3

Monetary-Fiscal Interface

INTRODUCTION

The monetary-fiscal interface gained considerable attention in the 1980s because of the large monetisation of budget deficits that it entailed. This issue became prominent in the latter part of the 1980s when the Reserve Bank of India had frequent dialogues with the Ministry of Finance to contain the level of market borrowing in order to limit the Reserve Bank credit to the Central Government and to raise the coupon rates on government securities. The effect of the growing fiscal deficit also spilled over into the external current account towards the end of the decade, which ultimately culminated in the balance of payments (BoP) crisis of 1991. These developments elicited academic debates on the policy interlinkages and co-ordination between the fiscal and monetary policy operations. While the Reserve Bank had to accommodate the needs of the Central Government by reducing the flow of bank credit to the commercial sector, the build-up of inflationary pressures could not be averted completely. The ability of the Reserve Bank to contain the credit growth became constrained since one of the major credit control instruments, cash reserve ratio (CRR), reached its operational statutory limit by the latter half of the decade. Statutory liquidity ratio (SLR), the other important instrument, had also been raised to near-peak levels by then.

In such an environment, the Reserve Bank had to balance and fine-tune its responsibilities towards monetary management and public debt operations, taking into account its statutory duties of maintaining monetary stability and conducting the market borrowing programmes of both the central and state governments in its capacity as banker and fiscal

agent to the governments. The Reserve Bank's effectiveness in formulating and carrying out the monetary management operations depended heavily on its success in co-ordinating with the Ministry of Finance and keeping the non-inflationary means of financing fiscal deficit within limits. However, by their very nature, the discharge of these functions required the Reserve Bank to continually impress upon the Central Government the need to practice fiscal prudence in the overall interest of maintaining price stability. These persuasions did not meet with the desired results, till the onset of the BoP crisis of 1991.

OVERVIEW

In the 1980s, the Reserve Bank had the unenviable task of neutralising the inflationary impact of growing budgetary deficits by mopping up large increases in reserve money. Given the then fully administered interest rate structure, the much-needed absorption of excess liquidity in the system was undertaken by increasing the CRR. Further, the prevalence of below-market rates for government securities meant that the SLR had to be progressively raised, persuading the banks to meet the large financing requirements of the Government. This process culminated in the CRR reaching its statutory maximum limit and the limit had to be raised by amending the Reserve Bank of India (RBI) Act, 1934, after protracted correspondence with the Central Government. As a corollary, the SLR was also progressively raised to a high of 38.5 per cent by September 1990. More importantly, the unlimited and automatic monetisation of budgetary deficits through the issue of *ad hoc* Treasury Bills strained the conduct of credit policy.

The in-built necessity for harmonious integration of monetary and fiscal policies was iterated and reinforced by the Reserve Bank on several occasions during the 1980s. The Governor, Dr Manmohan Singh, in his inaugural address at a seminar organised by the Maharashtra Economic Development Council, Mumbai, on November 18, 1982, had exhorted that if monetary restraint was to achieve its objective without too much loss of potential output, excessive burden must not be placed on monetary policy, and the fiscal system must be so operated as to avoid excessive recourse to the Reserve Bank credit to finance public expenditure. He added that the periodic recurrence of the overdraft phenomenon suggested that the problem of fiscal imbalances in the states merited deeper examination. The Governor further observed, "If we take seriously the objective of

accelerated growth in a regime of reasonable price stability and viable balance of payments we cannot assume that the resources which are not mobilised can somehow be made available through expansion of bank credit. Unless it is clearly understood, monetary policy cannot be expected to operate smoothly and effectively. Here lies both a challenge as well as an opportunity."

In this context, the Governor, Shri R.N. Malhotra, at the golden jubilee celebrations of the Reserve Bank on June 1, 1985, stated that while trying to meet the requirements of a growing economy, the Reserve Bank must continue to strive for price stability through its monetary and credit policies. He added that considering the requirements of the Seventh Plan and the difficult resources position, continued co-ordination of fiscal and monetary policies and optimal burden-sharing between them would be crucial. The Finance Minister, Shri V.P. Singh, in his presidential address on the occasion was more forthcoming. He said that fiscal deficits had a direct bearing on money supply and, therefore, a high degree of co-ordination was necessary between fiscal and monetary policies so that money supply growth was kept within limits and that the overall economic policy framework rested on a proper integration of its important components such as fiscal policy, monetary policy, foreign trade policy and industrial policy. The Prime Minister, Shri Rajiv Gandhi, speaking at the event on this issue lauded the Reserve Bank for being not only a controlling point for banks but also one of the key inputs for the Government on how to run its finances and how to control various financial aspects of the economy.

The report of the committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty) viewed such co-ordination in a broader perspective:

> A feasible approach to evolving a policy framework for ensuring the desired rate of growth of government expenditure as well as the desired rate of growth of reserve money supply involves a certain degree of co-ordination between government and the Reserve Bank in evolving and implementing agreed policies. Such co-ordination is essential and also feasible. The experience of the last fifteen years has shown that when occasion demands government has played even a dominant role in containing inflationary pressures. In normal times, however, its major preoccupation in the economic field is to play the role of a large entrepreneur in the country.

> Both government and the Reserve Bank would thus be required to show due concern for the achievement of price stability objective which must underlie government actions aimed at raising output levels and Reserve Bank's actions relating to the control of expansion in reserve money and money supply.

These sentiments were echoed later by Dr C. Rangarajan, Governor, in his M.G. Kutty Memorial Lecture on Autonomy of Central Banks, delivered on September 17, 1993, that as monetary policy was an integral part of the overall economic policy, there could be no meaningful separation between fiscal policy and monetary policy.[1]

RESERVE BANK'S VIGILANCE: TWO EPISODES

The Reserve Bank had been alert and responsive in discharging its responsibilities as was evident from two instances during the 1980s — one, when the economy was under the observance of the International Monetary Fund (IMF) loan stipulations, and the other towards the close of the decade, when expansionary fiscal policy was the order of the day.

In March 1984, the Reserve Bank was concerned about the monetary implications flowing from the central budget proposals for the year 1984–85 which could generate large fiscal imbalances. In a letter dated March 15, 1984 to the Ministry of Finance, from the Governor, Dr Manmohan Singh, the Reserve Bank conveyed its perception that towards the end of 1983–84, the growth of liquidity was higher than projected, the level of inflation at 10.0 per cent was considered high, and growth of output was lower than projected. The letter added, "Given the imperative need for containing inflation rate, moderation in the pace of monetary expansion is a necessary concomitant of a viable overall financial strategy."

The Reserve Bank advised that the developments were to be viewed in the context of the agreement with the Ministry of Finance to work towards overall growth of liquidity (M_3) of not more than 14.0 per cent in 1984–85 and that, consistent with this order of expansion, the Reserve Bank had indicated that the growth of net Reserve Bank credit to the Government would need to be contained at ₹ 2,000 crore during the year. Based on the budget estimates (BEs) of revenue and expenditure, the Governor visualised that the draft on the Reserve Bank (and, therefore, the creation

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1. Also refer to chapter 15: Public Debt Management for a more detailed discussion.

of high-powered money due to budgetary operations) would be much higher than the visible budget deficit of ₹ 1,762 crore. Significantly, the Reserve Bank emphasised that the arrangement of special securities to be issued to the Bank was no different than a straightforward increase in the Reserve Bank credit to the Government and that the Bank had, even otherwise, 'serious reservations' about the use of this device to reduce the 'visible' deficit. Moreover, even if SLR was increased by one percentage point in the course of the year, nearly ₹ 600 crore of the market borrowings of the Centre had to be absorbed by the Reserve Bank, again leading to the creation of reserve money. If the deficit of the state governments were added to the Centre's likely draft on the Reserve Bank, the monetary situation would turn out to be 'explosive', even if revenue and expenditure flows were in accordance with the BEs.

Analysing critically the proposals contained in the budget, the Reserve Bank was of the view that expenditure in several areas might turn out to be substantially higher than the BEs; some important sectors of the national plan as well as defence appeared to be underfunded; estimates of export subsidies and food subsidies were unrealistically low; and budgetary allocations for financial institutions (FIs) had been drastically reduced. The Reserve Bank concluded that government outlays at the revised estimate (RE) stage might involve a much higher draft on the Reserve Bank and the banking system than envisaged. On the receipts side, the Bank anticipated a large shortfall under the head 'other capital receipts', especially if there was a hardening of international oil prices in the wake of growth recovery in the industrial countries. Moreover, a large shortfall was anticipated in receipts from the national (small savings) deposit scheme. The Centre's borrowing programme in 1984–85 as per the budget was ₹ 4,100 crore as against ₹ 3,100 crore envisaged in the original calculations, and that would increase the dependence on the banking system. The budgets of the 12 state governments as per prevailing indications did not show any prospect of their overdrafts being brought down.

Coming to the crux of the issue, the Governor cautioned that the monetary implications of the vast fiscal imbalance on the horizon were truly disturbing and that after allowing for the proposed SLR increase of one percentage point, the increase in net Reserve Bank credit to the Government would be in the region of ₹ 4,500 crore in 1984–85 as compared with the Reserve Bank's earlier estimate of about ₹ 2,800 crore. Even if there was a larger draw-down of the net foreign exchange assets by ₹ 900 crore as against the earlier estimate of ₹ 600 crore, the Reserve

Bank's expectation was that the growth in M_3 in 1984–85 would be a little over 18.0 per cent as against the earlier estimate of only 14.0 per cent. This higher order of M_3 growth implied an increase in prices by at least 12.0 per cent in 1984–85 and, given the already high inflation rate that year, the large monetary expansion during the year could accentuate the cumulative inflationary process. The policy options for monetary policy appeared to be limited as curtailment of growth of non-food credit of banks, which was already moderate, would be counter-productive and therefore, it would not be desirable to reduce the credit flows. Nevertheless, the Reserve Bank assured the Government that it would remain vigilant so as to ensure that commercial bank credit did not provide a stimulus to inflationary expectations; at the same time, it sounded a note of caution on future economic prospects as well as the need for the Government to follow prudential policies in the letter dated March 15, 1984:

> The ensuing year is going to be a period of considerable anxiety for monetary management and, while formulating the credit policy for the ensuing year, we shall bear in mind the advice the Minister had given us. The task of orderly monetary management will be exceedingly difficult given the magnitude of the fiscal imbalance. If the dependence of the Government on the banking system increases in 1984–85, there would be an explosive expansion of primary money with consequent multiplier effects on monetary growth and an upsurge in the pace of inflation. If the inflation rate is not to accelerate beyond the present rate of 10 per cent, it will be essential to contain monetary expansion to moderate extent and significantly lower the rate than what is implied in the Central and State Budgets. Thus, an orderly financing of Government expenditures without excessive reliance on the banking system would be an imperative need and only strong financial discipline with a strict control on expenditure can ensure against the emergence of a serious monetary disequilibrium. This means that right from the beginning, the Central Government should plan for a smaller increase in overall expenditure than implied in the budget papers. In addition, some solution ought to be found so as to contain the overdrafts of State Governments.

A copy of this letter was also forwarded to the Principal Secretary to the Prime Minister.

The Government's response was positive and reassuring. In a letter dated April 5, 1984, the authorities assured that the Government was committed to maintaining monetary and financial stability as was evident from the series of measures taken in the past couple of years to contain net Bank credit to the Government within agreed limits. These included, *inter alia*, the difficult decision to reduce significantly both Plan and non-Plan expenditures, which had resulted in containment of budgetary deficit and a decline in the annual rate of inflation. The Ministry of Finance added that during the year the Government had kept a careful watch on the monetary situation and had readily agreed to all measures, including impounding of excess liquidity to contain inflationary tendencies and that their careful monitoring had ensured that the economy remained within the ceilings relating to bank credit to the Government as also bank credit to the commercial sector. The letter said, "Performance of this nature does reflect the keenness of the Government to maintain financial discipline and to readily take measures that would ensure this."

Responding to the anxiety expressed by the Reserve Bank with regard to the monetary outlook for 1984–85 due to the larger levels of state government overdrafts, the Ministry of Finance observed that efforts to bring the state overdrafts into a kind of financial discipline had already been initiated and, in pursuance thereof, payments on behalf of one state government were suspended when its overdraft exceeded the set limit and expressed the hope that greater financial discipline would be forthcoming from the state. However, the letter subtly put forth the Government's compulsions and constraints, requesting the central bank to consider the issue in a broader national perspective:

> However, you would agree…that it is equally important to ensure that urgent development requirements of the country are met as far as feasible. A too narrow and restrictive view would have serious repercussions on the long-term potential of the economy. As you know, our defence requirements are also increasing and obviously, there can be no compromise on this. This year's budget has tried to strike a balance between these pressing commitments and the need to contain the budget deficit. So far as market borrowing programme is considered, this year's BE is Rs. 4,100 crore which is only Rs. 100 crore higher than last year's BE of Rs. 4,000 crore. We have deliberately restrained the growth in market borrowing in order to ensure that there is no undue expansion in bank credit to the Government.

During the fourth quarter of 1988–89, the Reserve Bank resorted to the unusual step of directly taking up with the Government the vexing issue of the impact of Government budget proposals on monetary policy. In a letter dated January 7, 1989, from the Governor, Shri R.N. Malhotra, the policy dilemmas facing the Reserve Bank were highlighted in the context of the deteriorating macroeconomic variables:

> Monetary policy has to ensure the twin objectives of maintaining reasonable price stability and meeting the genuine credit requirements necessary to support the growth of output. The large and recurring Government budget deficits have been contributing to strong monetary expansion and, over time, there has been serious erosion in the effectiveness of monetary policy instruments. In the context of the large budget deficits, it is difficult to control monetary expansion which, in turn, contributes to inflation.

The letter also observed that the Government's market and other borrowings were rising rapidly, interest payments were very large, and that there was a steep increase in the Government's revenue deficit, which had swelled from ₹ 384 crore in 1981–82 to ₹ 4,224 crore in 1984–85 and further to ₹ 9,842 crore in 1988–89 (BE), which meant that the Government had been borrowing heavily to meet current expenditure. To quote, "While the need for corrective action is well recognised, effective measures have not yet materialised." The Government was advised that postponement of the needed adjustment would lead only to more acute problems.

The Reserve Bank apprised the Government also of the fact that up to December 16, 1988, the deficit was already 36.0 per cent more than the BEs for the full financial year and that it was also over a fourth more than the comparable deficit at that point of time in the previous year. The Reserve Bank emphasised the need to move away from monetisation and, as a first step, urged reducing the budget deficit in a phased manner from the level of 2.3 per cent of gross domestic product (GDP) in 1988–89 to, say, 1.0 per cent of GDP by 1992–93. The underlying reasons for the proposed fiscal correction were the unhealthy practice of automatic monetisation of large and growing budgetary deficits through the mechanism of issue of *ad hoc* Treasury Bills by the Reserve Bank, the continuous rollover of *ad hocs*, and the practice of a part of these outstanding Treasury Bills being converted into long-term securities but at the interest rate applicable to Treasury Bills. The letter reiterated:

> The eventual aim should be that only temporary accommodation to the Government is provided by the Reserve Bank, and the long-term needs being met from the market.

The Reserve Bank on its part had been struggling to partly neutralise the expansionary impact of large budget deficits and the consequent inflationary impulses moderated through the pursuit of cautionary monetary policy, the said letter to the Government stressed. The Government was reminded that the Reserve Bank's proposal for enhancement of the statutory limit for CRR from 15.0 per cent to 20.0 per cent was still pending with them. There were other major constraints which stood in the way of the Reserve Bank in discharging its monetary policy obligations, *viz.*, the limitation in the use of the interest rate instrument for monetary control owing to substantial concessionary lending to the priority sectors and at below the prevailing market rates at which the Government borrowed from the market. In the final analysis, the Reserve Bank was precluded from carrying on its open market operations (OMOs) to mop up the excess liquidity. To drive home the point, the Governor referred to the tenuous links that existed with the BoP situation and called for urgent reining in of the budgetary deficits:

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

POLICY CO-ORDINATION IN IMPLEMENTING THE GOVERNMENT'S MARKET BORROWING PROGRAMME

THE FRAMEWORK

The annual budget cycle normally begins towards the close of February with a presentation by the Government to Parliament of a detailed programme for expenditure, receipts and sources of financing for the fiscal year beginning in April. But months before this date, the Reserve Bank developed a framework within which the contour of annual plan for

domestic credit expansion was formulated. This framework sets out the estimated growth in M_3 and bank credit that was believed to be consistent with the economy's capacity for real growth at a moderate and acceptable rate of inflation taken together with the expected change in foreign exchange reserves during the year. Allowance was made for further monetisation of the non-monetary sector to a reasonable extent. On this basis, the Reserve Bank used to set out a feasible total market borrowing programme for central and state governments as also government guaranteed bodies, taking into account from the supply side the investible resources available from banks, financial and investment institutions and provident funds. After this critical input was supplied to the Ministry of Finance, in due course a follow-up dialogue took place between the officials of the ministry and the Reserve Bank, where the terms of the market borrowing programme were settled. The Ministry of Finance also set out indicative monetary targets to the Cabinet Committee on Economic Affairs (CCEA) sometime in May/ June of the year, after the March 31 data became available.

Apart from the quantum of borrowing from the market as well as accommodation from the Reserve Bank, certain incidental matters on public debt management, such as, revision in coupon rates on government securities and funding of Treasury Bills were also mutually discussed.

The following paragraphs give the salient aspects of periodic letters written to the Finance Secretary as a part of the pre-budget exercise, which provide valuable insights into the philosophy and the process of policymaking in the Reserve Bank in vogue at that time.

MARKET BORROWING PROGRAMME FOR 1984–85

In a communication dated December 22, 1983 to the Ministry of Finance, the Reserve Bank set the tone for determining the market borrowing programme for the year 1984–85. The exercise was strongly influenced by the performance criteria to be complied with in connection with the IMF loan:

> During the past three years, the market borrowing programme had been significantly larger than warranted on the basis of the resources available for market borrowing from commercial banks and non-bank resources. The procedure that we follow in booking the purchases from the IMF permit an expansion of the Reserve Bank credit to Government to an amount equivalent to the purchase without resulting in an addition to overall liquidity. Primary money creation effects of both a visible deficit and the

> Reserve Bank support to the market borrowing programme are, needless to say, identical. With the cessation of purchases from the IMF, the rationale for adjusting downwards the visible deficit through the Reserve Bank support to the market borrowing programme did not exist any longer. It is, therefore, necessary to plan for a market borrowing programme for 1984–85 without any support from the Reserve Bank.

Based on macroeconomic projections of bank deposits growing by about 15.0 per cent and the resources available from non-bank sources, a market borrowing of ₹ 5,000 crore was considered feasible. After making allocations to the state governments and central and state guaranteed institutional borrowings, the borrowing programme of the Central Government in 1984–85 was to be restricted to ₹ 2,300 crore as compared with ₹ 4,000 crore in the previous year. The letter stated that the adjustment was inevitable in the context of the changed circumstances and reiterated that the concept of 'zero support' from the Reserve Bank would need to be explicitly built into the borrowing programme and this tenet would have to be adhered to in the actual debt management operations, lest liquidity expanded unduly and fuelled inflationary pressures.

Related Debt Management Matters

The Reserve Bank pointed out that the non-bank holdings of government securities had risen sharply on account of various special transactions put through by the Bank and that these could decline as the FIs themselves progressively experienced resource constraints. Therefore, the Reserve Bank stressed the need to promote non-bank holdings of securities through adjustments in certain aspects of debt management. Accordingly, the Reserve Bank suggested, in a letter, narrowing the very wide spread between the rates on bank fixed deposits and yields on government and other approved securities with comparable outstanding maturities, while acknowledging that it was not then feasible to raise further the coupon rate of 10.0 per cent on the longest maturity.

The Reserve Bank strongly urged an increase in the Treasury Bill rate by at least one percentage point, as there had been increases in the rates on dated securities as also short-term instruments, while the Treasury Bill rate had remained static at 4.6 per cent since 1974, when all the other rates were also very low. In that context, banks were repeatedly pleading for more remunerative opportunities for short-term placement of their funds

and the need was felt for discouraging very short-term inter-corporate deposits.

MARKET BORROWING PROGRAMME FOR 1985–86

Along the lines of the norms suggested for 1984–85 (*i.e.*, a market borrowing programme without any support from the Reserve Bank), the Reserve Bank indicated that a similar principle should apply in 1985–86 in view of the already large overhang of liquidity in 1984–85. Realising that this was neither practical nor would be acceptable to the Government due to their overriding commitments, the Reserve Bank offered an alternative solution:

> Given the present structure of interest rates on securities, such a higher borrowing programme would result in monetary expansion significantly larger than the 13.5 per cent growth of M_3 which was deemed to be appropriate. Needless to say, a larger monetary growth carries with it the risk of prices rising sharply. It may still be possible to plan for a total market borrowing programme in 1985–86 of Rs. 7,100 crore of which the Central Government's borrowing programme could be Rs. 4,100 crore, *i.e.*, the same level as in 1984–85, if an upward revision of interest rates is offered on securities…Such an upward revision will have the effect of increasing the voluntary holding of debt by commercial banks and non-bank financial institutions. In any case, even if other measures are undertaken, the profitability of commercial banks will not be eroded. The reserve money expansion associated with a large borrowing programme would be reduced as these securities would be held by banks and non-bank institutions and not by the Reserve Bank.

Related Debt Management Matters

While suggesting ways to make government securities attractive to non-bank investors and thereby reduce the Government's dependence on the Reserve Bank, the Bank outlined a scheme for raising interest rate levels for different maturities to achieve a better alignment between short-term and medium-term maturities, which would facilitate the Government in raising a larger proportion of its loans at rates lower than the maximum rate of 10.5 per cent.

The Reserve Bank considered Treasury Bills as an integral part of the debt management system. With the volume of outstanding Treasury Bills recording a high of ₹ 19,000 crore, the Reserve Bank tried to persuade the Government to go in for funding of Treasury Bills in case they were not agreeable to enhancing the interest rate on them. It was indicated that the last funding took place in March 1982 for a sum of ₹ 3,500 crore. The Government, however, reasoned that such funding was a normal and well-established practice in debt management operations the world over but in the Indian context the funding, in the real sense of the term, was not possible due to the very large overhang of Treasury Bills; also, the determination of the appropriate rate of interest had until then inhibited the Government from considering a large scale funding operation. Taking into account these ground realities, the Reserve Bank suggested that there could be a funding to the tune of ₹ 15,000 crore into undated securities at a rate of 4.6 per cent, which would obviate the need for imposing a large burden on the Government in the form of interest rate cost. However, the Bank was quick to add that such a funding operation would be meaningful only if the Treasury Bill rate was raised to a level consistent with the other rates on securities. A higher Treasury Bill rate could correct the then prevalent distortions in the system caused by pegging the rate at 4.6 per cent for long periods and, more importantly, bring about better monetary control. The Bank suggested an increase from 4.6 per cent to 7.5 per cent, simultaneously effecting a large funding operation at 4.6 per cent. However, this did not find favour with the Government.

Soon after, Shri R.N. Malhotra assumed office as Governor on February 4, 1985, and Dr Manmohan Singh moved to the Planning Commission as Deputy Chairman. In the intervening period, the executives of the Reserve Bank discussed the Government's market borrowing programme for the year 1985–86 with the Ministry of Finance in a meeting convened on January 17, 1985. The ministry expressed the view that the borrowing programme for 1985–86 should be equal to the 1984–85 level and, given the budgetary constraints, there was no scope for any reduction. The Reserve Bank articulated that there was an integral link between the Reserve Bank agreeing to have the same level of market borrowing in the year 1985–86 and the enhancement of the rate of interest on government bonds. On the other hand, the representatives from the Government were not agreeable to raising the bond rate from 10.5 per cent to 12.0 per cent but were agreeable to substantially raising the interest rate offered on various maturities within the maximum rate of 10.5 per cent on 30-year bonds.

Further, the Government was prepared to raise the interest rate on Treasury Bills, provided the existing Treasury Bills were funded. The proceedings of the meeting were placed before the Governor on February 5, 1985, and it was indicated that the dialogue with the finance ministry should continue. It was also approved that the interest rates on government securities be raised, subject to a maximum of 10.5 per cent and that the rate on 5-year maturities should be 9.0 per cent instead of 8.5 per cent.[2]

LONG TERM FISCAL POLICY

The year 1985–86 was notable for the introduction of a long term fiscal policy (LTFP) with the objective of imparting an element of stability to the whole range of fiscal administration, and unprecedented buoyancy in the revenues of the Central Government along with the persistence of the structural problem of the capital budget having to cover the revenue deficit. In the area of state finances, there was a sizeable devolution of resources from the Centre and a scheme was introduced to prevent the emergence of overdrafts. The Government presented the LTFP to Parliament on December 19, 1985. It was conceived as an instrument to serve the basic objectives of the Seventh Five Year Plan, and heralded a new approach to the management of the economy. The policy was expected to provide a definite direction and coherence to the sequence of annual budgets and thus bring about a greater degree of predictability and stability in the economic environment. The LTFP placed greater emphasis on rule-based fiscal and financial policies and less reliance on discretionary, case-by-case administration of fiscal controls — a revolution in the economic management necessitated by the country's growing and complex economic structure. Last but not least, the new policy was designed to strengthen the operational linkages between the fiscal and financial targets of the Seventh Five Year Plan and the annual budgets. The LTFP also sought to increase over time the share of direct taxes in total tax revenue and curb tax evasion so that the fiscal system as a whole became even more progressive. Given the high priority accorded to inflation control, the LTFP visualised that non-inflationary financing of the Plan would require progressively greater reliance on surpluses generated by the budget and public sector undertakings (PSUs) and, correspondingly, diminished recourse to

2. At the meeting, the Finance Secretary also mooted a proposal to lower the general level of bank deposit and lending rates. The Reserve Bank's response to this proposal and further related developments are given in chapter 4: Monetary and Credit Policy.

borrowed funds. There is, however, no evidence to suggest that the LTFP was pursued vigorously and implemented.

The second important event in policy formulation was the acceptance by the Government in principle of the two major recommendations of the Chakravarty Committee, *viz.*, widening the definition of budgetary deficit to include the Reserve Bank's support to dated securities and setting the overall monetary targets with feedback. These, in the medium term, resulted in promoting a greater measure of co-ordination between monetary and fiscal policies.

MARKET BORROWING PROGRAMME FOR 1986–87

With the compulsions of the IMF surveillance over the extended fund facility (EFF) loan receding, the content of monetary policy exercise was considerably influenced by the LTFP, which set out in detail the policy direction to be followed in the forthcoming years. This document stressed that in the past the dependence of the budget on borrowed funds was too high and that it was essential to reverse this trend and reduce the ratio of budgetary deficit in 1986–87 to 1.2 per cent of GDP at current prices. This meant that the deficit in 1986–87 should not exceed ₹ 3,200 crore, that the ratio of central government market borrowing should be brought down to 1.6 per cent of GDP at current prices, and, finally, the Centre's market borrowing programme in 1986–87 should not exceed ₹ 4,300 crore.

The Reserve Bank in its communication to the Ministry of Finance dated January 7, 1986, while conceding that the trend rate of inflation in the past two years had declined, maintained that this rate for 1985–86 could end up at about 6.0 per cent based on the emerging trends in government finances. In 1985–86, the growth in M_3 was estimated at 16.5 per cent on the assumption that there would be no further increase in the net Reserve Bank credit to the Government in the last quarter of 1985–86. The upshot of the analysis was that the prospect of a high volume of reserve money creation anticipated in 1985–86 — which was well in excess of the real rate of growth of the economy — along with the excessive liquidity creation in the past would engender a strong potential for inflation in the following year.

The Reserve Bank's prescriptions were clear and firm. The possibility of any increase in SLR during 1986–87 was ruled out because this ratio had already been raised by one percentage point each in the preceding two years, which had resulted in a decline in bank credit and, moreover, the banks were expected to take considerable time to fully meet the 37.0

per cent SLR target. The Reserve Bank propounded that the gains of the past should not be eroded and further efforts should be directed towards reducing the inflation rate. Based on the projected real income growth of 5.0 per cent in 1986–87 and a tolerable rate of increase in prices of 5.0 per cent, the Reserve Bank considered it desirable to keep the growth in M_3 down within a band of 14.0–15.0 per cent. Growth in commercial bank deposits was estimated to be in the range of 15.0–16.5 per cent. In order to attain the targets set, the Reserve Bank came round to the view that the growth of reserve money in 1986–87 should be limited to ₹ 4,300 crore–₹ 4,700 crore and, as a corollary, the net Reserve Bank credit to the Government at ₹ 4,200 crore–₹ 4,600 crore. It was stressed that this increase in net Bank credit would be the outer limit if the outcome was to be consistent with the Seventh Plan and the LTFP prescriptions. Given the contours of the overall liquidity growth, the total net bank credit to the Government (*i.e.*, from the Reserve Bank and banks together) was not to exceed ₹ 7,800 crore–₹ 8,400 crore. The correspondence dated January 7, 1986 suggested that the various aggregates set out should be given serious consideration; after discussions between the Reserve Bank and the Government, these could be accorded the status of 'agreed targets'; and policy responses could be developed with reference to these aggregates as the year progressed.

The Reserve Bank postulated in the letter that the market borrowing programme for 1986–87 could be set at a level not requiring support from it. Consistent with the monetary growth set above, the available resources for total market borrowing in 1986–87 were estimated in the range of ₹ 7,450 crore–₹ 7,800 crore, as against ₹ 8,313 crore in 1985–86. However, it was expected that in 1985–86, ₹ 850 crore–₹ 1,000 crore would have to be absorbed by the Reserve Bank. The Government was also advised that if the state governments and state guaranteed institutions were to be provided an increase of 12.0 per cent over the 1985–86 programme and central guaranteed institutions an increase of 10.0 per cent, the market borrowing available to the Centre in 1986–87 would turn out to be in the range of ₹ 3,875 crore –₹ 4,225 crore as against ₹ 5,100 crore in the previous year. The LTFP had envisaged a lower reliance on market borrowings and the ratios laid down therein implied a market borrowing programme of about ₹ 4,300 crore by the Centre. The Bank emphasised that the overall borrowing programme for 1986–87 should not exceed ₹ 7,800 crore and that of the Centre ₹ 4,300 crore, and viewed any further increase in SLR as neither 'feasible nor advisable'. In any case, the Reserve Bank anticipated a gap between the visible deficit figure of ₹ 3,200 crore for 1986–87 and the

likely net Reserve Bank credit to the Government of ₹ 4200 crore–₹ 4,600 crore as envisaged earlier. The Bank advised the Government:

> …would urge that this gap be left as a cushion for absorbing unforeseen increases in the budget deficit which the Government may initially set in the budget estimate.

The acceptance, in principle, by the Government of the recommendation of the Chakravarty Committee that the definition of the budgetary deficit should be widened to include Reserve Bank support to dated securities was a defining event. The finance ministry began indicating in the budget from 1986–87 the size of Reserve Bank credit to the Government as a memorandum item. This practice was, however, abandoned later, presumably on the grounds that it would not be prudent to indicate *ex ante* the Reserve Bank's intended support for the Government's borrowing programme. Another far-reaching recommendation of the Chakravarty Committee accepted by the Government related to the setting of the overall monetary targets, which could be monitored. These decisions helped promote better co-ordination between the monetary and fiscal policies.

As a departure from the normal practice, there was no discussion on topical matters relating to public debt management. This was because in another policy letter dated January 14, 1986 to the Finance Minister, the Reserve Bank had charted a plan to implement the recommendations of the Chakravarty Committee, which included various aspects of public debt administration.[3]

MARKET BORROWING PROGRAMME FOR 1987–88

The outcome of the monetary budget exercise for the year 1987–88 was apprised to the Government in the Reserve Bank's letter dated December 13, 1986. The letter noted that during the three years ending in 1984–85, M_3 had expanded at a rapid pace and the average price increase [wholesale price index (WPI)] was around 7.7 per cent. Though expansion in liquidity and price level could be contained somewhat during 1986–87 (up to December 1986), the Reserve Bank was not prepared to ignore the fact that there was an overhang of liquidity in the economy. Further, the Reserve Bank credit to the Government had been running above the past trend and this impacted the price situation adversely. Therefore, taking a cautious view, the Reserve Bank expressed that liquidity growth of more

3. For more details, reference may be made to chapter 4: Monetary and Credit Policy.

than 15.0 per cent should not be targeted during 1987–88 and that this would imply holding down the increase in net Reserve Bank credit to the Government, both to the Centre and the states, at ₹ 5,870 crore (13.3%) and the increase in total net bank credit to the Government to around ₹ 10,140 crore. On the basis of projected deposit growth in 1987–88 and unchanged reserve requirements, non-food credit growth was expected to provide just adequate credit to support the productive sectors of the economy.

In accord with the various monetary targets arrived at, the Reserve Bank suggested that the total market borrowing programme for 1987–88 could be ₹ 8,950 crore as against ₹ 8,658 crore in 1986–87. Incidentally, the Centre's borrowing programme of ₹ 5,300 crore for 1986–87 had been reduced to ₹ 5,000 crore in light of adjustments to investments by provident funds in special deposits. The Reserve Bank recommended the acceptance of the aforesaid target if the broad objectives of containing monetary expansion and inflation were to be met. A total market borrowing of ₹ 8,950 crore in 1987–88 envisaged a support of ₹ 870 crore from the Reserve Bank and that the budgetary deficit of the central and the state governments taken together should not exceed ₹ 5,000 crore. The Government was again reminded about the need to fund 91-day Treasury Bills to the tune of ₹ 25,000 crore towards the end of March 1987 into long-term securities at an interest rate of 4.6 per cent. The Government acted on the suggestion of funding *ad hocs* of the value of ₹ 15,000 crore into special securities on March 31, 1987, which was followed by additional funding of ₹ 17,500 crore on March 31, 1988, in a similar manner.

MARKET BORROWING PROGRAMME FOR 1988–89

The letter dated January 15, 1988, to the Finance Secretary advised that the rate of M_3 increase in 1987–88 (up to December 18, 1987) was only 11.3 per cent as against 14.1 per cent in the comparable period in the previous year. But the data had been distorted owing to the large recourse by banks to buy-back arrangements in government and other approved securities, which had masked the real rate of growth of their aggregate deposits. A worrisome feature was that in 1987–88 (up to December 18, 1987), there was an 'explosive' increase in reserve money of the order of ₹ 6,766 crore (more than double) compared with ₹ 3,346 crore in the corresponding period of the previous year. During the same period, the net Reserve Bank credit to the Government escalated by ₹ 6,628 crore as against ₹ 5,265 crore in the previous year. It was feared that the increase for the full financial

year might exceed the figure set out in the budget documents for 1987–88 (*i.e.*, ₹ 5,688 crore) as well as ₹ 7,775 crore set out in the monetary targeting exercise submitted to the CCEA. "Such a large increase in primary money is a matter of concern to us and it is imperative, therefore, that in 1988–89, there should be an abiding commitment to moderate the pace of monetary expansion," the Reserve Bank reasoned.

The trends in wholesale prices presaged that double-digit inflation could be expected in the ensuing year, besides the historical experience that prices tended to harden in the year following a drought year. The Reserve Bank subscribed to the view that given the excess primary liquidity in the economy, and even allowing for a sharp recovery in real income growth in 1988–89, the policy should target an M_3 growth of not exceeding 15.5 per cent. Under the circumstances, the Reserve Bank thought it prudent to contain the growth in net Reserve Bank credit to the Central Government at ₹ 7,900 crore, as against the projected increase of ₹ 7,775 crore for 1987–88.

For 1988–89, the Reserve Bank suggested that the visible deficit of the Centre should be pegged at ₹ 6,500 crore and the net Reserve Bank credit to the Central Government at ₹ 7,900 crore. In line with these projections, the total market borrowing programme was placed at ₹ 10,900 crore as against ₹ 10,419 crore for the previous year. There was a word of caution that given the Plan commitments, it would be difficult to reduce the borrowing programme for central and state guaranteed institutions. The Reserve Bank suggested that, as a matter of cautious policy, the allocations within the borrowing programme, as agreed upon and subsequent increases as effected in 1987–88, should not be altered.

The Reserve Bank stressed the need to improve the internal consistency of the exercise. In the budget for 1987–88, the Central Government had set out a projection for the net Reserve Bank credit to the Government and also indicated that this figure would be identical to the visible deficit of ₹ 5,688 crore. But in the exercise submitted to the CCEA, a higher sum of ₹ 7,775 crore was shown for the former.

The Ministry of Finance, in a letter dated January 27, 1988 to the Reserve Bank, conveyed their perception that, assuming a normal monsoon, the GDP growth could be expected to be around 7.0 to 8.0 per cent, and that the targeted money growth in the ensuing year should take this into account, particularly the likelihood of substantial increase in food credit. Even conceding that monetary growth in the subsequent year might be relatively low, in order to take care of any build-up of excess liquidity

in that year, undue restraint might affect production adversely, the letter emphasised.

The Economic Times dated February 18, 1988 in its editorial, *Suppressio veri*, commented that the announcement of the latest tranche of two central loans for a total notified amount of ₹ 750 crore, which included the 10.0 per cent excess subscription that the Government could retain, was expected to bring in ₹ 825 crore on February 22 and thereby the Central Government was well set to exceed its net market borrowing of ₹ 6,300 crore budgeted for 1987–88. With SLR having been increased to 38.0 per cent from January 2, 1988, the subscription to loans was not expected to pose any problem since deposits would have increased sufficiently in last six weeks of the fiscal year. However, another financial daily surmised that even though the central borrowing beyond the targeted level could be feasible, it might impinge on the availability of bank credit to the commercial sector and, therefore, the extra tranche would have to be wholly subscribed to by the Reserve Bank for resale in the succeeding year. Referring to the practice of the Government asking the administrative ministries in charge of PSUs to invest their surpluses in Treasury Bills and as deposits with the Government, the financial daily in its editorial criticised the attempt to keep down the budgetary deficit as ultimately it would involve larger-than-visualised market borrowing, a draft on the expanding public sector borrowings, a foray into the surpluses of select PSUs and impose additional costs on them. Another facet was that the surplus PSUs would be compelled to lend to the Government at lower than market rates, whereas the deficit PSUs would have to go in for more expensive bank credit. The editorial noted, “The exercise will control the declared size of the budgetary deficit in nominal terms, but not its expansionary impulse.”

Related Debt Management Matters

Concerned about the cost of borrowing by the Government, the Reserve Bank was in favour of the existing structure of coupon rates and maturity pattern of government securities remaining unchanged. A suggestion was made that state governments and their institutions should also be permitted to borrow for 20 years at 11.5 per cent rate of interest so that their floatations did not encounter difficulties. As in the past, the Reserve Bank renewed the proposal for large-scale funding of 91-day Treasury Bills outstanding at the end of March 1988 at 4.6 per cent for ₹ 27,000 crore or more on the reasoning that “a funding operation is desirable as

there is no purpose served in having this large volume of Treasury Bills being renewed every three months." Accordingly, on March 31, 1988, the Government went in for funding of Treasury Bills to the tune of ₹ 17,500 crore by converting them into special securities.

ASSESSMENT

A case in point was that the monetary budget exercise was not limited to framing the monetary budget and advising the Government of the perceptions and projections for market borrowing as part of the budget preparation. As a follow-up, a dialogue took place between the two authorities at the highest level in which crucial decisions were taken, *inter alia*, about the quantum of market borrowing.

The cycle for determination of the borrowing programme of the Government over the period witnessed bold experiments in imparting a sense of discipline to fiscal management. Whatever might have been the success or failure of the exercise, the process during the 1980s illustrated the difficulties in arriving at a harmonious balance between fiscal profligacy and prudent monetary management to achieve the desired objectives of controlled expansion of liquidity and monetisation, where the compulsions of political governance predominated.

TABLE 3.1

Market Borrowings of the Central and State Governments, Local Authorities and Institutions Sponsored by the Central and State Governments

(₹ crore)

	1984–85	*1985–86*	*1986–87*	*1987–88*	*1988–89*
1. Borrowing Programme (as projected by the RBI during December/January)	5,000	7,100	7,450 – 7,800	8,950	10,900
2. Market Borrowings – Gross	8,281	10,133	10,888	12,755	13,671
3. Market Borrowings – Net	6,771	8,283	8,885	11,076	12,231
4. Excess of Item 3 over Item 1 (per cent)	35.4	14.2	13.9	23.8	12.2

Source: Reserve Bank of India, *Annual Report*; *Report on Currency and Finance*, various issues.

The borrowing programme in each of the years exceeded the levels projected by the Reserve Bank (Table 3.1). While apparently the excess of actual over projected market borrowings that exceeded 35.0 per cent

in 1984–85 narrowed down to about 12.2 per cent in 1988–89, such an outcome should not be construed as an improvement in fiscal discipline. The Government increasingly resorted to unlimited access to *ad hoc* Treasury Bills. The latter resulted in excessive and unintended monetisation, posing a challenge for monetary management by the Reserve Bank.

GROWING MONETISATION OF FISCAL DEFICIT: RESERVE BANK'S CONCERNS

With the large and recurrent budget deficits of the Government having to be monetised automatically by the Reserve Bank, the efficacy of monetary policy was greatly weakened and this was so especially in the latter half of the 1980s. The situation reached crisis proportions in 1989, when the Central Board of Directors of the Reserve Bank in their Annual Report for the year 1988–89 observed that over the years the practice had grown whereby the entire budget deficit of the Central Government was being financed by automatic monetisation of the deficit, which was in addition to the support the Reserve Bank provided to the market borrowing programme, and added:

> The Reserve Bank, therefore, has to address itself continuously to the task of neutralising, to the extent possible, the expansionary impact of deficits. The increasing liquidity of the banking sector resulting from rising levels of reserve money has to be mopped up on a continuous basis. The task of absorbing the excess liquidity in the system has been done in the past by mainly increasing the cash reserve ratio. With the frequent and sharp increases, the cash reserve ratio has now reached its statutory limit.

Governor Malhotra also focused on this important issue about the relations with the Government in his inaugural address at the annual conference of the Indian Economic Association (IEA) on December 30, 1989, and emphasised the urgency and seriousness of the problem. First, the net Reserve Bank credit to the Central Government was equivalent to a little over one-half of the net domestic debt of the Central Government. Second, while conceding that it was possible to raise the statutory limit for the CRR to contain the inflationary impact of such monetisation, growing and persistent budget deficits which were automatically monetised at highly concessional rates of interest progressively weakened the instrumentality of CRR on account of the need to pay interest on increasing amounts of impounded bank deposits. Third, the Governor emphasised, "A scenario

where monetary policy operations are thus severely constrained while monetisation of budget deficit proceeds apace induced by the tendency to dip into the cookie jar of the central bank of the country is fraught with serious risk of still higher rates of inflation." Finally, he counselled that it was high time for the authorities to take effective steps of a fundamental nature to address this problem of fiscal imbalance, one of which was to phase out the automatic monetisation of fiscal deficits so that in a few years the Government could place its entire borrowing requirement on the market at appropriate interest rates.

HISTORY OF *AD HOC* TREASURY BILLS

The Reserve Bank is authorised under the RBI Act, 1934 [section 17(5)] to grant to the central and state governments advances repayable in each case for a period not exceeding three months. These ways and means advances (WMAs) were granted to the Central Government so that its balances did not fall below the agreed minimum to be kept with the Bank. These provisions are enabling and not mandatory. As the economic and financial situation unfolded, the Reserve Bank was not called upon to finance unlimited deficits of the Government. In fact, the Government did not avail of the WMAs during the period from 1944 to 1954, and from the year 1954–55 onwards accommodation was made available through the purchase of *ad hoc* Treasury Bills under section 17(8) of the RBI Act. Both the officials of the Government and the Reserve Bank agreed that if the balances of the former fell below the stipulated minimum of ₹ 50 crore, the Reserve Bank would create *ad hocs* automatically to replenish the balances. While it was a fact that the Reserve Bank also found it convenient to purchase *ad hocs* from the Government for providing eligible assets in its Issue Department to facilitate currency expansion whenever needed, in the 1980s excessive issuance of *ad hocs* resulted in uncontrolled monetisation of government deficit, significantly affecting the Bank's manoeuvrability in reining in inflation.[4]

The Reserve Bank had discerned the hidden potential for the likely over-reliance on the arrangement, though without any mala fide intention on the part of the parties. The Bank, therefore, shared its fundamental concerns with the Government without losing much time. The office note dated July 2, 1957 postulated: "The arrangement is, prima facie, open to

4. The genesis of the problem of automatic monetisation has been chronicled exhaustively in the second volume of the history, namely, *The Reserve Bank of India (1951–1967)*.

the objection that the expansion of currency is automatic and neither the Government nor the Reserve Bank are called upon, at any stage, to take a conscious decision about the need for such expansion or its consequences." In a letter dated July 5, 1957 by the Governor, Shri H.V.R. Iengar, to the Finance Minister, Shri T.T. Krishnamachari, the Reserve Bank termed the automatic creation of *ad hocs* to finance government deficit as a 'merely mechanical' process, depending on the weekly closing balances of the Central Government and, as such, there was no check on the volume of currency that could be so expanded; that if the Government decided to go on increasing their expenditure without regard to the available resources, there would be nothing to stop them. The Bank drove home the point that with an automatic expansion of currency at the will of the Government, the Reserve Bank was not really in a position to discharge its statutory responsibility of 'securing monetary stability' in India. The letter stated in a subtle manner:

> …have, of course, no need to worry about the problem so long as you are the Finance Minister, for…know that you are as concerned as anyone could possibly be about the stability of the currency. The reason…exercised in…mind is that the present arrangement, as a standing arrangement, is therefore, defective. If there is a weak or careless Finance Minister in Delhi, which could conceivably happen after some years, the situation could easily get out of hand. It is, therefore, essential that proper conventions and safeguards are set up at the earliest possible stage.

In a perceptive response, the Finance Minister, in his letter dated July 27, 1957, while appreciating the Reserve Bank's concern in this matter, reasoned that it would be a mistake to lay down any rigid procedures such as those followed in France for example, but what was necessary was to ensure that the Government's policy was formulated in this respect after detailed discussions with the Reserve Bank and that the latter was kept informed from time to time of any changes that the Government felt necessary to make before they were made. He also reassured the Governor that it would be the duty of the finance ministry to formulate their proposals for borrowing as also for deficit financing in consultation with the Reserve Bank. The Finance Minister reiterated that the creation of *ad hoc* Treasury Bills when the government balances fell below a certain level was done within the limits prescribed in the budget, and if these limits were likely to be exceeded, the Government would make revised arrangements

in consultation with the Reserve Bank, and therefore, the latter could have every opportunity of discharging its 'responsibility of regulating the issue of banknotes and keeping of reserves with a view to securing monetary stability in India.'

More than three decades later, the discomfortingly high levels of deficit financing of the budgets and the consequent pressure on the Reserve Bank to check the strain on the price level by controlling liquidity in the economy prompted the Reserve Bank to take up the issue in a seven-page letter dated December 18, 1989, to the Finance Minister:

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

To reinforce the argument, Governor Malhotra explained that in the immediate past, the budget had been large and, apart from monetising this deficit, the Reserve Bank had to provide support to the Government's market borrowing programme through purchase of long-term bonds; as a result, the pace of monetary expansion had been unduly high and this had inevitably put pressure on prices. As on December 1, 1989, the outstanding reserve money amounted to ₹ 69,462 crore, as against the net claims of the Reserve Bank on the Central Government for ₹ 70,948 crore. At the end of March 1989, the net Reserve Bank credit to the Central Government was equivalent to 51.2 per cent of the net domestic debt of the Central Government. "This epitomises the impact of the automatic monetisation of the Central Government budget deficit," the letter averred. The Reserve Bank claimed that despite large monetisation of the budget deficit, its expansionary impact had been partly neutralised and inflation moderated, particularly in the 1980s, by a strong regime of monetary restraint, which was rendered possible because of the frequent use of the instrument of CRR. But this instrument was no longer available since the statutory ceiling for CRR had already been reached and the Reserve Bank's proposal to raise the ceiling from 15.0 per cent to 20.0 per cent was pending with the Government. The Reserve Bank contended that even this was a temporary expedient resulting in rather unanticipated adverse effects and, therefore,

a fundamental restructuring of the arrangement for financing the budget deficit was warranted, namely:

> …must however stress that cash reserve ratio cannot be effective for very long if the Government continues the present arrangement of automatic monetisation of budget deficit. This is because high cash reserve ratios entail payment of interest to banks to maintain their profitability and such interest payments materially reduce the effectiveness of the CRR instrument. Besides, a situation is created where the resources tend to move away from banks to non-bank financial intermediaries who are not subject to such reserve requirements. What the cash reserve ratio would provide is breathing time until a fundamental restructuring is undertaken of the arrangements for financing the budget deficit.

The Government was advised that this question was also addressed in the report of the Central Board of Directors on the working of the Reserve Bank for the year ended June 30, 1989, wherein it was stressed that an effective monetary policy would require the avoidance of the automatic monetisation of budget deficits and that over the medium term, beyond a mutually agreed WMA from the Reserve Bank, the Government should aim at placing its entire debt in the market at appropriate interest rates.

The Reserve Bank also outlined a radical proposal to remedy the situation, namely, promoting an explicit amendment to the RBI Act, whereby the Reserve Bank was not to be subject to any direction by the Government regarding its (*i.e.*, the Reserve Bank's) holdings of government securities. This was to be notwithstanding any powers which the Government possessed to give directions to the Reserve Bank under section 7 of the RBI Act and that any such directive should be issued with the consent of the Cabinet along with a statement to be placed before Parliament within the stipulated time. The communication also contained certain other suggestions, the more important of them being a progressive reduction in the overall budget deficit spread over the next three years, the longer-term resource requirements of the Government to be met through floatation of dated securities and not Treasury Bills, and a limit to be fixed on the outstanding level of WMA. It was also visualised that the Reserve Bank should not be required to provide any support to the government market borrowing programme from 1990–91, which meant that the Government should move towards a system of market-related rates on government securities as part of the progressive effort towards

placing the Treasury Bills outside the Reserve Bank; the rate of interest on 182-day Treasury Bills should be allowed to move up from the existing level; and as and when the budget deficit reached a point close to zero, 182-day Treasury Bill auctions were to be replaced by 91-day auctions. The letter concluded:

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

Before the Government could give serious consideration to the Reserve Bank's concerns and viewpoints, events in the political and economic arena took a turn for the worse. This necessitated pushing through a series of economic reform measures, including improvement in the budgetary position.

INCREASED STRAINS ON GOVERNMENT FINANCES AND EMERGENCE OF FISCAL IMBALANCES

In 1985, the Ministry of Finance made a strong case to consider deficit finance as a budgetary resource for development. According to a news item in the Economic Times on December 12, 1985, the Finance Minister, Shri V.P. Singh, expressed the view that the Indian economy had enough cushion to absorb substantially higher deficit financing than what 'traditional economic theories and analysis would permit'. He added that his conscious risk had paid off and the economy was witnessing buoyancy on all fronts, and that despite the highest ever budgetary deficit, the nation was having one of the lowest inflation rates in recent years. He, however, hastened to clarify that he was not being callous about deficit financing nor advocating it and that the Government was extremely careful about it. To quote:

> …deficit financing *per se* is not bad. The most important thing is that it should not fuel inflation. The Government could control inflation because of the comfortable foodstocks and the prudent management of the incremental growth in money supply.

Elaborating on his perception, the Finance Minister said that the quantum of deficit financing was related to GDP and the existing level of money supply. "Had I listened to those who advocated a smaller deficit, the economic activity including the Government's anti-poverty measures and public sector investments would have suffered. Let those theories and analysts come and explain where they went wrong", was the observation of the Minister.

TABLE 3.2

Trends in Budgetary Deficit and Net RBI Credit to Government (Centre and States)

(₹ crore)

Year	*Budgetary Deficit*	*Gross Fiscal Deficit (GFD)*	*Net RBI Credit to Government*	*Net RBI Credit to Government (as % of GFD)*	*Inflation Rate (WPI) (%)*
1980–81	3,374	8,299	4,038	48.7	18.2
1981–82	2,420	8,666	3,997	46.1	9.3
1982–83	2,476	10,627	3,368	31.7	4.9
1983–84	1,978	13,030	3,987	30.6	7.5
1984–85	5,183	17,416	7,540	43.3	6.5
1985–86	3,627	21,857	4,328	19.8	4.4
1986–87	8,928	26,342	7,607	28.9	5.8
1987–88	5,882	27,044	6,402	23.7	8.1
1988–89	5,262	30,923	6,928	22.4	7.5
1989–90	10,573	35,632	14,068	39.5	7.5
1990–91	11,275	44,632	15,165	34.0	10.3

Notes: 1. Budgetary deficit/surplus in the case of the Central Government was measured by net increase/decrease in outstanding Treasury Bills and withdrawals from/additions to cash balances. In the case of state governments, the criteria was net increase/decrease in RBI credit in the form of WMA, decline in/addition to cash balances and net sales/purchases of securities held by them in their cash balance investment account.

2. Net RBI credit to the Government comprised changes in RBI holdings of Treasury Bills, other government securities, rupee coins in the Issue Department, WMA to state governments and government balances with the RBI so that an increase in cash balance would imply a decline in RBI credit to the Government and vice versa. Data refer to fiscal year (April–March) and take into account adjustments at the time of final closure of government accounts.

3. Inflation rate calculated on the basis of WPI (average of weeks). For the WPI, the base year was 1970–71=100 for the years 1980–81 and 1981–82, and the base year was 1981–82=100 for the remaining years.

Source: Reserve Bank of India, *Report on Currency and Finance, Volume II*, various issues; *Handbook of Statistics on the Indian Economy, 1999.*

During the period 1981–1989, the budgetary position of the Central Government had evolved in a dramatic and profound manner (Table 3.2). In this context, three issues dominated the fiscal-monetary policy nexus, namely: (i) the emergence of internal imbalances and the consequent widening of fiscal deficits; (ii) relatively stable price levels; and (iii) external shocks, *e.g.*, adverse shifts in terms of trade for developing countries, weak demand from industrialised countries and high levels of interest rates abroad.

As far back as the early 1980s, the Reserve Bank, in the Annual Report for 1980–81, expressed its concern over the emergence of structural imbalances in the finances of the Government and felt that although the decline in foreign exchange reserves had off-set for the time being — and even necessitated to some extent — the expansionary impact of budgetary transactions, large revenue deficits could not be continued for long.

The Government, on its part, was cognisant of the emerging scenario. The Economic Survey for the year 1986–87 acknowledged that the rapid growth in non-Plan expenditure meant that the Centre's budget on revenue account was in deficit throughout the decade, which had increased steadily in the past five years. At ₹ 8,325 crore, the combined budgetary deficit of the central and the state governments for 1988–89 was more than four times the deficit five years before. The Bank's Annual Report for 1988–89 stressed that the existing level of borrowings was unsustainable; unless there were adequate surpluses in the revenue account which could be utilised for debt-servicing, the budgetary deficit would continue to widen, and increased borrowings for debt-servicing would culminate in a vicious cycle of progressively higher interest burden and still higher levels of borrowings. The Economic Survey for 1989–90 posted a grim picture of the fiscal health:

> As the final year of the Seventh Plan draws to a close, it appears that the underlying economic imbalances on fiscal and external accounts highlighted in the previous Economic Surveys have begun to exert some toll on overall economic performance. The unabated strains on public finances have continued to exacerbate a difficult balance of payments situation and fuelled high rates of liquidity growth with attendant inflationary consequences.

THE PROBLEM OF THE FISCAL DEFICIT OF THE CENTRE AND THE STATES

Until the early 1980s, the growth in government expenditure was in tandem with the growth in its revenues. As such, governments both the central and the state were by and large able to meet their current expenditure from the current revenues and, more important, their borrowings were used for capital formation. But subsequently, with revenue expenditure overtaking revenue receipts, a revenue deficit emerged both at the central and the state levels; initially, these were confined to the Plan account, but gradually revenue receipts were not enough even to cover non-Plan revenue expenditure (Table 3.3). The situation deteriorated to such an extent that a significant portion of borrowings had to be diverted to fill the revenue gap.

TABLE 3.3

Gross Fiscal Deficit and Revenue Deficit of the Central Government as percentage of GDP at Market Prices

Year	*Gross Fiscal Deficit*	*Revenue Deficit*
1980–81	6.10	1.50
1981–82	5.42	0.25
1982–83	5.97	0.73
1983–84	6.28	1.22
1984–85	7.53	1.83
1985–86	8.34	2.25
1986–87	9.02	2.66
1987–88	8.13	2.75
1988–89	7.83	2.66
1989–90	8.05	2.69

Source: Reserve Bank of India, *Annual Report, 1990–91.*

The budgetary position of the central and state governments during the years 1980–81 and 1981–82 was constrained by persistent inflationary and BoP pressures. Therefore, fiscal policy sought to moderate inflationary trends without inhibiting the tempo of development by laying stress on resource mobilisation to meet the developmental needs. The financial position of the states, which had improved considerably as a result of the implementation of the recommendations of the seventh finance

commission, experienced mounting strain. The state governments resorted to persistent overdrafts from the Reserve Bank. Therefore, the Central Government introduced a package of measures in July 1982, to help them clear their outstanding overdrafts as at the close of March 1982. However, even after doubling the entitlement of WMA of the state governments, the problem of overdrafts could not be completely solved. In this connection, the Economic Survey for 1984–85 observed:

> There must be greater circumspection in providing fiscal support for any activity. The States should abjure their tendency to meet shortfalls in resources by resorting to overdrafts from the Reserve Bank of India. Accumulated State overdrafts of sizeable amounts were cleared by the Centre twice in the recent past in the expectation that thereafter there would be no occasion for such assistance. But the problem has surfaced again and during the current year the overdrafts of States aggregated to a high figure. Unless this is checked firmly, price stability cannot be ensured and the Plan objectives will be in jeopardy.

The Reserve Bank provided WMA to the state governments to tide over temporary difficulties arising out of seasonal imbalances in their cash flow receipts and expenditure. The limits for WMA were revised in July 1982. In response to representations received from the state governments and taking into account the trends in the budgetary transactions since 1982, an increase of 20.0 per cent in the existing limits of normal ways and means of all states was made from October 1, 1986. Further, as the cash flow problem faced by the states was reported to be more severe in the first half of the year than the second half, an additional 10.0 per cent rise was sanctioned for the former period.

A disconcerting development in the fiscal field was the persistent and widespread resort to overdrafts by state governments. In October 1978, with a view to regulate unauthorised overdrafts, the Reserve Bank liberalised the limits for normal WMA by doubling the limits from 10 to 20 times the minimum balance to be maintained with it by the state governments; at the same time, it decided to resort to an extreme measure to suspend payments to the concerned state governments until the overdrafts were cleared.

To bring about financial discipline, an overdraft regulation scheme was introduced and placed on a firm footing in early 1985. The Central Government advised all states on February 4, 1985 to restrict their

unauthorised overdrafts in the fiscal year 1984–85 to the level of ₹ 1,809 crore reached on January 28, 1985. The state-wise limits on overdrafts were also fixed at levels outstanding as on that date. The states were further advised that in case the overdraft exceeded the level already reached on January 28, 1985 and continued for more than seven working days, the Reserve Bank would stop payments in respect of the concerned states. The overdraft regulation scheme evolved at this time was to serve as a model when a similar scheme was introduced for the Central Government much later.

In 1984–85, the states were able to avoid resorting to unauthorised overdrafts with the Reserve Bank. The states were put on notice that the Reserve Bank would stop payment on behalf of a state government if any overdraft emerged and continued for more than seven consecutive working days. However, there were major short-term and long-term policy initiatives on the fiscal front in 1985–86 resulting from implementation of key proposals of the LTFP. There was a sizeable devolution of resources from the Centre to the states. The combined budgetary deficit was restricted to a lower level and constituted 1.5 per cent of GDP at current market prices. The financial position of the state governments and union territories (UTs) showed improvement during the year. The budget deficit for the year 1986–87 was more than twice the size of the deficit projected in the BEs and over two-and-a-half times the actuals in 1985–86. As a proportion of GDP, the budgetary deficit was about 3.0 per cent, substantially higher than the average of 1.5 per cent in the quinquennium of 1981–82 to 1985–86. The deterioration in the budgetary position was noticeable in the case of the central and state governments and the widening trend in the current account deficit (CAD) continued, beginning in 1979–80. This was symptomatic of the pressure that had been growing on the Centre's budgets. The Economic Survey for 1987–88 stated that a durable solution to the underlying fiscal problem must be pursued vigorously on three fronts, namely, curbs on growth of expenditures, broadening the base of revenues and further improving the financial performance of public sector enterprises.

Economic development and performance were adversely affected by the drought in 1987–88. Nevertheless, the net outcome of the combined budgetary operations reflected prudent fiscal management in a difficult year. The year's combined budgetary deficit was about 16.0 per cent lower than the actuals in 1986–87. However, the budgetary deficit of the states

and UTs worsened. Despite the after effects of drought, the economy posted exceptionally strong performance in 1988–89. The focus of fiscal management turned to revitalise the drought-hit economy, accelerate the tempo of production, especially in agriculture, maintain the priority for export growth and restore the overall momentum of economic development, and at the same time keeping inflationary pressures under check. The broad policy mix had the objectives of stepping up expenditure and raising resources for investment in a non-inflationary manner, and concurrently keeping budgetary deficit within prudent limits. The combined budgetary operations in 1988–89 (RE) resulted in a deficit, which was about 50.0 per cent larger than that in 1987–88. About 75.0 per cent of the gap could be financed by draft on domestic savings, 7.0 per cent from external savings and 18.0 per cent from deficit financing. The Economic Survey for 1988–89 offered a balanced assessment of the prevailing fiscal scenario including the linkage with money supply:

> Restoration of better balance between Government revenues and expenditures is not only essential for bringing about the desired improvement in public sector savings performance, but also for enhancing future prospects of price stability. Relatively high rates of growth in money supply during the current decade averaging around 16–17 per cent per year have contributed to an average rate of wholesale price inflation of about 8 per cent per annum. As pointed out by the Chakravarty Committee Report on the Monetary System, much of the growth in money supply can be explained in terms of budgetary deficits run by the Central Government. A reduction in the underlying average rate of inflation in the medium term is likely to require a reduction in the average rate of growth of money supply, which in turn will entail moderation in the scale of Central Government budget deficits.

Consistently high deficits resulted in a rapid accumulation of public debt (Table 3.4). The internal debt of the Central Government galloped from ₹ 24, 319 crore in 1980 to ₹ 1,14,499 crore in 1989. Of this, the volume of market loans recorded a growth from ₹ 12, 867 crore to ₹ 55, 115 crore. The Treasury Bills increased from ₹ 10, 196 crore to ₹ 14, 840 crore.

One of the main reasons for the enormous growth of public debt in the second half of the 1980s was the persistence of fiscal deficits. The debt-GDP ratio went up from 48.1 per cent in 1981–82 to 64.3 per cent in

TABLE 3.4

Internal Public Debt of the Government of India

(Outstanding as at end-March)

(₹ crore)

	1980	*1981*	*1982*	*1983*	*1984*	*1985*
Public debt	24,319	30,864	35,653	46,939	50,263	58,537
of which :						
(i) Current market loans	12,867	15,549	18,461	22,232	26,270	30,366
(ii) Treasury Bills:						
91 days	10,196	12,851	10,273	17,431	15,756	19,452
182 days						
(iii) Special securities issued to RBI	80	585	4,110	4,210	4,570	4,650
(iv) (ii+iii)	10,276	13,436	14,383	21,641	20,326	24,102

	1986	*1987*	*1988*	*1989*	*1990*
Public debt	71,039	86,312	98,646	1,14,499	1,33,193
of which :					
(i) Current market loans	35,241	40,832	46,695	55,115	62,520
(ii) Treasury Bills:					
91 days	26,014	19,876	8,028	14,273	25,184
182 days				567	
(iii) Special securities issued to RBI	5,187	19,867	37,177	36,987	36,881
(iv) (ii+iii)	31,201	39,743	45,205	51,827	62,065

Note: Internal debt comprises market loans, special bearer bonds, Treasury Bills, compensation and other bonds, special securities issued to the Reserve Bank and international financial institutions and gold bonds.

Source: Reserve Bank of India, *Report on Currency and Finance*, various issues.

1988–89 (Table 3.5). A significant portion of this debt was monetised by the Reserve Bank through the mechanism of *ad hoc* Treasury Bills.

The Reserve Bank, in its Annual Report for 1989–90, stated that the sustainability of government deficits and the consequent domestic debt depended primarily on the size and nature of resource mobilisation, and the disposition of public expenditure. It expressed the fear that excessive dependence on domestic borrowings could become a substitute for mobilisation of resources through direct and indirect levies, besides leading to a rapid accumulation of debt and a concomitant increase in interest

TABLE 3.5

Debt Indicators of the Central and State Governments

(As percentage of GDP)

Year	*Domestic Liabilities of Centre*	*External Liabilities of Centre**	*Total Liabilities of Centre (2 + 3)*	*Aggregate Liabilities of States*	*Combined Domestic Liabilities of Centre and States*	*Combined Total Liabilities of Centre and States (3 + 6)*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
1980–81	35.6	8.3	43.9	17.6	40.8	49.1
1981–82	35.0	7.7	42.7	17.4	40.4	48.1
1982–83	40.0	7.7	47.6	18.4	45.1	52.8
1983–84	38.6	7.3	45.9	18.3	43.9	51.2
1984–85	41.8	7.2	49.0	19.3	47.9	55.1
1985–86	45.5	6.9	52.4	20.5	51.5	58.5
1986–87	49.9	6.9	56.9	20.7	56.1	63.0
1987–88	51.7	7.0	58.7	21.0	57.9	64.9
1988–89	51.5	6.5	58.1	20.5	57.8	64.3
1989–90	52.5	6.2	58.7	20.6	59.1	65.3

Notes: * At historical exchange rate.
Due to rounding-off, totals may not tally.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 1999.*

burden. The Economic Survey for 1989–90 presented a grim picture of the situation:

> It is a matter of concern that a significant part of the borrowed resources goes towards covering revenue deficit of Government, which is substantially higher than the extent of narrowly defined deficit…As borrowed resources command higher interest rates, the cost of financing the revenue gap has been on the rise. Moreover, the remunerative commercial activities also have not been generating adequate return flow by way of dividends and interest. On top of it, the interest cost of borrowing in the form of small savings, provident funds, *etc.* has increased in recent years. With a near-stagnant domestic saving rate, the increase in the cost of borrowing is not surprising, particularly when the borrowing is large.

An internal study on the subject drew pointed attention to the unwelcome prospect of growth in domestic debt reaching unacceptably higher levels in the near future and popularised the term, 'debt trap'.[5] Another study[6] used mathematical exercises to demonstrate the non-sustainability of public debt in India if the past trends in fiscal deficit were not reversed. Dr Raja Chelliah[7] had posited that the uninterrupted and rapid growth of public debt in India during the 1980s and early 1990s was a manifestation of the deepening of a financial crisis that had overtaken the country and that the fiscal crisis and the attendant exponential growth of public debt had arisen not merely because revenue expenditure had been running ahead of current revenues but also because capital expenditures financed by borrowing had not yielded adequate returns.

During the 1980s, some policy decisions were taken in debt management, following the report of the working group headed by Shri D.C. Rao and later the recommendations of the Chakravarty Committee. Active debt management was, however, put into practice only in the early 1990s. Meanwhile, the Reserve Bank made efforts to develop the money market and secondary market for Treasury Bills with the objective of diversifying the ownership of government debt and moving eventually to indirect and market-based instruments of monetary control.[8]

The budgetary deficit as conventionally reported was only a partial measure of fiscal imbalances that had built up in the 1980s. As far as growth in money supply was concerned, what mattered was monetised growth. From the broader view of macroeconomic balance, however, it would be useful to look at the overall deficit between the revenues of the Government and its total expenditure, which measured its borrowing requirement that had to be met from domestic and external sources.

The authorities progressively raised the coupon rates from 7.0 per cent in 1979–80 to 11.5 per cent by 1985–86. The maximum maturity of 20

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5. "The Burden of Domestic Public Debt in India", *Reserve Bank of India Occasional Papers* 8(1), June 1987.

6. Rangarajan, C., Anupam Basu and Narendra Jadhav (1989). "Dynamics of Interaction between Government Deficit and Domestic Debt in India", *Reserve Bank of India Occasional Papers* 10(3), September.

7. Chelliah, Raja J. (1992). "Growth of Indian Public Debt" in Bimal Jalan (ed.), *The Indian Economy: Problems and Prospects*. New Delhi: Viking.

8. Rangarajan, C. (1990). "Domestic Debt Management and Monetary Control", *18th SEANZA Central Banking Course Lectures*. October–December. Mumbai: Reserve Bank of India.

years prevailing since the early 1960s was increased to 30 years by 1969–70 and that continued until 1986–87, when it was reduced to 20 years. Thus, the effective increase in coupon rates was much larger than that indicated by the maximum coupon rate. Another feature was that Treasury Bills as an instrument came to be accorded a greater role. However, with the large overhang of 91-day Treasury Bills at a very low interest rate of 4.6 per cent, the authorities were not inclined to raise the interest rate to a more realistic level.

RESERVE BANK'S CONCERNS AND GOVERNMENT'S PERCEPTIONS

The Reserve Bank was conscious of the likely adverse effects of the deficit finance, ranging from inflation and external imbalances to the crowding out of domestic investment and finally burdening future generations with a mountain of debt. The Government tacitly conceded that deficit was a problem but they consistently pleaded their inability to accept the Reserve Bank's recommendations to take more effective action to contain it. The former reasoned that inflation was largely a structural problem and that the strategy had to be based primarily on the supply side.

The Reserve Bank made known its concerns from time to time mainly through the Annual Report to the Central Board on the working of the Reserve Bank and the speeches of the Governors at various forums, which highlighted the need for monetary restraint and fiscal discipline. The Reserve Bank's Annual Report for the year 1988–89 noted that whereas the Seventh Five Year Plan had projected deficit financing of ₹ 14,000 crore, the actuals for the first four years and the budgetary anticipations for the fifth year of the Plan period added up to ₹ 33,110 crore, which was nearly two-and-a-half times the Plan estimates. It added that to achieve the objective of healthy income growth with price stability, it was essential to reduce the dependence of the Plans on fiscal deficits.

As far back as 1985, the Governor, Shri R.N. Malhotra, in his speech at a seminar organised by the Indian Chamber of Commerce, Calcutta (now Kolkata), on December 12, 1985, expressed the view that the assessment of deficit financing to the tune of ₹ 14,000 crore made in the Seventh Five Year Plan document could be considered to be within safe limits of non-inflationary financing and noted with satisfaction that the Plan document had stressed the interrelationship between fiscal and monetary policies. He elaborated that an excessive budget deficit would shift the burden of inflation control unduly to monetary policy and considered co-ordination

between the two policies of crucial importance. Later in 1989,[9] when economic conditions showed signs of deterioration, the Governor was constrained to observe that persistent inflation over a secular period would not have been sustained without monetary expansion and, despite several measures to control monetary expansion, liquidity growth had been high, largely due to pressures emanating from the fiscal sphere.

In 1988, the Deputy Governor, Dr C. Rangarajan, cautioned that government budgets tended to be expansionary because of the demands of development and, with larger government deficits, Reserve Bank credit to the Government had expanded.[10] In this context, it was also articulated that in the past three-and-a-half decades, monetary policy measures had generally been in response to the fiscal policy; this was particularly noticeable from the early 1970s when a sizeable increase in the Reserve Bank credit to the Government became a normal feature.[11] In the Presidential address at the annual conference of the IEA, Calcutta, on December 29, 1988, the Deputy Governor, Dr C. Rangarajan, provided insights into diverse aspects of the emerging scenario. Selected excerpts from the speech are given below as they highlight the interconnected macroeconomic aspects of the subject:

> As each successive Plan came under a resource crunch, there was an increasing dependence on market borrowing and deficit financing which became pronounced in the Seventies and thereafter. The single most important factor influencing the conduct of monetary policy since 1970 has been the phenomenal increase in reserve money contributed primarily by Reserve Bank credit to the Government. It is in this context that the issues of stabilisation and the role of monetary regulation in containing inflation have been raised.

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9. Malhotra, R.N. (1989). *Current Economic Situation.* Address delivered to the members of Madras Chamber of Commerce and Industry: Madras. July 12.
10. Rangarajan, C. (1988). "Central Banking and Economic Development: Indian Experience". Paper presented at the *41st International Banking Summer School.* New Delhi. September 17-30.
11. Brahmananda, P.R. and V.R. Panchamukhi (eds.) (1987). *Issues in Monetary Policy in the Development Process in the Indian Economy*. Mumbai: Himalaya Publishing House.

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For regulating money supply, the monetary authority must have a reasonable degree of control over the creation of reserve money. Obviously, there are exogenous factors such as the movements in foreign exchange assets, which affect the level of reserve money. The degree of independence in regulating reserve money depends upon institutional arrangements governing the functioning of monetary authority. Over the years, the practice has grown under which the entire budget deficit of the Central Government has been taken by the Reserve Bank of India, leading to monetisation of deficit.

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The Reserve Bank had, therefore, to address itself to the difficult task of neutralising, to the extent possible, the expansionary impact of deficits after taking into account the short-term movements in its holdings of net foreign exchange assets. The increasing liquidity of the banking sector resulting from rising levels of reserve money had to be continually mopped up. The instrument of open market operations is not available for this task, given the interest rate structure. The task of absorbing excess liquidity in the system had to be undertaken mainly by increasing the cash reserve ratio. At some point, this can result in crowding out of credit to the commercial sector. With frequent and sharp increases, the cash reserve ratio has almost reached its statutory limit.

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The growing budgetary deficit and their absorption by the Reserve Bank highlight not only the close link between fiscal and monetary policies, but also the need for close co-ordination between the two. The essence of co-ordination between monetary and fiscal policy lies in reaching an agreement on the extent of expansion in Reserve Bank credit to Government year to year. This will set a limit on the extent of fiscal deficit and monetisation and thereby provide greater manoeuvrability to the monetary authorities to regulate the volume of money supply. It is in this context that the introduction of a system of monetary targeting mutually agreed

upon between the Central Government and the Reserve Bank assumed significance.

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Monetary policy can play a useful role in ensuring growth with price stability. Inflation, it is true, is not purely a monetary phenomenon. Supply shocks of various types can trigger price increases. The regulation of money supply in accordance with the output trends can succeed only if there is close co-ordination between monetary and fiscal policies. Deficit financing or created money is not a resource. It is only a means of transferring resources from one sector to another, which it can accomplish if practised in moderation. If price stability as an objective has to be achieved, fiscal deficits and, therefore, borrowings from the Reserve Bank, must be limited to levels consistent with the increase in money supply justified by the expected increases in output.

The Economic Survey of the Government of India that is published before the presentation of the Union Budget every year, invariably offered an assessment of the underlying causes and economic effects of budget deficit. It averred that continued stability in prices was possible if, in addition to augmenting domestic production, the growth in aggregate demand in the country was kept under control through appropriate restraints on expansion of domestic credit and the Government's budgetary deficit.[12] If the targets stipulated in the Plans were to be achieved, there had to be much greater fiscal discipline than in the past.[13] The rapid growth in non-Plan expenditure meant that the Centre's budget on revenue account had been in deficit throughout the decade and this deficit had increased steadily in the past five years and, as a result, the Government had to rely increasingly on borrowed funds to meet its expenditure commitments and this, in turn, led to a growing bill for interest payments.[14] Reserve money, the base money for monetary expansion, was largely influenced by the Government's budgetary deficit *via* changes in net Reserve Bank credit to the Government, and an analysis of the sources of change in reserve money showed that the Reserve Bank's net credit to the Government

12. Government of India, *Economic Survey, 1981–82.*
13. Government of India, *Economic Survey, 1984–85.*
14. Government of India, *Economic Survey, 1986–87.*

was the principal source of reserve money; this important variable as a proportion of reserve money, which formed 83.0 per cent at the end of March 1971, had risen to 101.0 per cent by the end of March 1987. Finally, the Economic Survey, 1986-87 expressed the view that:

> Success in controlling the growth of Government expenditure and in increasing surplus generation by public sector undertakings is essential not only to bring about better balance in the Government's final position but also to keep inflation in check. Clearly, the burden of checking inflationary pressures rests with fiscal and monetary policies to curb aggregate demand and measures to bring about rapid increases in domestic supply.

CONCLUDING OBSERVATIONS

Fiscal policy and monetary policy have been the two most important attributes of co-operation in macroeconomic management between the Government and the Reserve Bank. As a close link exists between the two policies, there is a need for understanding and co-operation, particularly for the effectiveness of monetary policy. It was important during the 1980s that the extent of monetisation of fiscal deficit through the Reserve Bank credit to the Government be contained within prudent limits. Furthermore, co-ordination was required in the framing of the interest rate policy and its administration. Both these aspects were stressed by the Chakravarty Committee.

Consequent upon the steadily deteriorating state of finances of the Central Government during the 1980s due to the political compulsions of an expansionary fiscal policy, management of the finances of the Government took precedence over the Reserve Bank's concerns about prudent monetary management. Nevertheless, to the extent possible, the Reserve Bank tried to neutralise the expansionary impulses of the government deficits and the attendant monetisation with the help of available tools of credit control in its armoury.

The primary responsibility for containing the liquidity growth in the economy fell on the statutory reserve requirements. CRR was a direct instrument of credit control and by 1989 it stood at the statutory ceiling of 15.0 per cent. Even though CRR restricted the credit-creating potential of banks, it impaired their profitability in the process. Therefore, the Reserve Bank paid interest on cash balances required to be kept with it; the rate was 10.5 per cent on the balances above the statutory minimum of 3.0 per cent.

Such interest payments, however, diluted the efficacy of this instrument to some extent. The increased scale of government borrowings resulted in a steady rise in SLR too, compelling the banks to invest larger quantum of their deposits in government securities, which carried an interest rate lower than the market rate. More disconcerting, the Reserve Bank became a residual subscriber to securities and Treasury Bills, thus leading to excess monetisation of deficits.

The automatic monetisation of budget deficits became the focus of discussion in the 1980s because almost the entire budget deficit of the Central Government came to be monetised by the Reserve Bank through the creation of *ad hoc* Treasury Bills; this practice assumed serious proportions and had wide ramifications. This also led policymakers to address the issue of the autonomy of the central bank with regard to monetary policy formulation and operations.[15]

The BoP crisis of 1991 and its resolution was responsible for not only a quick and strong revival of the Indian economy but also for the introduction of long-term fiscal and monetary reforms for strengthening and revitalising the functioning of the economic system and the financial sector, in particular. It also imparted a sense of discipline in the budgetary operations of the Central Government, *inter alia*, by gradually phasing out automatic monetisation of budget deficit, spread over a period of three years from 1994-95. Ultimately, from April 1997, the long-standing mechanism of the issue of *ad hoc* 91-day Treasury Bills to the Reserve Bank, which took root in January 1955 to replenish the minimum working cash balance of the Central Government with the Reserve Bank whenever it dipped below the minimum limit agreed upon on Fridays, was done away with about 40 years later. In the process, this strengthened the efficacy of monetary policy by providing flexibility in monetary management. Internal debt management operations were also activated, the government securities market recorded development and, above all, monetary-fiscal co-operation was strengthened.[16]

15. Chapter 4: Monetary and Credit Policy recounts the main monetary and credit policy responses in the context of the developments and changes that occurred in the macroeconomic sectors during this period.

16. These topics are discussed in detail in chapter 15: Public Debt Management.