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Monetary and Credit Policy

INTRODUCTION

The first half of the 1980s was characterised by a considerable extent of fiscal and monetary restraint, whereas the second half saw a reversal, led by the fiscal policy. Similarly, if the first half was a time of status quo, the second half ushered in far-reaching policy initiatives, of which the most important was the gradual activation of monetary policy. The Reserve Bank brought to the fore the issue of monetisation of budget deficit, *via* the mechanism of the issue of *ad hoc* Treasury Bills. The change, though initiated, took some time to materialise. In the meantime, the Reserve Bank was engaged in addressing the issues relating to the widening of the current account deficit (CAD) in the balance of payments (BoP) as also with the inflationary pressures, which were persistent through almost the entire period.

The Preamble to the Reserve Bank of India (RBI) Act, 1934, sets out the objectives of the Reserve Bank as: "to regulate the issue of Bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage." For the Reserve Bank, price stability was the dominant objective of monetary and credit policy. At the same time, it framed its policies so as to provide adequate flow of credit and finance to support the growth of the real sector. However, in actual practice, inflation control was perceived as the joint responsibility of the Government and the Reserve Bank.

The Reserve Bank through its credit policy measures attempted to moderate the growth of liquidity to the desired levels in order to restrain inflationary pressures without disrupting the flow of credit to vital sectors

of the economy. The Bank also had to provide funds for the budgetary operations of the Central Government and for its market borrowing programmes. Thus, monetary policy had to contend with the unenviable task of neutralising the inflationary impact of the growing deficit in the Government's budgetary operations.

After the nationalisation of major commercial banks in July 1969, the Reserve Bank was required to promote sectoral development of the economy in consonance with the priorities laid down in the Five Year Plans by influencing the volume, cost, term structure of credit and direction of flow of funds. For this reason, monetary policy during this period was essentially in the nature of 'credit policy'. In the 1990s, with the implementation of the financial sector reforms, its scope was widened to 'monetary and credit policy.'[1]

OPERATING FRAMEWORK FOR CREDIT/MONETARY POLICY

The formulation and deployment of monetary and credit policy followed a well established pattern. The Governor of the Reserve Bank announced two important credit policy statements each year at a meeting of bankers convened specially for this purpose at Mumbai. One announcement was made at the beginning of the busy season (October to March) and the other at the beginning of the slack season (April to September). This seasonality reflected the agricultural bias and the general pattern of the credit cycle in the economy. To arrive at not only the level of acceptable or desirable increases in bank credit but also its allocation among the various sectors, the Reserve Bank prepared a monetary and credit budget at the beginning of each financial year.

The Union Budget proposals and their impact on monetary and other macroeconomic aggregates were an important input in policymaking. The prospects about the onset and progress of the monsoon (*i.e.*, favourable or unfavourable) and its likely repercussions on the overall performance of the real sectors of the economy were also taken into consideration. Relationships derived from the past data were used to make this forecast. In this context, connect between growth in bank deposits and currency component was derived once the deposit growth had been estimated.

Thus, policymakers got a broad outline of the increases in broad money/money supply (M_3) as well as in deposits. The approach from the

1. Credit Planning Cell (CPC) circulars to scheduled commercial banks (SCBs), dated April 12, 1991, July 3, 1991, October 8, 1992 and April 7, 1993.

demand side was tallied with estimates from the M_3. The projections of money supply were based on reserve money or high-powered money, which was estimated on the basis of expected changes in the Reserve Bank credit to the Central Government and the commercial sector, and anticipated movements in the country's foreign exchange assets. This exercise provided an idea of the changes in high-powered money, which was estimated in greater detail. In a complete model, which incorporated both the supply and demand for money, the rate of interest was the equilibrating factor. However, in the Indian system, at least until the mid-1980s, this was not so since the interest rate was an administered price and the rate structure was designed to bring about a balance between demand and supply.

Having estimated deposit growth, bank credit available for the commercial sector was derived by subtracting from total deposits, investments in government securities by banks and the statutory reserves required to be maintained by commercial banks. The total credit thus available was allocated among various sectors, depending on national priorities and output targets. At times, an independent estimate of the demand for credit from various industrial sectors was also attempted to identify any serious divergences.

Further, the Reserve Bank had evolved an elaborate mechanism whereby the task of estimating the credit requirement was done independently by major commercial banks at the periodic credit budget discussions. The banks' estimates were compared with the Reserve Bank's estimates for reasonableness. At the credit budget meetings, the Reserve Bank indicated the limits for liquidity growth and offered advice to plan banks' lending operations from their own resources.

The next step was to take a view on whether the increase in M_3 or bank credit emerging from this exercise was acceptable from the point of view of maintaining price stability and/or any other designated goal. If it was felt that it was likely to generate inflationary pressures, the monetary authority decided to initiate appropriate policy measures to curtail credit growth, and *vice versa.* Thereafter, quantitative targets were set, both in relation to the aggregate credit as well as for some individual sectors. These were, however, adjustable rather than unalterable targets.

The Reserve Bank maintained close and continuous consultation with the finance ministry. Its ability to carry out monetary policy depended to a considerable degree on the extent of consensus with the ministry to meet the Government's financing requirements in a non-inflationary manner.

In particular, appropriate debt management policies and agreements for financial accommodation were integral and crucial factors for the effectiveness of monetary policy.

From 1986, even though the monetary policy framework underwent a change with the adoption of a monetary targeting approach with M_3 as the intermediate target, the operating procedures remained broadly the same until the late 1990s.

INDICATIVE GUIDELINES FOR GROWTH IN CREDIT AND MONEY SUPPLY

As the decade unfolded, the Reserve Bank had to manage the monetary situation as also the external payments problem. The Bank, at least until 1976–77, as part of the seasonal credit policy announcements was making known to banks the volume of expansion in credit consistent with the prevailing stance of credit policy. This advice was in the nature of guidelines and took the form of expansion in total credit, non-food credit or incremental credit-deposit ratio and was in essence moral suasion. However, in 1978–79, a quantitative limit was prescribed in terms of the incremental non-food credit-deposit ratio and from 1979–80 to 1982–83, in terms of expansion in non-food credit.

In the second half of the 1980s, the Reserve Bank adopted M_3 as the intermediate target variable, in which the fiscal impact on monetary aggregates was strong and the rates of interest were mostly regulated. This was the outcome of accepting the recommendations of the committee to review the working of monetary system (Chairman: Prof Sukhamoy Chakravarty).

The 1980s was a decade characterised by mixed developments, such as successful emergence from the second oil shock, the introduction of long-overdue reforms in macroeconomic management and fiscal policy triggered by the Chakravarty Committee report, and the Government's recourse to unsustainable fiscal expansion after it had prematurely terminated the International Monetary Fund (IMF) loan.

ECONOMIC RECOVERY AND STABILISATION
(NOVEMBER 1981 TO SEPTEMBER 1982)

IMF LOAN AND MACROECONOMIC RESPONSIBILITIES OF THE RESERVE BANK

The 1980s began with severe inflation and a BoP problem. India was, therefore, obliged to take recourse to the extended fund facility (EFF) of the

IMF and observe the monetary and credit conditionalities attached to the loan. The IMF formally approved the loan of SDR 5 billion in November 1981, which was to be availed of in three instalments, *viz.*, SDR 900 million by the end of June 1982, SDR 1,800 million by the end of June 1983 and the balance by November 1984. The performance criteria for the full payment of the first instalment specified ceilings to be effective at end-March 1982 for net bank credit to the Government (20.0% above end-March 1981 level) and total domestic credit (19.4% above end-March 1981 level). The authorities were also expected to limit the growth of M_3 at 15.7 per cent in 1981–82 and increase public investment in domestic oil production and infrastructure. The Reserve Bank, however, in anticipation of the IMF support programme, initiated the process of monetary tightening as early as July 1981. This considerably facilitated compliance with the targets later.

The other important elements of performance criteria were a limit on the total foreign non-IMF borrowing of SDR 1.4 billion in the first year of the programme and a prohibition against intensification of import restrictions. In tandem with the prescribed performance criteria was the Government's Statement of Economic Policies, which contained the broad commitment of the Government to the IMF on the economic policies to be pursued. Other declarations by the Government related to export promotion efforts, maintaining a realistic exchange rate, policies to strengthen public finances and attempts to encourage private savings and investment. During the drawal period of the loan (*i.e.,* till May 1, 1984), the Government and the Reserve Bank had to factor these stipulations into their policy formulation.

The loan programme imparted a sense of purpose and discipline to the long-term economic management and enabled an expansionary adjustment to the oil crisis of 1979–80 instead of a deflationary adjustment to domestic inflation. The BoP attained a measure of stability, which was reflected in the healthy growth in foreign exchange reserves, while a large public investment programme in energy and infrastructure took place. More importantly, credit targets were generally achieved for the duration of the loan due to the tight credit policies (especially during July–December 1981 and May–September 1984) and monitoring of the Reserve Bank. As long as the loan was in operation, it contributed to the adjustment of monetary and fiscal policies. Though the tight financial policies put through during this period were instrumental in bringing down inflation rates, they prolonged the weakness in output growth and kept interest rates at high levels in real terms.

GRADUAL IMPROVEMENT IN ECONOMIC SCENARIO

At the outset of the fiscal year 1981–82 (April–March), the economic situation was not encouraging. The memorandum to the Central Board of Directors of the Reserve Bank, dated February 26, 1981, evaluated the position thus:

> The trend in monetary expansion, especially viewed in the context of a deteriorating foreign exchange situation, is a cause for serious concern. The continued build-up of the primary money base is also a source of anxiety. While the liquidity of the banking sector during the current busy season is comfortable because of the pick-up witnessed in deposit growth, the banks would need to continue to deploy credit in accordance with productive requirements and also allot an increasing portion of credit to the priority sectors so as to maintain the target of 40 per cent of advances by 1985.

During the course of the year, however, the economy showed signs of revival. The continuous high rate of inflation beginning in August 1979 started weakening from August 1981 and by the end of the year, it came down to 8.0 per cent from a high of 18.0 per cent in 1980–81. Further, while agricultural and industrial output recovered, the strain on external trade and BoP persisted, mainly owing to the hike in oil prices and the after-effects of the severe drought. There was also a slowdown in the growth of liquidity in the economy, followed by a sharp decline in the growth of reserve money as well as M_3. The reduced liquidity coupled with the improved supply conditions contributed to abatement in price rise. The Reserve Bank took a cautious view and was not in favour of deviating from the objective of restricting the growth of overall liquidity and containing monetary expansion.

During the fiscal 1980–81, M_3 growth was marginally higher, at 18.5 per cent as against 17.4 per cent in 1979–80. An area of particular concern was the relatively high rate of growth in reserve money during 1980–81 despite a decline in foreign exchange reserves, which the Reserve Bank viewed as a potential for large monetary expansion in 1981–82. The credit policy circular addressed to banks in May 1981 observed that since a significant reduction in the pace of inflation was a basic policy objective, a slower pace of monetary expansion was an 'ineluctable' necessity. With no signs of abatement in prices, the Reserve Bank was left with no option but to continue the tight stance of credit policy for the first half of the year

1981–82. At the same time, however, it sought to maintain the flow of credit to the priority and productive sectors of the economy.

In May 1981, the Reserve Bank issued broad guidelines for credit expansion for the slack season (April–September) as well as for the financial year as a whole. Banks were asked to ensure a marginally lower expansion in non-food credit in absolute terms in the 1981 slack season than in the corresponding previous season. For the full financial year 1981–82, the expansion in non-food credit was to be marginally lower than the expansion in 1980–81. Further, to avoid excess credit expansion and maintain better control over monetary expansion generated by large increases in primary money, cash reserve ratio (CRR) was raised from 6.0 per cent to 7.0 per cent of deposits (legally defined as 'net demand and time liabilities'), of which 6.5 per cent was to be attained by July 31 and 7.0 per cent by September 11, 1981 (subsequently brought forward to August 21). The banks were also advised to plan their resource use in the slack season in such a manner that they were able to meet the increase in genuine credit requirements in the following busy season from their own resources and keep the expansion of credit in tandem with the guidelines.

INCREASE IN DEPOSIT AND LENDING RATES

The Reserve Bank was of the view that the interest rate offered by banks and small savings organisations was not attractive enough to mobilise financial savings to the extent visualised in the Sixth Five Year Plan. After detailed discussions between the Reserve Bank and the Government, interest rates were increased. The Finance Minister in his budget speech said that high rates of inflation were an impediment to financial savings, and since bank deposits were the most important single mechanism of financial savings, it was decided to raise interest rates on maturities from one year and up to five years. The slabs were also adjusted so that deposit rates on those up to three years maturity were increased by 50 basis points. There were adjustments in lending rates from March 2, 1981, reducing the total number of prescribed rates to four slabs of 12.5 per cent, 15.0 per cent, 17.5 per cent and 19.5 per cent, respectively. Fixed rates, instead of ceiling rates, on a number of categories of advances ensured uniformity of rates for the same category of advances, particularly in the case of the priority sector.

The Reserve Bank accepted the long-standing request by banks to enhance the interest rate paid on their balances kept with it in the context of

the general increase in interest rates in the past two years and, in particular, the rise in the interest rates on government securities. Consequently, from June 1, 1981, the interest paid on cash reserves maintained by banks above the statutory minimum of 3.0 per cent (inclusive of additional cash balances maintained as on October 31, 1980, under the 10.0% incremental CRR) was raised from 6.5 per cent to 7.0 per cent per annum.

REFINANCE/REDISCOUNT FACILITIES

Certain in-built inconsistencies in the refinance/rediscount rates made these facilities attractive to banks. As a result, far from being a facility of last resort, it turned out to be a lucrative source for primary credit expansion. In the case of discretionary refinance, which was provided at a minimum rate of 11.0 per cent for short periods in special circumstances and was subject to the maintenance of the stipulated reserve requirements, the tendency on the part of the banks was to apply for this facility for 2–3 months at a time, followed by a request for an extension. In contrast, a money market borrowing at 11.0 per cent adjusted for reserve requirements had an effective cost of 14.0 per cent. Therefore, to ensure that banks sought the discretionary refinance only in cases of urgent and unavoidable need, the minimum rate of interest on the Reserve Bank's discretionary refinance as well as the discount rate was raised sharply from 11.0 per cent to 14.0 per cent from June 1, 1981. The Reserve Bank advised banks that this change was expected to affect the lending rates charged to their ultimate borrowers as well.

Another correction made related to the conditions of availment for stand-by refinance, which was being provided to meet clear imbalances for a 2–3 day period at a rate of interest of 11.0 per cent and without any collateral. The banks had the option of either borrowing under section 17(4)(a) of the RBI Act, 1934, with the collateral of government securities or under section 17(3B), without any collateral. The Reserve Bank, with the objective that banks should be encouraged to maintain a small cushion over and above their statutory liquidity ratio (SLR) and to discourage them from selling government securities and purchasing them back whenever they experienced very short-term needs of a temporary nature for 2–3 days to meet swings in clearing, made the facility available from June 1, 1981, only under section 17(4)(a) without a collateral of government securities, but the rate of interest remained unchanged at 11.0 per cent.

CREDIT POLICY TIGHTENED

On May 21, 1981,[2] a note emanating from the Credit Planning Cell (CPC) put forth the underlying considerations for the proposed credit control measures. This note provided insights into the policymaking process at the central bank at that point.

The assessment was based on the monetary budget, discussed earlier with the finance ministry in the context of the ongoing negotiations with the IMF, and the impending ceilings for credit expansion for the financial year as a whole and at two intermediate points during the year. In the context of the proposed increase in CRR, the Reserve Bank considered it necessary that this increase was not vitiated by any undue increase in discretionary refinance/rediscount accommodation. At the same time, an increase in the refinance/rediscount rates was viewed as an effective signal to banks to slowdown the pace of credit expansion. The broader perspective of these changes was highlighted by the Executive Director in the aforementioned note:

> Since both these measures would operate towards reducing primary liquidity in the system, they would tend to have a direct impact on monetary expansion. They do not affect the cost of credit to the final borrower. At the same time, the measures would curb undue growth of credit, thereby preventing speculative build-up of inventories. They would thus dampen inflationary expectations. To the extent that the monetary expansion is kept lower, there would be a moderating effect on prices without adversely affecting real output, particularly of essential items, as the desired level of credit expansion makes adequate provision for essential credit requirements such as food credit and the requirements of other productive sectors.

It was also evident from the note that the Government was keen to effect a hike in the Bank Rate, in anticipation of the IMF loan. The Reserve Bank, however, faced a procedural snag owing to an agitation by its employees. The Government was advised that any change in the Bank Rate would have to be approved by the Reserve Bank management, *i.e.*, the Directors of the

2. Incidentally, the post of the Deputy Governor in charge of the Economic Department and CPC had been lying vacant since Dr K.S. Krishnaswamy demitted office on March 31, 1981. His successor, Dr C. Rangarajan, assumed office almost a year later on February 12, 1982.

Central Board, but under the prevailing circumstances such a course was not feasible. The letter added that, nevertheless, the process of reviewing the implications of a change in the Bank Rate and the various rates linked to it as well as their impact on economic activity was being done and, after the detailed examination was complete, the Bank made the following statement: "We will be consulting the Finance Ministry as usual, before announcing any change in the Bank Rate." The Bank Rate was increased to 10.0 per cent effective July 12, 1981.

The Reserve Bank noticed from the seasonal banking trends that banks were not strictly adhering to the May 27, 1981 guidelines on credit expansion. Up to June 1982, non-food credit expanded by ₹ 422 crore as against a decline of ₹ 42 crore in the corresponding period of the previous year, which was made possible mainly by the higher deposit growth on top of relatively high levels of liquidity at the beginning of the year. Nevertheless, it was expected that the pace of non-food credit expansion might slowdown during the quarter July–September 1981, the demand for food credit would be moderate and banks would have a comfortable liquidity position. A more determined effort to restrain credit expansion was made thereafter.

BANK RATE INCREASED AFTER SEVEN YEARS

Though the Reserve Bank had decided in principle to increase the Bank Rate, its implementation faced some serious logistical impediments due to the ongoing staff agitation, which disrupted the functioning of its offices in various parts of the country.

The officials of the Reserve Bank felt that it was difficult to hold the meeting of the Central Board of Directors in the normal course and get the increase in the Bank Rate approved. The Legal Department's advice was sought, which opined[3] that the RBI Act empowered the Governor to decide on the question of increase in the Bank Rate, that the matter could be placed before the Committee of the Central Board for information and that sufficient notice needed to be given only to Directors who were present in the area where the meeting was to be held. Further, in order to maintain secrecy, the change could be announced at a press conference held immediately after the meeting of the Committee. The note also contained details of the tour programme of Delhi-based Directors (*i.e.*,

3. In a handwritten note dated July 8, 1981.

when they would be out of Delhi) from which it could be deduced that under these extraordinary circumstances the meeting of the Committee of the Central Board was planned to take place in New Delhi on a low key. Staff relations at the time (*i.e.,* 1981) were so strained[4] that the draft press note was handwritten with the Governor, Dr I.G. Patel's modifications on it. The office note made a revealing statement:

> While it was recognised that Bank Rate as an instrument of monetary control had been used infrequently with the last change being in July 1974, when a package of inflationary measures was introduced, such infrequent use of this instrument was in a way considered advantageous in the sense that an increase in the Bank Rate would be a good signal to banks to avoid seeking refinance from the Reserve Bank unless there was an urgent, unforeseen and unavoidable need.[5]

A package of anti-inflationary measures was announced by the Reserve Bank on July 11, 1981. The Bank Rate was raised from 9.0 per cent to 10.0 per cent with consequent upward adjustments in refinance rates for food credit, export credit and certain special facilities. The second phase of the increase in CRR to 7.0 per cent was brought forward from September 11 to August 21. For better monetary control and to reduce primary money, SLR was increased from 34.0 per cent to 35.0 per cent to be effective in two phases, *i.e.,* to 34.5 per cent from September 25 and to 35.0 per cent from October 30. This hike in SLR was to ensure that the excess liquidity in the banking system was mopped up to pre-empt any undue expansion in the slack season. Interestingly, the previous increase in the Bank Rate to 9.0 per cent took place on July 23, 1974; the subsequent change to 11.0 per cent was effected nearly one decade later, *i.e.,* on July 4, 1991.

At the micro level, the minimum margins in respect of advances against stocks of wheat, paddy/rice and other food grains were raised across board by 10.0 percentage points. In the follow-up letter to banks dated July 20, 1981, the Reserve Bank conveyed its disappointment over the unhealthy trends observed in the growth of non-food credit in the

4. Industrial relations in the Reserve Bank form the subject matter of chapter 21: Institutional Changes.

5. The office note implied that as the Bank Rate was not revised frequently (for whatsoever reason), any change in the Bank Rate carried a strong announcement effect.

first half of 1981–82 as a serious infringement of the credit guidelines, and asked banks to issue 'positive' instructions to their branches not to violate the prescribed guidelines.

FURTHER TIGHTENING IN OCTOBER 1981

M_3 growth in the first half of 1981–82 was the same as in the corresponding period of 1980–81. The growth in real national income in 1981–82 was, however, substantially lower at 4.5 per cent as compared with 7.7 per cent in the previous year. There was also a sizeable loss of foreign exchange reserves, which warranted a slower pace of monetary expansion. The liquidity position of the banks was comfortable since they had already met the enhanced CRR level of 7.0 per cent.

In the circumstances, the Reserve Bank decided to take steps to mop up the excess liquidity and thereby reduce further expansion in credit during the busy season (October 1981–March 1982). Commercial banks were asked to maintain a higher level of 8.0 per cent CRR to be attained in four equal phases, the final one taking effect from February 26, 1982. The incremental CRR maintained with the Reserve Bank from October 31, 1980 was continued. The Reserve Bank advised banks to meet the increase in reserve requirements from their own resources besides correcting the excessive expansion in the non-food credit. Finally, the Reserve Bank prescribed that the credit ceilings applicable to the banking system for the year, *i.e.*, expansion in 1981–82, were not to exceed in absolute terms the actual expansion in 1980–81.

The Government wanted the negotiations for the forthcoming loan from the IMF to proceed smoothly. In a letter dated July 13, 1981 to the Reserve Bank, the Ministry of Finance forwarded a note, which prodded the Bank to take the matter more seriously. The note commented on the monetary situation as being 'far from satisfactory'; the slack season credit policy of May 25, 1981 did not have any effect on the banks' lending rates; SLR was kept unchanged at 34.0 per cent; and no change was made in the selective credit controls. The note observed that, considering the trends, the credit policy had to be made more restrictive, and M_3 and bank credit expansion should be maintained much below the 1980–81 levels.

The Reserve Bank had been thinking along similar lines, and had already increased SLR and tightened selective credit controls for advances against sensitive commodities even before receipt of the letter from the Government. The Finance Secretary suggested that the chairmen and

executive directors of the nationalised banks should be cautioned on the prevalent trends in credit expansion; this had already been done by the Bank. In a reply[6] to the Government, after detailing the various credit policy measures already taken, the Reserve Bank informed that a comprehensive review of the monetary and credit situation would be taken up again in October on the eve of the busy season.

The credit policy measures of October 15, 1981 did not stand out as a departure from the past. The Reserve Bank decided to make an indepth study for streamlining the instruments of credit control to make them more effective in the context of frequent breach of credit guidelines laid down by the Reserve Bank from time to time.

In the above context, one issue that was seriously examined was the feasibility of using a combination of the average and 'incremental' CRR. The point was whether it would be in order for the Reserve Bank to notify under section 42(1A) of the RBI Act, 1934 that an average daily balance should be maintained by banks till such time it equalled a specified percentage of deposits on a specified date. The Legal Department expressed the view that under the Act, there was no limitation on the powers conferred on the period for which the obligation to maintain additional average balance could be imposed and such an obligation could be terminated either through a separate notification or by specifying it in the initial notification. However, the proposal was not pursued as it was felt that the existing mechanism of maintenance of additional cash balances provided a powerful tool to expeditiously reverse any stringency by releasing a part of the additional cash balances. Moreover, it was feared that banks with faster deposit growth would be freed from the restraint of the proposed measure earlier than banks that posted slower deposit growth.

Another question was the need for the Reserve Bank to acquire more statutory powers to make the credit guidelines effective. In its credit policy announcements, the Bank was providing guidelines for the quantitative expansion of non-food bank credit. This, however, was advisory in nature and not mandatory. As a result, these tended to be ineffective and were biased against weak banks, which adhered to the guidelines. This was not

6. On the draft of the letter, which was to be issued under the signatures of the Governor, Dr I.G. Patel, he remarked that it would be 'good' if the concerned Executive Director sent the reply.

so in the case of CRR defaults, which attracted statutory penalties. So, the Reserve Bank wanted to arm itself with legal powers to impose financial sanctions as in the case of infringement of directives relating to bank credit. In an office note dated September 22, 1980, it was reasoned that "while reserve requirements are admittedly an efficient means of reducing the lending base of banks, credit ceilings or sub-ceilings with financial sanctions are particularly useful when the endeavour is not only to reduce total lending but to limit a portion of credit (*e.g.*, non-food credit or selective credit control items)."

A year later, the issue was revived. The CPC enquired with the Legal Department whether the prescription of financial sanctions for violation of credit ceilings was legally tenable and whether such sanctions could take the form of maintenance of non-interest bearing deposits with the Reserve Bank. The Legal Department opined in October 1981 that the act of fixing a ceiling limit for credit granted by a bank could not be construed as falling under the expression 'determination of policy on advances' under the Banking Regulation (BR) Act, 1949, but fell under section 35A, *i.e.*, 'the power of the Reserve Bank to give directions', and, as such, the Reserve Bank was empowered to fix ceilings on credit limits for each bank, taking into account relevant factors such as total deposits and advances granted earlier. If a bank violated the prescribed ceilings, it could be prosecuted under section 46(4) of the BR Act or, alternatively, the Reserve Bank could hold an enquiry under section 47A and impose a penalty under section 47A(1)(b). However, it was not thought to be in order for the Reserve Bank to direct the defaulting bank to keep amounts in the form of non-interest bearing deposits with the Bank, since the provisions of section 42 of the RBI Act could not be invoked to deal with contraventions of a direction issued under the BR Act. The Legal Department further clarified that under section 42, the Reserve Bank had the power to impound deposits, but impounding deposits could not be linked with the loans granted by a banking company. The matter was allowed to rest there.

The unexpected credit crunch at the beginning of the busy season in 1981 compelled the Reserve Bank to review the stance of credit policy. In the first week of November 1981, the banks found themselves in a liquidity bind, caused mainly by a perceptible slowdown in deposit accretion juxtaposed with the acceleration in demand for non-food credit. The Reserve Bank took recourse to moral suasion. The Governor in his letter

to banks dated November 6, 1981[7] pointed out that the banks would find it difficult to meet their reserve requirements as well as the seasonal increase in food credit, and they were strongly advised to maintain the enhanced cash reserve requirement from their own resources; for this purpose they were asked to undertake a 'serious and critical reappraisal' of their lending programme to ensure adherence to the May 1981 guidelines for non-food credit expansion. It was made known to the banks that in the event of non-compliance, the Reserve Bank would be compelled to act in the matter. A few months later, the Reserve Bank, however, had to concede some ground and make significant concessions since accretion to deposits during the year 1981–82 was expected to fall short of the previous year's growth.

By February 1982, there was a realisation within the Reserve Bank that insistence on adhering to increased CRR would merely result in CRR defaults. The option of allowing a more liberal use of the discretionary refinance facility to tide over the difficult liquidity position was considered, but the Reserve Bank was faced with the prospect of a large number of banks defaulting on SLR and CRR prescriptions for long periods. As a result, the Reserve Bank had to postpone the effective date of the last phase of CRR increase to 8.0 per cent from February 22, 1982 to April 30 (this increase was later rescinded on March 22). The Bank postulated in its circular that the policy of ultimate attainment of CRR at 8.0 per cent remained 'unaltered' and that if any bank failed to adhere to the stipulated CRR of 7.75 per cent, which became effective January 29, 1982, it could not escape penalties. The fact, however, was that the target of 8.0 per cent had to be abandoned. To ease the situation, the Reserve Bank provided substantial short-term refinance to banks on a selective and case-by-case basis, based on the overall resource position of the banks concerned, and the credit requirements of industries and vital sectors of the economy.

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7. "Banks that did not adhere to the credit guidelines would invariably face a resource gap and it is not intended to provide additional refinance from the Reserve Bank beyond already established refinance facilities. First, in the months that immediately followed, access to the commercial bills rediscounting facility will not be available. Second, the total amount of discretionary refinance which would be available for the system as a whole would be very limited and banks' access to this facility would only be under exceptional circumstances and for very short periods. I should also emphasise that banks whose credit expansion is clearly out of alignment with the guidelines would not be provided with discretionary refinance. The question of providing discretionary refinance merely to enable the banks to meet the enhanced cash reserve and statutory liquidity requirements does not arise. Essentially, therefore, banks would be required to finance their commitments out of their own resources."

Despite these efforts, there were no indications of a sustained pick-up in deposits and the banking system was faced with severe resource stringency. Banks were unable to fully meet the busy season credit demands and there were sizeable and widespread defaults in CRR maintenance in the quarter January–March 1982. The Reserve Bank was thus placed on the horns of a dilemma. While there was a strong need for restraint in the situation of declining deposit growth, the policy options open to the authority to increase availability of credit were limited. Nevertheless, within the possible scope for manoeuvrability, policy changes were made to increase the flow of credit. In a communication to banks dated March 22, 1982, the Reserve Bank advised that after assessing the trends, it had decided to rescind the final phase of CRR increase by 0.25 per cent; banks were to make judicious use of the eased constraint on resources implicit in this decision; and the Bank hoped that this step would help the banks meet the credit requirements of seasonal industries and other vital sectors, particularly exports. In April 1982, the Reserve Bank noted that the banking system as a whole had adhered to the non-food expansion guidelines set out in May 1981, but it was not before it had passed through a severe liquidity bind.

The concerted action by the Reserve Bank and the Government yielded results. Inflation between March 1981 and March 1982 was 2.6 per cent, while M_3 expansion was only 12.5 per cent in 1981–82 against 18.5 per cent in 1980–81, *i.e.,* one of the lowest recorded in the history of independent India. However, the foreign exchange assets held by the Reserve Bank in 1981–82 declined by ₹ 2,087 crore and offset a major part of the sharp increase in Reserve Bank credit to the Government during the year.

INCREASE IN DEPOSIT RATES AND GOVERNMENT'S CONDITIONAL APPROVAL

The rates of interest on term deposits of less than three years with banks were revised upwards in March 1982 to align short-term deposit rates with those of longer maturities and thereby smoothen the maturity pattern. The proposal was initiated by the Reserve Bank and, on receiving the approval of the Government, the decision was announced to synchronise with the budget proposals.

What invested this exercise of a routine nature with special importance was the intent of the finance ministry from a fiscal point of view. The Reserve Bank forwarded to the Government the proposal for revision of interest rates on term deposits of shorter maturities because the share of short-term deposits in total deposits was declining and this trend had to

be checked. The rates proposed by the Reserve Bank gave a lower return than the Treasury Bill rate up to a duration of 90-day deposits, but the rate for deposits from 91 days and above was to be somewhat above the Treasury Bill rate. The Bank in a communication dated February 4, 1982 to the finance ministry sought the Government's approval and also enquired whether the changes should be made immediately or simultaneously with the presentation of the central budget.

The Government, while basically agreeing with the proposals, had other views. In a letter dated February 14, 1982 addressed to the Governor, the Government conveyed the approval of the Finance Minister to the changes and advised that the announcement could be made by the Reserve Bank immediately after the Finance Minister presented the budget. The letter added that the Finance Minister had also approved a proposal in the report of the working group on foreign remittances into India by Indian nationals resident abroad and foreign nationals of Indian origin that deposits with maturities of one year and above held in the two non-resident external (NRE) accounts should carry interest at 2.0 percentage points above the rates on local currency deposits of comparable maturities. The higher rate was to be made applicable only to fresh deposits and on renewals of maturing deposits.

The officials of the finance ministry were cognisant of the reservations of the Reserve Bank in this regard and suggested that the Government should subsidise to the banks the extra cost they would incur in paying additional interest on this account; the Finance Minister, however, did not favour payment of the proposed subsidy but agreed to the banks being compensated by a somewhat higher return on government securities held by them under SLR. The Governor, Dr I.G. Patel's noting on Government's letter read: "Please see what follow up action is necessary. I tried to reopen the idea of going all the way. But the Economic Secretary was not prepared to change his view and the F.M. thought, let us see how far the present proposal works. We may have to be clear about what government would do [compensating by a somewhat higher return on government borrowings under SLR] and whether we should also in any case raise the return on impounded reserves."

On February 27, 1982, after the presentation of the Union Budget announcing the decision to increase deposit rates, the Reserve Bank followed suit. Besides the increase in domestic deposit rates, the interest rates for deposits of one year and above under the foreign currency non-resident accounts (FCNR) and the non-resident (external) rupee accounts

(NR(E) RA) schemes were enhanced as proposed by the Government. The Government on its part kept its word and later raised the coupon rates on government securities.

CREDIT POLICY FOR THE FIRST HALF OF 1982–83

Financial year 1982–83 started with a persistent and pronounced sluggishness in deposit growth, the continued failure of many banks in meeting their reserve requirements and strong credit demand for productive purposes. Food credit was expected to rise sharply to accommodate *rabi* procurement operations by the end of June 1982. The CPC came to the conclusion that in the critical phase covering seven weeks from about the second week of January 1982 to the third week of February 1982, a high level of non-food credit expansion had been sustained by banks, despite a substantial decline in deposits and the absence of return flow of food credit. This meant that banks had ceased to regard CRR pre-emption as the first claim on their resources. This impression of the erosion of the sanctity of CRR was strengthened by widespread defaults that took place towards end-December 1981. However, the policymakers took the pragmatic view that a downward adjustment was necessary to restore normalcy in banking operations and a degree of reasonableness in the maintenance of CRR levels.

The emphasis of credit policy for April–July 1982 was to ease up slightly. CRR was reduced from 7.75 per cent to 7.25 per cent from April 9, 1982 and the additional interest charge applicable on refinance of 3.0 per cent levied on shortfalls in reserve requirements during the period January 1–June 25, 1982 was waived. The Reserve Bank undertook to purchase securities on a buy-back basis to help banks that were facing temporary liquidity difficulties. Some banks with an excess position in their SLR but defaulting in CRR maintenance were permitted to sell certain securities to the Reserve Bank on the understanding that they would repurchase them within the stipulated time after making a correction in their reserve position. Such operations were later used by the Reserve Bank as buy-back arrangements to ensure the success of the Government's borrowing programme. The main objectives of the macro-monetary regulation was to help banks hold excess liquidity in a more remunerative manner and at the same time conserve their resources to meet the larger credit demands expected to arise during the second half of the year. The Reserve Bank, in its circular to banks in April 1982, stressed that the primacy of reserve requirements should be seriously accepted and the sanctity of CRR/SLR

should be made inviolate. No guidelines for bank credit expansion in the financial year 1982–83 were considered necessary at that stage. The minimum CRR of 3.0 per cent was made applicable for deposits under the NRE scheme from April 9, 1982. Banks were asked to eschew excessive reliance on volatile money market funds, especially in the context of the liquidity bind that they experienced and were cautioned that banks which chronically continued to rely on large money market borrowings — other than for occasional periods and for marginal amounts — would not be provided refinance when money market sources became unavailable.

The situation at the end of June 1982 required a judicious combination of policies. On one hand, there was a potential for further expansion in liquidity because of the increase in reserve money in the first quarter of the financial year 1982–83 and, on the other, the Reserve Bank did not want banks to slowdown too much. There were indications of a somewhat lower growth of real national product in 1982–83 than that in 1981–82. Although the rate of inflation continued to be low, there were signs of a possible uptrend, and trends in non-food credit had been punctuated by large and volatile swings with no discernible clear movement.

CRR was reduced from 7.25 per cent to 7.0 per cent from June 11, 1982 and food credit refinance was liberalised. With the banks having rectified their CRR defaults by the end of April 1982, the Reserve Bank hoped that any defaults in SLR too would be rectified without further delay and, in any case, by the end of June 1982, normalcy in banking operations would also be restored. The Reserve Bank also liberalised credit guidelines for 1982–83.

For the banking system as a whole, the expansion in non-food credit was estimated to grow at the same rate attained in 1981–82, *i.e.*, 16.8 per cent or, in absolute terms, a growth of ₹ 4,600 crore. Each bank was advised to modulate its credit growth in consonance with its resources growth and the demand for its credit. Certain changes were made with regard to banks' access to the Reserve Bank to assist them in their fund management. The banks had represented that even in the case of small defaults, they lost interest income on the entire cash balances and a scheme of graduated penalties was introduced in cases of small involuntary defaults by banks in the maintenance of CRR retroactively from January 1, 1983. The conditions applicable for stand-by refinance facility were liberalised to permit banks with sustained excess liquid assets to borrow more freely against the collateral of government and trustee securities. The cut-off point for working capital limits under the credit authorisation scheme

(CAS) for private sector borrowings was raised from ₹ 2 crore to ₹ 3 crore.

CRR REDUCTION IN JUNE 1982 AND THE ATTENDANT IMBROGLIO

The Reserve Bank reduced CRR from 7.25 per cent to 7.0 per cent on June 11, 1982 to ease the liquidity position of banks. Deposit growth showed some improvement, but was still considered uncertain. The Reserve Bank unexpectedly faced criticism from the Government, including the Prime Minister. The Governor, Dr I.G. Patel, much later, elaborated:[8]

> As part of a periodic review of credit policy, I had on one occasion reduced the cash-credit ratio for banks by 0.25 per cent to enable banks to meet the legitimate needs of the public and private sectors as we saw them. This released some Rs. 500 crore to the banks for further lending. After all, credit policy was always not to be tightened; it could be relaxed also; and the CRR was not a mechanism for raising money for the Budget. But at a meeting of the Planning Commission where the Prime Minister and the Finance Minister were present, this step was criticised and it was alleged that I have gifted Rs. 500 crore to the private sector at a time when the Government was finding it difficult to raise resources for the Plan.
>
> The Economic Secretary, Ram Malhotra, told me later that the Prime Minister had asked for the Ministry's explanation; but she was not satisfied, and he asked me to see the Prime Minister's Secretary, Shri P.C. Alexander. I saw him and explained the rationale for my action and the point that more than half the additional credit was intended for the public sector, especially oil, so that the charge of favouring the private sector was patently absurd. I could understand the argument that the credit situation was not such as to require reduction. These are matters of judgment. But to say that I helped the private sector was a loaded statement. Eventually, I was asked to explain my action in writing, the only time in my long career that I was asked to do so.[9]

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8. Patel, I.G. (2002). *Glimpses of Indian Economic Policy: An Insider's View*. New Delhi: Oxford University Press.
9. Dr I.G. Patel relinquished the office of the Governor on September 15, 1982.

ECONOMIC GROWTH OVERSHADOWED BY INFLATIONARY CONCERNS
(OCTOBER 1982–83, 1983–84, AND 1984–85)

The change of guard at the helm of the central bank did not immediately usher in any significant change in the stance of monetary policy. When the busy season policy review was taken up in October 1982, the prospects for the year were a slowdown in economic growth and subdued demand for commercial bank credit. A stimulus had to be provided to vital sectors of the economy that had been affected by sluggish demand. Accordingly, credit policy sought to assist the fuller utilisation of available capacities without allowing the revival of inflationary expectations. To attain these objectives, credit policy measures were devised in October 1982, including realignment of deposit rates of various maturities. Measures were also introduced to enhance the banks' ability to increase export credit without any constraints and to stimulate investment in capital and intermediate goods. Accepting a recommendation of the working group on deposits, a new category of deposits of five years and above, carrying an interest rate of 11.0 per cent, was allowed to be opened from October 26, 1982.

At the customary credit policy meeting with the chief executives of banks held on October 25, 1982, the Governor, Dr Manmohan Singh, stressed that the operations of banks during the ensuing busy season should be so modulated that their lending was met out of their own resources and there was an effective deployment of credit to provide stimulus to vital sectors of the economy without fuelling inflationary expectations and speculative inventory build-up. Credit policy, the Governor observed, must assist in fuller utilisation of available capacities and in promoting savings and the growth of exports. He added that there was scope for expanding bank credit to meet the genuine productive requirements of the economy, but it had to be a 'carefully controlled' expansion that took into account the broader national priorities and the need for continuing vigil against the resurgence of inflationary forces. More significantly, he postulated that while there was no need for apprehension of any credit squeeze, credit discipline needed to be observed.

The guidelines for non-food credit expansion announced in July 1982, envisaged the emergence of a modest resource gap in the forthcoming busy season, and to the extent that genuine credit requirements warranted the need to supplement the resources of banks, the Reserve Bank was prepared to bridge the resources gap suitably. Based on the credit trends in the first half of 1982–83 as well as detailed sectoral demand estimates, the Bank

was of the view that non-food credit requirements in the full financial year would be substantially below the guidelines indicated in July 1982 of an expansion of non-food credit in the entire year of ₹ 4,600 crore, which would be well within the capabilities of the resources of banks. The Reserve Bank made it known that the need to bridge the resource gap did not arise and that banks should effectively observe the broad parameters set out in the credit budget discussions with the individual banks.

There was disappointment in business circles that the Reserve Bank had not reduced the lending rates despite a slowdown in the inflation rate. The Governor, Dr Manmohan Singh, in his inaugural address at the seminar organised by the Maharashtra Economic Development Council, Bombay (now Mumbai), on November 18, 1982, clarified that in evolving the interest rate structure, the Reserve Bank had taken care to insulate as far as possible the interest rate on term loans for capital investment from the effects of the hike in short-term interest rates. Moreover, even though the maximum ceiling rate charged by banks was 19.5 per cent, the weighted average rate of interest earned by banks on their advances portfolio was no more than 12.0–13.0 per cent. "I venture to think that highly concessional rates applicable to export finance and for purchase of tractors and commercial vehicles have beneficial effects on suppliers of these goods who happen to be in the large-scale sector."

The Governor also reflected on the perception among large and medium industries in the private sector that there had been a progressive decline in their share of total bank credit. He pointed out that over the years, as the share of the public sector in production increased, the relative share of private sector industry in bank credit was bound to fall; the growing commercialisation of agriculture and its increasing dependence on expensive inputs such as fertilisers and pesticides meant that the credit needs of farmers for working capital would increase; small scale, dispersed and decentralised industrial development could result in a multiplier effect on the growth of the regional economy and, as such, deserved all encouragement, particularly because they did not have access to sources of funds such as company deposits, debentures or even credit extended by their suppliers and associated concerns. To quote, "Thus, preferential treatment accorded to agriculture, small-scale industry and the hitherto neglected sectors in the allocation of bank credit serves the cause of both growth and greater equity."

The low level of inflation in the last quarter of 1982–83 induced the Reserve Bank to look at the lending rates of banks, which at the maximum was 19.5 per cent. A reduction in interest rates on deposits was ruled out because of the overriding objectives to mobilise savings and to protect the profitability of banks. A composite package was therefore announced in February 1983 involving a reduction of lending rates by 1.5 percentage points at the maximum and correspondingly smaller reductions at lower ranges, effective April 1, 1983, along with the halving of the tax on interest income of banks from 7.0 per cent to 3.5 per cent by the Government, an increase in interest paid on banks' eligible cash balances with the Reserve Bank in May 1983, and an increase in the coupon rates on government and other approved securities in May 1983. The revised interest rate structure (in which the maximum lending rate was 18.0%) was expected to stimulate growth of real output by providing relief to a wide spectrum of borrowers, including large and medium industry and exports. It was only through a blend of these measures that it was possible to reduce the lending rates. This experience pointed to entrenched rigidities in the system and highlighted the need to develop a measure of flexibility in the interest rate structure.

As the Governor settled in, he received representations from the Government, *i.e.*, the finance ministry and Ministry of Industry, Steel & Mines, to increase credit flow for purchasers of commercial vehicles and tractors. The finance ministry, addressing the issue in a letter dated September 27, 1982, advised that manufacturers of commercial vehicles were complaining that prospective purchasers were not being provided sufficient credit by the banks, which had resulted in a huge pile-up of inventories and production cut-backs with harmful effects on ancillary units. He wanted the banks to provide financial support to hire-purchase companies set up by the manufacturers. According to the ministry, banks were reluctant to lend for commercial vehicles because the interest rate on such loans was rather low; also, the Finance Minister felt that the interest rate could be raised from 12.5 per cent to 15.0 per cent and should also be applied to the purchase of tractors. The Finance Secretary added that he proposed to send a separate 'formal communication' to the Reserve Bank in this matter.

In this connection, a copy of the letter written by the Minister for Industry, Steel & Mines to the Finance Minister in August 1982 urging the grant of relief to tractor and commercial vehicle manufacturers by removing the restrictions on disbursal of credit was also sent to the Reserve Bank. Separately, the Heavy Industries Secretary made a forceful

representation to the Governor to make suitable recommendations to the Finance Minister in the new credit policy. The Reserve Bank, taking note of these representations, announced in the credit policy of October 25, 1982, some measures to assist these sectors in generating greater demand for their products, namely, a reduction in the margins on tractor and truck loans from 25.0 per cent to 15.0 per cent and providing the Industrial Development Bank of India (IDBI) with substantial additional resources so that the state electricity boards (SEBs) and the state road transport corporations (SRTCs) were sanctioned additional limits that enabled them to purchase capital and intermediate goods and vehicles. In addition, the Governor in his meeting with the chairmen of banks impressed upon them to take a broader view and extend adequate credit to enable the purchase of multi-axle vehicles. While conveying these measures, the Governor expressed the hope that these would provide the necessary stimulus to the two sub-sectors:

> During the year, the thrust of anti-inflationary policies were both on demand and supply sides. Public food grain stocks were augmented by timely imports. The growing capability of the public distribution system in distributing essential commodities also played an important role in maintenance of relative price stability. These efforts were supported by the deflationary effect of continuous decline in net foreign exchange assets of the banking sector.

The Reserve Bank in the Annual Report for the year 1982–83 articulated its views on the effectiveness of monetary policy in the efforts towards control of inflation, which anticipated the introduction of monetary targeting mechanism later. These tenets and guiding principles are relevant even in the present time, and hence are quoted *in extenso*:

> Another concern that may be of relevance not only for immediate future, but also over the next several years relates to inflation and its control. It is now well recognised that inflation is a phenomenon that is hardly conducive to economic growth. The option of 'living with inflation' is no longer seen as an option. Also, the control of inflation becomes a necessity if viability of balance of payments, in particular, the competitiveness of our exports, is to be maintained. Hence, the relevant question now is that of appropriate dimensions of anti-inflationary policy. Regardless of the nature of inflation,

> whether it is primarily demand-induced or whether the cost-push factors are more significant, an important element of policy is the control of monetary expansion. If the goal sought to be achieved is one of price stability, obviously, the rate of growth of money and credit over any period of time cannot be far out of line with the increase in real output. However, as a matter of practical policy, a view can be taken of the desirable degree of overall expansion, taking into account not only the growth in real output but also some acceptable degree of increase in price level. Since the process of money creation is also a process of credit creation, it is not enough to determine by how much money supply can increase; it is equally necessary to determine how the credit will be allocated among the different users. Therefore, once a view on the desirable expansion is taken, the users of credit both in the Government and in the commercial sectors would have to be subject to the inescapable discipline of minimising the increase of credit and of maintaining total expansion within the limits set. It is only under such conditions that money supply becomes an aggregate truly under the control of the monetary authority.

With the resurgence of inflationary tendencies during 1983–84, the control of liquidity once again gained primacy among the objectives of monetary policy. The dilemma for policymakers was that despite a good *rabi* crop in 1983 and an equally good 1983–84 *kharif* crop, prices had risen sharply, whereas industrial growth was sluggish throughout the year. Monetary expansion was perceptibly larger than envisaged. In 1983–84, there was no credit ceiling for the full financial year, but a target for monetary growth and the liabilities of banks was implicit. The Reserve Bank's perception was that liquidity growth in 1983–84 had to be contained to a rate somewhat lower than that in the previous year.

There was strong economic recovery in 1983–84 led by large agricultural production, even though industrial production was slow. The national income was expected to rise by about 8.5 per cent as compared with an increase of less than 2.0 per cent in 1982–83. The country's BoP, which was under severe strain in 1980–81 and 1981–82, began to improve in 1982–83. The period 1983–84 saw a narrowing of the trade gap and an increase in the flow of remittances from Indians residing abroad. Still, the price level continued to be a cause for concern. An unusual feature of the price rise was that it was concentrated in a few commodities, namely, *gur*, oilseeds,

edible oils, pulses, milk and milk products, and tea. Excess liquidity in the system caused by rapid growth in primary money did not help matters. On the supply side, incentives were offered to stimulate production in critical areas and steps were taken to expand the public distribution system (PDS) to ensure that essential commodities were available at reasonable prices. Steps were taken to reduce government expenditure wherever possible. Fiscal policy was geared to support rapid economic expansion in anticipation of a normal crop and resumption of economic growth. On the demand side, monetary policy focused on mopping up excess liquidity in the banking system.

In a memorandum to the Central Board of Directors dated September 27, 1983, the main challenges for the Reserve Bank were succinctly spelt out. A careful watch had to be maintained on the price front and, in modulating the growth of money and credit to meet the evolving situation, the objective was to regulate the quantum of liquidity in the system so as to keep inflationary expectations under control while facilitating full realisation of the productive potential of the economy.

The Reserve Bank initiated a series of fine-tuning measures. CRR was increased from 7.0 per cent to 8.0 per cent to be achieved in two equal phases from May 28 and July 30, 1983 for better control over short-term liquidity. The cut-off point for food credit refinance was also raised. These changes were justified by the Governor in his letter to banks dated April 30, 1983, *viz.*, "The quintessence of credit policy is its ability to react expeditiously to short-term changes in economic situation."

Even after the first phase of inclusion of accrued interest liabilities for the purpose of maintaining the statutory reserves, there was no let-up in the growth of excess liquidity in the banking system. To achieve an efficacious smoothening of liquidity, CRR was successively raised to 8.5 per cent on August 27, 1983, and further to 9.0 per cent on February 4, 1984. The expansion of reserve money and deposit growth continued to be large and the price situation was still worrisome. Besides, the steep rise in Reserve Bank credit to the Government imparted a strong expansionary impulse during the second half of the year.

The second half of 1983–84 witnessed strong growth in bank deposits from the beginning of the year, while credit expansion, though larger than in the previous year, was moderate. This meant that the banking system was well positioned to fully meet genuine productive demand during this period from its own resources along with the drawdown of the excess liquidity built in the first half of the year. Therefore, no major changes in

credit policy were contemplated at that point of time (*i.e.*, October 1983) except for changes in the base period for food refinance facility and some liberalisation in export credit refinance.

In November 1983, the Reserve Bank realised that the banking system had considerable excess liquidity. Therefore, it imposed an incremental CRR of 10.0 per cent against deposits accruing from November 11, 1983, avoiding an increase in CRR because banks other than the State Bank of India (SBI) had unutilised refinance facilities, which could be drawn upon in case of need. It was feared that an increase in CRR might not achieve the desired results, and instead the banks might experience liquidity pressures.

By January 1984, the Reserve Bank concluded that the growth of reserve money continued to be strong. During 1983–84, it was almost twice as large in absolute terms as the increase in 1982–83 and the inflation rate (on a year-to-year basis) was well over 10.0 per cent. This forced the authorities to further immobilise the excess liquidity present in the system. CRR was enhanced to 9.0 per cent on February 4, 1984. Even so, the overall inflation for the whole year was high at 9.5 per cent, with M_3 going up by 17.9 per cent. But from this point on, the Reserve Bank became circumspect in its recourse to reserve requirements despite the presence of excess liquidity, because it did not wish to hamper growth. The next increase in CRR was made about three years later, *i.e.*, on February 28, 1987.

The Reserve Bank noted the link between fiscal and monetary policy in its Annual Report for 1984–85 thus: "While careful supply management could help, aggregate demand is a critical factor in the short run in the management of prices. In view of the direct bearing that fiscal deficit has on reserve money, and hence on money supply, co-ordination between fiscal and monetary policies is imperative if money supply growth is to be kept within limits and price stability is ensured with a view to facilitating growth with equity."

An important decision taken at this juncture was the complete abolition of the tax on interest income of banks and financial institutions (FIs). A 7.0 per cent tax on interest income had been imposed in the budget for the year 1980–81, which was reduced to 3.5 per cent in the budget for 1983–84 and, consequently, the lending rates of banks came down from April 1, 1983. In his letter dated January 19, 1984 to the Finance Secretary, the Governor wrote that "interest rates on bank advances are essentially a monetary instrument" and, hence, it would be advisable to keep these rates separate and distinct from fiscal measures and thus impart greater flexibility in the determination of lending rates. He pointed out that the

banking system was not in a position to bear the cost of reduction in lending rates without a corresponding reduction in deposit rates, which in any case was not feasible. He recalled the statement made in the Finance Minister's budget speech for 1983–84 that about half the loss on account of the reduction in interest tax could be recouped by additional tax revenue as a consequence of the lower deductible cost of borrowing to business and industry, and argued that a complete withdrawal of tax would also benefit public sector enterprises, thereby imposing a lower financial burden on the Government. The tax was abolished in the Union Budget for 1985–86.

The inflation rate in 1983–84 was nearly 9.0 per cent, and the main reason was the lagged effect of the previous year's drought, despite a growth in real income of around 7.0 per cent. The overall growth in M_3 in 1983–84 at 17.0 per cent was considered to be uncomfortably high and the increase in reserve money was also substantial. The tentative assessment was that the year could turn out to be a difficult one for monetary management. However, there were some bright spots, namely, an unprecedented level of food stocks with the PDS and a comfortable level of foreign exchange reserves, both of which were vital to maintain price stability. The recent fiscal reforms, relaxations in industrial licensing and import procedures, and the sustained growth of the capital market were expected to accelerate investment in the economy.

The Deputy Governor conceptualised the policy compulsions in his office note dated April 16, 1984 as follows:

> We need to work within the framework of an increase of M_3 by 15 per cent. Finance Secretary told me that he would be willing to abide by the restrictions on bank credit to Government that would flow as a consequence. This is his response to our fears that the budget implies a very heavy dependence on bank credit, particularly Reserve Bank credit.
>
> However, an increase of 15 per cent in M_3 would imply that non-food credit expansion by scheduled commercial banks in 1984–85 even in absolute amount would be no higher than what it was in the previous year. Partly this is caused by a contemplated increase in SLR by one percentage point. However, the situation in the first half of the year may not be difficult. We may have to watch how demand for credit picks up in the busy season. At that stage some relaxation, if necessary, may have to be thought of.

Faced with the prospects of rapid liquidity expansion, a significant rise in reserve money creation and about 9.0 per cent rise in wholesale prices during the previous year; the Reserve Bank felt that a deceleration of the rate of growth in M_3 and of primary money creation should be an important objective of monetary policy during 1984–85. Further, it was crucial that public sector investment proceeded smoothly during the year, as it was the final year of the Sixth Five Year Plan. The Reserve Bank perceived the issue thus: "In the overall milieu of scarce resources, rationing of available resources is an inescapable necessity. Given the national priorities and the needs of essential public sector investments, and given the large share of bank deposits as between claims of different sectors, such rationing has to be done."

Accordingly, in the slack season policy, SLR was raised from 35.0 per cent to 36.0 per cent in two phases (*i.e.,* 35.5% from July 28 and 36.0% from September 1, 1984). This was expected to regulate liquidity in the first half of the financial year as also provide resources for vital public sector investments without generating primary money. The Reserve Bank also offered to provide discretionary refinance on merit for short periods to banks that needed such assistance to enable them to adjust to the higher reserve requirements.

The Governor, in his credit policy circular to banks, highlighted the rationale behind the stance of credit policy as follows:

> …it is essential that in the interest of orderly economic management and reasonable price stability, a deceleration of the rate of growth of money supply, overall liquidity and of primary money creation is regarded as an important objective of economic policy during 1984–85.
>
> In formulating credit policy for the coming season, we have to pay balanced attention to all these considerations, often conflicting with one another, which have a bearing both on overall growth of the economy and the climate for economic stability…In the light of the uncertainty associated with weather conditions, the fiscal outlook and the balance of payments outcome, there can be no relaxation of credit discipline. Banks must ensure that bank credit finances only those productive ventures that effectively add to domestic productive capacity and productivity.

In the second half of the year, after a review and in anticipation that the banking system might experience a resource constraint, the Reserve Bank released in two equal instalments, one-fifth of the cash balances maintained under the 10.0 per cent incremental CRR as on October 31, 1980. This helped banks plan their resource allocation in a smooth manner before the onset of the 1984–85 busy season. But even after providing for the enhanced requirements, the excess liquidity was large. The proposed releases of impounded cash balances were postponed by one month to October 27 and December 1, 1984, respectively. However, since the spread of excess liquidity in the banking system was skewed, the Reserve Bank had to provide discretionary refinance for short periods to those banks which faced liquidity constraints.

The main tools of credit control deployed were the reserve ratios, refinance arrangements and selective credit controls. Unlike in 1983–84 when the main emphasis was on CRR as a control tool for reserve money growth, during 1984–85 greater reliance was placed on SLR, which was raised in a phased manner from 35.0 per cent to 36.0 per cent and further to 37.0 per cent by July 6, 1985. While SLR was traditionally considered as an instrument for allocation of credit between the public and private sectors, it had the advantage of minimising the expansionary impact of fiscal operations on the growth of reserve money. These measures, supplemented by those taken in the previous year, resulted in limiting the expansion in reserve money. During the Sixth Plan period, the annual rate of increase in national income was 5.3 per cent, in M_3 16.9 per cent and in prices 9.3 per cent.

Credit policy issues were becoming increasingly complex and reserve requirements were losing their potency. Both CRR and SLR were at historically high levels. Over time, the in-built operational constraints had also developed, which affected their efficacy. The average effective CRR was around 12.5 per cent and the ratios for individual banks were divergent (because of the application of incremental CRR); for some banks, the average was as high as 14.0 per cent, whereas by statute the ceiling was 15.0 per cent. The memorandum to the Central Board of Directors of the Reserve Bank of India dated January 24, 1985 advocated urgent attention: "For the rationalisation of CRR to be a practical possibility, it should be supportive of the overall thrust of liquidity management and as such the appropriate timing of any rationalisation of reserve requirements needs to be carefully worked out." From the second half of 1984, the Reserve Bank

started paying greater attention to 'working estimates' for deposit growth as an indicator to assess the need for policy response.

After the presentation of the Union Budget for 1984–85, the perception of the Reserve Bank was that the growth in M_3 for the year would be a little higher than 18.0 per cent if the policies remained unchanged. This order of monetary expansion was perceived to be uncomfortably high as it could jeopardise price stability. Since the real economic growth rate worked out to be not only significantly lower than in the preceding year but also well below the average rate of the previous four years, the Reserve Bank decided to target a lower rate of M_3 growth of about 15.0 per cent which, when translated into increases in its components on a consistent basis, yielded a net addition to deposits of ₹ 9,600 crore (or 15.8%) for scheduled commercial banks (SCBs). The working estimate of M_3 expansion of ₹ 13,000 crore (or 15.0%) also tied up well with the estimated reserve money expansion of ₹ 4,000 crore in the sense that the value of 3.12 for the incremental money multiplier was fairly close to its value based on outstandings for end-March 1984. To bring about the desired reduction in the pace of monetary expansion from around 18.0 per cent to 15.0 per cent, measures were taken in April and September 1984.

In May/June 1984, the Reserve Bank and the Ministry of Finance agreed that the overall growth of M_3 in 1984–85 should not exceed 15.0 per cent, as was evident from the exchange of letters between them. One of the critical assumptions in the exercise was that the decline in net foreign exchange assets would be of the order of ₹ 900 crore, a figure that was indicated by the Government at the time of the discussions to finalise the market borrowing programme. As a corollary, the increase in net bank credit to the Government was fixed at ₹ 6,000 crore. It was recognised that if the decline in net foreign exchange assets turned out to be lower, monetary growth could be contained within 15.0 per cent only if domestic credit expansion was lower than envisaged and inevitably such an adjustment would have to be borne 'proportionately' by the Government and the commercial sector. On its part, the Reserve Bank was hopeful that the drawal of refinance by commercial banks (which had been factored into the projections) could easily be curtailed and the release of impounded balances modified in accordance with the changed requirements. Initially, the Reserve Bank was in favour of showing the projections with a decline in net foreign exchange assets of ₹ 900 crore. With this strategy in mind, the Bank apprised the Government of its views along the lines approved by the Governor:

> We should also indicate to the Government that these projections are based on the Government's assessment as conveyed to us that the net foreign assets will decline by Rs. 900 crore. If the actual trend is not consistent with this assumption, the Government should so plan its operations that net bank credit to the Government does not increase by more than Rs. 5,700 crore over the year as a whole. It is too much to expect that the credit policy and bank credit to the commercial sector can bear the entire burden of adjustment to the behaviour of foreign exchange assets not consistent with the assumption of a draw-down of Rs. 900 crore in foreign assets.

In a letter dated June 6, 1984, the Ministry of Finance conveyed the Government's decision "to review the expansion in money and credit on a continuous basis keeping in mind the overall objective of 15 per cent growth in M_3", instead of relying on end-September and December ceilings. Further, the Government proposed to estimate a series of monthly reference points regarding tolerable levels of credit expansion.

Accordingly, both the Reserve Bank and the Government decided to monitor, in tandem, the monetary and banking trends. In this regard, the Government took the initiative. In a communication dated July 26, 1984, the finance ministry advised that based on their internal review of monetary and credit developments in the first quarter of 1984–85, part of the rise in prices up to July 14 could be traced to seasonal pressures, and that the rate of increase from June onwards, even after adjusting for seasonality, was disturbing and warranted a close watch on all fronts. The letter continued that the Government had initiated a review of budgetary developments and proposed to take serious measures to keep the budgetary situation under reasonable control. The finance ministry suggested that the Reserve Bank might wish to keep under review the decision to release one-fifth of the additional cash balances under the 10.0 per cent incremental CRR at end-September and October; the Bank was requested to consider additional measures at that stage and further that the finance ministry looked forward to the Reserve Bank's advice in the matter. This was followed by another letter dated July 31, 1984, referring to a letter from the Reserve Bank regarding the expansion of net bank credit to the Government up to end-June 1984. After affirming that the Government was keeping a close watch on movements in money and credit and was willing to take any steps to keep the budgetary situation under 'reasonable control', the ministry clarified that the expansion of net bank credit to the Government

up to end-June 1984 was to some extent inflated by the exceptionally large disinvestment of government securities (about ₹ 700 crore) by FIs, which were in all probability picked up by commercial banks. Further, in view of the many uncertainties, the most appropriate action would be to review the budgetary prospects to ensure that budgetary developments remained in line with the overall objective of keeping M_3 growth at around 15.0 to 16.0 per cent and the Government would be in a better position to judge the need for mid-course correction in September, when the harvest prospects were better known and the assessment of tolerable levels of M_3 growth could be reviewed in the light of price behaviour. As in the earlier case, the ministry requested the Governor to advise if any additional or specific measures were to be taken by the Government at that stage.

The Reserve Bank, on its part, after a periodic review of the monetary situation in the middle of August 1984, decided to maintain the *status quo.* In fact, the Governor had drafted a letter to the Finance Secretary to the effect that no action was deemed necessary but the situation was being kept under continuous review. In the meanwhile, however, the Governor and the Deputy Governor discussed the matter with the Finance Secretary and Special Secretary, and it was decided to watch the situation for another two to three weeks before taking any action.

The basic thrust of the credit policy for the second half of 1984–85 was to ensure that the overall increase in liquidity and the reserve money growth were kept at a level well below that of 1983–84. The Reserve Bank impressed upon banks to consider the reserve requirements as mandatory and adhere to these as commanding unquestioned primacy in their operations. Thus, the stance of credit policy was one of caution while being flexible enough to meet changing situations.

ECONOMY ON A NEW GROWTH PATH
(1985–86 AND 1986–87)

In the context of implementation of the recommendations of the Chakravarty Committee, monetary and credit policy was gradually reframed and interconnected with the fiscal policy. The Reserve Bank regained its primacy in formulating and administering monetary and credit policy. The contours of banking reforms, which occupied the centre stage in the early 1990s, were visible from the second half of the 1980s.

DECISION ON INTEREST RATES

Two major policy issues were awaiting decision at this stage. The first was the Government's keen desire to reduce the general level of interest rates and the other related to measures to check disquieting trends in the monetary and banking situation. At a meeting convened in New Delhi on January 17, 1985 by the Finance Secretary, to discuss the market borrowing programme of the Central Government for the year 1985–86, both the Finance Secretary and Special Secretary, and Chief Economic Adviser strongly advocated a reduction in both bank deposit and lending rates to be made simultaneously. The Deputy Governor, however, expressed reservations that at that point it was still not very clear whether inflation as viewed over a period of two to three years had really come down substantially. He reasoned that any reduction in the interest rate on deposits without a reduction in the rates on other financial assets, such as the national savings certificates (NSCs) and company debentures would have serious repercussions on the growth of bank deposits. It was recalled that this had happened in 1981–82 when deposit growth of banks was adversely affected when the NSC at 12.0 per cent for six years was introduced, and the maximum interest rate offered by banks was only 10.0 per cent. The finance ministry officials responded that they were simultaneously thinking of removing interest rate ceilings on all other saving instruments. In the meanwhile, however, the Government wanted the Reserve Bank to consider the proposal.

The issue was deliberated upon by the Reserve Bank top management. The Governor, Shri R.N. Malhotra, who took over in February 1985, fully concurred with the view that taking into account the fact that a major portion of bank deposits was in the category of 3–5 years made the case for immediate reduction of deposit rates far from strong. "The growth of liquidity in the economy in the last two years has been very high and we should not reduce the effectiveness of interest rates as an instrument of monetary control", he noted. The Governor felt that theoretically there could be a case for greater flexibility in interest rates but this would have to be examined in depth in the Indian context. Dissenting from the views of the finance ministry, he recorded that he was all for raising short-term deposit rates, which would bring about more rationality in the rate structure and improve the composition of short and medium term deposits with banks, with a beneficial impact on the cost in mobilising deposits. He appreciated the stand taken internally and recorded: "It is indeed a good beginning

that the Reserve Bank should take a bold stand different from that of the Government, based on sound reasoning and logic."

The Reserve Bank, on its own, reviewed the possibility of reducing the maximum bank lending rate and concluded that, against the background of the deceleration in the inflation rate, there was indeed a case for reducing the maximum lending rate from 18.0 per cent to 17.5 per cent. Meanwhile, the Union Budget for 1985–86 completely withdrew the tax on interest income of banks, as suggested by the former Governor.

Accordingly, the Reserve Bank reduced the maximum lending rate to 17.5 per cent from April 1, 1985. The interest rates on pre-shipment export credit for certain categories were readjusted; in particular, the reduction was expected to benefit public sector purchases and sales of commodities on commercial basis, and commodities covered by selective credit controls. The banks were required to absorb an additional burden of about ₹ 200 crore during that period on account of the wage settlement with 'award' staff and officers, even though they stood to benefit to some extent by the abolition of tax on their interest income.

The Reserve Bank decided to raise SLR from 36.0 per cent to 37.0 per cent in March 1985 in two phases — to 36.5 per cent and 37.0 per cent from June 8 and July 6, 1985, respectively — with the objective of providing resources for vital public sector investments within the framework of the Seventh Five Year Plan without excessive generation of reserve money.[10] Thus, even before the banks could benefit from the withdrawal of the interest tax, the amount was pre-empted by SLR hike.

MONETARY AND BANKING SCENARIO

The other issue was the Reserve Bank's policy response to emerging monetary trends. A review of the developments during 1984–85 (up to the middle of January) showed that there had been a significant overshooting of the parameters agreed to with the finance ministry to contain the annual M_3 growth within 15.0 per cent. This was compounded by the fact that banks had run down their liquidity and rapidly increased their drawal of food and export credit refinance limits.

The CPC examined the pros and cons of the available options. First, an increase in reserve requirements was thought to be dislocative at that

10. From the policy files of the CPC, it could be seen that the draft circular to banks had been handwritten by the Adviser-in-Charge, Shri S.S. Tarapore and Deputy Governor, Dr C. Rangarajan. Such an unusual step had to be resorted to because of the ongoing staff agitation, which seriously disrupted the normal functioning of the institution.

juncture of the busy season because these ratios were already on the high side, with 62.0 per cent of the incremental domestic resources of banks having been pre-empted under CRR and SLR. Second, recourse to interest rate changes was not seen as a feasible option in the milieu of high interest rates at the upper ranges, the relatively low rates of inflation and need to maintain the level of industrial output. Third, the guidelines on credit expansion ceilings were more in the nature of moral suasion and not mandatory, owing to the lack of legal backing for imposing penalties on infringements. Any restriction on utilisation of large limits was not considered practical, as credit to large borrowers was already somewhat subdued during this period.

Ultimately, the Reserve Bank had to fall back on the fourth option of tightening the food credit refinance facility. This was more as an anticipatory response, because although the cut-off point had been raised twice in that financial year, its utilisation by banks had reached a historically high level, both in absolute terms and as a proportion of food credit. Moreover, it was felt that if the cut-off point was increased, it would obviate large changes in the refinance cut-off point during the ensuing slack season.

The upshot was that to the extent a slowing down of the pace of credit expansion was a desirable objective, the overall discretionary refinance policy should be made more restrictive. The Deputy Governor observed that despite a substantial increase in M_3, prices had been behaving extremely well, but the lagged effects of a substantial increase in M_3 could not be wished away. In view of these overriding considerations, the Governor decided to send the 'right signal' by raising the cut-off point for food credit refinance facility to ₹ 4,500 crore at the end of February 1985. Subsequently, with the approval of the Governor, the limit was increased to ₹ 4,600 crore and the effective date of implementation changed to April 5, even though the announcement was made on March 8, 1985.

By April/May 1985, a number of banks reported SLR shortfalls and even resorted to window-dressing. The banks purchased Treasury Bills on Fridays from the Reserve Bank and rediscounted them on Saturdays; this enabled them to report maintenance of SLR in their reporting alternate Fridays, though there were large shortfalls on other days of the fortnight. The Reserve Bank counselled the banks to conserve their resources, rectify any shortfalls in their reserve requirements, and make an effective and smooth transition to proper maintenance of SLR on a daily basis.

In 1985–86, the first year of the Seventh Five Year Plan, monetary expansion decelerated sharply during the year and inflation came down to

5.7 per cent in continuation with the declining trend for the third year in succession. The Reserve Bank, however, remained intent on containing the inflationary impact of the larger generation of reserve money. Moderating the rate of growth in M_3 continued to be the principal objective of credit policy.

In 1985–86, a number of policy initiatives were taken by the Reserve Bank, both in the monetary and related fiscal areas. As cited above, the various recommendations of the Chakravarty Committee report were in the process of being implemented. In December 1985, the Government announced that it would adopt the long term fiscal policy (LTFP), which aimed to provide a detailed fiscal perspective for financing the Seventh Plan, and to facilitate a stable economic environment that reduced uncertainties and laid the foundations for higher economic growth.

Credit policy was reviewed in early April 1985. In view of the large increase in reserve money and the presence of overall liquidity in the previous three years, the Reserve Bank decided to continue the cautious stance of credit policy to avoid a resurgence of inflation. It decided to contain the growth in overall liquidity in 1985–86 at a rate lower than that in the previous year.

The credit policy measures introduced on April 6, 1985 had far-reaching implications on the functioning of banks. First, the threshold for food credit refinance was raised steeply from ₹ 4,600 crore to ₹ 5,800 crore spread over three stages — to ₹ 5,000 crore from August 2 to ₹ 5,400 crore from August 30 and to ₹ 5,800 crore from September 27, 1985. The rationale was that to the extent that the system was kept taut through the first half, and there appeared to be a need for some relaxation in the second half, the Reserve Bank would have better control over the monetary aggregates. Further, the Reserve Bank's perception was that the banking system would be placed in a comfortable position through the first half of the year and hence would be able to meet the credit demands even after repaying a sizeable amount of any outstanding Reserve Bank refinance. Commercial banks were asked to ensure that food procurement credit needs were fully met and that such credit was to be the first charge on their lendable resources.

Second, the interest rates on refinance had remained unchanged since 1981. With the increase in food credit rate to 14.0 per cent and the abolition of tax on interest income, the margin on refinance stood at 4.0 per cent. In effect, with high reserve requirements, the owned funds of banks became significantly more costly than the 100.0 per cent refinance

formula. The Reserve Bank took this opportunity to rectify the anomaly by raising the food refinance rate from 10.0 per cent to 11.0 per cent from October 1, 1985.

FREEDOM GIVEN TO BANKS TO FIX SHORT-TERM DEPOSIT RATES: SHORT-LIVED EXPERIMENT

The Reserve Bank granted freedom to individual commercial banks to fix deposit rates for maturities from 15 days to less than one year within a ceiling of 8.0 per cent in April 1985. At any point of time, however, each bank had to adopt uniform rates at all their branches and for all their customers. Simultaneously, deposit rates for one year and above but less than two years were raised from 8.0 per cent to 8.5 per cent. It was expected that with reasonable rates of interest on such maturities, the banks would be able to mobilise hitherto untapped resources and thereby widen their deposit base. A suitable increase in interest rates for shorter maturities was also envisaged to achieve a better distribution of term-deposits instead of the highly skewed distribution with concentration around the longer maturities at relatively higher costs. The press release issued by the Reserve Bank on April 6, 1985, termed this decision as 'an innovative move'.

BACKGROUND

The rationale behind this decision was that interest rates on deposits over the years had been increased, but these increases were largely at the longer end of maturities. Thus, in April 1974, the spread of fixed deposit rates was 3.0-8.0 per cent, while in October 1982 the range was 3.0-11.0 per cent. In fact, the deposit rate for less than one year was only 5.5 per cent and this was raised to 7.0 per cent in March 1982 in a limited effort to correct the distortion in short-term deposit rates. Moreover, with the ceiling on call money rates fixed by the Indian Banks' Association (IBA) at 10.0 per cent, the distortion in the short-term deposit rates came to be attenuated. Another disturbing aspect was that the share of short-term deposits in total fixed deposits was declining sharply as the interest for different maturities widened and these short-term deposits formed an insignificant proportion of the aggregate fixed deposits in May 1985. The deposits in the category of 15 days and above but up to 1 year that accounted for 54.7 per cent of total fixed deposits in l970, came down to 14.2 per cent in 1975, further to 9.6 per cent in 1978 and finally to 7.5 per cent in 1980. The short-term deposit rate structure had its impact on money market operations too. Entry into the money market was highly regulated. Apart from banks, only

the Life Insurance Corporation of India (LIC) and the Unit Trust of India (UTI) were permitted to place deposits of over 14 days. In 1982, there was considerable disruption since these regulations were flouted and banks accepted deposits from the UTI at money market rates for longer periods. Directives had to be issued to banks to reverse these irregular transactions. Further, certain institutions had from time to time pleaded that they might be allowed to enter the money market, but these requests were not acceded to, as it would be tantamount to offering significantly higher rates on short-term deposits.

The Reserve Bank came round to the view that the continuation of the extremely low short-term deposit rates would be stultifying and, if continued, there would be virtually no short-term fixed deposits with banks and the process of disintermediation would be weakened. An important feature of the change was that it was not mandatory for a bank to offer higher rates, and banks could within limits choose particular maturities at which they wished to offer higher rates. It was hoped that as the new system settled down, banks and customers would eventually work out a mutually desired maturity rate pattern. The advantage of removing the distortions in short-term deposit rates was that the funds, which were till then bypassing the banking system, would be drawn to it and would also bring about a better alignment between these rates and money market rates and would to a large extent reduce the inequity of some institutions getting higher rates than others from the banking system. While it was true that the interest rates in inter-corporate deposits were significantly higher than even the revised short-term bank deposits, there was a trade-off between security considerations and interest rates and, therefore, the banks could attract a large volume of funds and in the process widen their deposit base. Again, to the extent that depositors' preference moved away from longer to shorter term deposits, the cost of funds to banks declined.

FOLLOW-UP ACTION BY THE IBA

The Reserve Bank advised the banks that the change would take effect from April 8, 1985. But what followed was unexpected. Even before the banks could savour this freedom, on April 9 the IBA announced an indicative structure of interest rates to be followed by member banks for deposits of over 15 days but less than one year, which practically brought back the former regulated rate system. The IBA took the stand that the managing committee of the Association had decided on uniform adoption of interest rates by all members. This activism by the IBA was viewed with skepticism

in financial circles, as the Reserve Bank's advice seemed to have been wrongly interpreted. A report which appeared in the Economic Times dated April 10, 1985 pertinently queried:

> …Whether the message of the Reserve Bank had been wrongly understood by the banks, because by "innovative move" the Reserve Bank would have meant that the banks could themselves offer interest rates to their depositors, with each bank offering competing rates. With IBA having fixed rates uniformly for all the banks this merely amounts to the Association playing the same role that the RBI had hitherto performed. Was this the "innovation" that the RBI had in mind?
>
> It is felt that the IBA may have decided on uniform interest rates to avoid competition in attracting deposits from each other. Fixing of uniform rates may prevent deposit 'snatching' activities, financial circles aver.

Another comment made by a financial journalist was that the concept of higher interest rates on short-term deposits as well as allowing the banks to decide on their own interest rates within certain norms had been devised on the pattern prevailing in other countries, but it was to be seen how the banking industry absorbed the innovation.[11]

Faced with strident criticism, the IBA withdrew its controversial interest rates schedule for short-term deposits on April 29, 1985. As a result, banks were free to offer interest rates along the lines envisaged by the Reserve Bank.

EVENTS LEADING TO WITHDRAWAL

However, the expectations of the Reserve Bank were belied soon. The Reserve Bank had to hastily backtrack. A telex message received from the Finance Secretary dated May 13, 1985 addressed to the Governor expressed serious concern about the malfunctioning of the interest rate relaxation and even went to the extent of suggesting to the Governor to 'request' the concerned Deputy Governor to discuss the matter with them. The communication was as follows:

> You would have no doubt seen the reports in newspapers about the rate war among banks pursuant to RBI's decision to permit payment of interest rates up to eight per cent on deposits of fifteen days to

11. *The Economic Times*. April 29, 1985.

> one year. There is also apprehension that this measure apart from introducing unhealthy competition for short term deposits, will also lead to considerable erosion in the profitability of Indian banks. With increase in interest rates on such highly short term deposits, the present interest rate structure on deposits of more than one year has become somewhat distorted. I should appreciate if necessary background material for the decision can be sent to us. You may also consider requesting concerned Deputy Governor to discuss this matter with us.

The Reserve Bank's initial reaction was to stand by its decision. The office note dated May 16, 1985 prepared in the CPC averred that the fears expressed of an adverse impact on banks' profitability were unfounded, that the apprehension that foreign banks and small banks would wean away deposits from the large public sector banks (PSBs) had not been substantiated and that to the extent that depositors' preference moved away from longer to shorter deposits, the cost of funds to the banks would decrease and not increase as a result of the change. As regards the likelihood of competition from foreign banks, the Reserve Bank considered the fears as 'highly exaggerated' as these banks accounted for less than 3.0 per cent of total deposits and their banking business was heavily dependent on money market funds obtained from Indian banks/institutions and hence it was unlikely that these banks would be able to fully substitute these money market borrowings with short-term deposits. Another advantage visualised on account of the increase in short-term deposit rates was that it would bring about a better alignment between these rates and money market rates and would to a large extent reduce the inequity between some institutions getting higher rates than others from the banking system. Finally, the note highlighted the various positive features of the new structure:

> The recent changes in short-term deposit rates would not automatically result in an increase in the cost of funds to the banks. To the extent that there is a shift from current/savings deposits to fixed deposits, the cost of funds to the banking system would rise. To the extent that the banking system is able to attract additional funds and to the extent that the share of shorter term fixed deposits in total fixed deposits rises, the cost of funds to the banking system would fall. Again, with the flexibility in rates recently introduced, banks could choose the maturity at which they wish to attract short-term funds. The change does imply an

> element of deregulation and in any scheme of deregulation, there would be an initial period of uncertainty as the system settles down to the new regime.

Despite these justifications, it could be deduced from the notings recorded subsequently by the Deputy Governor that the Governor had discussed the matter with the Finance Minister and the Finance Secretary and the earlier decision had to be rescinded.

Through a circular dated May 25, 1985, the Reserve Bank restored the rates for maturities up to 90 days to the pre-change levels (*i.e.,* from 15 days to 45 days at 3.0% and from 46 days to 90 days at 4.0%), while the rate for maturities of 91 days and above but less than 6 months was fixed at 8.0 per cent. The interest rates on maturities of 1 year to less than 2 years, which was raised to 8.5 per cent on April 8, continued unchanged. The underlying reason for this revision was thus set out in the circular to banks:

> It was hoped that in the exercise of the discretion given to them, individual banks would fix the rates as to safeguard their current and savings accounts and at the same time bring about better portfolio management. However, the approach of banks has been such as to prevent the emergence of such efficient portfolio management. The major banks initially fixed uniform rates for the maturities below one year at a level of one percentage point above the rates prevailing prior to April 8, 1985. However, when a few banks started offering a rate of 8 per cent for maturities of 15 days, all banks simply followed suit and, without regard to consideration of profitability, set a single rate of 8 per cent for maturities starting from 15 days and below one year.
>
> Some of the banks are managing their 15-day deposits almost like current accounts. However, resort to maturities above 15 days but below one year has greatly diminished. The consequence was a shift of deposits from current accounts and, to a lesser extent, from savings accounts to 15-day deposits.

As a follow-up to this episode, the Reserve Bank thought it prudent to explain on its own to the Government the rationale for the April 1985 change. The Deputy Governor apprised the Secretary (Banking) and the Chief Economic Adviser of the main considerations for the change in his letter dated July 24, 1985. He also revealed that the proposal had been discussed by the Governor with the chief executives of major banks

in April 1985. The Reserve Bank had hoped that the revised structure of interest rates made effective from May 27, 1985 would enable the banks to increase the proportion of deposits of less than one year without any shifts from current and savings account and that the beneficial effects of the new structure would be visible after some time as longer-term deposits and depositors exercised their option among various maturities. Contesting the argument of the Finance Secretary (in his telex) about the loss suffered by banks, the Reserve Bank clarified that the actions taken by individual banks would have been in the best interests of their own profitability and that ultimately much would depend on the response of individual banks and the options exercised by them in tune with their requirements. Finally, the Reserve Bank stressed that the earlier decision was taken with the intention of helping all segments of the banking system and was not meant to serve the interests of any particular group of banks.

PRESS REACTIONS

The media reaction[12] to the developments in this context was that the reversal of the innovative step meant that the calculations of the Reserve Bank had 'misfired' and that it had no alternative but to protect banks from the misuse of the measure. It concluded that the banks in their greed failed to tap properly the facility granted to them with all good intentions and made the Reserve Bank act the only way it could — by making the banks operate in a more restrictive manner. The editorial[13] of this paper was unsparing in its criticism of the fiasco. It lamented that it took the Reserve Bank about seven weeks to realise that the interest rate differentiation in the short-term deposit would be wiped out and replaced by 8.0 per cent accounts renewable every 15 days and that it was only the Reserve Bank that was 'slow-footed' in its understanding of the way its objective was being rendered counterproductive. The editorial, while not denying that a correction in the pattern of deposit rates was overdue, pointed out that a basic correction at fiscal level was required for working out a consistent pattern of realigned interest rates.

In the final analysis, the experiment towards liberalisation turned out to be short-lived, and had to be aborted in May 1985 since the banks failed to follow the spirit behind the relaxation. This also showed that considerable

12. "RBI Expectations Belied", *The Economic Times*. May 27, 1985.

13. *The Economic Times*. May 28, 1985.

thinking at the policy level and planning had to be done before venturing into any reform of the well-entrenched rate structure.

The need was also felt to liberalise selective credit controls without departing from the main objective of preventing bank credit being used for speculative hoarding of sensitive commodities. After a review, the basic framework, namely, the prescription of minimum rates of interest, stipulations of levels of credit, minimum margins and prohibitions on grant of credit against book debts and clean credit, was maintained. The new structure, while attempting to reduce the complex and multiple prescriptions that had become part of the control mechanism over the years, simplified the operation of these controls.

The Reserve Bank introduced a phased scheme of applying penal rates on SLR shortfalls effective September 1985. The penalty for daily shortfalls up to 4.0 per cent of SLR requirement to be maintained was waived and the penalties became applicable only for shortfalls exceeding the 4.0 per cent band. Further, an additional interest of 3.0 per cent was charged on the portion of refinance accommodation from the Reserve Bank equivalent to the shortfalls in SLR and CRR. The proportion of daily default attracting levy of penal interest was stepped up in a phased manner.

The review of the credit policy for the second half of 1985–86 took into account the large increase in reserve money during this period attributable to some extent to the cash management system that banks followed. The result of the review was that aggregate deposits were expected to grow in the second half of the year by a minimum of ₹ 5,750 crore, giving a full year growth of at least ₹ 12,175 crore (16.9%). Therefore, despite some moderation in inflation rate and M_3 growth, there was no alternative but to continue with the cautious stance of monetary policy.

The basic objectives of the credit policy were to meet the food procurement requirements of the 1985 *kharif* season, to make available credit for normal seasonal requirements in the busy season and to provide credit support to sectors where there was a step-up in industrial output. From November 22, 1985, banks were provided with export refinance to the extent of 100.0 per cent of the increase in export credit over the monthly average level of credit for the year 1984 instead of the existing average level of credit in 1983. With the increase in the threshold for export refinance and the compulsions arising from compliance with SLR requirements, the banking system was expected to face a tight situation in the busy season and, therefore, some easing of liquidity was contemplated.

Accordingly, on October 26, 1985 the Reserve Bank released one-third of the impounded cash balances, thus making available about ₹ 495 crore to the banking system.

SLR applicable for NRE accounts was reduced from 37.0 per cent to 25.0 per cent to bring it on par with that applicable to the FCNR accounts; this reduced SLR burden by about ₹ 360 crore. The rate of interest payable on eligible cash balances maintained with the Reserve Bank (excluding the statutory minimum of 3.0%) was raised from 10.0 per cent to 10.5 per cent, in order to help banks adequately cover the cost of their funds and to increase their reserves.

Certain categories of advances — especially advances against wheat and advances to mills against raw cotton and *kapas* — were exempted from the provisions of selective credit controls, while the minimum margins in certain cases, namely, advances against paddy, rice, cotton and *kapas,* were reduced.

The Reserve Bank, at that time, was concerned about the fluctuations in banks' cash balances with it. These transactions resulted in large week-to-week movements in the cash balances of banks which, along with wide fluctuations in Treasury Bill holdings, caused violent swings in reserve money and in the net Reserve Bank credit to the Government. With the coming into force of the amendment to section 24 of the BR Act, 1949 regarding levy of penalty on SLR defaults, banks were giving increased attention to the maintenance of SLR. But in the initial stages, they resorted to heavy window-dressing of the SLR status on the reporting Friday by large withdrawals from their cash balances with the Reserve Bank, which were invested in Treasury Bills so as to report maintenance of the prescribed SLR level. As a result, in the early period of the financial year, there were high week-to-week movements in cash balances, which came down after the phased introduction of penalties on SLR defaults. The fluctuations disappeared after September 1985. Since such fluctuations in cash balances were counterproductive as they did not help banks to conform to the required reserve requirements, the Governor in his letter of October 25, 1985 urged them to desist from such window-dressing. The Governor expressed, "While normal movements in cash balances are legitimate and form part of efficient cash management, some banks have attempted excessive fine-tuning and in the result defaulted in the maintenance of CRR."

Meanwhile, the finance ministry was getting uneasy about inflation. The Finance Secretary wrote to the Governor on May 14, 1985, suggesting

that in order to keep an effective check on prices, a 'contingency plan' should be drawn in credit policy during July/August; for this purpose he wanted to hold preliminary discussions so that an action plan could be considered and kept ready.

The Governor's reaction was mixed as the Government was saying what the Reserve Bank had actually been doing for a number of years. A draft reply[14] was prepared, but the letter was not issued; perhaps the thrust of the draft letter was conveyed verbally to the Government.

CREDIT POLICY FOR THE FIRST HALF OF 1986–87

The review of credit policy in April 1986 was done against the backdrop of a slowdown in M_3 expansion in 1985–86 and a perceptible deceleration in the inflation rate. The Reserve Bank assumed that with an average monsoon and favourable industrial climate, the overall rate of growth of the economy in 1986–87 would be somewhat higher than in 1985–86, *i.e.*, around 5.0 per cent. The annual average rate of M_3 growth in the past three years had been higher, at about 17.0 per cent. In the interests of containing inflationary pressures, the Reserve Bank considered it necessary to regulate the rate of M_3 growth to a level below the average of the previous three years.

Even at the stage of reviewing the credit policy, the Governor had indicated certain desiderata. First, SLR was not to be raised beyond 37.0 per cent; second, the Reserve Bank would aim to enforce the existing SLR limit in all cases, except where special dispensation was necessary; third, CRR should continue at the existing level and further relaxations in selective credit control should be attempted.

The cautionary stance of monetary policy continued. Apart from ensuring that food procurement needs were fully met, credit policy sought

14. In the draft letter to the Government, the Reserve Bank expressed the view that while the need to have an appropriate action plan was unexceptionable, the contingency plan should be framed against the backdrop of the appropriate rate of desired monetary expansion; according to the Reserve Bank's assessment, there were no strong reasons at that time to change the perceptions which formed the background for formulating credit policy for the first half of 1985–86; and finally, the various credit policy measures announced in April 1985 would have come into effect. Therefore, the Reserve Bank felt that there was very little scope for further tightening in this area. Further, the credit policy having already been kept taut, any further tightening might be counter-productive. Throwing the ball into the Government's court, the Reserve Bank suggested that it was even more necessary that the Government's draft on the banking system was not higher than that envisaged earlier.

to ensure that all productive activity which contributed to increased output was financed by banks from their own resources. The process of rationalising selective credit controls was carried further. The overall exemption limit for advances under selective credit control was raised from ₹ 50,000 to ₹ 1 lakh. Due to improved supply conditions, several commodities were exempted and the minimum margins on oilseeds and vegetable oils were reduced by 15.0 percentage points.

In August 1986, the Reserve Bank rationalised the structure of interest rates on export credit and also reduced the rate of interest for a large part of export credit, ranging from 2.5 to 4.5 percentage points. The interest rate on export credit refinance to banks was also reduced from 10.0 per cent to 9.0 per cent.

THE CHAKRAVARTY COMMITTEE

During the year, many of the major recommendations of the Chakravarty Committee were implemented in consultation with the Government. These included modification in the form of presentation of data relating to the Government's budget deficit in the budget documents, the introduction of 182-day Treasury Bills with flexible rates determined on the basis of monthly auctions and increased yields on long-term government securities along with a reduction in the maximum maturity period.[15] The Reserve Bank's Annual Report, 1986–87 had observed:

> Monetary policy in recent years has been paying increasing attention to the need for controlling overall liquidity in the economy and for greater co-ordination between monetary and fiscal policies. While the broad inter-relationships of output, money and prices have always been kept in view, in the more recent period, there has been a clear recognition of the need to control the growth of monetary aggregates and in particular the growth of reserve money, in line with the increase in real output and an acceptable degree of increase in prices. These inter-relationships between output, money and prices are subject to complex lags. While it is difficult to set out the precise operation of these lags, it is found that the basic underlying inter-relationships nevertheless hold good over a period of time. It is for this reason

15. See Appendix 4.1 for a brief account of the Chakravarty Committee's recommendations and the process of implementation.

> that the Chakravarty Committee recommended the introduction of flexible monetary targets which would ensure that increases in money supply are not too far out of alignment with the growth in output. Furthermore, the Committee had focused attention on growth of net Reserve Bank credit to Government as a vital indicator as it accounted for bulk of the reserve money creation. The Central Budget for 1987–88, for the first time, referred to an estimate of the likely increase in net Reserve Bank credit to the Central Government. This should provide a basis for better co-ordination between monetary and fiscal policies.

The most important recommendation of the committee in the area of monetary management was the advocacy of a system of monetary targeting, which would bind the Government and the Reserve Bank to a mutually agreed level of Reserve Bank credit to the Government, consistent with the appropriate level of expansion in M_3. The committee also spelt out the method to arrive at the appropriate level of M_3 growth and linked it to the expected increase in real output and an acceptable level of increase in prices.

The Chakravarty Committee had recommended that Treasury Bills should be developed as a monetary instrument with flexible rates for better management of short-term liquidity. Accordingly, the 182-day Treasury Bills were introduced, initially on a monthly auction basis and without any rediscounting facilities from the Reserve Bank. State governments and provident funds were not eligible to participate in the auctions. The discount rate was not fixed, but varied in accordance with the outcome of the auctions. To impart flexibility, the amounts for each auction were not fixed in advance. The new instrument was expected to provide an alternative avenue for short-term investments for which an active secondary market could develop in the course of time. The Reserve Bank was hopeful that judicious operations by investors would result in the success of these auctions and a wide array of maturities would emerge, which would be advantageous to banks and other investors in the secondary market. In the context of the Government's commitment to adopt monetary targeting, it was felt that volatile movements in the holdings of Treasury Bills by banks should be avoided. Therefore, the Reserve Bank decided to levy an additional fee for early discounting of 91-day Treasury Bills within 14 days of their purchase from the Reserve Bank. The fee was so fixed that the effective yield would be zero on the first day and then rose gradually up

to the fourteenth day. Beyond this period, there was no additional early discounting fee and, therefore, the rate of return remained unchanged.

SLIGHT EASING IN THE SECOND HALF OF 1986–87

The growth of overall liquidity and aggregate deposits in the first half of 1986–87 had been broadly in line with the earlier projections. While the net bank credit to the Government during the period had increased at a faster rate than in the previous year, the growth in reserve money had been extremely erratic because of violent fluctuations in bank credit to the Government. With the anticipated pick-up in industrial production in the second half and the requirements of seasonal industries, the Reserve Bank expected a revival of credit demand.

The Reserve Bank was concerned that the currency and demand deposit components of M_3 had shown wide gyrations, which was mainly attributable to banks' interplay between their cash balances with the Reserve Bank and investment in Treasury Bills. With the commitment of the Reserve Bank to monetary targeting, it was considered essential that vital monetary aggregates should be free from the 'noise' and banks were asked to give this matter serious attention. To supplement the resources of banks during the busy season, the Reserve Bank released the remaining amount of ₹ 992 crore of impounded cash balances in two equal instalments. The Governor, while announcing the credit policy for the 1986–87 busy season, reiterated that maintenance of monetary discipline and observance of reserve requirements would be the central objectives of the policy.

To streamline the refinance facility, the Reserve Bank provided banks with easier access to the discretionary refinance facility. The Bank permitted SCBs (excluding regional rural banks [RRBs]) to draw discretionary refinance without prior approval up to an amount equivalent to 0.5 per cent of the bank's average deposits in 1985–86 at 14.0 per cent interest rate for a period not exceeding 14 days.

During the years 1985 and 1986, the Reserve Bank came across the practice of non-resident Indians (NRIs) finding it profitable to obtain loans from foreign branches/correspondents of Indian banks against the security of FCNR deposits. This was made possible because of the prevailing differentials in the interest rates on FCNR deposits and rates in the international markets. Such a situation induced the inflow of speculative capital in search of higher returns and defeated the objective of

the scheme to attract genuine savings and increase the flow of funds to India through official channels. This issue was considered by three departments in the Reserve Bank, *viz.*, the Exchange Control Department (ECD), the Department of Banking Operations and Development (DBOD) and the CPC.

In August 1985, the DBOD in consultation with the CPC advised Indian banks that had branches abroad and foreign banks operating in India that they should ensure that only mobilisation of genuine savings by NRIs should be facilitated under the special non-resident schemes. The Reserve Bank made it clear that extending credit to clients abroad to place deposits under the FCNR scheme and then holding such deposits as collateral against guarantees and/or loans extended at their branches outside India contravened the spirit of the scheme. However, the DBOD felt that these instructions had limited application because the writ of the Indian regulatory framework did not extend outside India and these instructions applied only to Indian banks' branches abroad and not to the foreign banks.

A few months later, when the ECD received an application from an Indian bank to grant credit facilities abroad to their correspondents against FCNR deposits, it suggested to the DBOD that banks could be cautioned against the possibility of arbitrage being sought by foreign banks through the FCNR scheme, and also that firms and companies owned predominantly by NRIs should be debarred from availing of loans under the FCNR scheme. The DBOD, in turn, referred the matter to the CPC, which expressed the view that these two suggestions were not feasible because the restrictions would apply only to Indian banks operating abroad and not to foreign banks and, more importantly, it would place the former at a serious disadvantage.

Similarly, a suggestion by the DBOD to prohibit a lien on the FCNR deposits and to permit loans to be granted only by branches of the same bank that maintained the FCNR deposits, thereby preventing arbitrage in the interest rates, was seen to be prejudicial to the interests of Indian banks as it might disrupt their normal lending operations against the FCNR deposits. The crux of the issue was aligning the rate on FCNR deposits to interest rates prevailing abroad. Over a period, the FCNR rate, which stood at 13.0 per cent on August 21, 1988, was reduced in stages to 10.0 per cent on May 5, 1986. Even this rate, it was conceded, was not low enough to pre-empt arbitrage, particularly in the case of dollar-denominated

deposits. Ultimately, the authorities decided to wait for the results of the change made earlier before taking the final decision.

Towards the end of 1986, the Reserve Bank examined the disadvantages that banks faced in garnering savings from the public as compared with competing savings instruments in the market. A note prepared on the issue[16] studied the position in 1986 and the gist of the note follows. The commercial banks faced stiff competition from other savings instruments, such as company deposits, debentures, various schemes of the UTI, fixed deposit schemes of non-banking financial companies (NBFCs), a variety of small savings schemes of the Government, including post office saving schemes, NSCs, social security certificates and the public provident fund (PPF). Some of these instruments were also eligible for one or more fiscal concessions. As a result, in terms of nominal interest rates, most savings instruments enjoyed a considerable degree of differential advantage over even the highest interest-bearing fixed deposit schemes of banks and, moreover, the latter did not hold any attraction for income tax payers. After taking into account the various fiscal incentives, the effective rates of return worked out to be much higher than the nominal interest rates. The note was emphatic that if no corrective action was taken, in the long run the rate of growth of bank deposits might decelerate. The situation was summed up thus: "Incentives for savings can be in the form of either interest rates or fiscal concessions. In the former case, the cost is open and known; in the latter case, it is concealed and, therefore, not fully known. Taking all factors into consideration, it would appear simpler and definitely preferable to operate incentives through open interest rates than concealed fiscal concessions." The Deputy Governor and the Governor concurred.

The Governor forwarded the note to the Finance Secretary on January 3, 1987 with a copy to the Secretary (Banking) as a background paper to the proposed meeting with the Finance Minister. Taking a broader perspective, the Reserve Bank stressed the need to consider lowering the level of interest rates in the economy not only in the banking sector but also on the entire gamut of savings instruments. This was considered important because, apart from the fact that certain savings instruments were crowding out bank deposits, the cost to the Government of garnering public savings under certain instruments was exceedingly high when the fiscal privileges were taken into account. For example, in the case of the

16. "Effective Rates of Return on Bank Deposits and Other Selected Instruments of Savings", CPC, Reserve Bank of India, 1986.

PPF and the NSCs, the effective rate of return varied between 18.0 per cent and 48.0 per cent, depending on the slab of section 80C deduction and the income tax bracket and, if wealth tax benefits were added, then the rate of return on certain income/wealth tax brackets would be as high as 56.0 per cent. In this connection, a reference was made to the note submitted by the Ministry of Finance[17] which made certain recommendations about the differential savings rates. One recommendation was that in the case of banks, the longest maturity deposits should be confined to the category '3 years and above' and, as such, the maximum deposit rate for banks could be 10.0 per cent instead of 11.0 per cent, thus reducing the costs to banks by about ₹ 120 crore per annum. In the case of lending rates, it was proposed that all lending rates above 15.0 per cent were to be reduced by one percentage point, which would again imply a reduction in bank earnings by ₹ 240 crore. The Reserve Bank felt that the interest rates on other instruments (such as the NSCs, post office time deposits, public sector bonds and company deposits) should be simultaneously reduced by one percentage point and that the then introduced 10.0 per cent tax-free public sector bonds should either be withdrawn or the interest rate on these be reduced to 8.0 per cent as these carried a very high effective rate of return.

The thrust of the communication was that the effective cost of various instruments should bear some semblance of order and, for that purpose, there was an imperative need to review the various concessions — which in any case were not viable and resulted in high cost of raising funds to the Government — to ensure that the cost of funds through these instruments was not excessive. The Reserve Bank made a number of important suggestions. First, the terms of floatation of public sector bonds should be on the same basis as that of corporate debentures, *viz*., a rate of interest of 14.0 per cent and exempt from section 80L concession. Second, as a matter of principle, an instrument should not be provided double concession under sections 80L and 80C. Third, the interest rate of 12.0 per cent available on PPFs was excessively high, since the interest income was completely free from income tax; it should be reduced to 11.0 per cent and the rules of withdrawal tightened. Fourth, section 80C concession was to be provided only to provident funds and life insurance premia, and the amount of deduction of the last slab should be reduced. Fifth, the Reserve

17. "Proposals for Reduction in the Cost of Money", Note prepared for the Group of CCEA, June 30, 1986.

Bank made a strong plea for paying greater attention to the avenue of raising funds through the government securities market, *viz.,*:

> Since the cost to the Government of raising resources under the various instruments is very high, it would be desirable to reassess whether the best course would be to move towards developing a consistent structure of nominal rates on various instruments without fiscal concessions and variations in nominal rates to reflect maturity and liquidity. In this context, it would be useful to consider whether greater attention should be given to mobilising resources from the non-captive market by offering higher rates on government securities. The overall cost to the Government of mobilising resources through the government securities market would be substantially lower than under the existing instruments and this matter needs to be given serious attention.

In 1986–87, judged by the overall growth rate the economy performed reasonably well, though the continued slackness in agricultural growth cast a shadow. In the industrial sector, although the overall growth was lower, some infrastructure industries, such as electricity, coal and cement, performed better. There was a reduction in the CAD but the BoP position had to be kept under watch.

Monetary expansion was higher at 18.5 per cent during 1986–87 as against 16.1 per cent in 1985–86, mainly contributed by net bank credit to the Government, which expanded by 21.9 per cent as against 19.6 per cent in the earlier years. Correspondingly, there was a spurt in other banks' credit to the Government at 30.4 per cent as against 2.3 per cent in the previous year. Wholesale prices on a point-to-point basis rose by 5.3 per cent as against 3.8 per cent in 1985–86 and 7.6 per cent in 1984–85.

From the beginning of 1987, there were unmistakable signs of strong pressures building up in the economy, which as time went on, were aggravated by drought conditions that engulfed major regions of the country. An analysis of deposit growth during 1986–87 (up to end-December 1986) revealed certain disquieting trends of a deposit growth larger than that in the corresponding period of the previous year, much in excess of the projections for the year as a whole, and a low rate of utilisation of limits by major borrowal accounts with the potential for an explosive increase in non-food credit sometime later. The price situation was also hardly reassuring. Therefore, the Reserve Bank decided to postpone the scheduled release of the second instalment of impounded cash balances

from January 31 to March 14, 1987, thus holding back ₹ 248 crore from the system, citing 'the comfortable liquidity position' of banks as the reason. Another major decision was to make a pre-emptive reduction of the limits sanctioned by the banks to large public sector borrowers in cases where their utilisation was already low. The Governor, while approving these measures, on January 16, 1987 sounded a note of warning: "I have a feeling that stronger steps are needed to curb the growth of money supply. We should give urgent thought to the various alternatives available to us."

The Industrial and Export Credit Department (IECD) took a quick assessment of the existing authorised working capital limits to large public sector borrowers in light of their actual utilisation, and in March 1987, ordered a drastic reduction of limits to be applicable till the end of March 1987. The cut-back was severe — the existing total limits for eight public sector corporations were slashed from ₹ 1,463 crore to a mere ₹ 420 crore.

It soon became apparent to the authorities that the emerging difficult situation could not be tackled by a mere tinkering of controls, and something drastic had to be done to immobilise a part of the liquidity without hindering the credit flow to productive sectors. The monetary policy projection of M_3 growth of 16.2 per cent during 1986–87 was based on the working estimate of increase in deposits with banks during the year of about ₹ 15,000 crore (17.5%). However, the actual increase in deposits during the first three quarters alone was ₹ 16,770 crore (19.7%). More worrisome, of this increase, about ₹ 6,900 crore or over 40.0 per cent had accrued during the six weeks ended January 2, 1987, and due to the resultant comfortable liquidity position, the refinance limits with the Reserve Bank remained substantially unutilised. As a result of a sharp increase in deposits, the increase in M_3 was also much in excess of what had been postulated. Deeply concerned over the abnormal growth in liquidity and the latent inflationary potential, the Reserve Bank decided to immobilise additional deposits of about ₹ 500 crore by increasing CRR from 9.0 per cent to 9.5 per cent from February 28, 1987, even though this step was seen as less than just to those banks which had shown only a moderate or normal deposit growth during preceding months. Incidentally, the earlier CRR increase took place nearly three years before in February 1984. The Governor also wrote to the Prime Minister in February 1987, conveying the concerns of the Reserve Bank over the growth trends in money and prices.

The possibility of releasing the postponed impounded cash balances was reviewed in early March 1987. Although the Reserve Bank was aware

that some banks might face a drain on their deposits due to annual tax payments (which to some extent was to be offset by the expected release of funds to the Food Corporation of India [FCI] by the Government), on March 3, 1987 it rescinded[18] the release of the remaining impounded cash balances.

DIFFICULT TIMES FOR THE INDIAN ECONOMY
(1987–88 AND 1988–89)

Towards the beginning of 1987–88, the primary concern of the authorities was that economic growth might be affected by drought. The year 1987–88 was characterised by a drought of intense severity along with floods in certain parts of the country, which had an adverse effect on the economy. The drought was one of the worst monsoon failures on record. However, in contrast to the earlier drought periods, the extent of economic dislocation was relatively limited due to the huge food stocks, which ensured that food grains were available in different parts of the country. The price situation was uneasy, even though the rate of inflation was not as high as in the previous droughts of the 1960s and 1970s. Prices came under pressure from the beginning of the year consequent upon poor weather conditions and shortages of some essential agro-based commodities. By 1987 these pressures were further aggravated when it became clear that the country was on the verge of a serious drought. A major part of the inflation was accounted for by a rise in prices of seasonal items of agricultural origin, which had a weight of 52.0 per cent in the wholesale price index (WPI). The BoP position came under further strain due to additional imports of essential commodities necessitated by a shortfall in domestic production. These short-term pressures came on top of a number of adverse medium-term factors, such as expected deceleration in indigenous crude oil production, protectionist tendencies abroad, and the bunching of repayment obligations to the IMF and other international financial agencies. On the brighter side, the industrial sector recorded satisfactory performance and critical infrastructure industries like coal, mining, railways and thermal power generation did well. Overall, the management of the economy was influenced by the drought conditions and the need to ameliorate the hardships suffered by the people. As part of

18. On the draft circular before issue, Deputy Governor, Dr C. Rangarajan, had noted: "While I have spoken to Dr Jalan, he felt we might tell Finance Secretary directly." Accordingly, the Governor spoke to the Finance Secretary, who had no objection.

the strategy to contain inflation, the Government attempted to maintain a check on the size of the budgetary deficit, despite the large and unforeseen surge in drought and flood relief expenditure.

Stemming from the continued and large overhang of reserve money and the persistence of strong inflationary pressures, the stance of credit policy in 1987–88 remained cautious, with an emphasis on containing the growth in M_3. Although the growth rate of liquidity showed substantial moderation, it was still excessive in the context of a considerable slowdown in economic growth. Moreover, the expansion of monetary aggregates was understated by the practice of buy-back arrangements in government and other approved securities entered into by banks with their non-bank investors. The growth in bank deposits declined in 1987–88 and the large return flow of bank credit resulting from substantial drawdown of food grain stocks necessitated various measures to mop up excess liquidity. CRR and SLR remained the fulcrum of credit policy. Selective credit controls were tightened in response to growing commodity imbalances and price trends, and the base for determining export credit refinance entitlement was advanced by two years.

COMFORTABLE LIQUIDITY CONDITIONS IN THE FIRST HALF OF 1987–88

While monetary projections for 1987–88 were finalised only in May 1987, in the case of deposit growth, consistent with the increase in the net Reserve Bank credit to the Government of ₹ 6,800 crore and M_3 growth of ₹ 22,000 crore (16.5%), the aggregate deposit growth of banks was estimated at ₹ 18,500 crore (18.3%). Banks were expected to experience a comfortable deposit growth and resources position throughout the year, even after complying with the proposed SLR increase of one-half of one percentage point. Thus, the Reserve Bank's perception was that the banking system could sustain a non-food credit increase of about ₹ 9,000 crore (16.0%). The upshot of the review was that while both net Reserve Bank credit to the Government and bank credit to the Government had been moving above the projected path since 1986, movements in M_3 and deposits of banks had been rather sharp since the end of November 1986. With the Government planning to release arrears of food subsidy during the first quarter of the year, food credit was correspondingly expected to record a substantial decline, as against an increase.

The Government's decision to reduce the cost of money in the financial system by one percentage point in consultation with the Reserve Bank was

given effect in the credit policy announcement for the slack season. For the first time, a co-ordinated across-the-board reduction in interest rates on savings instruments was implemented from April 1987. In the case of bank deposits, there was a conscious effort to reduce the maturity applicable to the maximum deposit rate to impart flexibility to the banks in aligning the changes in interest rates with the changing economic situation. The maximum lending rate was reduced from 17.5 per cent to 16.5 per cent, the bills rediscounting rate was raised from 11.5 per cent to 12.5 per cent and food credit refinance was raised from 10.0 per cent to 11.5 per cent.

During the first half of the year, the Reserve Bank increased SLR from 37.0 per cent to 37.5 per cent from April 25, 1987 and banks were expected to meet this demand without any difficulty. With the lowering of FCNR rates to a level below domestic deposit rates, the need to continue the lower reserve stipulation for FCNR deposits ceased to exist and, therefore, CRR was raised from 3.0 per cent to 5.0 per cent on these deposits. On the same analogy, SLR applicable to these deposits was enhanced from 25.0 per cent to 37.5 per cent in two phases, *viz.*, to 30.0 per cent from May 23 and to 37.5 per cent from June 20, 1987.

The system of graduated interest rates on cash balances with the Reserve Bank was modified because banks had been representing that this arrangement was punitive. Therefore, to afford relief to banks for small shortfalls, the schedule of graduated interest rates was revived from April 1, 1987. Banks were cautioned against relying on money market funds to maintain their reserve requirements, but despite repeated advice, some banks continued this practice to comply with reserve requirements, particularly the CRR. The Reserve Bank cautioned that excessive and chronic reliance on money market funds to maintain CRR amounted to 'hazardous' cash management and such banks would inevitably face difficulties when there was a sudden reduction in the availability of money market funds. Banks were also informed that discretionary refinance would not be provided to off-set paucity of money market funds and reserve defaults would not be condoned on the grounds of shrinkage in volatile money market funds. The credit policy circular to banks dated March 31, 1987 advised that reserve requirements were a prior charge on banks' resources and as such should be met out of the banks' own resources. Moreover, while an expanding and active money market was desirable, it was necessary that banks should not develop chronic deficits in reserve requirements, which were sought to be met through money market borrowings.

IMPLEMENTATION OF THE RECOMMENDATIONS OF THE WORKING GROUP ON MONEY MARKET

As a follow-up to the Chakravarty Committee's observation that the development of an efficient money market required the development of institutions, instruments and operating procedures that facilitated the widening and deepening of the market and allocation of short-term resources with minimum transaction costs and the minimum of delays, the Reserve Bank appointed a working group on money market, with Shri N. Vaghul as chairman in September 1986 (Vaghul Committee). The committee submitted its report on January 13, 1987.

The Reserve Bank's decision to implement some of the major recommendations of the Vaghul Committee also found a place in the credit policy announcement on March 31, 1987. The major recommendations accepted in principle for implementation related to call money rates, type of participants in the call money market, lowering the bill discount rate, raising the rediscount rate, opening the discount market to other participants, introducing measures to promote bill financing, redefining the proportion of receivables that could be financed under cash credit facilities, stipulation on bill acceptance to credit purchases, giving banks the discretion to sanction *ad hoc* bill limits, introducing the 182-day Treasury Bills refinance facility and setting-up a finance house to deal in short-term money market instruments. These measures, it was envisaged, would impart improved liquidity to these money market instruments.

In July and August 1987, the Reserve Bank tightened selective credit controls to counter the pressure build-up on commodity prices stemming from adverse monsoon conditions. Minimum margins were raised across the board in the case of oilseeds and vegetable oils and the level of credit ceilings was also reduced from 100.0 per cent to 85.0 per cent. The exempted categories were brought back and minimum margins were raised by 15.0 percentage points.

The repercussions of the adverse weather conditions during the *kharif* season permeated the economy. The gross national product at constant prices was estimated to rise in 1987–88 by only about 1.5 per cent. With M_3 growth placed in the region of 16.0 per cent, even allowing for lags, inflationary potential on a point-to-point basis of around 11.0 per cent appeared inescapable during the year. The Reserve Bank planned for a reduction in excess liquidity and to remain prepared to react as the situation unfolded. The credit policy response was to raise CRR from 9.5 per cent to 10.0 per cent from October 24, 1987 to check the growth in M_3,

thereby immobilising about ₹ 450 crore of liquidity. From December 5, 1987, the discretionary refinance facility provided to banks without prior sanction from the Reserve Bank was lowered from 2.0 to 1.0 per cent of their average deposits in 1986–87.

Even by the end of December 1987, the situation remained grim. Reserve money surged by ₹ 5,503 crore as against only ₹ 4,529 crore in the corresponding period of 1986–87, which led to a swelling of bank liquidity. In contrast, deposit growth slowed down. To moderate liquidity growth in the remaining months without impairing the credit needed to support output, SLR was raised from 37.5 per cent to 38.0 per cent from January 2, 1988. The letter to banks hoped that with the larger-than-anticipated decline in food credit and substantial unutilised refinance limits, they would be in a position to adjust smoothly to this measure while meeting genuine credit requirements.

The interest rate on FCNR deposits had been kept at a level attractive for NRIs to place deposits under the scheme. Particularly since April 1987, the interest rates in overseas markets on US dollar deposits had shown a steady rise and, against this background, the Reserve Bank revised the rates for different maturities under these deposits upwards from May 25, 1987, in the range of 0.5 to 1.5 percentage points. Thereby, the rates on FCNR deposits continued to remain attractive in comparison with those generally offered in major international markets. Again, from October 12, 1987, the Reserve Bank effected changes in the interest rates on deposits under the FCNR scheme as well as the NRE accounts scheme for different maturities, taking into account the rise in interest rates in overseas markets on US dollar deposits during the period.

The Finance Minister had directed the finance ministry that to step up the domestic savings rate all institutions connected with mobilising savings, such as banks, the LIC, General Insurance Corporation of India (GIC), UTI and the National Savings Organisation (NSO) should work out a co-ordinated action plan immediately. The Additional Secretary (Budget), in his letter dated August 7, 1987, requested the Deputy Governor to suggest concrete steps to be taken in this regard.

The office note recorded in the CPC (September 7, 1987) expressed the view that the rate of savings fluctuated depending on the interplay of economic forces and that even after concerted changes in the structure of interest rates in various savings instruments, the proliferation of concessions did not make for a rational structure of interest rates on savings instruments. It was also reasoned that providing concessions/

facilities did not necessarily induce large savings, but only encouraged the withdrawal of funds from savings schemes. The remedies suggested were, a drastic curtailment in loan and withdrawal facilities whereby large tax benefits accrued to the investors without any fresh investment; while the quantum of deduction under section 80C concession could be raised, the percentage deduction to be reduced; and schemes like Indira Vikas Patra and the post office monthly savings scheme to be fostered as they could yield better results than other schemes with relatively lower nominal rates and higher fiscal privileges. It was also suggested that the government securities market for non-captive investors needed to be widened.

For the year as a whole, expansion in M_3 at 15.3 per cent was lower than that in the previous year (18.8%). This was made possible due to the marginally lower increase in other banks' credit to the Government and the smaller increase in net foreign exchange assets of the banking sector. Net Reserve Bank credit to the Government was, however, higher than in 1986–87. In general, the main reason for the slower growth in bank deposits was the decline in household savings consequent upon the shrinkage of income due to drought and also the strong competition that bank deposits faced from other saving instruments. Despite the large increase in reserve money, secondary expansion was moderated by increased reserve requirements. Although considerable imbalances surfaced between demand and supply, giving rise to pressures on commodity prices, the overall price increase of about 10.0 per cent could be considered reasonable given the intensity of the drought. In the final analysis, monetary and fiscal policies were carefully designed to finance the additional expenditure on drought and flood relief without generating undue inflationary pressures.

BUY-BACK ARRANGEMENTS IN GOVERNMENT SECURITIES

Certain institutions were statutorily required to keep their short-term surplus funds in interest-free deposits with the Reserve Bank. These included the IDBI, National Bank for Agriculture and Rural Development (NABARD) and the Deposit Insurance and Credit Guarantee Corporation of India (DICGC). The Reserve Bank regularly provided a buy-back facility in government securities to these institutions. This arrangement attracted attention from 1981–82 onwards when the Reserve Bank credit to the Government was being monitored. From September 1986 to March 1988, this facility was also extended to the Industrial Credit and Investment Corporation of India Ltd (ICICI), but was confined to the rupee counterpart funds which accrued under the special arrangement

with the Reserve Bank for surrender of foreign currency deposits. The Reserve Bank sold government securities to these institutions without any limit at the prevailing rate and undertook to buy them back at the same rate whenever they needed funds, thereby enabling them to earn a return higher than the other alternative avenues open to other institutions. Such investments escalated from a modest ₹ 147 crore in March 1981 to ₹ 2,511 crore in February 1988. From the monetary policy angle, it tended to distort the maturity structure of interest rates on various instruments, since a long-term instrument was being converted into a short-term one by providing artificial liquidity. Moreover, the utilisation displayed wide monthly fluctuations, which made it difficult to monitor and forecast the Reserve Bank's holdings of government securities.

By March 1988, the Reserve Bank recognised the need to minimise, if not eliminate altogether, sharp variations in buy-back arrangements, which in any case did not emanate from the Government's need for credit from the Reserve Bank. The informal group on implementation of the new definition of budgetary deficit constituted by the Government, in their report submitted in September 1986, identified the variations in transactions in buy-back arrangements with FIs as one of the two major factors[19] which caused fluctuations in the Reserve Bank's holdings of dated securities, making its estimation difficult.

However, the Reserve Bank was not inclined to suddenly withdraw the buy-back facility since it would cause hardship to FIs. The more practical method chosen was to gradually reduce its size and ultimately to withdraw it. Accordingly, the Reserve Bank after consulting the institutions, decided that the lowest amount of investment outstanding in government securities of each institution on a specified date should be considered as part of their regular investment portfolio and taken out of the buy-back arrangement. Each institution was allotted a quota up to which they might enter into a buy-back arrangement with the Reserve Bank; over time, these quotas were gradually reduced. As a long-term solution, they were encouraged to move to 182-day Treasury Bills and, to the extent possible, to the commercial bills rediscounting market. With the establishment of the Discount and Finance House of India Ltd (DFHI), they were provided with another opportunity to invest their funds in the short-term money market.

19. The other factor was the large swings in holdings by banks of 91-day Treasury Bills. However, with the corrective measures taken by the Reserve Bank towards the end of 1986, the 'noise' created by this factor had been virtually eliminated.

CREDIT POLICY FOR 1988–89 ATTUNED TO PROMOTE GROWTH

The Reserve Bank in formulating the credit policy for 1988–89 was not swayed by nascent signs of recovery in output but preferred to continue with its cautious stance. The expansion in M_3 during 1987–88 (up to March 11, 1988) was 14.8 per cent, *i.e.*, the same as in the previous year. Deposit growth during 1987–88 was considerably below that of the previous year; for the first time, it fell short of the working estimate mainly due to a sharp deceleration in demand deposit growth. However, it was a matter of some discomfort that there was a sharp increase in currency with the public by almost 20.0 per cent as against 15.0 per cent in the previous year. In all, banking trends in 1987–88 foretold a clear shortfall in deposit growth and a possible overshooting of non-food credit over the projections for the current year; however, M_3 growth was expected to be close to the estimated increase of 16.0 per cent. Nonetheless, policymakers were concerned about the large expansion in reserve money — 18.8 per cent during the year 1987–88 (up to March 11) as against 19.4 per cent in the previous year.

On the assumption that the high reserve money expansion could result in strong inflationary build-up, the objective of moderating the growth in M_3 became the basic tenet of credit policy during 1988–89. The Reserve Bank modulated its policy measures so that the *rabi* 1988 food grain procurement measures were fully supported by banks, which had adequate resources to finance any temporary upswing in food credit. The entire cash balance that remained impounded (₹ 744 crore) was released on April 23, 1988 to support the demand for food credit, especially during the month of May 1988. To partially neutralise the return flow of food credit, the Reserve Bank asked the banks to maintain, from July 30, 1988, CRR of 10.5 per cent. However, banks that had attained an overall CRR level of 15.0 per cent were exempt from maintaining a ratio higher than 15.0 per cent. To provide a better return on short-term surplus funds, the term-deposit rate for 91 days and above but less than 6 months was raised from 6.5 per cent to 8.0 per cent from April 4, 1988.

There were changes in the availment of the 182-day Treasury Bills refinance facility. The Reserve Bank provided refinance to banks equivalent to 75.0 per cent of their holdings of 182-day Treasury Bills at 10.0 per cent interest. The DFHI was scheduled to commence operations soon, which was expected to impart enlarged liquidity to these instruments and make banks' dealings with the DFHI more attractive than refinance from the

Reserve Bank. Taking this into account, from April 23, 1988, the Reserve Bank made the refinance facility available at 50.0 per cent of a bank's holdings of 182-day Treasury Bills, and the interest rate on such refinance was raised to 10.25 per cent.

The wheat crop (*rabi* 1988) was expected to be good but the pipeline stocks of private trade had almost dried up. The Reserve Bank feared that private trade would make aggressive purchases and create difficulties for procurement agencies. Further, the stocks with the PDS were reported to be low. Therefore, to facilitate procurement and build-up of wheat stock, the Reserve Bank decided to bring wheat back within the purview of selective credit controls. Again, on a review of market developments relating to wheat, the Reserve Bank raised the minimum margins on bank advances against stocks of wheat across the board by 15.0 percentage points from June 9, 1988.

PROMOTING EFFICIENCY IN THE FINANCIAL SYSTEM

While the broad policy objectives of supporting production activities and containing inflationary impulses continued, the idea of promoting efficiency in the operation of the financial system was given a visible push during the year 1988–89. Several changes in financial policies were initiated, including easing of operational constraints in the credit delivery system, introduction of new money market instruments and strengthening of existing instruments. The rationale was to reduce rigidities by introducing flexibility to allow for diversification and bring about a more competitive environment in money and financial markets.

The changes introduced in the traditional instruments of monetary control, such as CRR, deposit and lending rates and money market rates, were of special significance. The prescription of a uniform CRR of 15.0 per cent, while not resulting in an additional burden for most banks, eliminated multiple prescriptions and simplified the entire CRR operation. The raising of short-term deposit rates was also a logical extension of the process of rationalising the structure of deposit rates, which began in April 1985. Another aspect of the reform was to bring short-term interest rates in better alignment with other interest rates in the system. Likewise, the prescription of a minimum lending rate for general category of borrowers, replacing the long-standing ceiling rate, made a significant qualitative difference to the structure of administered interest rates and also enabled banks to better equilibrate the cost of raising funds and the return on those funds. In the money market, there were significant changes relating

to instrument development and gradual easing of control.[20] Interest rate ceilings were abolished from May 1, 1989 on all money market instruments.

While announcing the credit policy for the first half of 1988–89, the Governor had expressed concern on the large overhang of primary liquidity and emphasised the need to contain the growth of overall liquidity during the year to a level somewhat below the average for the past three years (*i.e.*, about 17.0%). The expansion of M_3 during the year up to July 1, 1988 was 7.0 per cent as against a comparable increase of 5.2 per cent in the previous year. The reserve money expansion was ₹ 3,936 crore and ₹ 2,984 crore during these two periods, respectively. Such a large increase in reserve money alongside the existing liquidity situation caused concern. Following lower procurement, food credit failed to pick up and in fact declined as against an expected increase. Non-food credit was growing at a considerably faster rate. There were thus clear indications that the overhang of primary liquidity might aggravate the price situation. Although the increase in wholesale prices was smaller than in the previous year, the rate of increase showed signs of acceleration. In April 1988, in anticipation of an upsurge in food credit, ₹ 744 crore was released. However, since the increase did not materialise, the increase in CRR by 0.5 per cent scheduled for July 30, 1988 was brought forward to July 2, 1988. Simultaneously, CRR on FCNR deposit liabilities was raised from 9.5 per cent to 10.0 per cent. Subsequently, to partially neutralise the return flow of food credit, CRR was raised to 11.0 per cent from July 30, 1988.

The need to continue the standby refinance facility was reviewed after the banks were allowed to draw discretionary refinance up to certain limits without the prior approval of the Reserve Bank and the 182-day Treasury Bills refinance facility was instituted. The CPC perceived that the assurance of liberal standby refinance at a relatively low rate against the collateral of government securities would only encourage banks to build an excess SLR position, whereas its abolition would induce banks to stop investing large amounts in Treasury Bills. Finally, it was decided that the standby facility should be allowed to continue and the position reviewed when the Treasury Bill market grew to a sizeable extent, say, by ₹ 1,000 crore.

It became evident by October 1988 that the economy was poised to achieve a sharp improvement in output following the exceptionally good monsoon. *Kharif* food grain production was expected to record a sizeable growth. However, available data indicated that M_3 had already expanded

20. This topic has been covered in chapter 16: Financial Markets.

by 7.2 per cent by October, as against a comparable increase of 6.2 per cent in the previous year. In fact, this growth had been moderated by a substantial decline in net foreign exchange assets. The increase in net Reserve Bank credit to the Government up to September 23, 1988 at ₹ 5,721 crore as against ₹ 3,976 crore in the previous year provided the potential to expand overall liquidity in the second half of the year. On the banking scene, aggregate deposits of banks had already gone up by 8.7 per cent against an increase of 5.9 per cent; their resources position had further improved on account of the large return flow of credit. The net result was that even though non-food credit had expanded somewhat, the banks' liquidity position was comfortable. The deposit growth during the year was expected to exceed the working estimate of ₹ 20,000 crore, thus placing the banks in a position to expand non-food credit at a level somewhat higher than in the previous year. The policymakers' perception was that although M_3 growth had been moderate, the inflation rate had slackened and the effect of overhang of excess liquidity in the system (and the large increase in Reserve Bank credit to the Government) needed careful monitoring. The policy changes introduced by the Reserve Bank in October 1988 related essentially to structural aspects, such as relaxing interest rates and the control mechanism, and introducing new money market instruments.

The Vaghul Committee had recommended that inter-bank participation certificates, which were phased out a few years before, should be reintroduced in a modified form. To provide an additional instrument that would even out short-term liquidity within the banking system, the Reserve Bank decided in principle to introduce two types of participation certificates — one on a risk-sharing basis and the other without risk sharing. With a view to affording some degree of flexibility to the bills rediscounting market, the DFHI was allowed to participate in the call and money market, both as a lender and a borrower, and such operations were exempt from the provisions of the rate of interest ceiling set by the IBA, enabling it to contribute effectively to the overall stability of the money market.

INTEREST RATES

As a follow-up to the Chakravarty Committee's recommendation that there should be no interest rate ceiling for bank advances in categories other than those providing credit at concessional rates, the Reserve Bank decided that from October 10, 1988, all lending rates falling under the

prescription of 16.5 per cent (fixed) category would cease to have a ceiling stipulation, but be subject to a minimum of 16.0 per cent. Banks were to use their discretion to charge differential rates judiciously.

On a review of the working of CAS, the Reserve Bank withdrew the requirement of its prior approval for sanction of working capital credit limits/term loans by banks. However, all proposals involving a sanction of aggregate working capital limits beyond ₹ 5 crore (in place of the existing ₹ 2 crore) were subject to post-sanction scrutiny by the Reserve Bank to ensure that basic lending discipline had been observed.

The President of the Indian Merchants' Chamber, Bombay, at the annual general meeting held on February 24, 1989, where Governor Malhotra was present, made a plea for reducing interest rates on the grounds that the minimum lending rate was too high and, but for the Reserve Bank's prescription, many banks could bring the rates below 16.0 per cent as they enjoyed a large spread between lending rates and the cost of raising deposits.

The Governor took the opportunity to dwell on the rationale for the interest rate policy as also to clear some associated misconceptions. He advised that first, while flexibility was the cornerstone of the interest rate policy, a generalised reduction in the interest rate structure depended on an enduring slowdown in inflation. Second, the apparent spread between the cost of raising funds and the average rate of return earned by banks was not higher in India than in many other countries. Considering the low income earning capacity of small borrowers, some degree of cross-subsidisation in interest rates was inevitable and banks had to service a large number of small borrowal accounts, resulting in reduced average earnings and higher average cost. Taking into account the return on banks' investments and cash balances, the weighted average lending rate worked out to about 13.0 per cent. Third, while large borrowers had to pay an interest rate of 16.0 per cent or more, their average burden was lower owing to the concessional rates applicable on export credit and bill finance. Finally, the Governor emphasised that the interest rate structure had to subserve certain broad societal goals, namely, ensure a realistic rate of return for savers in bank deposits, discourage excess inventory holdings and generally encourage more rational use of scarce capital.

Looking back, monetary policy tried to restrain inflationary tendencies in the economy despite the constraints the Reserve Bank faced in using its policy instruments. In a succinct manner, Dr C. Rangarajan had the

following to say on the role played by the Reserve Bank during this critical period:

> Monetary policy did acquire a sharper focus in the 1980s. Against the background of raising budgetary deficits and their automatic monetisation, growth in money supply could be moderated only by limiting the secondary expansion through such instruments as the CRR, which became the most heavily used instrument during the decade. The Reserve Bank of India had little control over the primary creation of reserve money in the form of credit to Government.[21]

RATIONALISATION OF THE CALL MONEY RATE STRUCTURE

In March 1988, the CPC examined the possibility of freeing the interest rate stipulation on call money rates. The ceiling was revised in April 1980, by the IBA from 8.5 per cent to 10.0 per cent to counter a resurgence of inflation and the sharp upward movement in the administered interest rate structure. The Vaghul Committee had commented that the ceiling on the interest rate and the virtual ban on new entrants inhibited the proper development of the call money market, and that the cap on the interest rate was followed more in breach than in its observance, with participants resorting to various devices to circumvent the ceiling. It had recommended that the interest rate ceiling on call money rates should be freed only for inter-bank transactions but continued for borrowings from non-bank participants in the market.

Three alternatives were contemplated to rationalise the call money rate. The first option of freeing the rate as recommended by the Vaghul Committee, although seen to be desirable, could convey a shock effect to the market and, therefore, had to be implemented cautiously. It was felt that the rate could be freed when the DFHI acquired further experience in its operations in the call money market and augmented its resources. The Reserve Bank visualised that at a future date, the DFHI could be assigned to perform a stabilising role in the call money market and at that point the discretionary and standby facilities provided directly to banks by the Reserve Bank could be channelled through the DFHI. The second option was to raise the ceiling on the call money rate, which in any case was out of date, without altering the existing participants in the call money market.

21. "The Tuesday Interview", *The Economic Times*. September 10, 1991.

Then the ceiling could be raised gradually as a progressive move towards its complete removal. What went against this course was that any marginal increase in the ceiling rate would not prevent players in the market from circumventing the rate, which would then become an 'artificial' rate and infringements would continue. The third expedient was a gradual freeing of the ceiling on the call money rate. Initially, it was proposed that the IBA should be advised to exempt dealings by banks with the DFHI from the call/notice money ceiling rate guidelines, the main advantage being that since the DFHI would be playing a moderating and stabilising role, it would not try to raise call money rates to unacceptable levels. Moreover, the DFHI's operations were expected to impart a downward flexibility on the call money rates. The Reserve Bank implemented the last proposal in October 1988.

CASH RESERVE RATIO: IMPERATIVE NEED TO ACTIVATE THE INSTRUMENT

CRR had long been the most potent and oft used instrument of credit control in the arsenal of the Reserve Bank. But owing to its recurrent upward revisions, it was fast losing its efficacy. Banking data indicated that in May 1988, 7 out of 28 PSBs had already reached the statutory ceiling of 15.0 per cent, and a number of banks were on the verge of joining this club. More worrisome, it was expected that the SBI would reach this limit soon after the year 1988. "This would be the end of CRR as an instrument of monetary policy", bemoaned an office note (dated June 3, 1988) prepared by the CPC. Since CRR as a tool would also have to be resorted to in future, the Reserve Bank felt an urgent need to revive its utility. Therefore, the Reserve Bank took up the issue with the Government to amend the enabling statutory provision, namely, section 42 of the RBI Act, 1934, to raise the limit to 20.0 per cent.

The Governor, in his letter dated July 15, 1988 to the finance secretary, made a strong case for amending the Act. Surprisingly, the finance ministry took a contrarian view. The Government felt that a progressive CRR increase might be harmful in the long term and with only 50.0 per cent of the deposits available to banks for lending after providing for statutory pre-emptions — especially lending to the priority sector and exports at non-commercial rates — there could be pressure on the viability of banks and an increase in the cost of borrowing. This was most revealing, since all along it was the Reserve Bank that had been the guardian of the interests of banks! Second, conceding that no effective solution to the liquidity

problem was feasible without reining in the budget deficit, the Government reasoned that since the budget deficit could not be controlled, CRR itself could not provide a long-term solution to the liquidity problem. On this logic, the Government wanted the Reserve Bank to explore the possibility of devising a new policy instrument to control liquidity without impairing the viability of banks. Last, since CRR for some banks had already touched 15.0 per cent and other banks were near the ceiling, the Government's thinking was that an additional burden should not be imposed on conforming banks and that it would be better to raise CRR within 15.0 per cent so that the burden fell only on banks which had lower CRR ratios. It is fairly certain that the underlying message in the ministry's response must have taken the policymakers on the other side of the table by a surprise.

The Reserve Bank's response was that at the time of making the proposal, the Bank was aware of its negative impact on bank profitability. While agreeing with the Government's perception that the real remedy lay in solving the problem of fiscal deficits, until this objective was achieved, there was no option but to raise the statutory ceiling on CRR. The Reserve Bank urged the Government to approve the proposal early, as otherwise rapid monetary expansion could not be checked. Reacting to the suggestion to selectively raise CRR for banks with less than 15.0 per cent ratio, it was pointed out that CRR increases in the past two years had aimed precisely at achieving a uniform 15.0 per cent for the system as a whole. The Reserve Bank clarified that the incidence of a lower CRR level for some banks was because they had a very high proportion of deposits in the form of external accounts, which in terms of official policy attracted such a level of CRR. Moreover, as the overall CRR for the system was already around 14.7 per cent, equalising CRR to 15.0 per cent could have only a limited monetary impact on banks.

The prevailing situation was that the Reserve Bank could not use the other alternative of interest rate as a tool of monetary management mainly because a large part of the deposits was pre-empted by the Government through Treasury Bills at well below market interest rates. Raising the rate only for the non-government sector was not expected to have an economy-wide impact and instead might lead to 'crowding out' of credit for the private sector.

The insulation of government borrowings from market rates also foreclosed the Reserve Bank from undertaking active open market operations (OMOs). In a period of excess liquidity in the system, the sale of securities which might be required would only mean a fall in their prices

and an increase in rates. Thus, the Reserve Bank saw no alternative but to pursue vigorously with the Government the necessary legislative sanction in the absence of discipline in containing budgetary deficits. The Reserve Bank's persistence paid off but after a rather long wait.

PUBLIC SECTOR BONDS

With the objective of promoting financial autonomy and reducing the dependence of public sector companies on the Government for resources, these companies were allowed to raise resources by issuing bonds to the public a few years back. The subscription by banks and their trading in bonds issued by public sector undertakings (PSUs) on a large scale sparked a debate about the objective and method of their issue. For the Reserve Bank, it had serious implications for monetary management and public debt administration. Further, when banks started portfolio management schemes for depositors by allowing them to invest in bonds and then repurchasing them, this created another set of problems relating to debt management and banks violating reserve requirements. The public sector bonds, which were issued from 1985–86, carried a tax-free interest income of 10.0 per cent; this worked out to a pre-tax return of nearly 20.0 per cent or a taxable return of nearly 14.0 per cent and thus provided an attractive and safe long-term investment opportunity for banks. Of the total bonds issued amounting to ₹ 1,000 crore by seven public sector companies during 1985–86, about ₹ 600 crore were reported to have been subscribed by banks. However, according to newspaper reports, the finance ministry had made known to banks that the primary objective of raising resources from the market by tapping individual savings would be defeated if they held bonds in large quantities. They were asked to offload their holdings gradually to help develop an active secondary market for these bonds.

Subsequently, the authorities discovered that this type of investment threw up unanticipated issues. Since in terms of the banking laws, commercial banks could not hold more than 1.5 per cent of their incremental deposits in bonds, the question was whether this limit was above the 1.5 per cent permitted for investments in securities of private sector companies or inclusive of it. Further, the Reserve Bank, in principle, was not inclined to allow portfolio investment by banks as it violated the short-term deposit interest rates prescribed by it.

In July 1987, a few banks started selling these bonds to the public in Bombay and New Delhi. According to newspaper reports, the sale

transactions in New Delhi by the SBI were inaugurated by the Finance Secretary and the Banking Secretary.

The preliminary reaction of the Governor Shri R.N. Malhotra to this was one of discomfort. He recorded an office note on January 8, 1987: "We cannot allow institutional subscription by banks. If they have so much liquidity, I may suggest an increase in SLR." On another occasion he remarked, "This is an area where RBI should be more articulate and take a final view." The Deputy Governor was not sure whether the subscription to public sector bonds came within the purview of the limit of 1.5 per cent subscription to 'shares and debentures' prescribed by the Reserve Bank and added that the banks were "assuming that it did not".

While the Reserve Bank was mulling over the problem, it had to adopt an overtly supportive stand when in February 1987, a Member of Parliament questioned the very basis of the issue of bonds and specifically enquired about the Government's policy in this regard. His main contention was that by subscribing to the issues, nationalised banks transferred funds to PSUs, which were also owned by the Government. The Governor, in his reply in April 1987, clarified that the broad objective of the bond issue was to reduce the reliance of public sector units on the Government budget and expressed the hope that the investing banks would gradually replace them with end-investors and meanwhile hold the bonds in their investment portfolio.

The issue came to the fore when the Government announced that during 1987–88 public sector corporations would float bonds aggregating ₹ 1,500 crore. The Governor, in his letter of November 6, 1987 to the Finance Secretary, pointed out that during the previous year, a number of issues were oversubscribed, the Controller of Capital Issues (CCI) had permitted the oversubscription to be retained, and such oversubscription was made possible with the subscription by banks and other institutions. The Reserve Bank was concerned that the banks were yet to complete the effective placement of the previous year's issues through the secondary market and, in this regard, the timely availability of bond certificates of the right denominations posed a problem.

With a number of public sector companies simultaneously negotiating with banks and other institutions, there was a possibility of oversubscription that year, particularly in the case of issues that were early in the queue. The Governor was forthright in advising that such oversubscriptions could have serious repercussions. His point was that banks had very limited resources to support public sector bonds and, if oversubscriptions were allowed

to be retained, the subsequent issues might not be successful. From the credit policy angle also, this strategy of raising resources could impinge on the availability of non-food credit, and any such curtailment could affect productive activity as well as the flow of funds to the capital market.

From a wider perspective, the Reserve Bank cautioned that it would be difficult to implement some of the policy responses which it had agreed to, in order to support that year's borrowing programme. This would hurt the interests of the Government, where it mattered most. In view of these policy ramifications, the Governor suggested that the Finance Secretary might make it clear to the concerned public sector organisations that they would not be permitted to retain any oversubscription and also that they should not attempt tie-up arrangements with banks and other institutions for amounts larger than those sanctioned.

The issue was resolved soon. According to newspaper reports,[22] FIs and Foreign Exchange Regulation Act (FERA) companies which had comfortable liquidity started picking up the public sector bonds in a 'big way'. In the process, a minor irritant in the relations between the fiscal and monetary authorities was removed.

PORTFOLIO INVESTMENT MANAGEMENT SCHEME

The portfolio investment management scheme came under the scanner soon after it was launched. A press report[23] read as follows:

> Under the so-called portfolio investment management scheme, half a dozen banks "sell" public sector Government bonds to the party against funds deposited by it for the period contracted and pay interest at the higher rates…At the end of the period, these banks "buy back" the bonds. But, all these buying and selling operations were only on paper and the bonds remained with the banks themselves. In fact, these banks put the condition that all investments and disinvestments of the portfolio would be transacted only through the bank. This means that banks which have devised the scheme to earn 14 per cent on bonds pay up to 13.25 per cent on the funds borrowed against the bonds. But, in the process, they got large amounts of deposit, which technically did not fall under the purview of the RBI policy and hence were immune from Cash Reserve Ratio (CRR) and Statutory Liquidity

22. *Business Standard*. February 5, 1988.
23. "A Mockery of RBI Interest Rate Policy", *The Indian Express*. February 18, 1987.

Ratio (SLR). If these funds had come in as deposits as per normal terms, 45 per cent of this amount would have been impounded, which could have been utilised for developmental programmes of the Government.

Under this arrangement, certain banks offered lucrative interest rates for short-term funds that were substantially higher than the rates prescribed by the Reserve Bank for deposits. According to the same newspaper report, even the finance ministry was shocked to note the massive purchases of public sector bonds by banks, since the objective behind permitting the issue of such bonds with tax benefits was to raise funds from the public and reduce the burden on the Government. But the cornering of these bonds by banks had resulted in the transfer of funds from one public sector agency to another.

For the next few months, regulators in the Reserve Bank grappled with the issue. An internal study revealed that certain banks had in fact been indulging in this practice and this was also commented upon in the inspection reports of the concerned banks but no follow-up action was taken. What worried the authorities more was that no real purchase in securities took place, and in the process, substantial bank funds got locked up on account of the purported purchase/sale operations in securities/bonds instead of being deployed in regular lending operations.

Moreover, banks that did not have surplus resources to invest termed this arrangement as unfair as it lured away major customers, particularly public sector concerns. In an extreme case, the possibility of the bulk of the large short-term deposits disappearing from the banking system (with a consequent increase in the cost of funds and an adverse impact on their profitability) could not be ruled out. From the perspective of the regulator, this was seen as a subtle way of bypassing interest rate directives on deposits as well as avoiding compliance with CRR and SLR regulations.

At the same time, the Reserve Bank recognised that there could be no objection to a bank buying and selling government securities on behalf of its customer who was genuinely interested in investing in securities at the prevailing market prices, but without any buy-back condition as to predetermined yields and prices.

At the policymaking level, it was perceived that while some curbs were needed on these activities, at that point of time, nothing should be done to hamper the conduct of these transactions, provided they did not involve any violation of Reserve Bank directives on interest rates on deposits or non-observance of reserve requirements.

The Reserve Bank decided to tackle the issue with circumspection. The Governor in his slack season credit policy circular dated March 31, 1987, *inter alia*, conveyed the concerns of the Reserve Bank over the unhealthy practices adopted by certain banks under the scheme of buy-back arrangements in securities and asked them to exercise caution. The follow-up circular dated April 15, 1987 allowed the continuation of the buy-back arrangements in government and other approved securities with non-bank clients subject to certain conditions. Again, in October 1987, while announcing the credit policy for the busy season 1987–88, the Reserve Bank repeated its advice to exercise caution in these dealings.

Despite these exhortations, the Reserve Bank noticed that there was a large spurt in buy-back arrangements and apprehended that a mismatch could develop between short-term availability of funds with investors and long-dated maturity of securities on one hand and, in the event of a sudden unwinding of buy-back arrangements, a serious liquidity bind might emerge, on the other. Since the issue was becoming complex, the Deputy Governor discussed it with the Finance Secretary and recorded as follows:

> Initially, the F.S. was very cut up with the idea of terminating the scheme. I explained to him that what the banks were doing is not 'portfolio management' but simply paying a higher rate for short-term funds. He finally seemed to appreciate the point. However, he felt that instead of banning the scheme, RBI should insist on procedures relating to buying and selling to be followed according to rules. Governor may like to have a word with FS before issuing any new circular. I could not explain fully to FS the implications of buy-back arrangements.

The finance ministry remained unconvinced and the Governor had to adopt an ambivalent position, as could be deduced from his notings dated December 20, 1987: "This has been discussed. Finance Secretary has no special problem but I wonder whether in view of some steps which we contemplate, the present time is right for taking the proposed action." The Reserve Bank was once again left clueless. It preferred to buy time by calling for data from banks on these transactions before a final decision was taken.

By November 1987, the finance ministry started evincing interest. The Banking Division sought the views of the Reserve Bank (in this case, the DBOD) out of a concern that owing to these arrangements, there was a

sharp decline in bank deposits, thereby increasing the cost in mobilising deposits. The Reserve Bank apprised the Government of the action taken to remedy the situation.

Meanwhile, the economic newspapers got wind of the goings on and began to draw their own conclusions. A media report[24] made the disclosure that several PSUs, which had raised about ₹ 2,350 crore in public sector bonds, found their disbursements staggered and conveniently placed the funds for a short period in government securities through banks. In the process, they reaped a return of 10.0 per cent and made a profit of 1.0 per cent on the money raised through the 10.0 per cent bonds. In April 1988, the curtain was rung down. The Reserve Bank, in its credit policy announcement for the first half of 1988–89, prohibited banks from entering into buy-back arrangements with non-bank clients in government and other approved securities, effective April 4, 1988 and advised them to terminate all existing arrangements on the date of their expiry or by July 1, 1988, whichever was earlier. However, banks were permitted to undertake outright purchase/sale at market prices on complying with existing procedures for such transactions. The Reserve Bank also clarified that outright purchase/sale transactions with the same party and for identical accounts would be construed as a violation of the instructions prohibiting buy-back arrangements. Since some instances of violation had been noticed, the Reserve Bank stipulated a minimum lock-in period of one year for portfolio management schemes from March 28, 1989.

INTEREST RATE MANAGEMENT

There was no market-related interest rate policy in the true sense of the term until the late 1980s. The interest rate framework evolved in a regulatory environment, aimed at keeping government borrowing costs and long-term interest rates low to promote investment and direct credit flows to specific sectors of economic activity in line with the objectives of the Five Year Plan. The desired level and structure of interest rates as also the direction of allocation of bank credit was achieved through direct controls.

This meant that in the 1980s, as before, almost all interest rates in the financial markets were administratively determined. In some cases, the precise level was fixed, while in others there were ceilings or limits on flows, or both. The main consideration was the need to finance the Government's

24. "RBI May Ban Portfolio Management by Banks", *Business Standard.* November 26, 1987.

borrowings as cheaply as possible. The Reserve Bank, therefore, provided short-term accommodation to the Central Government for short periods (*i.e.,* 91 days) through Treasury Bills at 4.6 per cent interest and the rates on government bonds were within the average range of 5.0 to 9.0 per cent, depending on maturities. A system of preferential interest rates was evolved to support the activities of specific groups or sectors, *e.g.*, 4.0 per cent was applicable for loans to small farmers, small businesses and small borrowers in the backward regions under the differential rate of interest (DRI) scheme. Average deposit rates ranged between 8.0 and 11.0 per cent, depending on the maturity period. Such trade-offs among objectives kept the deposit rates low and lending rates high. Paradoxically, the lending rate ceilings worked out to be positive in real terms, but deposit rates fluctuated widely from being negative to positive, depending on movements in inflation levels.

The Chakravarty Committee had observed that the administered rate system was inflexible, and that flexibility was necessary to augment financial savings by changing the deposit rates from time to time. However, banks were wary of increasing the average cost of deposits. The Government and the Reserve Bank were aware that it was desirable to offer an attractive return on savings, but efforts in this direction were weak and circumscribed by the commitment to pursue other objectives. Even so, an attempt was made to tackle the high cost of money.

Pursuant to a meeting of the Cabinet Committee on Economic Affairs (CCEA) on February 19, 1986, which reviewed the then prevailing interest rate structure and directed the Ministry of Finance to prepare a paper on the cost of money, the Deputy Governor received an urgent message that the Finance Minister wanted a note on the cost of the money in the Indian economy. To the Finance Minister's question as to why interest rates were so high, the finance ministry had explained that this was because of the cross-subsidisation of government borrowing at low rates and the low rates of interest for advances to the priority sector. The Reserve Bank was requested to send a paper on this subject by the following day. A note titled 'Interest Rates in the Banking System' was prepared in the CPC to be sent to the Ministry of Finance. The note observed that any significant reduction in lending rates without a reduction in deposit rates was not feasible and any reduction in deposit rates would hamper deposit mobilisation efforts. This was due to the highly restrictive features of the structure of administered interest rates in the economy.

The Governor outlined the policy aspects having a bearing on the evolution of a more rational interest rate structure which had to be addressed. The more important of these were, the need to bring down the existing high level of reserve requirements; SLR not to be raised as a matter of medium-term policy; continuation of a high level of CRR was inescapable as long as the Reserve Bank credit to the Government remained at the then persisting high levels; and avoiding the temptation to increase the area of concessional interest rates. The note made the pertinent point that any reduction in deposit rates might not be possible if government borrowings (including those under small savings schemes and floatation of bonds by public sector companies) continued to be high. The Government was also advised, *inter alia*, that given the prevailing rates of return on alternative financial assets, any reduction in deposit rates was not feasible. In support, a reference was made to the recommendations of the Chakravarty Committee report for rationalising the structure of interest rates and for a gradual reduction in the multiplicity of concessional rates.

The finance ministry's consolidated note on cost of money was submitted to the CCEA. It postulated that the prospects of reducing the cost of money to medium and large industrial borrowers without affecting the interest paid to deposits did not seem feasible in the immediate future without a direct or indirect subsidy. In the medium term, major issues with the objective to reduce the apex rate of interest to, say, 16.0 per cent were identified. Some of these were: fewer categories of borrowers who were given loans at concessional rates; financial nursing of sick units to be confined to potentially viable units; timely recovery of dues in priority sector advances, particularly agriculture; and a restraint on government borrowings from the Reserve Bank and from banks through SLR since such borrowings impacted the overall M_3 and, in turn, affected any measures to contain M_3 growth, which inevitably culminated in an increase in CRR.

The CCEA, at its meeting on March 27, 1986, considered the paper prepared by the finance ministry. It favoured bringing down the cost of money by 2.0 percentage points and formed a group of 10 ministers to look into this matter.

On April 15, 1986, the finance ministry wrote to the Deputy Governor suggesting a discussion on the preparation of a paper to implement the 2.0 percentage points' reduction in the cost of money as directed by the CCEA. A detailed note titled: Review of Interest Rates was prepared, which conceptualised a policy package for a general reduction in the interest

rate structure. In his letter to the Chief Economic Adviser, the Governor summed up the issue thus:

> If the aim was to achieve a reduction in the cost of money in the economy, it would be necessary to reduce the structure of interest rates not only in the banking sector, but also the interest rates on a large number of other financial saving instruments and, further, that an across-the-board two percentage point reduction in deposit and lending rates would seriously jeopardise the profitability of the banking system. It would also affect the mobilisation of savings in the organised sector.

Subsequently, at the request of the Government, the Reserve Bank discussed the subject with the officials of the finance ministry. The ministry, taking into account the viewpoints of the Reserve Bank, finalised the note and submitted it to the Cabinet Secretary on June 30, 1986. The main thrust of the note was that in order to sustain the viability of the banking system, any reduction in lending rates should be accompanied by a reduction in interest rates on all other saving instruments, such as the NSCs, post office time deposits, bonds of public sector corporations, debentures and company deposits. In other words, the sweep of reduction was to encompass all saving instruments except government securities, provident funds and bonds with an interest rate of 10.0 per cent or less. A milder proposal was also mooted which intended to reduce the general rates by making adjustments in interest rates and the maturity structure of bank deposits.

The finance ministry also bought time by suggesting that the proposals could be implemented by September 1986 when the outcome of the monsoon was known; in case the monsoon was below normal and there was a pressure on prices, it would be 'economically undesirable to reduce money interest rates as further restraints on growth in M_3 will then become necessary.' The Chief Economic Adviser advised the Cabinet Secretary on June 30, 1986 as follows:

> Since the monsoon picture is likely to be fully known by September 1986, it has been proposed that reduction in rates should be effected only at that time. In view of this, with FM's approval, it is proposed to place this paper for consideration by the Group in early September or so.

> ...A copy of the note is also being sent... with a request that PM might be briefed on the proposals contained in the note, including the proposal regarding timing. Subject to PM's further directions, it is proposed to proceed as stated above.

The question of spreads was also examined. The Department of Economic Affairs (DEA), in a fresh note prepared in consultation with the Reserve Bank, sought to clarify that the spread available to banks between the average cost of deposits and the average return on deployment of funds at around 3.5 per cent was more apparent than real, and was barely adequate to cover their operational costs because of the large number of small deposits and borrowal accounts. It also pointed to the high operational costs in relation to earnings of branches in previously unbanked rural and semi-urban areas, the low recovery rate of agricultural loans, the increasing incidence of sick units in the portfolio of banks and their mounting wage bill. In view of these circumstances, the note concluded that the scope for reducing the spread was limited. The CCEA, however, remained unmoved.

As desired by the Banking Secretary, in September 1986, the Governor forwarded a note titled Measures to Reduce the Spread Available to Banks. It set out the Reserve Bank's stance, as also its perceptions on how the Government could help improve the viability of the banking system. In the main, the Governor noted that the spread of 3.5 per cent was to be seen in the perspective that banks were not receiving all the interest income due to them, and that the high maximum interest rate was masked by cross-subsidisation with relatively low rates for priority sectors and exports. He pointed out that the argument that banks in several foreign countries operated on very narrow spreads in contrast to a higher one in India did not apply to India because the spreads generally referred to inter-country comparisons, did not relate to actual spreads and, even within a country, the spread could vary according to the method of calculation.

Ultimately, the Reserve Bank yielded some ground. It suggested that given the constraints on Indian banking, it would be reasonable to target a reduction in the spread of about 0.25 percentage points to 0.50 percentage points between 1986 and 1990, which would still be contingent on action in different areas. There were restrictions on the growth of employees, containment of establishment expenditure per employee, improved recovery of loans and stemming the loss to banks caused by increasing sickness in borrowal accounts. The Governor observed that the financial viability of banks was of 'fundamental importance' and added categorically,

"Should a conflict arise between ensuring such viability and the objective of reducing the spread, the former should take precedence over the latter."

On March 31, 1987, the Reserve Bank announced changes in the deposit and lending rates with a view to reducing the cost of money and to impart flexibility in the interest rate policy, to be made effective from the following day. The reduction in lending rates was expected to provide relief to many categories of borrowers for whom the interest rates were sharply raised earlier, whereas the simultaneous changes in deposit rates would help protect the profitability of banks.

All lending rates of commercial banks prescribed at levels above 15.0 per cent were reduced by one percentage point. The system of interest rate bands was retained for various categories, but a fixed rate of 16.5 per cent was made applicable for the maximum slab of 16.5–17.5 per cent. The maximum deposit rate was reduced from 11.0 per cent to 10.0 per cent and this maximum was made applicable to deposits with maturity of two years and above. The shortening of the maturity structure, (*i.e.*, with the maximum deposit rate being paid on 2 years' deposits instead of 5 years' deposits as hitherto) was to enable easier adjustment of bank interest rates in response to changing circumstances.

Just prior to the announcement of the credit policy by the Governor in Bombay (now Mumbai), the Minister of State for Finance made a statement in the Lok Sabha on March 31, 1987, that in consultation with the Reserve Bank, the Government was making corresponding changes in the interest rates applicable to other financial instruments, except in the case of provident funds (PFs). The Reserve Bank, on its part, did try to ensure that the policy decision to reduce rates did not discriminate against banks *vis-a-vis* other saving instruments.

RELATIONS BETWEEN THE RESERVE BANK AND THE GOVERNMENT

The Reserve Bank, whose main task was to restrain inflationary pressures from rising to unacceptable levels, felt that fiscal policy should not weaken the effectiveness of monetary and credit policy.

PROPOSAL FOR INCREASE IN SLR

In January 1984, with its finances under severe strain, the finance ministry sounded the Reserve Bank for a possible increase in SLR over and above the level mutually agreed upon when finalising the market borrowing

programme. Towards the end of December 1983, both the Government and the Reserve Bank had agreed that market borrowing for 1984–85 would be determined within the overall framework of M_3 growth of 14.0 per cent in that year, consistent with Reserve Bank credit to the Government of ₹ 2,800 crore, Reserve Bank's support to market borrowing of ₹ 600 crore and the net borrowing of the Central Government placed at ₹ 3,100 crore. The request from the Government was for a possible increase in SLR by 2.0 percentage points.

The Governor, Dr Manmohan Singh, was firmly against the proposal and resisted the demand for SLR hike. In his letter dated January 20, 1984 to the Finance Secretary, the Governor postulated that the effect of an enhancement in SLR would mean that about ₹ 1,550 crore would be diverted from non-food credit to the Government, resulting in lowering of the projected level of non-food credit of 14.8 per cent to 10.6 per cent. This would be much lower than the levels reached in 1983–84 (14.4%) and in 1982–83 (13.5%) and culminate in severe repercussions for the productive sectors of the economy. To quote, "A situation would be reached whereby inadequate availability of credit for working capital needs would severely affect the utilisation of available capacities, thereby accentuating inflationary pressures in the economy."

The other option of injecting primary money in the form of a lower CRR or refinance limit was not available to the Reserve Bank since the main objective was to keep within the framework of 14.0 per cent M_3 growth, which was one of the 'central targets' of the policy. The letter further hypothesised that even a one percentage point increase in SLR would mean a reduction in availability of non-food credit by ₹ 775 crore in 1984–85 which, along with the inclusion of accrued interest in demand and time liabilities (*i.e.,* bank deposits) for the purposes of reserve requirements, implied that banks had to set aside about one per cent of their deposits to meet the additional reserve imposition. Over and above these repercussions on the productive capacity of the economy, any sharp increase in SLR would severely erode the profitability of banks given the existing interest rate structure. Eventually, the matter was sorted out in a meeting with the Finance Minister on January 25, 1984, where the Finance Secretary, the Chief Economic Adviser and Special Secretary to the Prime Minister were present. Consequently, no written reply went from the Reserve Bank. The proceedings and outcome of the meeting were handwritten by the Governor.

To elaborate, initially at the meeting, the Governor was agreeable for an SLR increase of 0.5 per cent as an optimal course of action — which was accepted in principle by the finance ministry officials — but he expressed the view that it might not have the desired effect of curbing inflationary expectations. The authorities, however, saw the matter differently; they were more concerned with reducing the deficit in the budget to whatever extent possible. The Governor reiterated his conviction that an increase of 2.0 percentage points would either lead to monetary growth in excess of the mutually agreed 14.0 per cent or result in a very severe squeeze on growth of credit to the commercial sector, which would in turn depress capacity utilisation and also impact the revenues of the Government and growth in output. The Chief Economic Adviser suggested that monetary growth could be contained if external reserves were drawn upon by ₹ 1,200 crore instead of the ₹ 200 crore provided for in the agreed estimates. The Governor, while seeming to concur with this idea, was still doubtful whether in the light of the experience in that year, such a large withdrawal was feasible and, in any case, did not consider it a prudent course of action.

The Finance Secretary shared this view. Both the Finance Secretary and the Chief Economic Adviser, however, reasoned that since there was no scope whatsoever for a further cut in government expenditure, the Reserve Bank could allow at a suitable time of the year for an increase in SLR by at least one per cent and also agree to a market borrowing programme of ₹ 4,100 crore for 1984–85.

The Governor pointed out that such a proposition would be inconsistent with the Centre's market borrowing programme (of ₹ 4,100 crore) and, in the context of the sustained growth in liquidity during the past three years, planning for an M_3 growth in excess of 14.0 per cent in 1984–85 would invite undue risks on the price front. He finally averred, "If inflation rate went up, a normal increase in government expenditure financed by created money would not achieve the objective of securing a real increase in expenditure", which in effect meant that the Government would be hurt most.

At this juncture, the Special Secretary to the Prime Minister expressed surprise that he was not aware of the agreement between the Reserve Bank and the finance ministry to limit M_3 growth to 14.0 per cent but nevertheless went along with the Governor's assessment that a higher market borrowing would intensify pressures on monetary growth.

However, both the Finance Secretary and the Chief Economic Adviser stuck to their stand that government borrowing could not be reduced any

further and, therefore, higher market borrowing was necessary. In the face of persistence by the Government, the Governor somewhat resiled his stand, namely:

> I pointed out that if Government felt that we could live with a higher growth rate than the 14 per cent of M_3, I would be prepared to respect their decision even though I did not agree with it and market borrowings in that event be scaled up. I also stated that I did not have a closed mind on a change in the SLR and that if the next monsoon was favourable, we could perhaps take some further risks with monetary expansion. In that event, I did not rule out a phased increase in SLR by a maximum of one percentage point in 1984–85, but no firm decision could be taken at this stage. We would have to watch the state of the monsoon in 1984–85. Also, if the SLR was to be increased, it was absolutely necessary to raise the interest rates on government borrowing. Otherwise, there would be severe effects on profitability of banks. The discussion was inconclusive. However, given the state of government finances and the inescapable requirements of additional expenditure, we would have to think in terms of increasing the SLR by one percentage point, though the timing will have to be left to be decided later on. Discussions with the Government on interest rates on government borrowings should be conducted bearing this in mind.

TRANSFER OF SURPLUS PROFITS OF THE RESERVE BANK AND INCREASE IN SLR

During 1986–87, the pressures on government finances prompted the finance ministry to ask for larger transfer of surplus profits of the Reserve Bank and also a higher SLR prescription. The Governor, Shri R.N. Malhotra, in his letter dated September 11, 1986 to the finance ministry, conveyed his reservations that it would have implications on the conduct of monetary policy and public debt management. Setting out his reactions, he argued that the profits of the Reserve Bank were generically different from those of any other PSU and that it could not be considered as any other public institution. The letter pointed out that the Reserve Bank's profits were notional and to a large extent reflected the mounting deficits of the Government itself. If these profits were channelled back to the Government, it would merely aggravate the problem of large money creation that could not but have detrimental effects on the economy. Moreover, transfers

from the Reserve Bank resulted in the creation of reserve money as they were akin to the Reserve Bank credit to the Government and, as such, the Government should not consider these transfers as a resource. The Governor stated, "In the context of a large money creation, a judgment is necessary on the amount of total reserve money creation and any increase in transfer to Government would necessarily require a corresponding reduction in the allocations to term lending financial institutions." He also referred to the deleterious effects on development activity if a resource crunch was imposed on these FIs.

The Governor then examined the components of the balance sheet surplus of the Reserve Bank, juxtaposed against the escalation in expenditure and costs that were incurred on behalf of the Government. The fact that the surplus transfer had remained unchanged at ₹ 210 crore per annum was to be seen in the context of other responsibilities borne by the Reserve Bank. The agency charges paid by the Reserve Bank to banks for conduct of government business went up from ₹ 52 crore in 1979–80 to ₹ 150 crore in 1985–86 and were expected to rise further once the recommendations of a committee, which was looking into the issue of the need to revise these charges, became available. During this period, the cost of security printing increased from ₹ 20 crore to ₹ 100 crore and the allocations to its statutory funds moved up from ₹ 455 crore in 1979–80 to ₹ 760 crore in 1985–86. By far the largest drain on the Reserve Bank was subvention to the banking system through payment of interest on banks' statutory cash balances with the Reserve Bank, *i.e.*, from ₹ 121 crore in 1979–80 to ₹ 810 crore in 1985–86, which were expected to touch over ₹ 1,000 crore by 1987–88 due to the growth of liabilities of banks.

The Governor saw the whole process as a 'vicious cycle' since high cash reserve requirements were the result of large liquidity increase caused mainly by fiscal deficits. Accordingly, he advised, "Any attempt to increase the surplus transferred by the Reserve Bank to the Central Government would have adverse effects on the economy and I would recommend that the Government should not consider this as an avenue for augmenting resources."

As regards SLR, he observed that it was a convenient mechanism for transferring resources to the Government, but the then existing level of SLR was so high that it did not permit any further increase. Although SLR had not been increased since July 1985, the effective implementation of SLR on a daily basis and the imposition of penalties on defaults

resulted in a sizeable additional burden on banks in the region of ₹ 2,000 crore. The Governor did not consider it advisable to increase SLR at that stage because any curtailment of banks' resources might lead to a severe credit squeeze on medium and large industry in both the public and private sectors that had large investment plans, which required substantial working capital.

Therefore, the Governor did not want to impede the flow of credit to productive sectors of the economy, which would also affect funds to social welfare programmes that were of importance to the Government. He reiterated, "In the light of what I have stated above, I do not recommend any increase in the Reserve Bank's surplus to be transferred to the Government" and that any increase in SLR in 1987–88 would only aggravate the already strained position of banks and impair their capacity to meet the genuine credit needs of the productive sectors.

The Governor was resigned to representing the case directly to the Prime Minister and he directed the CPC to supplement the issues included in his letter. The note prepared in this regard suggested additional supporting arguments, *viz.,* any increase in SLR would severely attenuate monetary control and thereby fuel inflationary pressures; curtailment of lendable resources of the banks was not consistent with a possible reduction in lending rates; increase in SLR would result in erosion of the profitability of banks and to compensate them, the coupon rates on securities would have to be raised by one percentage point at the maximum rate and somewhat smaller increases at shorter maturities; and these *quasi*-fiscal costs would ultimately have to be borne by the Government itself, besides pre-empting a large share of the banks' resources.

The Finance Minister was apprised of the views of the Reserve Bank. The Governor in his note dated October 14, 1986 recorded:

> I have discussed this with F.M. and Deputy Chairman, Planning Commission, as the meeting with the P.M. was cancelled at the last moment.
>
> It was agreed that getting extra resources through an increase in SLR or larger transfer of profits from RBI was not the best (or even a good) way of funding the Plan and that efforts should be made to reduce non-Plan expenditure and divert consequent savings to the Plan. However, the question might be discussed again if such efforts do not succeed.

About a year later, the issue of transferring Reserve Bank profits surfaced again. The Finance Secretary, in his letter dated January 12, 1988, renewed the Government's desire to step up the annual profits by the Reserve Bank and referred to the discussions that had been going on. The urgency arose because on one hand, the resource constraints had emerged in financing the annual plans of the Central Government and on the other, the annual profits being transferred had remained static at ₹ 210 crore. The finance ministry even suggested that the profits to be transferred for the years 1987–88 and 1988–89 might be fixed at a 'suitable percentage', say, 50.0 per cent of the annual profits before appropriation to the statutory funds, which would help set the revenue deficit in a slightly better perspective. The Finance Secretary requested an early reply to the proposal since the Government was to finalise its budget estimates. However, the Governor remained unmoved. The letter from the Government was received by the Reserve Bank on January 16 and replied to on January 20. After recalling the settled views of the Reserve Bank conveyed in his earlier letter (September 11, 1986), the Governor adduced further reasons to strengthen this stand. The Reserve Bank's profits were showing a declining trend because the interest rates on Reserve Bank's investments abroad were lower than the burden of interest payments made to banks in India on their cash balances impounded with the Reserve Bank, which was on an inexorable increase. Moreover, the burden of agency charges and cost of security printing of currency notes were rising. These developments had resulted in acute pressure on the Reserve Bank's profits. On the other hand, allocations to the statutory funds were escalating sharply as the development financial institutions (DFIs) had been assigned a larger promotional role. In 1986–87, the Reserve Bank had held down these allocations at ₹ 740 crore as against ₹ 760 crore in 1985–86.

The Governor argued that any reduction in allocation to these funds would result in a severe cut-back in lending by these FIs. In fact, new institutions like the National Housing Bank (NHB) would have to be provided with resources and if the Bank's profits continued to show a decline — which appeared a distinct possibility — the Reserve Bank might even find it difficult to maintain the level of transfer of ₹ 210 crore. As regards the Government's new proposal, the Governor responded that any predetermined formula for transfer to the Government, say, 50.0 per cent of gross profit, could only result in curtailing allocations to the statutory funds, thereby seriously jeopardising the very activities of the institutions which the Government and the Reserve Bank were committed to support.

"As such, it will be neither possible nor desirable to increase the present level of surplus being transferred by the Reserve Bank to the Government," was the final say on the matter from the Reserve Bank.

In 1990–91, the Reserve Bank transferred its surplus profits at a higher level of ₹ 350 crore; in 1991–92 a substantially higher amount of ₹ 1,500 crore was transferred (Table 4.1).

TABLE 4.1

Income and Expenditure of the Reserve Bank of India (Select Years)

(₹ crore)

	1988–89	*1989–90*	*1990–91*	*1991–92*	*1992–93*
Total income	4,030	4,427	4,625	5,700	5,632
Total expenditure	3,005	3,257	3,280	4,200	4,128
Transfer to Central Government	210	210	350	1,500	1,500

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

MONEY SUPPLY AND INFLATION

In 1987, faced with the prospect of high inflation, the Governor, Shri R.N. Malhotra, conveyed his concern directly to the Prime Minister, hoping to influence the content of the fiscal policy for the year 1987–88. In his letter dated February 7, 1987, he recalled that in the 1986–87 Budget, the Government had shown its commitment to the introduction of monetary targeting and the Government with the Reserve Bank undertook certain exercises during 1986–87 in order to announce targets for monetary growth from 1987–88.

At the start of the financial year 1986–87, consistent with a real economic growth of around 5.0 per cent and an inflation rate of 5.0–6.0 per cent, the letter stressed that it would be prudent to contain the growth in M_3 in 1986–87 to well below the average for the previous four years (17.3%) and, therefore, an informal indicative target of 16.2 per cent was considered desirable. The Governor observed that movements in monetary aggregates till then indicated strong monetary expansion, clearly well above the desired projected path. The growth in M_3 in 1986–87 (up to January 16) was of the order of 16.0 per cent, well above 2.0 percentage points of the corresponding expansion in the previous year. Taking into account the seasonal pattern of monetary expansion, the Reserve Bank estimated that M_3 growth for the full year could be around 19.0 per cent.

A major factor responsible for faster M_3 growth was the rapid expansion of bank credit to the Government (*i.e.*, emanating from the Reserve Bank and banks). The net Reserve Bank credit to the Government had already increased by about ₹ 7,000 crore by January 16, 1987 (as against an indicative target of ₹ 5,573 crore for the full financial year). This resulted in generating primary money that could not but have a harmful effect on the economy, which was already afflicted with lower-than-targeted agricultural output and was facing pressures on the price level. The Governor indicated, "The continuing large monetary expansion triggered by the strong growth in net Reserve Bank credit to the Government cannot be viewed with equanimity in the context of the clearly emerging pressure on consumer prices which were strongly pushing towards a double-digit inflation."

The Reserve Bank saw the answer in moderating the pace of fiscal deficits:

> In view of the sharp increase in money supply, we are contemplating action to sterilise a part of the increase in primary money by raising the cash reserve ratio. However, action by the monetary authorities alone will not be adequate as the main source of creation of primary money lies in fiscal deficits. There is need, therefore, for action on the fiscal front. It is imperative to contain the fiscal deficit in the current year and in 1987–88 so that the money supply growth can be kept within prudential limits to achieve a reasonable degree of price stability.

In concluding the letter, the Governor expressed a wish to meet the Prime Minister to discuss this and related matters. A copy of this letter was sent to the Finance Secretary and Secretary (Banking).

DECISION TO INCREASE CRR

The decision to increase CRR in the credit policy measures for the second half of 1987–88 had been finalised and the meeting with the bankers to announce the credit policy was scheduled for October 10, 1987. Just two days before the meeting, the finance ministry asked the Reserve Bank to put the proposed CRR increase on hold. The Governor received a telex message from the Finance Secretary that the Government did not concur with the perceptions of the Reserve Bank on the premise that the measures taken by the Government had resulted in wholesale prices showing a decline. It also said that the industrial circles apprehended a reduction in the lendable resources of banks on account of the Government's market

borrowing programme and agro-based industries might suffer for want of credit. The Government's perception was that even though the increase in CRR was marginal, it would send the wrong signal to banks to contract credit more severely than intended by the Reserve Bank. The telex message from the Finance Secretary elaborated:

> Kindly refer to our recent discussion regarding CRR. The matter has been further discussed by me with the Finance Minister. You could have noticed that because of action taken by the Government in recent weeks, which has introduced comprehensive measures for mobilising additional resources, for increasing supply of essential commodities and avoiding hoarding of stocks, there has been a perceptible change in the inflationary psychology leading to a decline in wholesale prices by 1.3 per cent in the past three weeks. As suggested by the RBI, the Government has also agreed to increase government borrowing from the banking sector by Rs. 500 crore. This would have the effect of reducing the lendable resources of the banking system in the coming months. At the same time, there is apprehension in industry about the likelihood of recession in the next few months. The Government is trying to counteract this apprehension so that maximum support is provided for industrial production and maintenance of employment. It is particularly essential to ensure that agro-based industries which were facing higher prices for their raw materials have adequate credit. Taking all these factors into account it is the view of the Government that an increase in CRR, even though marginal, will give a totally wrong signal at this time and lead to undue cutbacks in production and may aggravate sickness particularly as banks may interpret this move as a signal to contract credit more severely than intended by the RBI.

The next day the response of the Governor, Shri R.N. Malhotra, was sent directly to the Finance Minister. At the outset of his letter, he recalled that during their discussions in Washington DC, he had apprised the Finance Minister that as part of credit policy for the busy season, the Reserve Bank intended to hike both CRR and SLR by 0.5 percentage points each and, in fact, it was the Finance Minister who had 'urged' him to announce these early. But on receiving the telex from the Finance Secretary just two days before the meeting, he had to postpone the meeting 'even at the risk of some embarrassment to the Reserve Bank'.

Next, he recounted the gist of discussions, which were held with the Government prior to the decision to raise the reserve requirements and reminded that it was a joint and well-deliberated decision. The matter was first discussed in early September in the presence of the Finance Minister, the Finance Secretary and the Chief Economic Adviser, where the Finance Minister had suggested that the net market borrowing programme of the Government, which had been set at ₹ 6,300 crore for 1987–88, should be raised to ₹ 7,000 crore. The Governor had agreed, provided it was accepted as an exceptional measure in view of the severe drought. This understanding also implied increasing SLR by 0.5 percentage points from 37.5 per cent, which also met the need for additional borrowing by the Government. During the discussion, the Governor had also apprised that in view of the high liquidity and the likely decline in the national income growth during the year, the Reserve Bank contemplated raising CRR by 0.5 percentage points. However, at the suggestion of the Government, he had agreed to postpone the announcement of these measures by about three weeks.

The necessity and urgency for raising CRR were emphasised in the letter. First, the Reserve Bank considered it necessary to plan for a lower rate of monetary expansion than that of the previous year on account of the prospect of lower economic growth in 1987–88 than that envisaged in April 1987. Second, growth in reserve money in the second half of 1987–88 was alarmingly high, impacting a strong expansionary effect on liquidity. Third, the rate of inflation (up to September 19, 1987) was 7.3 per cent as against 6.3 per cent in the previous year and the inflationary potential had persisted because of the uncertain prospects of *kharif* crops. Fourth, belying expectations, there was a major turnaround in the food credit situation and this had changed the liquidity position of banks. Based on these considerations, the Governor reasoned that unless timely measures were taken — and these had already been delayed — there could be a very large expansion in liquidity:

> The problem of excess liquidity has to be tackled at the primary base and it is here that a hike in cash reserve ratio becomes relevant. In the absence of such a measure, we could expect an expansion of credit which would be a multiple of the amount proposed to be neutralised. This would be clearly unwarranted. It is, therefore, necessary to mop up at least a part of the excess liquidity which is already evident and is likely to grow.

Allaying the fears of a credit crunch, the Governor explained that the intent of the credit control measure was only to reduce a part of the excess liquidity without affecting the availability of credit to the productive sectors and in fact, the two measures taken together would still leave half of the decline in food credit remaining with banks. He reasoned, "It will thus be seen that the proposed measures are indeed mild and will take more than adequate care of the credit needs of the economy, including that of drought-related lending." Referring to the assertion made in the telex of the implicit assent of the Reserve Bank to an increase in borrowing from the banking sector, the letter clarified that it only represented the last tranche of the central government borrowing programme within the overall borrowing programme agreed to earlier and it was dictated by administrative convenience in the face of persistent excess liquidity with banks. If the Centre had to borrow ₹ 600 crore over and above the figure provided in the budget, it would still be necessary to increase SLR by 0.5 percentage points.

The Governor further stated that there was no question of a wrong signal being given and, "right signal to give to the economy was that the excess liquidity would be reduced in order to minimise its impact on prices, while taking care that the requirement of the productive sectors would be met." Raising SLR by 0.5 percentage points, which was implied in the Government's intention to increase its borrowing programme, would send signals very similar to those of a rise in CRR. The Governor concluded that the measures contemplated by the Reserve Bank were the 'minimum' needed in the circumstances and, "we would be failing in our duty if we do not adopt them as early as possible." He requested that the Reserve Bank should be allowed to go ahead with these measures to which the Government had already agreed.[25] His persuasions did not go in vain and CRR was raised from October 24, 1987.

CONCLUDING OBSERVATIONS

During the period from 1981 to 1989, the two major objectives of monetary and credit policy of the Reserve Bank continued to be the maintenance of price stability and ensuring adequate flow of credit to the productive sectors

25. The office copy of the letter in the policy file carries no initials or the signature of the Governor. Since the CRR was raised after the Governor made the policy announcement in his meeting with bankers on October 17, there is a strong likelihood that the Governor conveyed his views to the Finance Minister in person.

of the economy. The latter objective subsumed promotion of economic growth in general. These were, to a great extent, interrelated. However, the objective of price stability or inflation control was the dominant one on the underpinning that real growth would be unsustainable if the rate of inflation exceeded acceptable levels. Therefore, the overall stance of credit policy was cautious. Nevertheless, the focus of credit policy was at times modulated to respond to endogenous developments in the economy, *e.g.*, high inflation induced by oil price hike (1981–82), sluggish economic conditions (1982–83) and the slump in agricultural output consequent upon the severe drought (1987–88).

The high rate of inflation and the difficult BoP problem faced in the early part of the 1980s were overcome with the assistance under EFF from the IMF, supported by tight monetary policy and fiscal measures. After May 1984, when a part of the IMF loan was terminated by India, the monetary and credit policy issues became more complex but not intractable, because of uncontrolled increase in public expenditure financed by higher public debt, causing widening of India's fiscal deficit and as a corollary, deficit in the current account which turned out to be unsustainable.

When the price situation was under severe strain in 1987–88 and 1988–89, the Reserve Bank voiced its concerns in various Annual Reports and also brought this to the notice of the Ministry of Finance through letters.

The onerous task of limiting the excess liquidity present in the economy was carried out mainly through the instrument of CRR, which had a direct impact on monetary expansion. It, however, tended to take a unidirectional upward movement (except on two occasions in 1982–83). Its auxiliary version, *i.e.*, the incremental CRR, came in very useful to the Reserve Bank in adjusting liquidity in the economy as it carried greater flexibility in its operations. The fact that the Reserve Bank was required to pay interest on such impounded balances at rates approximating to those of term deposits, considerably blunted the effectiveness of the instrument. This was compounded by the fact that CRR had already reached the statutory ceiling of 15.0 per cent, and the Reserve Bank's request to the Government in July 1988 to initiate legislative measures to increase the ceiling to 20.0 per cent for more effective liquidity management was delayed, becoming effective only in January 1991. Thus, with its most potent credit control instrument not being operational, the Reserve Bank found it challenging to control the bulging liquidity in the economy.

Due to the compulsions of the policies carried over from the previous years, the refinance windows of the Reserve Bank turned out to be another unintended source of reserve money creation. There were two types of refinance facilities available to the commercial banks. The first one was the export credit refinance, which was formula based. The other was general refinance window, which provided very short-term funds to banks to tide over their temporary liquidity shortages. The Reserve Bank had to fine-tune these to integrate them with the overall stance of credit policy. Nevertheless, the central bank subtly used them to its advantage for quickly regulating the volume of liquidity in the economy as well as to discipline the banks, which happened to breach any of its prescriptions.

In the context of the Reserve Bank's regulation over bank credit to the public, there were two major statutory pre-emptions over the banks' lendable resources. CRR, at the time of the establishment of the Reserve Bank, was intended to serve as a prudential measure for ensuring solvency of banks, but over the years — particularly since the early 1970s — was transformed as a powerful and handy monetary control tool. Under SLR prescription, banks had to statutorily invest a portion of their deposits (*i.e.*, liabilities) in government and other approved securities; these securities earned interest at below market rates. At the beginning of the period under consideration, (namely, 1981–82), both these pre-emptions totalled well over 40.0 per cent and climbed up to 49.0 per cent by 1988–89. Moreover, banks had to maintain as CRR 10.0 per cent of their incremental deposits from the specified date and also CRR on non-resident deposits. To elaborate, by July 1, 1989 when a uniform CRR prescription of 15.0 per cent became effective, the pre-emptions on account of both CRR and SLR stood at 53.0 per cent. Of the remaining lendable resources of banks, the first allocation was food procurement credit and credit to the priority sector (which, at the maximum was 40.0% of total outstanding credit) at subsidised rates of interest. Credit to the export sector was another preferred sector advance. The DRI scheme claimed 1.0 per cent of outstanding advances at a very low rate of 4.0 per cent interest. Due to the combination of the statutory pre-emptions of deposit resources of the banking system on one hand, and the policy of directed credit based on societal considerations on the other, the impact of the credit policy measures of the Reserve Bank was borne by the commercial sector. The Reserve Bank also made efforts to introduce some degree of rationalisation and simplification in the administered interest rate structure, which had an in-built element of cross-subsidisation.

In addition to its regulatory role, the Reserve Bank actively promoted the evolution of a more efficient functioning of the financial system in the late 1980s by bringing about structural changes and introducing new instruments, while strengthening the existing ones. These facilitated the efforts to widen and deepen the financial system.

The Chakravarty Committee set up by the Reserve Bank in its report made a number of wide-ranging recommendations relating to the objectives of monetary policy, regulation over money and credit, interest rate policies and co-ordination of fiscal and monetary policies. Most of them were accepted by the Reserve Bank and their prompt implementation helped to strengthen monetary policy implementation.

However, one major area of concern for monetary management was the process of automatic monetisation of budget deficits by the Government as it strengthened the creation of reserve money; this was one of the subjects of the previous chapter. Over and above, the Reserve Bank, as part of its public debt management function, had to take up the unsubscribed portion of market issues of dated securities of the Central Government, which added to the excess liquidity in the system. Even otherwise, the erratic and variable pattern in government revenues and expenditures posed challenges for the Reserve Bank in managing the liquidity in the economy.

ANNEX 4.1

Evolution of Monetary and Credit Policy in India (1981–1990): Part I

1981–82

Restoration of Economic Stability

Governor: Dr I.G. Patel (1.12.1977 – 15.9.1982)

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
The Indian economy in 1981–82 consolidated the gains of the previous year, but remained vulnerable to the adverse impact of international economic developments. In particular, the country's external trade and BoP position was under severe strain due to the steep rise in petroleum/ oil prices and the after-effects of drought.	Restrictive stance with multiple objectives of restraining expansion in M_3 and credit, mobilising deposits and directing credit flow to priority and other productive sectors.	• Broad guidelines indicated for non-food credit expansion by banks. • Rise in CRR to 7.0 per cent (July 31–August 21, 1981). • Increase in the minimum rate of interest on RBI's discretionary refinance and rediscount from 11.0 to 14.0 per cent. • Hike in Bank Rate to 10.0 per cent (July 12, 1981). • Rise in SLR to 35.0 per cent (September 25–October 30, 1981). • Rise in CRR to 8.0 per cent (November 27, 1981–February 26, 1982) (Proposed).	

1982–83

Economy Under Strain

Governors: Dr I.G. Patel (1.12.1977 – 15.9.1982)

Dr Manmohan Singh (16.9.1982 – 14.1.1985)

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
Severe drought conditions resulted in a serious set-back to agricultural output and a decline in industrial production. Growth in M_3 was higher due to a reduction in the negative impact of decline in foreign assets. During the year, the price level was generally stable despite rapid monetary expansion.	To counter sluggishness in deposit growth, the failure of banks to meet their statutory reserves and the demand for credit from productive sectors, the Reserve Bank decided to restore normalcy in credit availability and provide a stimulus for industrial activity by increasing the flow of credit.	• Lending rates lowered. • CRR reduced to 7.25 per cent (April 9, 1982) and further to 7.0 per cent (June 11, 1982).	The committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty) was set up in December 1982.

1983–84
Economic Growth Overshadowed by Inflationary Concerns

Governor: Dr Manmohan Singh (16.9.1982 – 14.1.1985)

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
A sharp pick-up in agricultural growth and higher industrial production helped in strong economic growth in 1983–84. While overall, the BoP showed improvement, the growth of liquidity at 17.0 per cent was considered to be uncomfortably high.	To reduce the expansionary impact of rapid growth in reserve money and at the same time support productive activities with increased credit flow.	• CRR raised to 8.0 per cent (May 28, 1983–July 30, 1983) and again to 8.5 per cent (August 27, 1983). • Incremental CRR of 10.0 per cent (November 11, 1983). • CRR increased to 9.0 per cent (February 4, 1984).	Government of India terminated from May 1, 1984, the three-year EFF borrowing arrangement with the IMF, *i.e.,* about six months before it was to conclude.

1984–85
Monetary Policy Attuned to Achieving Strong Economic Growth

Governors: Dr Manmohan Singh (16.9.1982 – 14.1.1985)

Shri A. Ghosh (15.1.1985 – 4.2.1985)

Shri R.N. Malhotra (4.2.1985 – 22.12.1990)

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
Monetary expansion (M_3) at 18.2 per cent was higher than in the previous year. The two factors responsible were: (i) the large increase in net foreign exchange assets of the banking sector; and (ii) increases in net bank credit to Government and commercial sector. On the fiscal side, large deficits on revenue account emerged due to a spurt in revenue expenditure for defence, subsidies and interest payments.	The basic stance was to contain overall liquidity and thus curb inflationary expectations. At the same time, the needs of vital public sector investments had to be met.	• Main instruments were reserve ratios, changes in refinance limits and selective credit controls. • SLR raised to 36.0 per cent (July 28–September 1, 1984). • Release of a part of impounded cash balances (October 27 and December 1, 1984).	The Reserve Bank completed 50 years of service to the nation on March 31, 1985. The golden jubilee celebrations were inaugurated on June 1, 1985, by the Prime Minister, Shri Rajiv Gandhi. The function was presided over by the Finance Minister, Shri V.P. Singh.

1985–86
Emphasis on Fiscal Reforms and its Impact on Monetary Policy

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

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
The economy exhibited many welcome features: deceleration in inflation rate for the third year in succession, comfortable level of foreign exchange reserves despite a massive trade deficit and sizeable food grain stocks. The Government of India, in the budget for 1985–86, announced the adoption of long term fiscal policy (LTFP) to impart an element of stability to the whole range of fiscal measures.	The cautious stance of credit policy was continued to avoid resurgence of inflation in an environment of large increase in the volume of reserve money and overall liquidity in the economy. The main objective was to contain the overall growth in liquidity in 1985–86 to a rate lower than that in 1984–85.	There was no increase in reserve requirements during the year other than an increase in SLR. • SLR raised to 37.0 per cent (June 8, 1985 – July 6, 1985). • One-third of impounded cash balances released (October 26, 1985). • Penalties imposed for defaults in SLR maintenance by banks.	The Reserve Bank, in consultation with the Government of India (Ministry of Finance), began implementing many important recommendations of the Chakravarty Committee.

1986–87
The Chakravarty Committee (1985): Implementation of Major Recommendations

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

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
The generally poor performance of the agricultural sector impacted on overall economic growth. Expansion in M_3 was on the high side at 18.5 per cent.	In view of the large accretion to reserve money, the Reserve Bank pursued a cautious credit policy to restrain inflationary pressures during the year.	• Emphasis on effective maintenance of SLR on a daily basis by commercial banks. • CRR raised to 9.5 per cent (February 28, 1987). • Changes made in the structure of bank lending and deposit rates to reduce the cost of money and to impart flexibility to interest rate policy.	

1987–88
Pursuit of a Cautious Monetary Policy

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

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
India was afflicted by a severe drought followed by floods in parts of the country. These had an all pervasive effect on the economy. The massive expenditure by the Government towards drought relief, among other factors, fuelled inflationary expectations.	The credit policy was cautious, with emphasis on containing the expansion of overall liquidity. The objectives were to prevent excessive monetary expansion and to provide adequate credit to agriculture, industry and exports.	• SLR raised to 37.5 per cent (April 25, 1987). • CRR raised to 10.0 per cent (October 24, 1987). • SLR raised to 38.0 per cent (January 2, 1988).	

1988–89
Economic Recovery and Inflation Control

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

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
The excellent monsoon of 1988 helped produce a remarkably good performance by the economy. There was excessive reserve money creation, which had a strong potential for expansion in non-food credit.	The objectives of monetary policy were to provide adequate credit to agriculture and industry, while containing the growth of overall liquidity to a level below the annual average of the past three years (*i.e.*, 17%). To moderate the growth in primary liquidity, the broad stance of monetary and credit policy was one of restraint.	• The remaining impounded balances under the incremental CRR released (April 23, 1988) to meet the increase in food procurement credit. • CRR raised to 10.5 per cent (July 2, 1988) and to 11.0 per cent (July 30, 1988).	

1989–90
Build-up of Serious Macroeconomic Imbalances

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

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

Macroeconomic backdrop	*Objectives and stance of credit policy*	*Salient policy measures*	*Important event/s*
Although the Indian economy recorded a reasonably good performance, several serious structural imbalances caused concern. These included, unsustainable level of budget deficits, mounting CAD in the BoP and pressure on prices. In particular, M_3 growth was nearly 20.0 per cent, due to reserve money expansion caused by budget deficit.	There was need to contain inflationary pressures without endangering the growth potential of the economy. Therefore, the stance of credit policy was one of restraint on the pace of expansion of non-food credit.	• CRR was made applicable at a uniform rate of 15.0 per cent for all deposit liabilities of scheduled commercial banks. This had the effect of simplifying the multiple prescriptions into a single prescription. • The other measures were prescription of an annual incremental non-food credit-deposit ratio for each bank (October 1989); reduction in access to export credit refinance (November 1989); and tightening of selective credit controls.	

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

STATEMENT 4.1

Chronology of Major Credit Policy Measures (1981–1997)

	1980–81	*1981–82*	*1982–83*	*1983–84*	*1984–85*	*1985–86*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*
Bank Rate	9.0 (revised last on July 23, 1974)	10.0 (July 12)				
Cash Reserve Ratio* (CRR)	6.00 (revised last on November 13, 1976)	6.50 (July 31)	7.25 (April 9)	7.50 (May 28)		
		7.00 (Aug 21)	7.00 (June 11)	8.00 (July 30)		
		7.25 (Nov 27)		8.50 (Aug 27)		
		7.50 (Dec 25)		9.00 (Feb 4)		
		7.75 (Jan 29)				
Statutory Liquidity Ratio (SLR)	34.00 (revised last on December 1, 1978)	34.50 (Sept. 25) 35.00 (Oct 30)			35.50 (July 28) 36.0 (Sept 1)	36.50 (June 8) 37.0 (July 6)

contd...

	1986–87	*1987–88*	*1988–89*	*1989–90*	*1990–91*
(1)	*(8)*	*(9)*	*(10)*	*(11)*	*(12)*
Bank Rate					
Cash Reserve Ratio* (CRR)	9.50 (Feb 28)	10.00 (Oct 24)	10.50 (July 2) 11.00 (July 30)	15.00 (July 1) [uniform prescription, including incremental CRR]	
Statutory Liquidity Ratio (SLR)		37.50 (April 25) 38.0 (Jan 2)			38.50 (Sep 22)

contd...

concld.

	1991–92	*1992–93*	*1993–94*	*1994–95*	*1995–96*	*1996–97*	*1997–98*
(1)	*(13)*	*(14)*	*(15)*	*(16)*	*(17)*	*(18)*	*(19)*
Bank Rate	11.0 (July 4) 12.0 (Oct 9)						11.0 (Apr 16)
Cash Reserve Ratio* (CRR)			14.50 (Apr 17) 14.00 (May 15)	14.50 (June 11) 14.75 (July 9) 15.00 (Aug 6)	14.50 (Nov 11) 14.00 (Dec 9)	13.50 (Apr 27) 13.00 (May 11) 12.00 (July 6) 11.50 (Oct 26) 11.00 (Nov 9) 10.50 (Jan 4) 10.00 (Jan 18)	9.75 (Oct 25) 9.50 (Nov 22) 10.00 (Dec 6) 10.50 (Jan 17) 10.25 (Mar 28)
Statutory Liquidity Ratio (SLR)	38.50+# (Feb 29)	38.25+ (Jan 9) 38.00+ (Feb 6) 37.75+ (Mar 6)	37.50+ (Aug 21) 37.25+ (Sep 18) 34.75^$ (Oct 11)	34.25^ (Aug 20) 33.75^ (Sep 17) 31.50 (Oct 29)!&			25.00 (Oct 25)

Notes: * Besides the increases in CRR as indicated, the Reserve Bank also levied additional (also known as incremental) prescription of CRR on deposits accruing on and from a specified date. These impounded balances were released in instalments, whenever the Reserve Bank considered it necessary. These developments have been covered in the text.

+ SLR on NDTL (net demand and time liabilities) as on April 3, 1992.

In addition there was 30.00 per cent SLR on the increase in NDTL over April 3, 1992 level. Since February 1992, a multiple system of maintenance of SLR was adopted.

^ SLR on NDTL as on September 17, 1993.

$ In addition there was 25.00 per cent SLR on the increase in NDTL over April 3, 1992 level.

! SLR on NDTL as on September 30, 1994.

& In addition there was 25.00 per cent SLR on the increase in NDTL over September 30, 1994 level.

1. The Bank Rate is the standard rate of interest charged by the Reserve Bank on various types of advances and accommodation granted to banks and other institutions eligible to borrow from it under the RBI Act, 1934.
2. CRR and SLR are applied to domestic deposits. These are legally termed as 'net demand and time liabilities' of scheduled banks.
3. In the case of deposits under NRE and FCNR accounts of non-residents maintained by banks, the rates of applicable CRR and SLR were lower than those for domestic deposits, until July 1989.

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

STATEMENT 4.2

Growth Rates of Selected Monetary and Other Macroeconomic Variables (1981–1990)

(Percentage variations)

Variable	*1980–81*	*1981–82*	*1982–83*	*1983–84*	*1984–85*
(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*
Aggregate Monetary Resources (M_3)	18.1	12.5	16.6	18.2	19.0
Reserve Money (RM)	17.4	7.9	10.1	25.5	21.5
Currency with Public	15.2	7.8	15.1	17.7	15.7
Demand Deposits with Banks	20.5	7.4	13.6	15.5	23.3
Time Deposits with Banks	18.8	16.9	18.1	19.0	18.6
Net RBI Credit to Central Government	30.3	21.0	18.2	18.1	23.5
Other Banks' Credit to Government	21.9	9.9	22.0	11.2	15.6
Other Banks' Credit to Commercial Sector	18.6	18.5	18.9	18.5	16.9
Banks' Investments in Government Securities	23.8	10.2	18.9	11.5	38.8
Net Foreign Exchange Assets of Banking Sector	-11.5	-41.5	-34.0	-10.0	+90.4
Memorandum Items:					
Growth Rates (NNP at factor cost)	7.5	5.8	2.2	8.1	3.4
Wholesale Prices*	18.2	9.3	4.9	7.5	6.5

concld.

Variable	*1985–86*	*1986–87*	*1987–88*	*1988–89*	*1989–90*
	(7)	*(8)*	*(9)*	*(10)*	*(11)*
Aggregate Monetary Resources (M_3)	16.0	18.6	16.0	17.8	19.4
Reserve Money (RM)	8.4	17.4	19.4	17.7	23.2
Currency with Public	10.5	13.3	18.2	14.2	20.8
Demand Deposits with Banks	12.6	21.8	7.8	12.9	23.0
Time Deposits with Banks	19.5	19.7	17.3	19.9	18.3
Net RBI Credit to Central Government	19.4	18.6	14.5	12.6	23.7
Other Banks' Credit to Government	22.8	31.0	23.1	16.3	17.9
Other Banks' Credit to Commercial Sector	16.9	14.5	13.5	18.0	18.8
Banks' Investments in Government Securities	1.9	30.5	22.8	17.4	18.1
Net Foreign Exchange Assets of Banking Sector	+23.5	+24.4	+17.8	+19.9	+ 0.3
Memorandum Items:					
Growth Rates (NNP at factor cost)	3.9	3.8	3.8	10.7	7.0
Wholesale Prices*	4.4	5.8	8.1	7.5	7.5

Note: * For the year 1980–81, the base was WPI 1970–71 = 100, and for the remaining years the base was WPI 1980–81 = 100.

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

STATEMENT 4.3

Growth in Money Supply, Inflation and National Income

(Per cent)

Year	*Money Supply (M_3)*	*Inflation (WPI)*	*Real GDP*
(1)	*(2)*	*(3)*	*(4)*
1980–81	18.1	18.2	7.2
1981–82	12.5	9.3	6.1
1982–83	16.6	4.9	3.1
1983–84	18.2	7.5	8.2
1984–85	19.0	6.5	3.8
1985–86	16.0	4.4	4.1
1986–87	18.6	5.8	4.3
1987–88	16.0	8.1	4.3
1988–89	17.8	7.5	10.6
1989–90	19.4	7.5	6.9
1990–91	15.1	10.3	5.4
1991–92	19.3	13.7	0.8
1992–93	14.8	10.1	5.3
1993–94	18.4	8.4	6.2
1994–95	22.4	10.9	7.8
1995–96	13.6	7.7	7.2
1996–97	16.2	6.4	7.5

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

STATEMENT 4.4

Estimates/Projections of Growth in Select Macroeconomic Variables and Actuals

(Per cent)

Year	*Growth Estimates*		
	M_3	*National Income*	*Inflation*
(1)	*(2)*	*(3)*	*(4)*
1980–81		7.0 (GNP)	
1981–82	21.5	5.0 (GDP)	
1982–83	16.8	Between 1-2 per cent (NNP in real terms)	–
1983–84	16.2	8.5 (NNP)	–
1984–85	18.2 "growth of liquidity and primary money creation"	3.5-4.0 (NNP in real terms)	"curbing inflation"
1985–86	"liquidity growth lower than that in 1984–85", *i.e.*, 19.0 per cent	"output growth of the same order as in 1984–85", *i.e.*, 4.0 per cent GNP	"to avoid resurgence of inflation"
1986–87	"below annual average level of previous three years", *i.e.*, 17.5 per cent	4.5-5.0 (NNP in real terms)	"rate of inflation to be continued to be kept under check"
1987–88	"well below expansion in 1986–87", *i.e.*, 18.6 per cent	2.5 (NDP in real terms)	"avoid resurgence of inflationary pressures"
1988–89	"growth to be below average of previous three years", *i.e.*, 16.9 per cent	10.0 (GDP at 1980–81 prices)	--
1989–90	"growth to be contained at a level lower than the average of last four years", *i.e.*, 17.1 per cent	4.5 (real GDP)	--

contd...

concld. *(Per cent)*

Year	*Actuals*		
	M_3	*National Income (GDP at factor cost)*	*Inflation*
(1)	*(5)*	*(6)*	*(7)*
1980–81	18.1	8.1 (NNP in real terms)	18.2
1981–82	12.5	5.0 (NNP)	9.3
1982–83	16.6	1.7	4.9
1983–84	18.2	8.3	7.5
1984–85	19.0	3.8	6.5
1985–86	16.0	4.1	4.4
1986–87	18.6	4.3	5.8
1987–88	16.0	4.3	8.1
1988–89	17.8	10.0	7.5
1989–90	19.4	6.9	7.5

Notes: 1. Since 1985–86, the Reserve Bank started announcing the annual target for expansion in M_3, with the acceptance of the recommendations of the committee to review the working of the monetary system. In earlier years, the Reserve Bank made known to commercial banks the annual indicative ceiling for expansion in M_3, which was generally on July-June basis.

2. The Reserve Bank started the exercise of estimating the growth rate in NNP in real terms from 1982–83 onwards in its Annual Report.

3. In 'Actuals' National Income relates to GDP at 1980–81 prices, unless indicated otherwise.

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

STATEMENT 4.5

Selective Credit Control in Respect of Sensitive Commodities: Major Changes During 1981–1989

Year	*All Commodities (subject to selective credit control)*	*Food grains*	*Paddy and Rice*
(1)	*(2)*	*(3)*	*(4)*
1981–82		Minimum margins raised (except for advances to roller flour mills against stocks of wheat) (October 30, 1981).	
1982–83	Reduction in minimum lending rates of interest (other than advances to sugar mills) (April 1, 1983).		
1983–84	Direct advances by banks up to ₹ 2,500 per farmer or the amount of crop loan outstanding completely exempt from selective credit control purview (July 4, 1983).		
1984–85	Rationalisation of selective credit controls initiated from April 1985. Minimum margin requirements against stocks were revised downwards from April 8, 1985. The minimum lending rate on advances against commodities (other than sugar) covered by selective credit controls were lowered. Multiplicity of prescriptions for certain commodities were reduced. Controls considered no longer necessary were abolished.		

Year	*Roller Flour Mills (against stocks of wheat)*	*Sugar, Gur and Khandsari*
(1)	*(5)*	*(6)*
1981–82		
1982–83		Minimum margins reduced (September 13, 1982 and November 18, 1982).
1983–84		
1984–85		

contd...

contd...

Year	*All Commodities (subjective to selective credit control)*	*Paddy and Rice*	*Roller Flour Mills (against stocks of wheat)*	*Cotton and Kapas*
(1)	*(2)*	*(3)*	*(4)*	*(5)*
1984–85	Minimum lending rates lowered (other than sugar) (April 1, 1985).		Advances exempt from all provisions of selective credit control (April 8, 1985).	
1985–86	Advances upto aggregate ₹ 50,000 per borrower in respect of all commodities exempt provided the borrower dealt with only one bank (October 26, 1985). This limit was raised to ₹ 1 lakh from April 4, 1986. The base year was also brought forward.	Minimum margins reduced (October 25, 1985). Advances exempt from provisions of selective credit control (April 4, 1986).		Advances against raw cotton exempt from all provisions of selective credit control (October 25, 1985). Advances against cotton/*kapas* exempt from selective credit control (April 4, 1986).
1986–87			Banks were advised to consider freer flow of credit to wheat millers and traders than hitherto.	

Year	*Vegetable Oils, Cottonseed and its Oil*	*'Other Food grains' and Pulses*	*Sugar, Gur and Khandsari*
(1)	*(6)*	*(7)*	*(8)*
1984–85			
1985–86	Minimum margins against vegetable oils further reduced (April 4, 1986). Bank advances against stocks of cottonseed and its oil were completely exempt from selective credit controls.		
1986–87		Minimum margins reduced across the board (April 1, 1987).	Minimum margins (on unreleased stocks of sugar) reduced.

contd...

concld.

Year	*Cottonseed and Cottonseed Oil (including vanaspati)*	*Oilseeds and Vegetable Oils*	*Paddy and Rice*
(1)	*(2)*	*(3)*	*(4)*
1987–88	Bank advances brought back within the purview of selective credit controls (July 15, 1987).	Minimum margins raised across the board (July 15, 1987). Credit ceilings on bank advances were reduced.	Advances brought back within the purview of selective credit controls. Minimum margins stipulated on bank advances against stocks (August 17, 1987). Minimum margins raised across the board (October 19, 1987). Base year period was advanced (April 4, 1988).
1988–89		Minimum margins reduced and the level of credit ceilings raised (February 10, 1989). Minimum margins reduced (March 28, 1989).	

Year	*Cotton and Kapas*	*Wheat*
(1)	*(5)*	*(6)*
1987–88	Advances brought back within the purview of selective credit controls. Minimum margins stipulated on bank advances against stocks (August 17, 1987). Credit to cotton mills continued to remain exempt from controls. Base year period was advanced (April 4, 1988).	Minimum margins raised across the board (June 9, 1988).
1988–89		Minimum margins raised across the board (April 22, 1989).

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