of monetary policy as usual was on containing inflation by limiting monetary expansion, while at the same time ensuring adequate availability of bank credit for revival of economic activity. Accordingly, the Reserve Bank planned a sharp reduction in M_3 from 18.6 per cent in 1991–92 to less than 11.0 per cent in 1992–93.

CHART 14.1

I. Monetary Policy Announcement for the First Half of 1992–93 (on April 21, 1992)

Endogenous factors	*Exogenous factors*	*Fiscal developments*
The large build-up of foreign exchange reserves resulted in acceleration of monetary aggregates. Growth in M_3 in 1991–92 was estimated at around 18.6 per cent as against 14.9 per cent in 1990–91. The process of implementing the recommendations of the Narasimham Committee on the financial system was taken up.	Growth in select macro-economic variables had to conform to the conditions attached to the drawals under the IMF stand–by loan.	The Central Government decided to reduce GFD from 6.5 per cent of GDP in 1991–92 to 5.0 per cent in 1992–93.
II. Monetary Policy Announcement for the Second Half of 1992–93 (on October 8, 1992)		
By the second half of 1992–93, there were distinct signs of economic recovery. Real GDP was expected to grow by about 3.5 per cent as against about 2.0 per cent in 1991–92. There was strong expansion in M_3 in the first half of the year. The inflation rate by August 1,1992 touched a single-digit level — after two years of double-digit inflation. This was made possible by a reduction in the GFD/GDP ratio and an improvement in the supply position of essential commodities of mass consumption.		The increase in net RBI credit to the Central Government up to September 18, 1992 was 6.0 per cent against 10.2 per cent in the previous year.

Source: Reserve Bank of India, CPC circulars.

The key elements of monetary and credit policy for the first half of 1992–93 were rationalisation of deposit and lending rates, reduction in the average level of CRR and discontinuation of the incremental net non-food credit (excluding export credit)–deposit ratio, which was prescribed in October 1989. Emphasis was placed on encouraging exports in order to alleviate the deficit in external payments. At the same time, the Reserve Bank was aware that the export refinance arrangement attenuated the effectiveness of monetary control, since it accounted for very large refinance limits to commercial banks, which could draw upon the facility as and when required.

Coming to details, the Reserve Bank made conscious efforts to not only gradually reduce the level of interest rates in the banking system, but also rationalise the rate structure as the inflation rate slowed and the macroeconomic situation improved. The lending rate structure of commercial banks was reduced from six to four, according to the size of limit, from April 22, 1992. The lowest category of credit limit, *i.e.*, up to and inclusive of ₹ 7,500 and the interest thereon, was, however, kept unchanged. The second slab was over ₹ 7,500 and up to and inclusive of ₹ 25,000 and the third slab was over ₹ 25,000 and up to ₹ 2 lakh. As a step towards further rationalisation of deposit rates, the number of prescribed rates was reduced. As against fixed rates of interest prescribed for term deposits for three maturity periods in the range of 11.0 per cent to 13.0 per cent, from April 22, 1992, the deposit rate for maturity of 46 days to 3 years and above became a single prescription of 'not exceeding 13.0 per cent per annum'. Moreover, as the economic crisis receded, an early move towards maintenance of lower reserve requirements was felt to be an appropriate policy response.

Banks were exempted from the maintenance of the 10.0 per cent incremental CRR for increase in net demand and time liabilities (NDTL) (*i.e.*, deposits) over the level as on April 17, 1992. However, the 10.0 per cent incremental CRR continued to be operative up to the level of deposits as on April 17, 1992. With the reduction in the effective CRR as a result of the discontinuation of the incremental CRR, the Reserve Bank decided that from May 2, 1992: (i) on the eligible cash balances based on deposits as on March 23, 1990, interest would continue to be paid at 10.5 per cent; and (ii) on the increase in eligible cash balances based on deposits after March 23, 1990 — under the average 15.0 per cent CRR as well as the 10.0 per cent incremental CRR — interest would be paid at 3.0 per cent (earlier, the first category was paid interest at 10.5 per cent and the second category at 5.0 per cent). Measures were introduced to allow a more liberal flow of refinance to banks and institutions and augment their lendable resources. Further, credit policy measures sought to improve the flow of credit to sectors such as exports, the priority sector including agriculture and small scale industry, and medium and large industry.

Perhaps the most striking aspect of the credit policy, which marked a break from the past, was that it initiated a multi-pronged strategy. For example, the Reserve Bank took steps to develop an institutional framework for financial markets by facilitating the emergence of an active secondary market in government securities. The Reserve Bank broadened the gilt-edged market, which, in the long run, decreased the dependence of the Government on borrowings from it and the banks. The credit policy circular dated April 21, 1992 averred that this was an important element of monetary and credit policy for 1992–93 and that once credit to the Government did not pre-empt the resources of the banking sector, it should be possible to augment credit availability to support the revival of private sector activity in the economy. In pursuance of this approach, one of the major steps was the introduction of 364-day Treasury Bills, the first auction of which was held on April 28, 1992. Under the scheme of money market mutual funds (MMMFs), banks were allowed to raise resources to the extent of 2.0 per cent of the sponsoring bank's fortnightly average deposits during 1991–92.

In the first half of 1992–93, there was a strong growth in time deposits, which was attributable to the telescoping of the maturity structure of term deposits, the flexibility given to banks to pay interest on term deposits within the cap of 13.0 per cent, the increase in interest rate on savings deposits, the increase in the limits for the issue of CDs and inflow of funds from abroad. Interestingly, the uncertainty arising from the irregularities in the transactions in the securities market during this period seemed to have contributed to the spurt in term deposits.

Before moving to the developments in the second half of the year, it is worth recording an instance of policy undercurrents and dilemmas. As a prelude to the finalisation of the credit policy for the first half of 1992–93, at the meeting held with the Finance Minister in April 1992, the Government sought clarifications on some of the proposals. At the meeting, the Reserve Bank officials shared the Government's concern in respect of rationalisation of short-term deposit rates and that the April/May 1985 episode[8] should be avoided with rigorous follow-up. As regards changes in CRR, the Reserve Bank showed a distinct preference for reducing the average CRR rather than merely abolishing incremental CRR, because the former had the advantage of inducing benefit at the time of change and reducing interest payments at the same time, while abolishing

8. Refer to chapter 4: Monetary and Credit Policy and chapter 6: Banking and Finance for details of this event.

the incremental CRR provided benefits only over time. The third proposal — which, however, did not find a place in the final policy measures for the first half of 1992–93 — related to changing the base for determining export credit refinance with the intent of better monetary control, as severe difficulties were foreseen in putting through adjustments in CRR. The Reserve Bank was reconciled to the fact that if the status quo on the rupee export credit base was to be maintained, it was better not to reduce CRR at that stage.

The measures introduced in the credit policy for the second half of 1992–93 (announced on October 8, 1992) carried forward the emphasis on the development objective that had been initiated at the beginning of the year. The changes mainly related to minimum lending rates, deposit rates and reserve requirements. The rationale for the proposed changes, as evidenced from the internal notings at the time of formulating the policy, gives an insight into the progressive evolution of monetary policy. These are dealt with in the following paragraphs.

MINIMUM LENDING RATES

The high lending rates for certain sectors were necessitated by the pre-emption of resources at subsidised rates for the Government, as well as the priority sector (as per the mandate) and the slackness in recovery of advances by banks. The official perception was that high interest rates could be brought down only when pre-emption at subsidised rates came down and the overall interest rate structure was rationalised. In October 1992, there was a perceived fall in the inflation rate to a single digit which meant the emergence of relatively high real rates of interest. This development induced the Reserve Bank to reduce the lending rate of SCBs on credit limits of over ₹ 2 lakh by one percentage point, from the minimum of 19.0 per cent to the minimum of 18.0 per cent from October 9, 1992.

RESERVE REQUIREMENTS

The aggregate pre-emptions of the banking system on account of SLR and CRR declined from 63.5 per cent in 1991–92 to 45.0 per cent in the first half of 1992–93. Following the moderation in the GFD, SLR (which was being computed against the outstanding deposits as on April 3, 1992 at 38.50 per cent) was reduced from 38.50 per cent to 37.75 per cent in three steps of 0.25 percentage points each from the fortnights beginning January 9, 1993, February 6, 1993 and March 6, 1993, respectively. SLR of 30.0 per cent on the increase in deposits above the April 3 level was retained.

As dicussed earlier, from April 17, 1992, the incremental CRR of 10.0 per cent was discontinued. Again, of the impounded cash balances of ₹ 3,848 crore maintained under the 10.0 per cent incremental CRR between May 3, 1991 and up to the level of April 17, 1992, one-third (₹ 1,280 crore) was released in three equal instalments in the fortnights beginning October 17, 1992, November 14, 1992 and December 12, 1992, respectively. This, in effect, implied a reduction in the effective CRR by about 0.6 percentage points. Further, CRR base of commercial banks (excluding RRBs), which had remained unchanged since July 1989, was reduced by one percentage point from 15.0 per cent to 14.0 per cent in two equal steps from the fortnights beginning April 17, 1993 and May 15, 1993.

In order to minimise the fragmentation of CRR, the concession granted to banks of exempting a part of the CDs was withdrawn by April 1993. However, the reduction in CRR by augmenting the lendable resources of banks also strengthened their profitability. From May 2, 1992, the Reserve Bank reduced the interest payable on eligible cash balances on the basis of increase in deposits (that is, the NDTL of SCBs) over the level as on March 23, 1991 from 5.0 per cent to 3.0 per cent. On the eligible balances as of March 23, 1990, interest was continued to be paid at 10.5 per cent. To make three non-resident deposit schemes, namely, the NR(NR)RD, foreign currency (ordinary non-repatriable) deposit scheme (FCON) and foreign currency (banks and others) [FC(B&O)] scheme more attractive, they were made fully exempt from reserve requirements.

An area of disquiet shared with the banks (in the credit policy circular dated October 8, 1992) was that, while recognising the paramount need for continued support to the external sector, the unlimited export credit refinance turned out to be counterproductive as it resulted in loss of monetary control. The Reserve Bank's strong misgivings in this regard were articulated by the Deputy Governor, Shri S.S. Tarapore, in his office note dated October 1, 1992 as follows:

> We are riding a dangerous tiger in terms of export refinance facility. This facility was expected to provide some incentive to banks to provide export credit and between 1982 and 1987, the proportion of refinance to export credit ranged between 7 per cent and 27 per cent. Since then, there has been an insidious increase in the proportion of export refinance and the CPC estimate is that on the present formula, by March 1993 the export refinance will be equivalent to 75 per cent of total export credit. The rise in the proportion of refinance has emboldened the export lobby to cry

foul unless export refinance covers 100 per cent of export credit and that too at a very low rate of interest.

In accord with the above perception, the Reserve Bank made certain modifications in this refinance facility. Export credit (rupee) refinance would be provided to the extent of 60.0 per cent of the increase in outstanding export credit over the monthly average level of 1988–89 up to the monthly average level of 1989–90 plus 110.0 per cent of the increase over the monthly average level of outstanding export credit in 1989–90, as against 125.0 per cent hitherto. Under the post-shipment export credit denominated in US dollars (PSCFC)[9] refinance facility, banks were eligible for export credit refinance limits equivalent to 120.0 per cent of such credit provided by them as against 133.3 per cent earlier. Both the changes were effected from October 31, 1992.

RELEASE OF IMPOUNDED INCREMENTAL CRR

The main intention of the authorities was that the pace of reduction of the impounded CRR balance should be carefully worked out, as faster reduction might aggravate the excess liquidity in the economy. In the wake of the slowdown of the inflation rate and the Central Government's renewed commitment to reduce the GFD, the Reserve Bank decided towards the end of 1992 that one-half of additional cash balances that remained impounded with it under the 10.0 per cent incremental reserve ratio between May 3, 1991 and April 17, 1992 could be released in three equal instalments spread over the period from October 17, 1992 to December 12, 1992. The office note dated September 28, 1992 observed that the expansionary impact of the release of CRR balances on M_3 should be borne in mind and ways of mopping-up the excess liquidity through OMOs be explored.

RATIONALISATION OF DEPOSIT RATE STRUCTURE

The deceleration in the rate of inflation during 1992–93 encouraged the Reserve Bank to explore the feasibility of rationalising the structure of deposit interest rates. A reduction in the banks' maximum deposit rate was effected in two stages so that the banks could maintain their economic viability. Rates on domestic deposits of 46 days and above were reduced by one percentage point each from October 9, 1992 (from not exceeding 13.0 per cent to not exceeding 12.0 per cent) and again from March 1, 1993 (to

9. Post Shipment Credit in Foreign Currency.

not exceeding 11.0 per cent). The rate on domestic saving deposits which had been raised from 5.0 per cent to 6.0 per cent from April 24, 1992 was lowered to 5.0 per cent from July 1, 1993. Thus, the maximum deposit rate, the saving deposit rate and the lending rate for limits over ₹ 2 lakh was reduced to the level which ruled before interest rates were raised on April 13, 1991. The interest rate on savings account under the NR(E)R deposits scheme was raised by one percentage point to 6.0 per cent from October 8, 1992. Term deposits on these accounts were rationalised to be in broad consonance with the domestic deposit rates. At the same time, the rates for NR(E)R accounts for maturity of 46 days to three years and above were made subject to a single prescription of not exceeding 13.0 per cent and this was further reduced from April 8, 1993 to not exceeding 12.0 per cent.

TRANSFORMATION OF THE ECONOMY (1993–94 TO 1996–97)

As the year 1992–93 drew to a close, the transition of the Indian economy — which had been afflicted with fiscal dominance and extensive regulation over the functioning of banks and other financial institutions (FIs) — to a more liberalised and market-driven structure gained momentum. Also, the country moved away from the spectre of the BoP crisis to that of convertibility under Article VIII of the International Monetary Fund (IMF).

Fiscal deficits and the automatic monetisation of the budget deficit by issue of *ad hoc* Treasury Bills to the Reserve Bank had been reined in as a result of fiscal consolidation and the Government meeting its temporary budgetary needs by sale of securities in the gilt-edged market. In the period from 1993–94 to 1996–97, huge inflows of foreign capital and the consequent surplus in the BoP, welcome as they were for several reasons, opened new and unforeseen challenges for domestic monetary management. The Reserve Bank's responsibilities, as a result, extended beyond monetary and credit management to promoting financial stability and growth of financial markets with the ultimate objective of achieving more efficient and quick transmission of monetary policy impulses. In the course of implementing the financial sector reforms, the Reserve Bank forged close rapport and understanding with the Ministry of Finance. This was, for instance, reflected in the two agreements with the Central Government in September 1994 and March 1997 to phase out automatic (and unlimited) monetisation of budget deficit in order to reinforce the process of macroeconomic management by the Reserve Bank, on one hand, and impose greater fiscal discipline on the Central Government on the other.[10]

The underlying theme of the narrative covering the years beyond 1993–94 is the manner in which the Reserve Bank tackled the problems arising out of huge capital inflows, given the consequential sharp increases in primary money creation and the impact on other macroeconomic variables. It could also be hypothesised that there was no diversity in these challenges. In fact, what emerged was a 'blended' pursuit of short-term fine tuning and long-term objectives of monetary policy.[11] In the final analysis, in an increasingly open economic environment, the pressure of developments emanating from the external sector was instantly felt in the conduct of monetary policy.

Inflation control, however, remained the cornerstone of the objectives of monetary policy during this period, with varying degrees of emphasis accorded to other subsidiary goals.[12] The latter category included revival of economic growth (1993–94), meeting genuine credit requirements, including that of exports, agriculture, small scale industry and weaker sections (1994–95), necessary credit support for production and investment (1995–96), and support for productive activity by easing resources available to banks without jeopardising the main objectives of monetary and exchange rate stability (1996–97).

Before moving on to narrate the important developments in monetary management during these four years, the accompanying two charts (Chart 14.2 and Chart 14.3) present an overview of monetary policy operating procedures and its strategy, *viz.*:

(i) Major macroeconomic developments that influenced formulation of monetary policy during the period 1993–94 and 1996–97.

(ii) Monetary policy responses during 1993–94 and 1996–97.

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10. Refer to chapter 15: Public Debt Management for details.

11. Reserve Bank of India, *Annual Report, 1996–97*.

12. That monetary policy had been anchored to inflation control all along would be evident from the two policy statements appearing in the Annual Reports of the Reserve Bank of India for the years 1991–92 and 1996–97. The former averred that while there were always multiple objectives, ultimately the mission of the Reserve Bank had been to steer monetary policy with its sights set firmly on inflation control. Five years later, in the *Annual Report 1996–97*, the Reserve Bank elaborated (in the context of the conduct of monetary policy having been criticised by a few as being obsessed with achieving a lower inflation rate) that emphasis on inflation control was not meant to lower the importance of the growth objective and that, on the other hand, it was the sustained reduction in the inflation rate which would pave the way for attaining all the broad macroeconomic objectives including higher economic growth.

These charts are intended not to supplant the historical narration that follows but only to serve as reference points for the study.

CHART 14.2

Major Macroeconomic Developments which Influenced Formulation of Monetary Policy (1993–94 to 1996–97)

Explanatory note:

The periodic internal exercise for framing monetary and credit policy took into account several macroeconomic fundamentals and developments. The more important of these were: (i) trends in macroeconomic variables in the previous year/half-year and the outcome of credit control and other policy measures of the past; (ii) current economic developments, trends in monetary and financial aggregates and the broad monetary policy objectives proposed to be achieved; and (iii) an assessment of the likely performance of the economy and its key components in the short-term.

Monetary Policy (Year and announcement date)	*Endogenous factors*	*Exogenous factors*	*Fiscal developments*
(1)	*(2)*	*(3)*	*(4)*
1993–94 (first half) April 7, 1993	Real GDP growth in 1992–93 recovered remarkably to about 4.0 per cent from a low of 1.2 per cent in 1991–92. There was some moderation in monetary expansion, *i.e.*, 14.2 per cent in 1992–93 instead of 19.4 per cent in 1991–92.	Due to large foreign capital inflows, the current account of BoP recorded a sharp improvement in 1992–93. To sterilise the primary money creation, the Reserve Bank resorted to OMOs.	Monetised deficit (*i.e.*, net RBI credit to Central Government) was contained at 4.6 per cent in 1992–93 as against. 6.3 and 20.5 per cent in 1991–92 and 1990–91, respectively.
June 23, 1993 September 1, 1993	Price situation showed improvement and inflationary pressures weakened. Inflation stood at 6.2 per cent on August 14, 1993 as against 9.3 per cent the year before.		
1993–94 (second half) October 11, 1993	Real GDP was estimated to grow at around 5.0 per cent in 1993–94. WPI as on September 25, 1993 expanded by 7.3 per cent (10.2 per cent the year before). Monetary expansion (M_3) for the full year 1993–94 was projected to exceed 12.0 per cent estimated at the beginning of the year to record 14.0 per cent.	The opening up of the external sector and the strong accretion to foreign exchange reserves created pressures on the domestic economy. Also, the transmission processes of the impulses from the domestic sector to the external sector and vice versa became powerful.	There was some slippage in the GFD target for the year due to pressures on expenditure on both the Plan and non-Plan accounts. But its impact could be contained through sizeable open market sales of government securities by the Reserve Bank.

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(1)	*(2)*	*(3)*	*(4)*
1994–95 (first half) May 14, 1994	A sea change took place in 1993–94 in the factors operating behind monetary expansion. Reserve money expanded by 25.1 per cent compared to 11.3 per cent in 1992–93. M_3 grew by 18.2 per cent in 1993–94 as against 15.7 per cent in the previous year. Inflation at 11.2 per cent as on April 23, 1994 was higher than 7.0 per cent the year before, which caused concern to the Reserve Bank. Increase in net RBI credit to Government in 1993–94 was a nominal ₹ 260 crore, whereas in the past this item accounted for a predominant share of reserve money growth.	The quantum jump in foreign exchange reserves, although welcome for a number of reasons, contributed to large expansion in primary money and thus overall monetary growth.	The Government announced in the Union Budget for 1994–95 its decision to phase out automatic monetisation of the budget deficit through recourse to *ad hoc* Treasury Bills. The agreement of September 9, 1994 between the Reserve Bank and the Central Government formalised this arrangement.
1994–95 (second half) October 17, 1994	In the immediate past, the rate of inflation showed signs of decline. The source of reserve money growth turned out to be the strong expansion in net foreign assets (NFA) of the Reserve Bank. M_3 expanded in 1993–94 (up to September 30, 1994) by 9.7 per cent as against 7.8 per cent in the corresponding period in the previous year, propelled by overhang of primary liquidity from the last quarter of 1993–94 and the continued inflow of foreign funds in the second half of 1994–95. Net RBI credit to the		The reduction in the Central Government's reliance on the Reserve Bank was reflected in a decline in the issue of *ad hoc* Treasury Bills as compared with an increase in the previous year. Monetised deficit of the Central Government remained well below the budget level despite some slippage in GFD.

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(1)	*(2)*	*(3)*	*(4)*
	Central Government and NFA of the Reserve Bank moved in opposite directions for the most part of the year.		
1995–96 (first half) April 17, 1995	In 1994–95, GDP growth picked up to 6.4 per cent and in 1995–96 was expected to perform better at 7.0 per cent. The major sources of M_3 increase in 1994–95 were the growth in NFA of the Reserve Bank and a sharp pick-up in RBI credit to commercial banks. Strong inflationary pressures at the beginning of 1994–95 weakened by the third quarter but picked up during the fourth quarter. M_3 up to March 17, 1995 grew by 22.2 per cent (18.4 per cent in 1993–94). The Reserve Bank perceived this as well beyond what could be considered desirable after taking into account the expected increase in real output. Incidentally, the high growth of M_3 exceeded the 20.0 per cent mark for the third time, the earlier occasions being 1976–77 and 1978–79.	The volume of capital inflows turned out to be higher than anticipated. The phenomenal increases in capital inflows in the second half of 1993–94 and the first half of 1994–95 had a pronounced effect on monetary expansion in 1994–95.	For the first time in two decades, M_3 expansion was not due to monetisation of the budget deficit. The Central Government did not have recourse to *ad hoc* Treasury Bills for the greater part of the year. However, towards the close of the year, the strains on Government finances surfaced and the Government experienced some difficulty in putting through its borrowing programme.

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(1)	(2)	(3)	(4)
1995–96 (second half) September 29, 1995	Unlike in the previous year when much of the created money emanated from an increase in NFA, in 1995–96 the growth was due to larger net RBI credit to the Central Government. The run of normal monsoons continued for the eighth successive year with prospects of good agricultural output.	In spite of the volatility in the foreign exchange market, the Reserve Bank felt that the economic fundamentals were strong and the causes for volatility reflected the sharp changes that were taking place in the international currency markets.	Net RBI credit to the Central Government spurted by ₹ 13,225 crore from March 31 to September 15, in contrast to a decline of ₹ 640 crore in the corresponding period of the previous year.
November 11, 1995 and December 9, 1995	The Reserve Bank provided large support to the money market to counter the escalation in call money rates to very high levels till November 10, 1995. However, with the moderation of this support and taking into account the monetary and credit developments, the Reserve Bank decided to reduce CRR from 15.0 to 14.5 per cent from November 11, 1995 and further to 14.0 per cent from December 9, 1995.		
1996–97 (first half) April 3, 1996	The commercial sector had articulated its concerns about shortage of resources. Conditions in the foreign exchange market displayed considerable volatility. Macroeconomic fundamentals in 1995–96 recorded robust growth, especially in real GDP. After two years of double-digit inflation,	The resumption of capital inflows together with the narrowing of the CAD in the BoP helped augment the external reserves of the country.	

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(1)	*(2)*	*(3)*	*(4)*
	its growth eased to 4.7 per cent by March 16, 1996. This turn of events called for active Reserve Bank intervention in the areas of monetary policy and exchange rate management. The Reserve Bank recognised that the high level of interest rates that prevailed during 1995–96 needed to be reduced to facilitate credit off-take during 1996–97.		
1996–97 (second half) October 19, 1996	The real sector of the economy, after posting strong growth in the past few years, showed signs of slackening, particularly in the industrial sector. However, agriculture was expected to perform much better. Monetary growth was on the targeted course of 15.5 – 16.0 per cent for the year. Inflation (WPI) stood at 6.3 per cent during the week ended September 28, 1996 as against 8.8 per cent during the corresponding week of the previous year.		The automatic monetisation of budget deficit was finally phased out from April 1, 1997, following the supplemental agreement dated March 26, 1997. The financial position of the Government was not comfortable as there was large deceleration in revenue growth together with a sharp rise in expenditure commitments. Despite the fiscal pressures, favourable conditions in the securities market and improved liquidity conditions facilitated Central Government in raising the needed resources without much support from the Reserve Bank.

Source: Reserve Bank of India, Credit Policy circulars issued by Credit Planning Cell/Monetary Policy Department; *Annual Report*, various issues.

CHART 14.3

Main Credit Policy Responses during 1993–94 to 1996–97

(A period of financial sector reforms and inflow of foreign funds)

Year	*Instrument*	*Changes*	*Reason/objective/in response to*
(1)	*(2)*	*(3)*	*(4)*
1993–94	*CRR* (on domestic deposits)	Reduced from 15.0 to 14.0 per cent in two stages (April 17, 1993 and May 15, 1993).	Reductions in monetisation of fiscal deficit, and in inflation rate and carrying forward of financial sector reform.
	SLR (on domestic deposits)	Reduced from 37.75 to 34.75 per cent on deposits as on April 3, 1992/September 17, 1993 (August 21, 1993 – October 16, 1993); however, SLR above the September 17,1993 level remained unchanged at 25.00 per cent.	– do –
	Lending Rates	Four categories of lending rates reduced to three categories (April 8, 1993). Minimum lending rates for term loans of over ₹ 2 lakh brought down from 17.0 per cent to 16.0 per cent (June 24, 1993) and to 15.0 per cent (September 2, 1993).	To rationalise the lending rates of commercial banks. Abatement in inflationary pressures.
		Minimum lending rate on term loans of three years and above lowered from 15.0 per cent to 14.0 per cent (March 1, 1994). Fixed interest rates on term loans over ₹ 25,000 and up to ₹ 2 lakh reduced from 16.5 per cent to 16.0 per cent (June 24, 1993) to 15.0 per cent (September 2,1993) and to 14.0 per cent (March 1, 1994).	To provide stimulus to investment.
	Deposit Rates	Rate on savings deposit reduced from 6.0 per cent to 5.0 per cent (July 1, 1993).	Consequent upon reduction in maximum term deposit rate.
		Deposit rates for maturity of 46 days to 3 years and above revised to 'not exceeding' 10.0 per cent per annum (September 2, 1993).	Reduction in inflation rate.
1994–95	*CRR*	Raised to 15.0 per cent from 14.0 per cent in three stages (*i.e.*, June 11, 1994, July 9, 1994 and August 6, 1994).	To counter the strong inflationary impact of the increase in NAF.
	SLR	SLR (up to September 17, 1993 level) lowered from 34.75 to 33.75 per cent in two phases (August 20 and September17, 1994).	With the progressive move to market-related rates of interest on government borrowing, the need for high SLR was reduced.

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(1)	*(2)*	*(3)*	*(4)*
		SLR (up to September 17, 1993 level) reduced to 31.50 per cent (October 29, 1994).	In furtherance of the objective of bringing down SLR to 25.00 per cent by March 1996.
	Interest Rates	Deregulation of lending rates: Lending rates of commercial banks for credit limits over ₹ 2 lakh were freed; the prescription of a minimum lending rate for credit limits over ₹ 2 lakh was abolished; and banks were given the freedom to fix the lending rates for such borrowers (October 18, 1994).	The objective was to further reduce the element of prescription of interest rates by the Reserve Bank. With the reduction in inflationary pressures the lending rates should reflect lower interest rates and at the same time, the savers should get an adequate rate of return in real terms.
		For loans up to ₹ 2 lakh, protection to these borrowers (in lending rates) was continued.	
		Savings deposit rate reduced from 5.0 per cent to 4.5 per cent (November 1, 1994).	A large proportion of savings deposit accounts were being operated essentially as current accounts. Moreover, depositors were able to get interest rate as high as 7.0 per cent for 46-day term deposits. The reduction in rates was to reflect better the nature of savings deposits.
		The maximum term deposit rate was revised from 'not exceeding' 11.0 per cent to 'not exceeding' 10.0 per cent (February 10, 1995).	To evolve a more stable asset-liability balance and to ensure that deposit rates remained attractive in an environment of high inflation.
1995–96	*Interest Rates*	The maximum term deposit rate (*i.e.*, 'not exceeding') was increased from 11.0 per cent to 12.0 per cent (April 18, 1995).	To make banks' term deposits attractive in the context of the prevailing inflation level and to enable banks to mobilise more deposits.
		Banks were given the freedom to fix their own interest rates on domestic term deposits with a maturity of over 2 years (October 1, 1995).	To increase the resources of banks and to make the structure of interest rates on deposits more flexible.

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(1)	*(2)*	*(3)*	*(4)*
	CRR	Reduced from 15.0 to 14.5 per cent (November 11, 1995).	This was done simultaneously with the moderation of money market support and to augment the resources of banks
		Further reduced to 14.0 per cent (December 9, 1995).	The prevailing monetary and credit situation
1996–97	*CRR*	Lowered in two stages to 13.0 per cent (April 27, 1996 and May 11, 1996).	To augment the lendable resources of banks, which would enable them to meet genuine productive requirements for credit.
		Brought down to 12.0 per cent (July 6, 1996).	Rationalisation, *i.e.*, CRR reduction along with a reduction in refinance.
		Reduced to 10.0 per cent in four stages of 0.5 percentage points each (October 26, 1996, November 9, 1996, January 4 and 18, 1997).	Consistent with the medium-term objective of reduction of CRR over a three-year period.
	Interest Rates	Banks were given the freedom to fix their own interest rates on domestic term deposits with a maturity of over one year (July 2 1996).	To provide banks with greater flexibility in determining their term deposit rates.
		The minimum period of term deposits was shortened from 46 days to 30 days (July 2, 1996).	To provide some outlet for management of short-term surplus funds of banks.
		Interest rates on domestic term deposits for maturity of 30 days and up to one year were reduced from 'not exceeding' 11.0 per cent to 10.0 per cent (October 21, 1996).	

Notes: 1. Besides the frequently used credit control instruments (as detailed above), changes in refinance facility were also utilised to influence liquidity in the economy. OMOs were increasingly relied upon after the mid-1990s as an instrument (indirect) of monetary management as well as public debt management. In this connection, repo transactions shot into prominence. Moral suasion by the Reserve Bank, even though not apparent to the public at first sight, was a potent and trusted weapon in the armoury of the Reserve Bank.

2. The reserve requirements (CRR and SLR) as well as interest rate prescriptions were made applicable to non-resident deposit accounts albeit in less rigorous form and not necessarily simultaneously with the changes in reserve prescriptions on domestic deposits. Some of the reasons were to augment/reduce the lendable resources of banks, to bring all deposit liabilities of banks under reserve requirements, to rationalise the overall SLR prescription and make it attractive for banks to mobilise deposits from non-residents.

3. In the case of interest rate payable on various non-resident deposit accounts, the objectives included bringing about an alignment of the maturity structure with that of domestic term deposits, giving more flexibility to banks in mobilising deposits from non-residents, to bring about a better alignment with the maturity structure/interest rate pattern of term deposits under various schemes and the interest rates prevailing in international markets for comparative maturities.

Source: As in Chart 14.2.

From 1993–94, the conduct of monetary management and credit policy came to be determined strongly by the huge foreign capital inflows and their impact on creation of primary money. It became the dominant, if not the prime mover of monetary expansion. Moreover, with the gradual opening up of the economy, developments in the external payments position impinged on the behaviour of domestic macroeconomic variables. In a short time, the Reserve Bank came to focus sharply on a monetary policy that was consistent with the exchange rate and payments policy.

NEW THRUST TO MONETARY POLICY (1993–94)

During 1993–94, the BoP improved, especially in the second half of the year. However, this entailed substantial monetary expansion and acceleration in inflationary pressures. On the fiscal side, there was slippage in the fiscal deficit target due to large supplementary budgets on both Plan and non-Plan accounts. Even though the fiscal deficit during the year was much larger than the budgeted level, its monetary impact could be contained through sizeable open market sales of government securities by the Reserve Bank. Nevertheless, M_3 growth was recorded at 18.0 per cent in 1993–94 as against 15.7 per cent in 1992–93. NFA of the Reserve Bank escalated sharply to ₹ 28,775 crore in 1993–94, an increase of ₹ 24,966 crore as against a modest increase of ₹ 3,809 crore in the previous year. While presenting the Union Budget for 1994–95, the Finance Minister announced a major financial reform under which the monetisation of *ad hoc* Treasury Bills for the year as a whole would not exceed ₹ 6,000 crore and ₹ 9,000 crore for more than 10 consecutive days at any time during the year. This arrangement was expected to strengthen financial and monetary management. Apart from continuing the reform process, the monetary policy for 1993–94 sought to enlarge the availability of credit for production purposes through further reductions in CRR and SLR.

MONETARY POLICY RESPONSES

Despite the major constraints on account of the developments in the fiscal sector, monetary policy measures sought to ensure that the banking system extended adequate credit support for revival of output by reducing the cost of money and increasing the availability of credit, particularly for key sectors like agriculture and small scale industry (SSI). Indirect instruments of monetary policy were deployed in the second half of the year. Notably, the Reserve Bank undertook large sales of securities from its portfolio to counter fiscal expansion. The Annual Report for 1993–94 admitted that the effects of this measure were insufficient to reduce primary liquidity growth. The pressure of demand was reflected in double-digit inflation, *i.e.*, 10.8 per cent, at the end of March 1994. The main responses in credit policy measures were a reduction in the deposit and minimum lending rates of banks and reductions in SLR and CRR.

The removal of controls on interest rates formed an important aspect of the financial sector reform. Taking a cue from the Economic Survey for 1992–93, the Reserve Bank modified four categories of lending rates to three from April 8, 1993. Also, the minimum lending rate for term loans of over ₹ 2 lakh was brought down from 17.0 per cent to 16.0 per cent (June 24, 1993), and further to 15.0 per cent (September 2, 1993). The minimum lending rate on term loans of three years and above was lowered from 15.0 per cent to 14.0 per cent from March 1, 1994. The fixed interest rate on term loans over ₹ 25,000 and up to ₹ 2 lakh was reduced from 16.5 per cent to 16.0 per cent from June 24, 1993, to 15.0 per cent from September 2, 1993, and to 14.0 per cent from March 1, 1994. Correspondingly, the maximum deposit rate (applicable for maturity for 46 days to 3 years and above) was brought down from 13.0 per cent to 11.0 per cent, so that the viability of the banking system was not impaired. In September 1993, this rate was revised downwards to 10.0 per cent. The Reserve Bank's Annual Report for 1993–94 explained that in determining the deposit rate, one had to take into account the perceptions of depositors as well as the returns available on alternative financial assets and it was not the intention of the policy to keep real lending rates at very high levels over a long period. Finally, it expressed the view that interest rate policy must be deployed as a flexible instrument to raise and lower interest rates as the circumstances warranted.

In the context of the need for continued progress towards financial sector reform, reducing the GFD of the Central Government and moderating the inflation rate, the base level SLR to be maintained by commercial banks up to the level of outstanding NDTL (excluding non-resident liabilities) as on April 3, 1992 was lowered from 37.75 per cent to 36.75 per cent in four phases of 0.25 percentage points each from August 21, 1993, September 18, 1993, October 16, 1993 and November 13, 1993, respectively. Citing the same reasons as for SLR, CRR was reduced from 15.0 per cent to 14.0 per cent in two phases of 0.5 percentage points each from April 17, 1993 and May 15, 1993.

AN EVENTFUL AND DEFINING YEAR (1994–95)

In several ways, the year 1994–95 was eventful and momentous for the conduct of monetary policy. For the first time in two decades, monetary expansion was not attributable to monetisation of the fiscal deficit of the Central Government. It took place due to sizeable and sustained capital inflows. The growth in net Reserve Bank foreign exchange assets constituted 76.0 per cent of the reserve money expansion in 1994–95. Although lower than the contribution of 103.0 per cent to the reserve money increase in the preceding year, it was still historically large. Second, a landmark development in fiscal policy was the decision of the Central Government to phase out and ultimately discontinue automatic monetisation of the budget deficit. The Union Budget for 1994–95 announced that there would be a limit on its recourse to the Reserve Bank for issue of *ad hoc* Treasury Bills. This was formalised by an agreement between the Government and the Reserve Bank, signed on September 9, 1994, in terms of which automatic monetisation of the budget deficit through the issue of Treasury Bills would be phased out over three years and completely eliminated from 1997–98.[13] In practice, the Central Government did not take recourse to *ad hoc* Treasury Bills during the greater part of 1994–95. At the end of 1994–95, the recourse to *ad hocs* was a modest ₹ 1,750 crore as against the budget estimate of ₹ 6,000 crore.

The monetised deficit of the Central Government in 1994–95 remained well within the budgeted level, despite minor slippage in the GFD. The Reserve Bank activated its OMOs in government securities to lessen the strong monetisation effect of large capital inflows and the consequent inflationary impact. It made special efforts to expand the financial sector by permitting entry of several financial entities that provided a wide range of services. The external sector exhibited strength and resilience during the year, thereby consolidating stabilisation and structural adjustment efforts that had been evident since June 1991. This development and the groundwork done by the Reserve Bank and the Government to move forward in liberalising the external sector enabled India to accept the obligations of Article VIII of the IMF in August 1994.

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13. Refer to chapter 15: Public Debt Management for further details on this development.

CHALLENGES TO MONETARY MANAGEMENT DUE TO MASSIVE CAPITAL INFLOWS

The continuous accretion to foreign currency reserves no doubt reflected a sustained improvement in the current account of the BoP and strong capital inflows, which included both foreign direct and portfolio investment. However, injections of large external liquidity posed problems for monetary management. Although capital inflows moderated somewhat in the second half of 1994–95, foreign reserves (including gold) touched an unprecedented level of US$ 25.2 billion, equivalent to around 10 months of the country's imports. This was a far cry from the middle of 1991, when foreign reserves were adequate only to meet two weeks of import payments. As regards policy formulation, with the growing integration of the Indian financial system with international markets, the need to maintain internal consistency among the exchange rate, monetary and fiscal policies had become paramount.

The rise in the NFA of the Reserve Bank combined with a sizeable expansion in net domestic assets (NDA) in the last quarter of 1994–95 was responsible for a strong expansion in reserve money. However, the rising trend in the ratio of NFA to currency in circulation — an indicator of the quality of monetary management — was disquieting, because during a period of falling NFA, if domestic assets expanded rapidly, the pressure on international reserves might have been aggravated (Table 14.4).

TABLE 14.4

NFA/Currency Ratio

(Per cent)

Year (end-March)	*NFA/Currency in circulation*
1991	14.4
1992	29.6
1993	31.8
1994	60.2
1995	71.4

Source: Reserve Bank of India, *Annual Report*, various issues.

IMPACT OF CAPITAL INFLOWS ON MONETARY VARIABLES

In the Reserve Bank, policymakers were concerned about the impact of foreign capital inflows on monetary variables during the second half of 1994–95. An internal note in October 1994 expressed concern that based on the prevailing trends; the increase in NFA that was estimated at the time of formulating the credit policy for the first half of the year might be surpassed by the end of the year. On the basis of the trends in reserve money expansion as on September 16, 1994, it was feared that if the NFA increased to US$ 7.0 billion and the Centre utilised *ad hocs* up to the ceiling of ₹ 6,000 crore, the expansion in reserve money could turn out to be 'explosive'. In such an eventuality, the authorities contemplated taking recourse to huge OMOs equivalent to at least ₹ 7,000 crore. Moreover, the perception was that if the money multiplier turned out to be higher than it had been so far, open market on a substantially larger scale might be needed and for this purpose, 4.6 per cent non-marketable securities held by the Reserve Bank could be converted into marketable securities, such as, zero coupon bonds.

MONETARY POLICY RESPONSES

Policy Framework

The most crucial task for monetary management during 1994–95 was the mode of management of the strong surge in capital inflows. To elaborate, this came down to two issues: (i) how to frame policies to increase the productive use of foreign exchange; and (ii) the need to sterilise them to restrain inflationary pressures without raising real rates of interest. The first issue was not directly connected with monetary policy or central banking. The second one was more pertinent since the basic objective of policy was to bring about a reduction in the inflation rate while ensuring that the credit requirements of the economy, especially those of agriculture, small scale industry and weaker sections of society, were met. For the first time, monetary policy was 'predicated' on a specific 4.0 percentage points reduction in the inflation rate, which meant that the stance of policy was unequivocally one of tightening monetary control. The expansion in M_3 was, therefore, proposed to be contained within the range of 14.0–15.0 per cent during 1994–95, as against 18.4 per cent in the previous year.

In his speech at the Bankers' Club, Bangalore (now Bengaluru), on May 19, 1994, the Governor, Dr C. Rangarajan, articulated that a sea change had occurred in the factors operating behind monetary and credit expansion, and that the quantum jump in foreign exchange reserves, welcome as it was for several reasons, led to a subsequent expansion in primary money and monetary growth. He envisioned new responsibilities for the Reserve Bank in monetary management in the coming years as follows:

> With the opening of the external sector, the transmission impulses from domestic to the external sector and vice versa are becoming powerful. Therefore, domestic monetary policy and policy relating to the external sector need to be harmonised. Stability of the real exchange rate depends crucially on the degrees of success achieved in holding down inflationary pressures. Thus, it is imperative that excessive monetary expansion should be avoided. The monetisation effect of large foreign capital inflows and the consequent inflationary impact on monetary expansion is a major concern. If the increase in net foreign exchange assets is large, it will be necessary to take various measures to offset their impact. In this context, active open market operations by the Reserve Bank in government securities would be an integral part of monetary policy endeavour to stabilise the inflows.

Changes in Measures

The credit policy responses to tackle the strong expansionary impact of the increase in the NFA took the form of a package of measures, which included an increase in CRR, a reduction in SLR, reduction in the export credit refinance limit and tightening of selective credit controls. More significantly, these instruments of control were supported by active OMOs to sterilise part of the capital inflow.

To contain the monetary consequences of a rapid rise in foreign exchange reserves from the second half of 1993–94, CRR was increased by 1.0 percentage point to 15.0 per cent that was spread over the period of June–August 1994. With the termination of the FCNR (A) scheme, there was a corresponding rise in deposits under other non-resident schemes that were subject to nil or low reserve prescriptions. This shift weakened the impact of the overall CRR. Therefore, from January 21, 1995, CRR under the FCNR (B) scheme was enhanced from 7.5 per cent to 15.0 per cent. Similarly, deposits under the NR(NR)RD scheme, which were exempt from reserve requirements, were subjected to a CRR of 7.5 per cent. Surprisingly, even after the imposition of these reserve requirements, the inflow under these schemes continued to be strong.

With the progressive movement towards market-related rates of interest on government borrowings, the justification for maintaining a high level of SLR lost its force. Therefore, while the incremental SLR was retained at 25.0 per cent, the base SLR was reduced in two equal instalments from 34.75 per cent to 33.75 per cent on deposits as on September 17, 1993 (August and September 1994). Further, from October 29, 1994, SLR was fixed at 31.50 per cent up to the level of outstanding deposits as on September 30, 1994, and on the increase in deposits over that date SLR was prescribed at 25.0 per cent. In the pre-reform period, changes in SLR were invariably determined by the support needed to make the Government's annual market borrowing programme successful. However, this concept underwent a change as is evident from the notings of the Deputy Governor, Shri S.S. Tarapore, dated October 7, 1994:

> We have long since crossed the Rubicon and the borrowing programme is no longer SLR-driven. Banks hold excess liquid assets of over Rs. 27,000 crore and bringing down SLR further does not affect the borrowing programme. Rather than large changes next year, we could effect a small change now. The shifting of the base year allows for a better presentation of the SLR prescription and is also more equitable between the older and newer banks.

The Governor went along with this exposition.

Deregulation of the minimum lending rate of banks was an important strategy of monetary system reform. There was a gradual but weakening trend in the inflation rate, which became pronounced by the first half of 1994–95. The Reserve Bank, therefore, considered that the time was opportune to deregulate the minimum lending rate for credit limits over ₹ 2 lakh from October 18, 1994. However, to shield the small borrowers with loans up to ₹ 2 lakh, the interest rates on the first two slabs continued to be administered. The lending rate for credit limits up to ₹ 25,000 was retained at 12.0 per cent and the rate for credit limits of over ₹ 25,000 and up to ₹ 2 lakh for all advances (including term loans) was fixed at 13.5 per cent. For credit limits above ₹ 2 lakh, banks were given the freedom to fix lending rates. Banks, with the approval of their board of directors, were required to declare their respective prime lending rates, which would be the minimum rate charged by them for credit limits of over ₹ 2 lakh uniformly at all branches. The deregulation of interest rate on the highest slab of bank advances was expected to stimulate healthy competition among banks and improve their operational efficiency.

The Reserve Bank discerned that a large proportion of savings deposit accounts were being operated essentially as current accounts and moreover the depositors were able to get rates of interest as high as 7.0 to 8.0 per cent for 46 days as in the case of term deposits. Therefore, the savings deposit rate was reduced by 0.5 percentage points from 5.0 per cent to 4.5 per cent from November 1, 1994. The internal policy note prepared in the CPC in October 1994 envisioned that the abolition of the minimum lending rate and the eventual deregulation of the administered rate structure would give a fillip to the development of financial derivatives and also help evolve a 'reference rate' of interest.

While the minimum lending rate for advances over ₹ 2 lakh was deregulated in October 1994, the ceiling rate on term deposits continued to be administered. The Reserve Bank was conscious of this anomaly, but it preferred to deregulate deposit rates at the end of the deregulation process and after inflation was under firm control. In actual practice, in the absence of a 'reference rate' by the Reserve Bank, the maximum deposit rate prescribed by it served as an important signalling device for interest rate administration. On the other hand, the prevalence of a high inflation rate called for a positive real rate of return on bank deposits. The situation was compounded by the fact that bank credit expansion exceeded the increase in the resources of banks. Under these circumstances, the Reserve Bank devised a more stable asset-liability balance by raising the maximum term deposit rate by one percentage point from February 10, 1995, *i.e.*, from 'not exceeding' 10.0 per cent per annum to 'not exceeding' 11.0 per cent.

Selective Credit Controls: A Review

A critical assessment of the working of selective credit controls was done during 1994–95, which brought to the fore different viewpoints of the Government and the Reserve Bank.

In April 1993, the Ministry of Finance suggested that the Reserve Bank initiate a review by external experts of selective credit controls as a relevant credit policy instrument. However, the Reserve Bank was not keen on the proposal because this was an important instrument of monetary control available to it and had special relevance to developing countries like India that had to contend with growing fiscal deficits and the persistent overhang of liquidity, which generated inflationary pressures in the economy. Further, this measure restrained speculative hoarding of essential commodities, since any pressure on them would affect adversely the most vulnerable sections of society. The Reserve Bank in its reply concurred that the outstanding bank credit against sensitive commodities as a percentage of total outstanding bank advances was small and administrative measures played a small role in controlling price rise, but countered that the ability of traders in these commodities to speculate with bank finance was not inconsiderable and that the impact of administrative measures supplemented by selective credit control would be greater in containing price rise. The letter added that in administering this tool, care had been taken that the legitimate production and distribution needs of the concerned sectors were not affected and that the complex nature of these measures had been greatly simplified since 1985. The Reserve Bank pointed out that a quick look at the policy responses in the past revealed several instances where the Government found that changes in selective credit controls provided support to its policy objectives. In particular, the Reserve Bank did not favour an in-depth study by outside experts because several such studies in the past had generally found that these controls had indeed been effective and had helped contain the price rise in sensitive commodities. Nevertheless, at the insistence of the Government, the Reserve Bank agreed in its letter dated April 5, 1994 to an external study.

The National Institute of Bank Management (NIBM), Pune, was entrusted with the study, which was completed in October 1994. Its main findings were: (i) during the 1960s and 1970s, in India, selective credit controls played a pivotal role and shouldered a major responsibility in containing inflationary pressures emanating mostly from speculation in sensitive commodities of agricultural origin; (ii) subsequently, the scope for speculative hoarding in these commodities diminished due to commercialisation of agriculture and existence of public sector agencies operating the distribution system; and (iii) the role of selective credit controls in credit policies was on the wane. The study, therefore, recommended a phased 'deregulation' of the structure of selective credit controls. A copy of the study was forwarded to the Ministry of Finance. The Economic Survey, 1994–95, nevertheless, took a favourable view of selective credit controls, *viz.*:

> ...a role in inflation control in a closed economy with short-run inelasticity of supply. By increasing the cost and reducing the availability of credit for stock accumulation, the build-up of inflationary expectations can be moderated. Delicensing of imports along with appropriate tariffs can, however, be more effective and also more efficient as it increases the supply.

CONTINUATION OF RESTRICTIVE MONETARY POLICY (1995–96)

Monetary and financial developments during 1995–96 were dominated by the interface between external sector developments, especially the foreign exchange market, and the behaviour of the related domestic financial markets.

DOMESTIC MACROECONOMIC ENVIRONMENT

The Reserve Bank continued its tight monetary policy during 1995–96, since the growth in M_3 at 22.2 per cent (up to March 17, 1995) was higher than 18.4 per cent in 1993–94. This was viewed as well beyond what could be considered desirable after taking into account the expected increase in real output. The money multiplier had risen to 3.27 in the 1990s from 3.10 in the 1980s. Since the strong demand for funds from both the government and commercial sectors drove up interest rates, the Reserve Bank strove to achieve a delicate balance between money, output and prices. To a great extent, the Reserve Bank succeeded in bringing about a subdued increase in M_3 of 13.2 per cent during the year, which was lower than the long-run annual average of about 17.0 per cent. The success in this regard should be viewed with caution. As pointed out by the Reserve Bank in its Annual Report for 1995–96, the lower growth in M_3 was largely due to the unusually high base of March 31, 1995 caused by an unprecedented increase in the deposits of SCBs by as much as ₹ 20,161 crore as on the last Friday of March 1995. However, if one were to take the preceding reporting Friday, *i.e.*, March 17, 1995 as the base, the M_3 growth worked out to only 17.9 per cent.

The continued buoyancy in economic activity was reflected in the performance of the economy during 1995–96 with an estimated GDP growth of about 7.0 per cent (6.4 per cent in 1994–95). A welcome feature was the reduction in the inflation rate to 7.7 per cent on the basis of movements in the WPI on average basis (or 5.0 per cent on point-to-point basis). The average rate of inflation measured in terms of changes in the WPI from 1990–91 to 1994–95 at 10.7 per cent exceeded the long-term average of 6.3 per cent for the period 1950–51 to 1989–90. In 1995–96, inflation on average basis abated to 7.7 per cent as against 10.9 per cent in 1994–95, which was made possible by prudent demand management as well as supply management of essential commodities. The substantial gains on the inflation front during 1995–96, juxtaposed against the slower expansion in M_3 and reduction in the fiscal deficit from 6.7 per cent of GDP in 1994–95 (RE) to 5.5 per cent in 1995–96 (BE) was a matter of satisfaction for the Reserve Bank. Its Annual Report for 1995–96 predicated that it was possible to target inflation without hurting real activity and that, in a more fundamental sense; inflation targeting had to be part of the known transmission mechanisms of monetary policy. The Economic Survey for 1995–96 took the view that the opening up of international trade in agricultural commodities had also contributed to the success of active supply management of essential agricultural products.

The year was exceptional due to the fact that the Government found it difficult to finance its borrowing needs despite a rise in interest rates on account of lower non-bank sources of financing. This resulted in large monetisation of fiscal deficit, and *ad hoc* Treasury Bills exceeded the within-the-year gap on net issues for extended periods of the year. Unlike the preceding year when much of the created money emanated from an increase in Reserve Bank's NFA, the increase in created money in 1995–96 was attributable to credit to the Government by the Reserve Bank. A reduction in NFA to ₹ 2,575 crore (till September 29, 1995) in contrast to a large increase of ₹ 12,688 crore in 1994–95 moderated the expansion in reserve money.

MONETARY POLICY RESPONSES

Monetary policy for 1995–96 was framed against the backdrop of double-digit inflation in the previous two years and robust growth in real GDP. The thrust of monetary policy was accordingly on moderating monetary expansion, consistent with the expected growth in real output and a relatively tolerable rate of inflation. Given the expected high growth, the financing needs of the economy were considered relatively large. To ensure that development needs were met, it was considered essential to provide incentives for deposit mobilisation. The Reserve Bank, therefore, increased the maximum deposit rate by one percentage point to 12.0 per cent from April 18, 1995 to enable banks to mobilise more term deposits to finance their growing loan operations. However, when an acute problem of volatility emerged in the foreign exchange market in the second half of the year, the Reserve Bank intervened in the market, which impinged on domestic liquidity. It was only after stabilising the foreign exchange market that the Bank could take measures to ease pressures in the money market and enable banks to meet the rising credit demands in the context of growth in real output. Liquidity injection mainly took the form of money market support through reverse repo transaction arrangements with the Securities Trading Corporation of India Ltd (STCI) and the DFHI. Intervention, in turn, was supported by measures such as imposing an interest surcharge on import finance effective October 1995 and tightening of concessionality in export credit for longer periods. On November 11, 1995, CRR was reduced from 15.0 per cent to 14.5 per cent and further to 14.0 per cent from December 9, 1995, which augmented the resources of banks by about ₹ 4,000 crore. Several policy initiatives were taken in a phased manner to reduce CRR prescriptions for non-resident deposit schemes. These actions served the dual purpose of not only easing domestic liquidity but also encouraging the inflow of funds into the foreign exchange market by providing more incentives to banks to mobilise non-resident deposits.

The other measures introduced in the second half of the year were freeing interest rates on domestic term deposits with maturity of over 2 years, enhancing the limits for refinance to banks against government and other approved securities and raising the ceiling interest rate on term deposits in NR(E)R accounts by 2.0 percentage points.

A PROTRACTED DEBATE ON THE CREDIT CRUNCH

Monetary and banking trends exhibited some unusual features in 1995–96. Increase in M_3 and growth in deposits were below past trends, while bank credit expanded sharply. This generated an animated discussion in banking and industrial circles, as the latter expressed the view that growth had been impeded by a restrictive monetary policy that emphasised price stability. With the base as March 31, 1995, non-food credit expanded by 22.1 per cent by March 31, 1996 and the increase in non-food credit in absolute terms between March 17, 1995 and March 31, 1996 was ₹ 54,684 crore compared with an increase of ₹ 45,777 crore in the corresponding period in the previous year. In fact, such a large credit expansion was partly facilitated by a series of monetary policy measures that augmented the lendable resources of banks through CRR reductions.

The Governor, Dr C. Rangarajan,[14] responded to the criticism. Terming the conduct of monetary policy in 1995–96 as having received more than 'normal' attention, the Governor stated that monetary policy had to be tight at certain points to prevent the flow of funds from the domestic money market to the foreign exchange market, which was exerting

14. Rangarajan, C. (1997). "Dimensions of Monetary Policy", *Anantharamakrishnan Memorial Lecture*. Chennai. February 7.

pressure on the rupee. However, as the situation changed, the policy direction also changed. He articulated that though the rate of monetary expansion had moderated, this was not true of bank credit expansion. Despite low deposit growth, credit expansion was large in 1995–96 because of successive lowering of CRR and the consequent augmentation of lendable resources of banks. The INFCDR was high at 96.0 per cent, while investments of commercial banks in government securities during the year were much less. As a result, the Reserve Bank had to contribute almost 33.0 per cent of the government's borrowing programme. The Governor rebutted complaints from the corporate entities about the liquidity crunch despite sizeable expansion in non-food credit in 1995–96. First, part of the liquidity crunch should be traced to the decline in funds that the corporate sector was able to raise from the domestic capital market and foreign issue of GDRs, which recorded a substantial decline in relation to both these sources compared with the previous year. Second, bank credit could not be a total substitute for these sources. The Governor also made a pointed reference to the fact that since November 1995, monetary policy measures had been in the direction of easing rather than tightening.

Earlier, in March 1996, the Deputy Governor, Shri S.S. Tarapore, at the meeting organised by the Confederation of Indian Industry (Western Region) had set out in a forthright manner the Reserve Bank's views on this vexatious issue of liquidity crunch. The address, aptly titled: The Liquidity Crunch: Facts and Fiction, termed this problem as a 'debate of unprecedented intensity.'[15] Referring to similar occasions in the past (*i.e.*, 1981–82 and 1991–92), he stated that in these two years the absolute level of credit from the banking sector was 'crushed' to lower absolute amount of increase than in the corresponding previous years. Regarding the argument that the total resource flow from bank and non-bank resources was the same in 1995–96 as in 1994–95, he answered that there was no substance in the argument that the potential of the economy had been stunted because of shortage of credit. On the question whether monetary policy was too tight and warranted relaxation, he pointed out that while M_3 growth during the period from March 17, 1995 to February 6, 1996 was 13.0 per cent as against 15.8 per cent in the previous year, the latter growth was one of 'unbridled' expansion and it would not be prudent to take the previous year as a good indicator of the desired pace of monetary

15. Tarapore, S.S. (1996). *The Liquidity Crunch: Facts and Fiction.* Address at the meeting organised by the Confederation of Indian Industry (Western Region): Mumbai. March 8.

expansion. He took pains to counter the demand from business circles that, since the real rates of interest were on the higher side, interest rates should be lowered, as follows:

> Be as it may, it would be extremely imprudent to try and artificially reduce interest rates by increasing the flow of created money from the central bank as such a course of action will only cause a sharp resurgence of inflation and thereby merely flare up nominal rates of interest. There is, therefore, no easy way out. If created money could bring about a general reduction in real rates of interest and promote growth, surely all countries would use this panacea. A country following the path of pump-priming in such a situation would be taking recourse to a reckless policy which would eventually abort growth. Large injection of created money would result in a large monetary expansion and consequently inflation would accelerate and such creation of money can make no contribution to the real growth of the economy. While small adjustments in the form of policy responses can be considered depending on the evolving monetary and credit situation, it would be most imprudent on the part of the Reserve Bank to try and fill the gap between the availability of resources and the 'desired' level of resources by created money.

Continuing in the same vein, to the argument that a liquidity crunch brought about by escalating interest rates would damage industrial growth, the Deputy Governor commented that a permissive policy of monetary expansion would be detrimental to the interests of industrial growth, because an acceleration in inflation would force nominal interest rates to rise to even higher levels; and to finance inventories at higher levels, demand for credit would rise even faster and, in the process, aggravate the tight credit conditions.

In his summing up, Shri Tarapore reminded the audience that the pressure on liquidity was a symptom and not the cause of the ailment; the ailment was the problem of scarce means with alternative uses, and unless demand for resources was realistic and reflected the available resources, interest rates would remain high and liquidity continue to be tight. "Expanding money supply when the net foreign exchange assets are rising is one thing, but expanding money when the net foreign exchange assets are falling is quite another," he stressed. His final point was that the relatively large expansion of domestic assets of the Reserve Bank in that financial year clearly pointed to the need for continuing caution. Focussing on the dilemma faced by the central bankers in developing economies, he averred:

> While a cautious policy is often criticised as being an unrealistic ivory tower approach to practical problems, yielding to these pressures would be tantamount to an irresponsible monetary policy. This is the cross the monetary policy has to bear in the best interests of the economy.

Some press comments attributed the liquidity crunch in 1995–96 to the rigid monetarist stance followed by the Reserve Bank. Finally, the authoritative views of both the Reserve Bank and the Government on this topic could be gleaned from the Reserve Bank Annual Report and the Economic Survey for the year 1995–96. The Reserve Bank took the stand that while borrowers had voiced some concern regarding the insufficiency of credit, all indicators showed that the flow of credit to the productive sectors had been well maintained, credit drawals continued to be well below the credit limits and, therefore, there was very little substance in the argument that government borrowing had ‘crowded out’ credit for the private sector. It added that all sectors of the economy must recognise the need for a more efficient use of credit.

The Economic Survey, 1995–96 also reiterated that the facts did not support complaints regarding a liquidity crunch and crowding out by government borrowing. But the subsequent Economic Survey 1996–97 modified its stand with the comment that the Reserve Bank might have overreacted when it observed that the tightening of monetary policy in 1995–96 to counter the inflationary effect of the surge in capital inflows and the resulting faster monetary growth in the previous year might have been too ‘sharp’. Further, it added:

> The policy has since been adjusted during 1996–97 to bring it in line with targets which are still valid. We must now be careful to avoid over-compensating in the opposite direction by easing money supply too far above the target level, and thus building up inflationary pressures in the next year. Any short-term temptation of depending solely on monetary policy to solve problems arising from other policy imperatives should be avoided.

The episode of the 1995–96 liquidity crunch remained a subject of debate for more than a year.

MOMENTOUS YEAR FOR MONETARY MANAGEMENT (1996–97)

The year 1996–97 was significant for the conduct of monetary policy in India in a number of ways. For the first time, CRR was reduced sharply by 4.0 percentage points within a period of one year. The net sales of government securities under OMOs registered a record level of ₹ 10,435 crore. The contraction in the CAD and resurgence of capital inflows in 1996–97 culminated in substantial excess supplies of foreign exchange in the market. Hence, the Reserve Bank undertook regular purchases of US dollars amounting to US$ 7,801.0 million (₹ 27,037 crore) during 1996–97 to prevent nominal appreciation of the rupee. The resultant improvement in liquidity together with CRR cuts was so strong at the short end of the market — particularly in the second half of 1996–97 — that the repo operations that had been discontinued since February 3, 1995 had to be revived in November 1996. The Reserve Bank made conscious efforts to reduce its reliance on direct instruments of monetary control, especially the administered structure of interest rates. OMOs, including repo transactions, emerged as the principal policy tool. The interest rate instrument was sought to be developed by reactivating the Bank Rate as a signalling device to the market, along with the provision of the general refinance facility. The operating procedures of monetary policy also necessitated close co-ordination between liquidity management and debt management, as well as between liquidity management and institutional developments, for it had become necessary to evolve and put in place appropriate risk management strategies for efficient functioning of the financial markets.

The Reserve Bank's task was greatly facilitated by the Government's recognition that the key to providing flexibility in the conduct of monetary policy depended on control over fiscal deficit. The signing of the first supplemental agreement between the Reserve Bank and the Central Government on September 9, 1994 to phase out the issue of *ad hoc* Treasury Bills by the end of fiscal year 1996–97 marked an important step in achieving this goal. The system of *ad hoc* Treasury Bills was discontinued from April 1, 1997 consequent upon the signing of the second supplemental agreement between the Government and the Reserve Bank on March 26, 1997.

NEW STRATEGY OF MONETARY MANAGEMENT

The formulation of monetary policy during 1996–97 underscored a 'blended' pursuit of short-term fine-tuning and long-term objectives of monetary policy. The short-term policies attempted to address the immediate concerns that had arisen out of developments during the previous year and hence were specific to 1996–97. The long-term policies focused on institutional changes aimed at securing a greater degree of manoeuvrability in the management of liquidity in the economy and bringing about greater integration of the various financial markets. Accordingly, the Reserve Bank adopted a stance of cautious monetary policy in 1996–97, which in the main attempted to sustain the lower and stable level of inflation achieved during the previous year, while ensuring that the legitimate credit requirements of all sectors of the economy were met.

It is worth noting that the long-term policy affirmed the firm commitment of the central bank to pursuing a low and stable order of inflation by specifying the order of expansion in M_3 that would be used as an intermediate target to realise the core policy objectives. The Reserve Bank's commitment to price stability was reiterated in its Annual Report for 1996–97 as follows:

> In the case of India, both output expansion and price stability are important objectives, but depending on the specific circumstances of the year, emphasis is placed on either of the two. Increasingly, it is being recognised that central banks would have to target price stability since real growth itself would be in jeopardy if inflation rates go beyond the margin of tolerance.

To contain the rate of inflation at around 6.0 per cent during 1996–97, the Reserve Bank projected the rate of expansion in M_3 during the year at 15.5–16.0 per cent. The policy for 1996–97 addressed two immediate concerns, *i.e.*, reducing high real interest rates and making available larger lendable resources to the system. Structural changes, aimed at improving and strengthening the efficacy of the instruments of monetary control were also simultaneously pursued.

MONETARY POLICY RESPONSES

Monetary policy for the first half of 1996–97 (announced on April 3, 1996) contained a package of measures devised to support productive activity by easing the resource availability of banks without jeopardising the objectives of monetary and exchange rate stability. The two immediate concerns of the authorities in the early part of the year were the high rates of interest and the declining trend in credit growth. The average CRR was reduced by one percentage point to 13.0 per cent in two phases of 0.5 percentage points each (April 27 and May 11, 1996), which augmented the lendable resources of banks by about ₹ 3,800 crore. Further, CRR on NRE deposits was reduced to zero, which released ₹ 1,400 crore. However, the rationalisation of export refinance initially resulted in reducing the limits which, however, was expected to be temporary. Interest rates on NRE term deposits of over 2 years were freed. Again, in order to rationalise CRR *vis-a-vis* the refinance facility against government and other approved securities (which, in any case, had not been utilised) and to impact favourably on banks' profitability, CRR was lowered from July 6, 1996 to 12.0 per cent.

As part of the rationalisation of CRR and refinance facilities from the Reserve Bank, sector-specific refinance facilities were either eliminated or curtailed considerably. The refinance facility against government securities was withdrawn from July 6, 1996. Export credit refinance to commercial banks under the first tier of the formula was diminished from 45.0 per cent to 20.0 per cent (effective April 13, 1996) of the total outstanding export credit eligible for refinance over the level of credit as on February 16, 1996. On an incremental basis, however, the export credit refinance to the extent of 100.0 per cent of the increase in outstanding export credit eligible for refinance over the level as on February 16, 1996 continued.

To provide banks with greater flexibility, banks were given the freedom to fix from July 2, 1996 their own interest rates on domestic term deposits of over one year as against the earlier stipulation of over two years applicable from October 1, 1995. The minimum maturity period of term deposits was shortened from 46 days to 30 days to offer some outlet for management of short-term funds with the progressive move away from the cash credit system to loan system.

As the year progressed, time deposits recorded strong growth, which substantially eased the liquidity situation. In the second half of the year, capital inflows resumed, but demand for credit from the corporate sector was relatively low mainly due to slack industrial production. These two contrasting developments contributed to a decline in nominal interest rates at the shorter end. Surprisingly, interest rates at the longer end displayed marked stickiness, partly because inflationary expectations had not yet weakened. The consequent increase in the term spread, particularly in the second half of 1996–97, impelled active liquidity management by the Reserve Bank to ensure that the overall liquidity in the system did not build up inflationary pressures and the interest rate and exchange rate remained relatively stable.

Despite the softening of interest rates in May, the lending rates of banks continued to rule high. The Reserve Bank came round to the view that the interest rates charged by banks should be made sustainable and must reflect the lower cost of funds emanating from reduced levels of CRR and SLR prescriptions. Measures were taken in October 1996 to augment the lendable resources of banks without excessive monetary expansion and inflation, to improve the credit delivery system and to bring down the cost of credit. CRR was lowered by two percentage points to 10.0 per cent in four phases of 0.5 points each on October 26, 1996, November 9, 1996, January 4, 1997 and January 18, 1997, respectively. The credit policy circular to banks dated October 19, 1996 advised that the reduction in CRR should not be viewed only as a response to certain short-term developments, but as part of the plan to restructure CRR and refinance regime through a simultaneous reduction in reserve requirements and refinance entitlement. Export credit finance limits were rationalised.

An internal review carried out at the end of December 1996 evaluated that notwithstanding the prevailing comfortable monetary and price conditions, the last phase of reducing CRR envisaged for January 4, 1997 might be effected. The Deputy Governor, Dr Y.V. Reddy, agreed with the assessment and made his perceptions known. In his opinion, there was some risk in having larger-than-desired monetary expansion and excess liquidity, though it was 'manageable' through OMOs as and when warranted. He added that there was no question of going back on CRR increase as it would have a highly 'disruptive' influence by giving a jolt to market participants and, more importantly, convey the message that the monetary and price developments were not favourable.

ENDEAVOURS TO RE-ACTIVATE THE BANK RATE

The Reserve Bank attempted to re-activate the Bank Rate by linking the interest rates of significance to it, in terms of credit policy circular dated April 15, 1997. It also became the rate at which refinance to banks was granted. The Reserve Bank expressed the hope (in the Annual Report for 1996–97) that this would facilitate its emergence as the 'reference rate' for the entire financial system. Proceeding further in this direction, from April 16, 1997 the maximum deposit rate for maturity for 90 days and up to one year was linked to the Bank Rate by prescribing as 'not exceeding' the Bank Rate minus two percentage points per annum, which implied that the applicable rate would be 9.0 per cent. Further, all interest rates on advances from the Reserve Bank — besides the penal rates on shortfalls in reserve requirements — were linked to the Bank Rate.[16]

While on this subject, it is useful to refer to two instances where the feasibility of a more active deployment of Bank Rate was contemplated by the authorities since the early 1990s. There was a memorandum submitted to the Committee of the Central Board of Directors of the Reserve Bank in March 1990 that arrived at the following important conclusions. First, in India, the Bank Rate had a limited significance as a policy instrument mainly because of an administered structure of interest rates and the absence of a direct link between the Bank Rate and several interest rates of significance, especially the refinance rates of the Reserve Bank. Second, changes in the Bank Rate did not induce 'cost effect' and 'announcement effect'. Third, the Bank Rate had got increasingly distanced from the refinance rates because the latter were changed several times during the 1980s, while the Bank Rate had remained unchanged since July 1981. "The signals of change in policy has thus emanated not from the Bank Rate, but from the refinance rates", the memorandum observed. Fourth, even where certain rates were linked to the Bank Rate, they had been either formally delinked or effectively delinked by altering the margins between the particular rates and the Bank Rate. But there were still some rates in the system linked to the Bank Rate, such as accommodation to the state governments, short-term accommodation to financial institutions and penalties on defaults in reserve requirements. Fifth, the fiscal-monetary relationship in the Indian context had worked to minimise the effectiveness of the Bank Rate by the budget deficit being the major constituent of reserve money creation. Nevertheless, the memorandum concluded on an optimistic note that if and when it was decided at some future date to move away from sector-specific refinance to general refinance, the Bank Rate could once again become a major instrument of policy.

An internal group on the Bank Rate (constituted by the Reserve Bank) in its report submitted in March 1997 expressed the view that certain pre-conditions had still to be met if the Bank Rate had to be used effectively as an instrument of monetary policy. The more important of them

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16. Incidentally, the Bank Rate was reduced to 11.0 per cent from the close of business on April 15, 1997, to 10.0 per cent from the close of business on June 25, 1997 and further to 9.0 per cent from the close of business on 21, October, 1997.

were moderation in the Central Government's GFD, discontinuation of automatic monetisation of budget deficit, move away from sector-specific refinance to general refinance, active conduct of OMOs, deregulation of interest rates and gradual reduction in reserve requirements. It noted that the process of moderation in fiscal deficit and phasing out automatic monetisation of the budget deficit through creation of *ad hoc* Treasury Bills had begun. The report contemplated several measures to improve the effectiveness of the Bank Rate, namely, doing away with all sector-specific loans and advances/ refinance facilities at different rates so that the Bank Rate would be the rate at which advances were provided to banks (instead of such interest rate being linked to the Bank Rate), and a movement away from both export credit refinance facility and concessional interest rate, with a simultaneous setting-up of a generalised refinance window/ liquidity adjustment facility (LAF) linked to the Bank Rate. Clearly the internal group's influence was manifest in the credit policy circular of April 15, 1997.

RELATIONS BETWEEN THE RESERVE BANK AND THE GOVERNMENT

The conduct of monetary management during the prelude to the BoP crisis and in the thick of the crisis from 1989–90 to 1991–92 proved to be somewhat stressful since fiscal restraint and containment of monetisation of government deficit had been elusive. Inflation control found paramount importance in the Reserve Bank's correspondence with the Government. The policy and operational framework, however, underwent some significant changes with the onset of a comprehensive package of economic and financial sector reforms since mid-1991 as an integral part of the overarching shift in the economic policy regime. The change implied that while the conventional objectives of price stability and promoting economic growth through appropriate credit flows should be pursued, the framework for the Reserve Bank in operating its various policy instruments needed to be attuned with the emerging liberalised environment in the financial sector without jeopardising monetary and financial stability. The shift in the economic regime also required that the Reserve Bank's policies be framed in tandem with those of the Government and other stakeholders in the system. This necessitated exchange of views and close consultation on a variety of issues — both relating to policy and operations — between the two authorities. The select interactions relating to shaping of monetary policy and related matters are briefly dealt with in this section.

NEED TO CONTAIN FISCAL DEFICIT AND ITS MONETISATION

As early as in December 1988, the Reserve Bank appraised the Ministry of Finance of the unmistakable indications of imbalances building up in the components of the BoP of the country. An internal review in May 1989 confirmed that the situation continued to be perilous at the beginning of 1989–90, especially because the foreign exchange reserves were depleting at a rapid pace. This prompted Governor Malhotra, in his letter dated May 24, 1989 to the Finance Minister, Shri S.B. Chavan, to suggest, *inter alia*, that domestic inflation should be brought down from 8.0–9.0 per cent to less than 5.0 per cent and for this purpose, special attention needed be paid to containing fiscal deficit (during 1989–90) to the level actually achieved in 1988–89 by reducing unnecessary government expenditure, careful pruning of imports on government account and a review of the trade policy.[17]

The substantial liquidity growth and the attendant pressure on the price level were strongly in evidence in September 1989. Moreover, the Reserve Bank was constrained in the deployment of CRR as it had reached its statutory ceiling of 15.0 per cent. The Reserve Bank brought this disturbing situation to the notice of the Principal Secretary to the Prime Minister in September 1989. The main thrust of the letter was the need to supplement monetary by strong fiscal measures and for an effective anti-inflationary package.

During 1989–90, the expansion in M_3 was 19.4 per cent, compared to 18.1 per cent in 1988–89. The rate of increase in M_3 in 1989–90 was the highest since 1978–79, whereas the indicative monetary target for 1989–90 as set out in the note to the Cabinet Committee on Economic Affairs (CCEA) was 16.1 per cent. Governor Malhotra, in his letter to the Finance Minister, Prof Madhu Dandavate, dated April 28, 1990 conveyed his deep concern that the very large increase in overall liquidity would inevitably put pressure on prices which were already on the uptrend. Despite two good harvests in 1988–89 and 1989–90, the WPI rose by 8.4 per cent on a point-to-point basis in 1989–90 and the pressure on prices was expected to persist in 1990–91. The main factor that propelled this expansion was the net Reserve Bank credit to the Central Government.

17. In the main, the letter to the Government stressed the need for the Government to take strong measures to check the deterioration in the CAD. Refer to chapter 5: Balance of Payments and Exchange Control for more details.

In order to contain this monetary variable within agreed limits, the Reserve Bank urged the Government to make concerted efforts from the early 1990–91 onwards to adhere to the budgeted deficit for the year. The Reserve Bank also emphasised that the budgeted deficit and the net RBI credit to the Central Government should not rise to very high levels during the major part of the year and then nominally attain the target at the end of the year; the average level of created money during the course of the year was even more important than the level at the end of the year; and, finally, specific targets should be set on a quarterly basis for the budget deficit and net RBI credit to the Central Government.

RESERVE BANK TO OVERSEE THE OPERATIONS OF FINANCIAL INSTITUTIONS AS AN ADJUNCT TO MONETARY MANAGEMENT

The Governor, Shri R.N. Malhotra, decided to expand the Reserve Bank's supervision to developmental financial institutions (DFIs) and other financial intermediaries in the early 1990 on the analogy of similar action by the Swiss National Bank, which extended banking supervision to financial intermediaries and investment banks. In the case of Switzerland, the main considerations were to ensure smooth functioning of credit and capital markets, complement the protective measures of capital market legislation *vis-a-vis* the investment banks and promote competitive neutrality between financial market institutions, both domestic and international.

Queries Raised by the Ministry of Finance and Reserve Bank's Reply

The Ministry of Finance raised several queries over this initiative. The Finance Secretary, in his letter dated October 1, 1990 to the Governor, advised that it had learnt from the news reports that the Reserve Bank had started to monitor the working of DFIs, which apart from collection of information from them, involved co-ordination of activities of the FIs and banks. The main issue raised by the Government was that the Reserve Bank's action would tantamount to a major 'shift' from the existing practice on three counts. First, under the Industrial Development Bank of India (IDBI) Act, the IDBI was the principal FI for co-ordinating in conformity with national priorities the working of institutions engaged in financing, promoting or developing industry. Second, the Reserve Bank under its Act could call for statements and particulars relating to their business from banking companies and it was not clear whether the monitoring of FIs and the assessment of the quality of assets and their activities needed legal amendments. And, third, the IDBI and other FIs were expected to play an activist and developmental role with a measure of autonomy and for this reason, the IDBI had been separated from the Reserve Bank about a decade ago.

The Governor, in his reply dated October 10, 1990 to the Finance Secretary, clarified that he had in his earlier letter dated May 18, 1990 (to the Government) already spelt out the need for a comprehensive oversight over the entire financial system, the fact that the Reserve Bank already had legal backing for undertaking such a task and outlined the steps proposed to be taken in the immediate future. He added that in the Reserve Bank's Annual Report for 1989–90, there was a specific reference to the growth of non-bank financial institutions, the need for taking an integrated view of the financial system and what the Reserve Bank intended to do in this regard. It was also pointed out that this aspect had come up for discussion at the Central Board meeting (in which the Finance Secretary was present) wherein the approach indicated in the report was fully endorsed.

Further, the Reserve Bank averred that the RBI Act had been amended to include chapter III B to enable it to exercise a 'comprehensive oversight' of the entire financial system for the purpose of regulating the credit system to the country's advantage. The Reserve Bank was cognisant that different FIs had different roles to perform and the relevant sections of the RBI Act themselves had laid down that, in issuing any direction to any FI, the Reserve Bank should have 'due regard' to the conditions in which and the objects for which the institution had been established and its statutory responsibilities. The Governor assured the Government that in initiating measures for periodic monitoring of operations and assessment of the health of the FIs, there was no intention to detract from the role that had been assigned to the IDBI as the principal institution for co-ordinating the activities of all-India and state-level term-lending institutions in their respective areas.

The Reserve Bank also advised in this letter that the Governor had discussed the matter with the chairman of the IDBI and the latter had indicated that he would have no difficulty in furnishing the Reserve Bank with the requisite information or for the Reserve Bank looking at the health of the asset portfolio, but in doing so he wanted the role of the IDBI as a co-ordinating agency to be kept in view. Moreover, the Reserve Bank reasoned that FIs were already providing information to it in various formats and the intention of setting-up the financial institutions cell (FIC) in the Reserve Bank was to streamline the monitoring of information it received and to have more structured discussions with the FIs. To strengthen the Reserve Bank's stand, the Governor astutely introduced the monetary policy angle:

> Our objective is broadly to monitor and oversee, within the current legislative framework, the operations of financial institutions as an adjunct to monetary and credit policy. The role of the Reserve Bank in relation to financial institutions has to be seen essentially in terms of the need for a macro-perspective of monetary and credit policy, assessing the quality of assets of the financial system and improving co-ordination between banks and financial institutions.

Government's Conditional Acquiescence

The Government, in its letter dated October 18, 1990, opined that notwithstanding the clarifications offered by the Reserve Bank in the letter, it expected that before specific proposals were finalised, the latter would consult them. It was emphasised that a general discussion took place at the Board meeting pertained to the desirability of the Reserve Bank maintaining an oversight of the entire financial system but no specific decisions were taken. The Finance Secretary suggested that it was desirable to clearly identify the role of the FIC set up in the Reserve Bank. First, the cell would be concerned only with compiling and analysing the data received from FIs necessary for a macro perspective and credit policies and not develop into a cell for co-ordinating or supervising the activities of FIs. Second, the Reserve Bank could have periodic dialogues at the Governor's level with the top management of the FIs to discuss matters of mutual interest. Third, policy matters that called for joint action of banks and FIs, *e.g.*, synchronisation of term loans and working capital loans, handling of sick units might be dealt with by the Reserve Bank. Fourth, the Reserve Bank could continue to take decisions in regard to the interest rate of FIs after appropriate consultations. Last, the market borrowings for FIs were within the purview of the Reserve Bank in consultation with the Government. More importantly, the Government indicated that: "in order to avoid duplication of functions and authority" the Reserve Bank should not get involved in operational matters of FIs without its 'concurrence', in individual cases or periodic assessment of the assets of the institutions.

The Governor, in his letter dated November 26, 1990 to the Finance Secretary, agreed with the responsibilities of the Reserve Bank as outlined in the Government's letter, but still felt that it was essential for the central bank to assess broadly the quality of the assets of the FIs that had grown over the past decade and stood at about half the assets of commercial banks. Further, the Reserve Bank clarified that it proposed to make periodic assessments on the basis of data supplied by the FIs and not preceded by onsite inspections. Finally, the Reserve Bank urged that its intention was to: "establish a monitoring system which served its purpose without interfering with the functional autonomy of the institutions or with the co-ordinating roles of apex institutions."

Before the Government could take a view on the Governor's letter, the Governor, Shri R.N. Malhotra, tendered his resignation as of December 22, 1990, though he had not completed his extended term. While this event had no parallel with the earlier event of the resignation of the Governor, Sir B. Rama Rau in January 1957,[18] his successor, Shri S. Venkitaramanan, a former Finance Secretary, had to deal with this issue with the Government.

Issue Resurfaces and its Resolution

The Finance Secretary, Shri S.P. Shukla, in his letter dated March 19, 1991 to the Governor, Shri S. Venkitaramanan, reiterated that the Government would not be in favour of any 'examination' of the portfolios of FIs in so far as they related to individual companies, but the Reserve Bank could seek from them data of an aggregate nature that affected the recycling of credit by FIs and impinged on monetary and credit flows. This was in the context of the stand taken by the Reserve Bank that it would like to make periodic assessment of the quality of the assets of FIs without getting involved in operational matters.

The Governor in his letter dated May 6, 1991 affirmed that the Reserve Bank's response in the recent past had been towards developing a 'sharper' macro policy focus and a more 'efficient and purposeful monitoring' of FIs, and that the information obtained from the IDBI and other FIs would give it a useful feedback on macro aggregates and thereby enable formulation of a more effective monetary policy. Next, the Governor stated that while the Reserve Bank had already indicated to the FIs what it 'intended to do' as regards broad classification of assets according to their health, the Government's letter appeared to convey some anxiety regarding

18. An absorbing account of the events leading to the resignation of the Governor, Sir B. Rama Rau in January 1957 is given in the second volume of the Reserve Bank of India history, *The Reserve Bank of India (1951–1967)*.

what the Reserve Bank 'should not do'. He emphasised that an assessment of the quality of financial assets of the institutions was an integral part of the monitoring mechanism, at the same time conceding that it was not its intention to focus primarily on individual companies. The letter also pointed out that in an increasingly sophisticated financial system the flow of funds was inevitably intertwined, and there could be occasions when the Reserve Bank had to take an integrated view in individual cases. The Governor's observation: "I am afraid that reluctance to allow RBI an oversight of the quality of financial assets of financial institutions is inconsistent with the expressed desire to have a better monitoring of the monetary and credit system through RBI" marked a hardening of the stance as compared with that of his predecessor. However, in the concluding part of the letter, the tone was conciliatory, *viz.*:

> As you are aware, the existing provisions of the Reserve Bank of India Act give adequate powers to enable the Reserve Bank to undertake the kind of monitoring we intend to do and I hardly need stress that the Reserve Bank would always operate within the confines of the Act. In fact, in the context of the forthcoming negotiations with international agencies on financial sector reforms, it would be useful to stress the role the Reserve Bank can play in taking an integrated view of the operations of both banks and financial institutions. The powers of oversight over the credit system have increasingly been vested with the central banks in other countries and I urge that we move in the same direction. Fortunately, the powers already exist. I would, therefore, feel that any step we take should be in the context of these powers and not in the direction of their dilution.

RESIGNATION OF THE GOVERNOR, SHRI R.N. MALHOTRA (DECEMBER 22, 1990)

The sudden and abrupt resignation of the Governor, Shri R.N. Malhotra, and his being replaced by Shri S. Venkitaramanan on December 22, 1990 cast a shadow over relations with the Government. Even though this incident was not comparable with the resignation of the Governor, Sir B. Rama Rau, in January 1957, (referred to earlier) his graceful exit was the culmination of the growing differences between the finance ministry and the Reserve Bank on various issues.

Besides steadfastly maintaining a strong stance on controlling inflation by moderating fiscal deficits and trying to uphold the Reserve

Bank's responsibility as a monetary authority in an environment of fiscal profligacy, Governor Malhotra's reign of over six years was notable for successful efforts to make the financial system more flexible and competitive. He implemented in a dedicated manner the wide-ranging recommendations of the Chakravarty Committee, which set the platform for further reforms after the gulf crisis. Special mention may be made of Shri Malhotra's efforts at fostering disintermediation in the financial system. These included allowing banks manoeuvrability in their most profitable business areas, introducing new money market instruments and, above all, making attempts towards reform in the interest rate structure. In this task, among others, especially in the area of monetary and credit policy administration, he was ably supported by the Deputy Governor, Dr C. Rangarajan, with his sound economic background and analytical mindset.

The memorandum to the Central Board of Directors of the Reserve Bank of India, dated January 22, 1991, paid tributes to Shri Malhotra's administrative capabilities and achievements:

> As Governor of the Reserve Bank of India, he strove to ensure that the Bank contributed effectively towards achieving the national goal of growth with stability, particularly through its monetary and credit policies and that the country's financial system remained sound. He provided the impetus for a more flexible, transparent and competitive financial system and more significant contributions in ensuring that the banking system adopted prudential norms and took particular interest in ensuring improved housekeeping by banks.

DISQUIETING TRENDS IN GOVERNMENT FINANCES AND DEPENDENCE ON RBI CREDIT

Although the concerted and structured reform measures were launched in July 1991 by the new Government, it took some time for the macroeconomic fundamentals to stabilise. Stabilisation required both monetary and fiscal discipline to go hand-in-hand. With this end in view the Governor, Shri S. Venkitaramanan, in his letter dated December 10, 1991 informed the Finance Minister, Dr Manmohan Singh, that he had been 'perturbed' for some time by the disquieting trends in the finances of the Government as also its dependence on Reserve Bank credit, *i.e.*, the data for December 6, 1991 revealed that the budget deficit and the related RBI credit to the Centre had reached 'historically' high levels even by December. The letter pointed out that even though the net market borrowing till then had been lower than in the corresponding period of the previous year, this was compensated by larger accretions under the 182-day Treasury Bills. The none-too-comfortable situation had been made even more acute because the IMF performance criteria had to be complied with, and it had become a 'Herculean' task for the Reserve Bank to ensure that the NDA target on the previous 'test date' (November 1, 1991) was met.

The Reserve Bank's anxiety was not merely about the difficulties in adjusting these numbers on 'test dates'. There were several other concerns. First, the persistent increase in liquidity caused by fiscal deficits had serious implications for inflation, which was a cause for worry. Second, if monetised deficit persisted at high levels for major parts of the period and was sharply brought down to adhere to the 'test date' criterion; it might leave behind considerable monetary impulses that would not be entirely reversible. The letter added that it was partly for this reason that M_3 growth was running at a rate faster than in the previous year and also faster than the implied annual growth of 13.0 per cent accepted for 1991–92. The third source of concern for the central bank was the prevailing credit situation for the commercial sector, which was feeling the adverse effects of unusually 'stiff' credit policy measures and, with the onset of the busy season, it was expected that demand for commercial credit would pick up. In such a prospect, refinance facilities for commercial banks could not be unduly compressed without further hurting the availability of bank credit for productive sectors in general and for export purposes in particular. It was against this background that the Governor stressed that the required burden of adjustment in NDA would have to be borne by the Centre's budgetary operations and that the Government should take measures of an enduring nature to contain the budget deficit and liquidity growth on a sustained basis. He expressed a desire to meet the Finance Minister before his meeting with the officials of the finance ministry on December 14, 1991. As events later unfolded, the subtlety of the letter was felt, with the fiscal authorities paying increasing attention to consolidating the fiscal position.

CO-ORDINATION BETWEEN DEBT MANAGEMENT AND MONETARY POLICY

The idea of having large-scale OMOs *ipso facto* called for closer co-ordination between debt management and monetary policy. In this connection, the views of the Reserve Bank on the method of co-ordination underwent a change between November 1992 and February, 1993, which reflected the individual perceptions of the two Governors.[19] The Government took seriously the idea put forth by the Governor, Shri S. Venkitaramanan, in November 1992 that a co-ordination committee might be set up with participation from the Ministry of Finance and the Reserve Bank to co-ordinate debt management and monetary policy issues. When the Finance Secretary suggested that such a committee be set up immediately in February 1993, the Governor, Dr C. Rangarajan, gave a different viewpoint that was based on the premise that there had always been intense discussions on the topic with the Ministry of Finance both prior to and after the budget, and the Reserve Bank had taken co-ordinated action in this area. The central problem was the need to reduce the Government's heavy reliance on a captive market for government securities and move towards a genuine market-related interest rate structure.

The Reserve Bank conceded that while considerable reform had been managed, the authorities had still to 'bite the bullet'. The Governor remarked: "I am of the view that to the extent that co-ordination and consultation was the issue, we have plenty of it! I frankly do not see the central problem being resolved merely by setting-up a Co-ordination Committee." However, he left the door open by concluding the letter as follows:

> My preference would be to continue with the present system of consultation. A formal Committee approach may add to the problems rather than improve co-ordination. If, however, the Ministry of Finance wishes to set up the Committee, the Reserve Bank will be glad to participate and endeavour to bring about greater co-ordination between public debt and monetary management.

The co-ordination committee, however, did not materialise and debt management was continued to be handled by the monetary authorities on behalf of the Government.

DENT IN RESERVE BANK'S BALANCE SHEET DUE TO MANAGEMENT OF LARGE ACCRETION TO FOREIGN EXCHANGE RESERVES

Quite early in his office, the Governor, Dr C. Rangarajan, was confronted with disturbing evidence about the profits of the Reserve Bank. The

19. In the interim period, Dr C. Rangarajan took over as Governor from Shri S. Venkitaramanan on December 22, 1992.

evidence concerned the reimbursement made to the State Bank of India (SBI) at the Government's instance in respect of the premium paid by the SBI on purchase of Exim scrips, the depreciation in the value of dated government securities held in the investment portfolio of the Reserve Bank and the losses to the Reserve Bank due to its intervention operations in the foreign exchange market. The profit and loss account of the Reserve Bank was expected to show a net loss of ₹ 375 crore after making the necessary provisions. The Government was kept informed of the anticipated course of events so that the budget estimates for 1993–94 would be made on a realistic basis. The Governor's letter to the Finance Secretary of February 3, 1993 gave substantive reasoning behind each of the three factors, the main gist of which is worth recounting.

Due to the Government's budgetary constraints, the Reserve Bank had been asked to bear the premium of 20.0 per cent to be paid by the SBI on its purchase of Exim scrips, even though it was not its responsibility. The statutory auditors had initially raised objections to the payment on the ground that this was not an expenditure relating to the Reserve Bank's business and hence should not have been borne and recorded in its books. But after the relevant letter from the Government was placed before the auditors and after clarifying that the amount involved was not very large, they did not pursue the point. In February 1993, the amount reimbursable to the SBI worked out to ₹ 797 crore. But by February 28, 1993, which was the last date for the purchase of Exim scrips, the year's reimbursement to the SBI was estimated to go up to ₹ 1,000 crore. In addition, the depreciation in the value of dated government securities held in the investment portfolio of the Reserve Bank was placed at about ₹ 800 crore by June 1993.

The item involving current losses to the Reserve Bank was its intervention operations in the foreign exchange market. Ever since the introduction of partial convertibility in March 1992, the Reserve Bank had to buy surplus dollars in the Indian forex market so as to maintain the premium above 15.0 per cent. Until the end of January 1993, the Reserve Bank had made net purchases of US$ 2,150.0 million at market rates. Since the Reserve Bank's books were being maintained at the official rate, the rupee losses booked till February 3, 1993 due to the intervention operations amounted to ₹ 818 crore and, based on this trend, the exchange loss figure was expected to go up to ₹ 1,200 crore by end-June 1993.

The Reserve Bank in its letter advised that according to the current estimates, there would be no profit to be passed on to the Government as against the profit of ₹ 1,500 crore transferred for the preceding year and that the reduction in current receipts of this magnitude in the Government's budget would be difficult for the Government to handle. However, to alleviate the situation, the Governor outlined one possible way for the Government to consider. While provisions would be required as far as Exim scrip purchase and depreciation in government securities were concerned, it would be possible to handle the market intervention transactions without booking current losses by creating within the existing reserves a market operations fund to which would be transferred all the foreign currencies (at that time only the US dollar) purchased from the market under the stabilisation operations at the ruling market rates.

The dollar amounts would be valued at the prevailing market rate in the books of the Reserve Bank. When the US dollar was sold at market rates, this fund could be drawn upon. If this method was adopted, the exchange loss ranging from ₹ 850 crore to ₹ 1,000 crore could be avoided, but it would still be reflected in the higher rupee cost of the dollars held in the books of the fund. As far as published reserve figures were concerned, this proposal was not expected to make any difference. However, if the reserve fund came down drastically and the fund had to be drawn, the sales would have to be effected only at the market rate. In other words, the dollars held in the fund would be like any other foreign currency and would be subject to revaluation at the end of every month as in the case of other foreign currency holdings. The auditors who were sounded informally did not voice any objection to this course, provided that no transfer of the 'official rate' dollars was made to the market operations fund in order to boost the profits. If the proposal was acceptable, the Reserve Bank expected to be in a position to transfer a profit of ₹ 850 crore to ₹ 1,000 crore during the Government's financial year 1993–94. In actuality, the Bank's surplus profits that were transferred to the Government in 1993–94 (July–June) remained unchanged at ₹ 1,500 crore.

The Bank also took the opportunity to apprise the Central Government that, in the immediate past, several foreign currency borrowings/funding operations involving sizeable exchange risk had devolved on the Reserve Bank. These included deposits under the FCNR (A) and FC(B&O)D schemes, the parking facility extended to certain FIs (IDBI, ICICI and SCICI[20]), India Development Bonds (IDBs), the swap facility extended to

20. Shipping Credit and Investment Company of India Ltd.

authorised dealers, intervention in the forex market, the compensation paid to Exim scrip holders by the SBI, the cost of cover given to the IDBI and ICICI in respect of certain IBRD credit lines and the foreign currency liabilities of the Indian Oil Corporation (IOC) and the SBI, which had been crystallised in rupee terms in 1985 for which IOC had been discharged from further liability. In a forthright assessment, the emerging scenario was depicted by the Governor thus:

> These involve considerable exchange risk. An idea of the risk involved can be had from the fact that with the present liability on these counts amounting to $ 15 billion less reserves of $ 5 billion, every change of just one rupee in the rupee value of the US dollar led to a loss/gain of Rs. 1,000 crore in the books of the Reserve Bank. The exchange risk on this liability had to be provided for in full to the satisfaction of the auditors and till then, the Bank had been able to make necessary provisions from its internal reserves. The internal reserves have been depleted to just Rs. 2,900 crore. It will not, therefore, be possible for the Reserve Bank to take over the exchange risk in respect of any further foreign currency liabilities. Apart from this, if the value of the dollar goes up by more than, say, Rs. 2 per dollar, the reserves would not be adequate to make the required provision which may lead to a remark to that effect by the Statutory Auditors in the balance sheet of the Bank. I need hardly mention how undesirable such a remark would be. Unlike in the Bank, in the case of the Government of India, there is no need to make any provision for the corpus of the liability and the loss as and when arises at the time of repayment can be booked in the Government account. It is in view of this that we had earlier requested that the exchange risk in respect of FCNR deposits should be taken over by the Government. At that time it was not agreed to but the Government may have to think of this before any significant improvement of dollar-rupee rate materialises.

The views that the Bank offered were essentially to provide important inputs to the Government in its formulation of the budget for the subsequent year. As events unfolded, the surplus profits transferred to the Government in 1994–95 in fact rose to ₹ 3,558 crore compared with ₹ 1,500 crore in 1993–94.

PHASED REDUCTION IN SLR

The issue of phased reduction in SLR was being discussed between the Government and the Reserve Bank since May 1993 when the Finance Secretary sought the Reserve Bank's views about the feasibility of bringing about a reduction of SLR to 25.0 per cent to be achieved by the end of 1995–96, keeping in view that any feasible plan must ensure adequate availability of SLR resources to the state governments and state government owned institutions. The letter also acknowledged that in identifying the resources for the Centre's borrowing programme (after reduction in SLR), the possibility that in future, several banks might still opt for government securities not only because of SLR prescription but also because of the zero risk attached to them should also be factored in. "In effect, capital adequacy ratio would operate in the opposite direction to the reduction in SLR by increasing the flow of finance to Government borrowing," was the observation made by the Finance Secretary.

The Reserve Bank's reaction was based on a detailed study. First, it would not be prudent to plan the borrowing programme on the basis of excess SLR holding by banks. Second, if the Central Government guaranteed institutions had to be provided resources under the market borrowing programme, there would have to be a *pro tanto* reduction in the Centre's borrowing programme. Third, as a result of the contemplated reduction in SLR, the market borrowing programme would be supported by commercial banks to a relatively small extent. Fourth, while there might be some excess investments in SLR securities over and above the stipulation, the assumption regarding investments by non-bank institutions could go awry if stipulations on their investments in government and other approved securities were lowered, which was a distinct possibility. While conveying these perceptions to the Government in the letter dated July 8, 1993, the following important suggestions were offered:

(i) While the programme of SLR reduction to 25.0 per cent could be phased over a period of three years inclusive of 1993–94, it should be conditional on a satisfactory fiscal adjustment and the borrowing programme supported by 'captive' investors.

(ii) The rate of interest on government bonds would require to be raised in order to attract investments consistent with the borrowing requirements. If the borrowing requirement was set at too high a level compared with the available resources from SLR stipulations, the rate of interest might have to be raised to levels that would make the task of containing the fiscal deficit difficult. This could lead to a vicious spiral of rising interest rates and growing fiscal deficits. Therefore, borrowing requirements would have to be kept within limits.

(iii) The system of automatic monetisation of the Central Government's budgetary deficit should be discontinued under a phased programme during this period. Accordingly, the phased reduction in SLR should be dovetailed into a programme to phase out automatic monetisation of the budget deficit over a three-year period. Thus, the proportion of auctioned bills in the total creation of 91-day Treasury Bills should be one-fourth in 1993–1994, one-half in 1994–95, and three-fourth in 1995–96, and from 1996–97 the system of *ad hoc* Treasury Bills should be totally discontinued. The Central Government could then be provided a ways and means (WMA) limit from the Reserve Bank to meet temporary requirements, which should be liquidated by the end of the year.

Under the multiple system of maintenance of SLR adopted since February 1992, SLR at the rate of 25.0 per cent was made applicable for any increase in domestic deposits over the level as on September 17, 1993. However, SLR on deposits up to the level as on September 17, 1993 was 34.75 per cent.

DILEMMA FACED BY THE RESERVE BANK IN ITS MONETARY MANAGEMENT IN THE CONTEXT OF LARGE ACCRETION TO FOREIGN RESERVES

With the rapid accumulation of foreign exchange reserves in 1994–95, the Reserve Bank's task of monetary management became more complex. The movements in foreign reserves and the consequent control over liquidity in the economy called for continuous monitoring by the Reserve Bank. The control tool of CRR was not expected to be effective, as interest had to be paid on banks' balances held with the Reserve Bank, thereby creating reserve money. The only option left, namely, OMOs, was no doubt handy, but the Reserve Bank had to surmount the problem of availability of government securities with suitable coupon rates and maturity composition.

The policy challenge for the Reserve Bank became more apparent when it undertook a review in May 1994. An increase in NFA, given the order of net RBI Credit to the Government, gave rise to two possible scenarios which, as the Governor, Dr C. Rangarajan, implied through his letter of May 5, 1994 to the Chief Economic Adviser to the Government, presented a dilemma for monetary authorities should the Government not act to bring about fiscal discipline or to discourage large capital inflows.

The first of the projections estimated M_3 growth in 1994–95 at 16.0 per cent on the assumption of an increase in NFA by US$ 3.0 billion, an increase in net RBI credit to Government of ₹ 6,000 crore, and an incremental money multiplier of 3.55. This order of increase in M_3 combined with a rate of growth of 5.0 per cent in real terms was expected to bring down inflation to around 7.0 per cent. While terming this as an ‘acceptable scenario’, the Governor felt that it was advisable to prepare for other contingencies.

The second alternative envisaged that with an NFA increase of US$ 5.0 billion, the increase in M_3 would be about 21.4 per cent, which was termed as ‘totally unacceptable’. If the NFA exceeded US$ 3.0 billion, the authorities would have to take necessary action. If the increase in NFA was US$ 1.0 billion above the first alternative, it was still possible to keep M_3 growth at 16.0 per cent by undertaking OMOs. Securities at market-related interest rates held by the Reserve Bank for OMOs were around ₹ 4,000 crore, which was felt to be inadequate. If the gross foreign currency reserves of the Reserve Bank increased beyond US$ 18.0 billion, the authorities must be willing to take some other actions, all of which would be costly.

A step-up in CRR would seriously affect the profitability of banks. No doubt, the other course of converting part of the non-marketable securities with the Reserve Bank at a rate of 4.6 per cent into marketable securities at prevalent coupon rates would bolster OMOs. However, the cost of such conversion was estimated at ₹ 80 crore per annum for every ₹ 1,000 crore of securities. As the conversion cost was fairly high, the Reserve Bank advised that the immediate cost to the Government could be avoided by converting non-marketable securities into zero coupon bonds. Besides these measures, action would need to be taken on other fronts to prevent an increase in the NFA to unacceptable levels. The letter concluded that as it was not possible to predict how the NFA would move during the year, the authorities should be prepared to put into effect the various suggestions as and when circumstances demanded and that the overall objective should be to ensure that M_3 did not increase beyond 16.0 per cent in 1994–95.

These projections, however, turned out to be much lower than the actual outcomes. By the end of October 1994, the NFA and M_3 exceeded their respective projections. The Reserve Bank, therefore, had to revise its views on the policy options with a view to containing M_3 growth in 1994–95 at 16.0 per cent.

A detailed letter from the Governor to the Finance Secretary, Shri Montek Singh Ahluwalia, dated October 31, 1994 recalled that at the time of the announcement of monetary policy for the first half of 1994–95, the NFA were projected to increase in the range of US$ 3.0 billion to US$ 5.0 billion, but in the financial year up to October 21, 1994, the NFA had increased by a little over US$ 5.6 billion. The growth of reserve money up to that period was ₹ 16,869 crore, compared with an increase of ₹ 14,934 crore during the comparable period of the previous year and this growth was to some extent subdued due to a decline of ₹ 7,225 crore in *ad hoc* Treasury Bills. The rate of growth in M_3 during the year up to October 14, 1994 at 11.1 per cent was considered to be much higher than the projected trajectory of 14.0–15.0 per cent for 1994–95 envisioned by the Reserve Bank and also the 16.0 per cent growth estimated at the time of the monetary policy announcement in April 1994. "Unless the reserve money growth is slowed down in the second half of the year, there could well be an explosive increase in M_3 with adverse impact of acceleration of inflation," the Governor postulated.

As regards NFA, the Reserve Bank opined that the increase during the full financial year 1994–95 could be a minimum of US$ 7.0 billion or ₹ 22,400 crore. If the Centre used *ad hoc* Treasury Bills up to the predicted level of ₹ 6,000 crore, an 'explosive' growth of reserve money of the order of ₹ 32,400 crore (23.4 per cent) in 1994–95 was expected and the resultant growth of M_3 was estimated at around 20.5 per cent, a figure even higher than the increase of 18.2 per cent in 1993–94. The Governor, therefore, reckoned that such a large monetary growth would be clearly 'unacceptable' and that given the paramount objective of achieving a significant reduction in the inflation rate, it was essential to contain M_3 growth in 1994–95 to around 16.0 per cent.

The Reserve Bank came out with drastic measures to contain the pace of monetary expansion. A reduction in interest rates on non-resident deposit schemes and the imposition of CRR on the FCNR (B) scheme could be expected to moderate the inflows, but in any case the increase in NFA was unlikely to be less than US$ 7.0 billion and the increase could be significantly larger. Therefore, to have a meaningful impact on reserve money growth, the Reserve Bank suggested very large OMOs, but in the prevailing situation, this posed serious logistical problems. The Reserve Bank held marketable dated securities of ₹ 4,000 crore (book value) of which only about ₹ 2,900 crore were with coupon rates of over 10.0 per cent and the balance carried low coupon rates, which would be difficult to sell even if the prices were lowered to match the yield-to-maturity on recently floated securities by raising the current yield. To facilitate effective OMOs, the Reserve Bank was required to have in its portfolio an additional ₹ 7,000 crore worth of non-marketable 4.6 per cent securities from its own stock converted into marketable securities.

To tide over the situation, the Reserve Bank put forward two proposals. First, the non-marketable non-terminable securities were to be converted into marketable ones with a maturity of 5 years and the coupon rates left unchanged. But given the face value of these securities *vis-a-vis* the prevailing yield to maturity, the Reserve Bank would have had to incur a huge capital loss for raising the yield to at least 10.0 per cent (if not the desired 11.5 per cent) to make them marketable. Therefore, this option was ruled out. The remaining alternative was for the Government to issue to the Reserve Bank, zero coupon bonds of 5-year maturity in lieu of the redemption of special securities. This had the advantage that the financial burden of the Government would arise only at the time of maturity.

The Governor recommended: "We are of the view that this alternative is feasible and that the Government should bear this burden in the overall interest of macro-economic stability." In the concluding paragraph of the letter to the Government, the Governor expressed the fear that the projected increase in NFA of US$ 7.0 billion would itself be a 'serious underestimate' and the Reserve Bank might have to undertake OMOs of an order significantly more than ₹ 7,000 crore. He urged the Government to take early action to implement the main proposal to redeem ₹ 7,000 crore face-value of special securities and invest the corresponding sum in zero coupon bonds of 5-year maturity at an implicit yield-to-maturity of 11.5 per cent. The Governor felt that the additional cost of ₹ 483 crore in order to keep down the inflationary pressures was not that onerous and the cost need, in any case, not be borne immediately.

CONCLUDING OBSERVATIONS

In contrast to the 1980s, when expansionary fiscal policy posed a continuous challenge in the conduct of monetary policy, the onset of financial sector reforms beginning in the mid-1991 also meant that monetary management would need to be broadly aligned with other macroeconomic and institutional policies. The agreements reached between the Reserve Bank and the Government to limit the net issue of *ad hoc* Treasury Bills from 1994–95 culminating in discontinuation of issuing these bills effective April 1997 meant the end of a four-decade old practice of automatic monetisation of budget deficits. With market-based government borrowings through auctions, the co-ordination between monetary and public debt management was strengthened. Second, while the twin objectives of price stability and support to growth remained intact, monetary management turned to increasing use of market-based instruments, such as OMOs and interest rates. The interest rate structure, which was rigid and complex, was progressively rationalised and deregulated during the reform period to make it flexible and its rigours considerably reduced. Third, with market integration improving, in particular between the money, government securities and the foreign exchange markets, the financial stability consideration of maintaining orderly conditions in financial markets gained prominence as an additional responsibility of the Reserve Bank, particularly after the irregularities in the government securities market that pervaded all market segments in 1992. Fourth, monetary policy had to handle the impact of large capital flows into the economy that was increasingly becoming open, especially after current account convertibility in 1994 followed by significant opening of capital account to foreign institutional investors. All these resulted in testing the Reserve Bank in realising better control over inflation, while providing adequate support to growth impulses generated by economic reforms across sectors.

The decade of the 1990s opened with a serious BoP crisis and until about 1992, monetary management had to take the extra burden of bringing back macroeconomic stability and closely tracking the IMF-supported programme targets on M_3 and credit. Both the reserve requirements and interest rates reached their peaks during these years. Thereafter, a process of gradual relaxation in terms of bringing down SLR and flexible use of CRR was set in motion. Monetary management also assumed the responsibility of ensuring stability in the foreign exchange market.

The year 1991–92 was a landmark in terms of quickly overcoming the severe BoP crisis through fiscal correction, exchange rate adjustment and reform. The overcoming of the payments crisis was followed by policy measures to stabilise the economy and to bring about more efficient allocation of resources. By 1992–93, substantial results were achieved in reducing the volume of fiscal deficit and keeping inflation under reasonable control, and the momentum was kept up in the following years. A cautious attempt was made to move away from direct to indirect instruments of monetary control. A beginning was made to develop OMOs as an effective instrument of credit control, and it became the most potent tool in the subsequent years — in the form of repos — to modulate liquidity.

In 1993–94, a sea-change occurred in the factors contributing to reserve money expansion, shifting from domestic assets to FCA in the Reserve Bank's balance sheet. The quantum jump in foreign exchange reserves, although welcome for several reasons, led also to a substantial expansion in primary money and the overall M_3. With the opening up of the external sector, the transmission of impulses from the external sector to domestic markets became powerful. The stability of the exchange rate came to depend crucially on the degree of success in holding down the inflationary pressures. The monetisation effect of large foreign capital inflows and the consequent inflationary impact on monetary expansion became a major concern and preoccupation of the Reserve Bank in the mid-1990s. OMOs by the Reserve Bank in dated government securities formed an integral part of the monetary policy strategy to sterilise inflows. As a corollary, internal debt management policies were activated and integrated with monetary management.

In 1994–95, the conduct of monetary policy was influenced by the rise in capital inflows and consequent increase in the FCA of the Reserve Bank. Therefore, the Reserve Bank tried to impart a sharper focus on evolving internal consistency among monetary, fiscal and exchange rate policies. A far-reaching development was the initiative to delink budget deficit from monetisation. The Reserve Bank entered into an agreement with the Government to place a ceiling on its unlimited borrowing from the former through *ad hoc* Treasury Bills so as to curb automatic monetisation of the fiscal deficit and the resulting growth of reserve money. Another agreement paved the way for discontinuation of *ad hoc* Treasury Bills from April 1997. It provided greater flexibility in monetary management and strengthened the linkage between fiscal and monetary policies in achieving their respective goals more optimally.

Overall, during the 1990s, the Reserve Bank's monetary policy helped contain inflation and inflationary expectations. Towards the close of 1996–97, the Reserve Bank's various policy initiatives and responses made it also possible for the financial markets — especially the money and gilt-edged markets — to attain greater depth and strength. In the process, new financial instruments were deployed. Fiscal consolidation markedly scaled down the Central Government's dependence on Reserve Bank credit and also the draft of the Government on the resources of commercial banks. The transmission channels of monetary policy apparently became operationally more effective. The Reserve Bank came to enjoy greater freedom in framing monetary policy compared to the 1980s, with the elimination of automatic monetisation of fiscal deficit.

The interconnected measures designed to develop financial markets, payment and settlement systems and other financial infrastructure, along with the development of banking regulation and supervision, contributed to the maintenance of financial stability in India and helped to meet successfully the challenges thrown up by the South-East Asian financial crisis that affected the global economy in the mid-1997.

ANNEX 14.1

Evolution of Monetary and Credit Policy in India (1990–1997) – Part II

1990–91

A TRAUMATIC YEAR: MACROECONOMIC IMBALANCES AND STRAINS ON BALANCE OF PAYMENTS AGGRAVATED BY THE GULF CRISIS

Governors: Shri R.N. Malhotra (4.2.1985–22.12.1990)

Shri S. Venkitaramanan (22.12.1990–21.12.1992)

Deputy Governor: Dr C. Rangarajan (12.2.1982–20.8.1991)

Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
From the beginning of 1990–91, the economy faced several problems. These were the medium-term, large and continuing fiscal imbalances (mainly on the revenue account), the build-up of strong inflationary pressures in the economy, and strains on the BoP (*i.e.*, CAD). The fragile economic situation was abruptly aggravated by the eruption of the gulf crisis (August 1990). Consequently, the deterioration in the foreign exchange reserves position was on an alarming scale. The drying up of commercial loans from abroad and reduced access to international financial markets was exacerbated by a sharp outflow of NRI deposits starting from the last quarter of 1990 to practically the end of 1991. The uncertain political conditions came in the way of taking timely policy decisions. In particular, the unsustainable level of fiscal imbalances that had been building up for several years resulted in a large expansion in M_3 and the build-up of inflationary pressures despite a satisfactory monsoon and good agricultural output for the third year in succession. These factors placed severe pressure on the BoP.	Taking into account the strong acceleration in primary money growth and its adverse impact on inflationary expectations, the main objective of the tight credit policy for the first half of 1990–91 was to reduce monetary expansion (M_3) by about 4.0 percentage points during the year. However, in the second half of the year, with the sudden eruption of the economic crisis, the short-term management of the BoP situation became the overriding concern of both economic and monetary policy, besides the continuing objective of price stability. The need to conserve as well as augment the slender foreign exchange reserves of the country became the dominant objective. These were sought to be achieved by import compression and export promotion.	The package of credit policy measures announced on April 12, 1990 sought to regulate growth in M_3 and credit and thus moderate the growth of liquidity in the system. • SLR increased from 38.0 per cent to 38.5 per cent from September 22, 1990, excluding non-resident accounts. • Selective credit controls imposed on bank advances against price-sensitive commodities. In the second half of the year, due to the deterioration in the macroeconomic imbalances, credit policy measures became progressively stiffer to contain the overall demand for imports and culminated in the imposition of cash margins as high as 200.0 per cent on imports of goods under OGL and 150.0 per cent on specific import licences; this was termed “the use of monetary instrument in a non-discretionary manner to moderate the level of imports”. The other measures were:

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Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
		• Imposition of interest rate surcharge on export financing. • Raising interest rates on post-shipment export credit beyond certain maturities to encourage faster. realisation of export proceeds. The lending rates of banks were re-structured (September 22, 1990). From April 23, 1991, banks were advised that every transaction of sale of foreign exchange or payment to any person resident outside India equivalent to or above ₹ 2.5 crore (other than for repayment of balances in FCNR and NRE accounts and inter-bank transactions) should be referred to the Reserve Bank for clearance before effecting the transaction.

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Fiscal-monetary co-ordination	*Financial sector reform*
The conduct of monetary policy was closely co-ordinated with fiscal policy. Measures to contain M_3 growth were backed by associated measures to contain fiscal deficit.	The Government took recourse to borrowing from the IMF. • India used its reserve tranche during July-September 1990 to obtain SDR 487.26 million (₹ 1,173 crore). • In January 1991, ₹ 3,334 crore was availed of under the modified CCFF and the first credit tranche under a three month stand-by arrangement.

1991–92

UNPRECEDENTED AND ACUTE BALANCE OF PAYMENTS CRISIS

AGENDA FOR ECONOMIC REFORM – THE NEW ECONOMIC POLICY (JULY 1991)

TRANSFORMATION IN CONDUCT OF MONETARY AND CREDIT POLICY

Governor : Shri S. Venkitaramanan (22.12.1990 – 21.12.1992)

Deputy Governors: Dr C. Rangarajan (12.2.1982 – 20.8.1991)

Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
The year 1991–92 was exceptionally traumatic for the Indian economy. The BoP situation turned critical. Despite substantial financial aid from multilateral and bilateral agencies/governments, the foreign exchange reserves declined to about US$ 1.0 billion by mid-June 1991. Both M_3 and price level exhibited expansionary tendencies. The new Government under the Prime Minister, Shri P.V. Narasimha Rao initiated economic reforms in July 1991. These included short-term corrective measures aimed at crisis management as well as long-term measures of structural reform to improve the efficiency and productivity of the economy and put it on the path of sustainable growth with equity and social justice. These measures were piloted by the Finance Minister, Dr. Manmohan Singh. The regular budget for 1991–92 set in motion the process of fiscal adjustment as part of macroeconomic stabilisation efforts, with a promise to follow up with continued fiscal consolidation over three years. As a result of a series of crisis management measures, that is, stabilisation and structural adjustment programmes that included financial sector reform, the economy turned around.	The Reserve Bank continued to adopt a restrictive credit policy during the first half of 1991–92 to contain aggregate demand, particularly in the demand for imports. After July 1991, two considerations dominated the framing of credit policy. One was the need to align financial sector reforms with the macroeconomic adjustment process launched by the Central Government. The second was the need to contain inflation, which reached a high of 16.7 per cent by August 1991. Monetary and credit policy sought to achieve monetary stability by trying to attain a lower M_3 expansion of about 13.0 per cent for the full year. Therefore, a restrictive credit policy was adopted.	The thrust of monetary and credit policy measures for the first half of 1991–92 was two-pronged. The first set of measures sought to contain aggregate demand (particularly of imports) and encourage acceleration of export receipts, while the second category enhanced the competitive position of banks in deposit mobilisation by increasing the rate of interest on deposits of three years and above. An incremental CRR was imposed from May 3, 1991. The Reserve Bank announced a package of policy measures effective from July 4, 1991 to curb imports and reduce aggregate demand in the economy, namely, • Bank Rate hiked from 10.0 to 11.0 per cent. • Rates of interest on advances from RBI specifically linked to the Bank Rate raised. • Interest rates on bank advances over ₹ 2 lakh raised. The GoI also announced major structural reforms in trade policy on July 4, 1991.

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Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
The FCA of the RBI, which had plummeted to US$ 975.0 million on July 12, 1991, spurted to US$ 5.6 billion by the end of the year.		In the second half of the year, the important changes in credit policy were: • Increase in the Bank Rate from 11.0 per cent to 12.0 per cent. • Withdrawal of all RBI refinance facilities (except for exports). • Reduction in the rate of interest paid on cash balances impounded with the RBI. • Increase in the short-term interest rates on deposits.

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Fiscal-monetary co-ordination	*Financial sector reform*
	The measures of macroeconomic stability formulated by the Government in July 1991 related to fiscal consolidation, exchange rate adjustment and reform, fixation of monetary targets and inflation control. These were supported by structural reforms through industrial deregulation, overhauling of public sector enterprises and financial sector reforms. To improve the international competitiveness of India's exports and restrain import demand, the Reserve Bank on July 1 and July 3, 1991 adjusted downwards the value of the Indian rupee, which in terms of GBP worked out to 17.38 per cent and in terms of US $ about 18.7 per cent.

1992–93

GOOD PROGRESS IN ECONOMIC STABILISATION – DEEPENING OF REFORM PROCESS
INTRODUCTION OF FINANCIAL SECTOR REFORM
UNION BUDGET FOR 1992–93 – CREDIT POLICY FOR 1992–93
Governors: Shri S. Venkitaramanan (22.12.1990 – 21.12.1992)
Dr C. Rangarajan (22.12.1992 – 22.11.1997)
Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

Macroeconomic backdrop	*Objectives and stance of*	*Salient policy measures monetary and credit policy*
Within 10 months, the Government not only overcame the BoP crisis and reduced macroeconomic imbalances, but also initiated the process of a major transformation of India's development strategy. Changes in industrial, trade and financial policy had liberalised one of the most regulated economies in the world. During 1992–93 progress was made in economic stabilisation and revival of economic activity. The high expansion in M_3 was caused by the build-up of foreign exchange reserves; but the price level could be contained. The Central Government brought about a substantial budgetary reduction in GFD from 6.5 per cent in 1991–92, which had a favourable impact on other macro variables.	Monetary and credit policy for the year focussed on making adequate credit available for renewal of productive activity (especially in industry, agriculture and exports) and containing inflationary pressures. The Reserve Bank decided to effect a sharp reduction in the pace of monetary expansion (M_3) from 18.6 per cent in 1991–92 to less than 11.0 per cent in 1992–93 to supplement the anti-inflationary impact of the proposed reduction in the budget deficit. In effect, the stance of credit policy was restrictive, except for some relaxation to stimulate productive sectors of the economy. The Reserve Bank started implementing the major recommendations of the Narasimham Committee.	The important policy measures during the period were: • Gradual reduction in the bank lending rate, followed by a reduction in maximum deposit rates. • Rationalisation of the structure of lending rates. • SLR reduction in a phased manner (April 3, 1992). • Release of part of additional cash balances. • Reduction in effective CRR in a phased manner. There was a cautious attempt to move away from direct to indirect tools of monetary control and to develop OMOs as an active control instrument.

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Fiscal-monetary co-ordination	*Financial sector reform*
Monetary policy was increasingly co-ordinated with internal debt management policy. The Reserve Bank accorded priority to activating public debt management by reorganising the gilt-edged market so that the Government gradually reduced its dependence on the Reserve Bank to meet its borrowing programme and the budgetary gap. To move towards conducting regular OMOs, the Reserve Bank conducted repo auctions for Central Government dated securities from December 10, 1992.	Reforms in the financial sector included a reduction in incremental CRR and SLR on outstanding deposits. The Reserve Bank tried to reduce the role of reserve requirements as a tool of monetary control. The development of the government securities market impacted favourably on the conduct of monetary policy. The dual exchange rate arrangement instituted in March 1992 under LERMS enabled an orderly transition from a managed floating rate regime to a market-determined system in March 1993.

1993–94

SPEEDING UP OF ECONOMIC REFORMS

Governor: Dr C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
The Indian economy emerged stronger from the payments crisis of 1991. A sea-change occurred in the factors operating behind money and credit expansion. The quantum of foreign exchange reserves generated strong expansion in primary money growth. The monetised deficit, which used to be the predominant factor in reserve money creation, was significantly weak during the year.	Despite the success in reining in inflation in 1992–93 by monetary and fiscal discipline, the focus of monetary policy for 1993–94 was to be on guard against the resurgence of inflation. The Reserve Bank indicated its objective to bring about a 4.0 percentage points reduction in the annual inflation rate. Also, monetary policy was formulated against the broad framework of financial sector reforms.	To impart greater flexibility to monetary management, the following changes were made: • Both SLR and CRR reduced in a phased manner, thus increasing the lendable resources of banks at market rates. • Lending and deposit rates reduced in stages against the backdrop of overall improvement in the economic situation and softening of the inflation rate. • The minimum lending rate slashed by 3.0 percentage points (March, June and September 1993). • Deposit rates reduced (June and September 1993).

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Fiscal-monetary co-ordination	*Financial sector reform*
Monetary and exchange rate management became intertwined owing to large inflows of capital and their direct effects on money creation and liquidity expansion.	Monetary reform — as part of financial sector reform — continued the process of modernising the instruments of control to make them more suitable for the conduct of monetary policy in a market-oriented financial environment. The administered interest rates were made more flexible and less rigorous.

1994–95

INDIAN ECONOMY ON GROWTH PATH

NEW DIMENSIONS FOR MONETARY MANAGEMENT

Governor: Dr C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
Macroeconomic management during 1994–95 encountered problems due to the high fiscal deficit of the Central Government and the large inflows of foreign capital. In the second half of the year, credit expansion was sharp. M_3 growth of 22.2 per cent in 1994–95 was worrisome. For the first time in almost two decades, monetisation of the Centre's budget deficit was not the major factor accounting for monetary expansion.	Large capital inflows and injection of external liquidity posed problems for effective monetary management. Also, the Reserve Bank faced multiple challenges in having to: (i) increase the productive deployment of foreign exchange assets; and (ii) sterilise the build-up in liquidity and thus reduce the pressure on the price level without raising the real rates of interest. The M_3 expansion during the year was targeted at 14.0-15.0 per cent. Price stability was the primary objective of monetary policy, to be achieved by bringing about a reduction in the inflation rate by about 4.0 percentage points.	Active OMOs continued to be the anchor of monetary policy in order to sterilise capital inflows. • CRR increased from 14.0 to 15.0 per cent (in three phases during May 1994). • Increase or imposition of CRR on non-resident accounts. • Tightening of guidelines on Euro issues. • SLR reduced in phases (October 1994).

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Fiscal-monetary co-ordination	*Financial sector reform*
The historic agreement with the Central Government (September 9, 1994) strengthened the efficacy of monetary policy by eliminating the automatic monetisation of fiscal deficit phased over three years. Meanwhile, the access of the Central Government to borrowings from the Reserve Bank through the issue of *ad hoc* Treasury Bills was to be kept within the agreed annual limits. This removed one major source of instability in monetary management and helped control inflation.	

1995–96

RESTRICTIVE MONETARY POLICY CONTINUED DESPITE DECLINE IN INFLATION RATE

Governor: Dr. C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
Two significant developments during 1995–96 were a strong demand for bank credit generated by the good performance of the real sector (GDP growth of 6.0 per cent) and volatile conditions in the foreign exchange market, albeit temporary, that impacted the inter-connected domestic money market. The Reserve Bank was compelled to inject funds into the money market to restore normalcy. Even though capital inflows slackened during the second half of the year, tight liquidity position persisted due to strong expansion in non-food credit.	The Reserve Bank pursued a tight monetary and credit policy that helped moderate M_3 growth to about 13.0 per cent compared to 22.3 per cent in 1994–95; however, the latter was mainly due to increased net RBI credit to Government. In view of the highly satisfactory position of their statutory reserves, commercial banks reduced their holdings of government and other approved securities. This necessitated Reserve Bank's support to market borrowings of the Central Government, which increased the growth of net RBI credit to Government.	The significant credit policy measures of 1995–96 were: • Increase in maximum term deposit rate (April 1995). • Moderation of export credit refinance limits. • Freeing of interest rates on term deposits of over 2 years. • Changes in interest rates and CRR levels for different categories of NRI accounts to counter the excess demand in the foreign exchange market (October 1995 – January 1996). • CRR reduced to 14.5 per cent (November 1995) and then to 13.5 per cent (December 1995).

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Fiscal-monetary co-ordination	*Financial sector reform*
	Domestic monetary management had to take into account the external pressures transmitted through the foreign exchange market, particularly when volatile conditions ruled in the market. The Reserve Bank intervened during October and November 1995 to stabilise the volatility in exchange rates, which resulted in a sharp rise in the call money rate. The Reserve Bank injected large sums in the short-term money market, which helped stabilise the two markets.

1996–97

MOMENTOUS YEAR FOR MONETARY MANAGEMENT
CRR REDUCED BY FOUR PERCENTAGE POINTS
SUBSTANTIAL FOREIGN CAPITAL INFLOWS LED TO SIZEABLE LIQUIDITY GROWTH
INCREASED RELIANCE ON INDIRECT INSTRUMENTS OF CREDIT CONTROL
REACTIVATION OF INTEREST RATE
AGREEMENT OF MARCH 26, 1997 PHASED OUT MONETISATION OF GOVERNMENT DEFICIT AND STRENGTHENED CONDUCT OF MONETARY POLICY

Governor: Dr C. Rangarajan (22.12.1992 – 22.11.1997)
Deputy Governors: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)
Dr Y.V. Reddy (14.9.1996 – 31.7.2002)

Macroeconomic backdrop	*Objectives and stance of monetary and credit policy*	*Salient policy measures*
There was considerable softening of interest rates with an improvement in the overall liquidity situation, inflation was under control despite some supply-side pressures and M_3 growth was within the targeted range of 15.5–16.0 per cent. The reduction in external CAD coupled with large capital inflows translated into foreign exchange reserves scaling a new peak of US $ 26.4 billion by end-March 1997. In fiscal consolidation, the GFD of the Central Government at around 5.0 per cent of GDP was considered to be satisfactory. However, the Reserve Bank was concerned that while the foreign exchange reserves swelled, there was some appreciation of the real effective exchange rate (REER), with a possible impact on export performance in an environment of depressed global demand.	The objective of monetary policy pursued during 1996–97 reflected a "blended" response to short-term and long-term concerns. While the immediate need was to reduce the high level of interest rates which prevailed in 1995–96, the long-term concern centred around building an appropriate environment to ensure a low and stable level of inflation (which was postulated at 6.0 per cent). The latter purpose was helped by phasing out the automatic monetisation of government deficit, which became a reality from April 1, 1997. Monetary policy sought to consolidate the gains against inflation achieved in 1995–96. However, its basic stance for the year was one of relative ease. It envisaged expanding the lendable resources of banks without fuelling excessive monetary expansion and the consequent pressure on the price level.	The monetary and credit policy measures announced were: • CRR reduced by one percentage point to 13.0 per cent (April 27 – May 11, 1996) and in the case of NRE deposits from 10.0 per cent to zero (April 13, 1996). • Export refinance rationalised. • CRR reduced to 12.0 per cent and simultaneously the refinance against collateral of Treasury Bills and government dated securities terminated (July 6, 1996). • CRR was further reduced to 10.0 per cent (in four stages from October 26, 1996 to January 18, 1997). • Banks granted freedom to fix their own interest rates on domestic deposits of over one year instead of two years (July 2, 1996). • The minimum maturity period of term deposits reduced from 46 days to 30 days.

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Fiscal-monetary co-ordination	*Financial sector reform*
The operating monetary policy procedures necessitated close co-ordination between liquidity and debt management. Even though there was pressure on Central Government finances, favourable market conditions and the improved liquidity position of banks helped raise the needed resources for the Government without placing much reliance on Reserve Bank support. The elimination of automatic monetisation of fiscal deficit became the key to providing flexibility to the conduct of monetary policy.	The financial sector reforms were responsible for forging linkages between money, capital, gilt-edged and foreign exchange markets.

Note: The Deputy Governors indicated in this Annex were in-charge, *inter alia*, of the formulation and conduct of monetary and credit policy in the respective years. Besides, there were three or four Deputy Governors who were entrusted with other important central banking functions of the Reserve Bank.