MONETARY POLICY OF THE RESERVE BANK OF INDIA AND ITS EFFECT ON THE OPERATIONS OF THE INDIAN BANKING SYSTEM, 1956-61

by
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CHAPTER I

INTRODUCTION

I

The Purpose of This Study

India has completed two successive five-year plans. These plans embodied India's effort to lift the economy from the mire of poverty and stagnation. The First Five Year Plan (1951-52 to 1955-56) was modest in size and could be completed without imposing visible strains on the economy. In fact, at the end of the First Plan period India had comfortable reserves of foreign exchange, and the price level was actually lower than at the beginning of the plan.

By contrast the Second Plan (1956-57 to 1960-61) was bolder in design and was expected to create serious problems for monetary authorities. Since the plan began with a large gap in expected saving and investments--a gap that was to be filled mainly with the help of foreign aid and deficit financing--stresses and strains on the economy were bound to be felt. In fact foreign exchange reserves in 1960-61 had been reduced to the level of about three months of imports, and the cost of living index had reached an all-time high level.[1] These results had

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[1]It should, however, be noted that in 1955-56 the general index of wholesale prices was below 100.

been anticipated by the planners, but not to the extent that they have actually materialized.

In the Second Plan, the Reserve Bank had been assigned the contradictory role of helping to finance planned expenditures in the public and private sectors on the one hand and prevent an excessive rise in prices on the other. What constituted an excessive price increase was, of course, not laid down! Therefore, we have termed the Reserve Bank policy as ambivalent. These tasks were handled by the Reserve Bank without the benefit of past experience, and with the aid of tools some of which were quite novel in the Indian setting.

Under these circumstances it is not easy to evaluate the performance of the Reserve Bank's policy. The difficulty arises mainly because, on account of ambivalent goals, we are deprived of a single or consistent criterion by which to evaluate policy. Economic theory does not furnish plausible hypotheses which can be tested in the Indian background. The most obvious hypothesis, that price level is directly related to changes in the stock of money, is far too crude to deserve serious consideration. However, considering the emphasis on control over inventory speculation in Reserve Bank publications, one might hopefully investigate the statistical relationship between variations in bank credit and variations in the size of inventories. But paucity of data on inventories in the private sector precludes this possibility.

In view of the difficulties involved in relating monetary policy either to national income, or any of its components, or to the price level directly, it follows that the entire focus of evaluation should be on the banking system. Thus the confines of study were narrowed to

commercial banks only.[1] The investigation is now restricted to the effects of Reserve Bank policy on the operating assets of scheduled banks.[2] There were two reasons for excluding nonscheduled banks. First, the Reserve Bank used only scheduled banks for implementing its policy. Thus all the directives stipulating selective controls are addressed to scheduled banks only. Second, the data pertaining to nonscheduled banks is not available as fully and in as usable a form as for scheduled banks. Moreover, the importance of nonscheduled banks has been steadily going down; in 1960 their share in total deposits was less than 10 per cent. Therefore, not much is lost by excluding nonscheduled banks.

Organization of Thesis into Chapters

This is a study of the "impact" of monetary policy on the assets of scheduled banks. "Effects" of monetary policy can, however, be inferred from changes in bank assets. These inferences are drawn in the light of theoretical reasoning about the probable lines of transmission to the rest of the economy. This thesis is accordingly divided into nine chapters. The first chapter is the introduction which among other things includes the summary of other chapters and the principal

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[1] While studying the behavior of bank credit during 1957-61, it should be borne in mind that the shortage of foreign exchange and the restrictive import policy of the government had weakened the demand for bank loans. The slackness in the demand for bank credit in certain years was mainly due to this factor rather than to the monetary policy of the Reserve Bank.

[2] Those banking companies which carry on the business of banking in India and have paid-up capital and reserves in the aggregate of not less than 500,000 rupees and are listed on the Second Schedule of the Reserve Bank of India Act, 1934, are called scheduled banks.

conclusions. Chapter II is devoted to outlining the goals of the Second Five Year Plan, the mode of financing the Plans, and the achievements and failures. This chapter also brings out the record of price increases during the Plan period, the increase in money supply, the fall in foreign exchange reserves, and other factual details of importance. The task of the Reserve Bank and the limitations of its policies are also discussed in this chapter. In the third chapter the relationship of the Reserve Bank with the organized and indigenous money market is outlined. At the same time the efficacy of instruments of credit controls is discussed and the limitations of the Reserve Bank's policy arising from the peculiar institutional features of the Indian money market are brought out. These three chapters thus provide the background necessary for proper evaluation of the policies of the Reserve Bank.

The fourth chapter is devoted to a chronological account of general or quantitative controls. The Reserve Bank's quantitative credit control policies are accorded a critical appraisal in the context of the overall economic situation. The fifth chapter discusses the position of selective controls within the broad strategy of the Reserve Bank's policy. After discussing the theoretical pros and cons of selective controls, a separate account is given for each of them. Thus the method of presentation followed in this chapter is different from the preceding one. The discussion is followed by a critical appraisal of the working of selective controls in India. Chapters IV and V thus constitute an appraisal of the monetary policy in India, as it affected the working of the banking system.

The succeeding three chapters discuss the effects of credit policies on the growth and composition of scheduled bank assets. These chapters have three things in common. First, seasonal variations are analyzed separately from annual variations. Second, the behavior of the State Bank of India is discussed separately from all other banks. Third, banks are classified into five groups and subclassified into foreign and Indian. These classes are formed according to size of deposits. Comparisons of important ratios are made between them.

In Chapter VI the effects of credit policies on the availability, the cost, and the distribution of credit between economic sectors is analyzed. In Chapter VII variations in the investment portfolio and its relationship with the open market policy are analyzed. In Chapter VIII the problem of bank liquidity and changes in it are analyzed in the context of changes in the market demand for loans and the Reserve Bank policies.

In Chapter IX important lessons are drawn from the experience of the Reserve Bank policy during the Second Plan period. In order to improve the effectiveness of monetary policy in the future, some new proposals are made. Similar proposals, along with others, were extensively discussed in the United States about ten to fifteen years ago but became defunct with the restoration of freedom of action to the Federal Reserve System. The need for greater coordination between monetary policy, fiscal policy and debt management is stressed. In the same chapter several useful suggestions have been made to improve the statistical basis for the conduct of monetary policy in the future.

II

The Source Material

In preparing this thesis four kinds of statistics have been used. These statistics pertain to (1) national income, (2) prices, (3) the banking and monetary system, and (4) public finance. Statistics pertaining to these can be divided into three categories: (a) actual, which generally relate to the past, (b) estimates or revised estimates about the current period, and (c) Plan projections into the future. The sources of these statistics are indicated in the text wherever used. Here the general nature of Indian statistics and their limitations are described.[1]

National Income

The official data on national income are compiled by combining the net output for certain sectors with estimates of income originating in other sectors. These are presented as "national income by industrial origin" classified into fourteen subsectors which together add up to "net domestic product at factor cost." To this is added "net earned income from abroad" to obtain "net national output at factor cost = national income." Using this figure as the base, estimates are prepared for "national income at market prices," and the shares of the public sector and the private sector, respectively. In addition, estimates of per capita income at constant and market prices are also given.[2] The

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[1]B. N. Asthana and S. S. Srivastava, Applied Statistics of India (Allahabod: Chaitanya Publishing House, 1960).

[2]Government of India, Central Statistical Organization, Cabinet

chief limitations of official national income data are that no estimates are provided on depreciation, consumers' current expenditures, private capital formation (including inventories), and private saving. Moreover, there is considerable delay in the publication of estimates. Even the "preliminary estimates" are made available after a lapse of one year.

These deficiencies are being slowly met with the efforts of government and private research organizations and individuals. Thus estimates of savings in the private sector have recently been made available from several sources. However, a good deal of work remains to be done in reconciling different estimates.[1] For past years some estimates[2] for other aggregates have also been prepared. These include saving, capital formation and private consumption expenditure. However, the data on capital formation in the rural and unorganized sectors as a whole continue to be very inadequate. As far as the author knows there is only one set of estimates of changes in inventories for the period 1951-52 to 1955-56.[3] But these estimates are admitted to be "very broad

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Secretariat, Estimates of National Income 1948-49 to 1959-60 (New Delhi, March 1961).

[1]National Council of Applied Economic Research, Saving In India, A Monograph (New Delhi, 1961); Reserve Bank of India, "Estimates of Saving and Investment in the Indian Economy 1950-51 to 1958-59," Reserve Bank of India Bulletin (August 1961), pp. 1200-13; H. Mazumdar, Business Saving in India, an estimate and an analysis in relation to profitability and the growth of the national saving rate (Groningen: J. B. Wolters' Publishing Co., 1959).

[2]V. K. R. V. Rao (ed.) et al. Papers on National Income and Allied Topics, Vol. VII (Indian Conference on Research in National Income; New York: Asia Publishing House, 1960).

[3]See B. K. Barpujari, "The National Accounts of India, 1951-52 to 1955-56." and Appendix II, ibid., pp. 91-106.

and tentative" and do not provide "a complete coverage of all possible commodities that can be stocked."

In this connection reference should also be made to the National Sample Surveys, especially of consumption expenditure. These surveys have been conducted by the National Sample Survey Organization set up by the Government of India, while the data are processed and published by the Indian Institute of Statistics, Calcutta. These surveys throw a flood of light on regional disparities in standards of living. However, results of different surveys are not strictly comparable, nor in their present forms are they usable for national accounting purposes.

Prices

Commodity price statistics in India are available in two forms. These are wholesale prices on which the Index Number of Wholesale Prices is based, and retail prices on which the Consumer Price Index Number for the working class is based.[1]

The trend in the price level can be shown both by the Wholesale Price Index and the Consumer Price Index. Both have moved in the same direction. However, the base year for WPI is 1952-53 and for CPI it is 1949. In addition the Reserve Bank published an Index Number of Security Prices using 1952-53 as the base year.[2] Use has been made of both index

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[1]The WPI, however, includes commodities which are imported and exported. The latter have no bearing on the domestic costs and prices.

[2]Report on Currency and Finance for the Year, 1960-61, Statement 48. Cited hereafter as Report on Currency and Finance, 1960-61. Also see Asthana and Srivastava, op. cit., Chap. 8, pp. 207-47.

numbers to show the extent of price inflation during the Second Plan period. However, WPI is more useful not only because of its wider coverage but also because it reveals the sectoral distribution of inflationary pressures. For these reasons the Reserve Bank also relied on the behavior of WPI for determining the target and timing of selective controls.

Banking and Monetary Statistics

These statistics are published by the Reserve Bank and are of the highest quality. These are not as extensive as in the United States, but efforts have been made in recent years to cover new ground as well as to improve the existing statistics. This is especially true of statistics on money supply which are now more accurate and more reliable.

Data pertaining to banks, even though satisfactory for general purposes, are insufficient in detail. On the liability side, the interbank borrowings are not separated for each class of bank from borrowings from the Reserve Bank. Similarly, until recently interbank deposits were not separated from deposits of the nonbank public. On the asset side there are no indications other than the annual surveys of variations in maturities of government securities held by banks. Similarly, there are no data on the maturity distribution of loans outstanding, held either by all banks or for classes of banks. As for rates of interest charged by banks on loans of different categories (other than interbank loans), there is no information. Another glaring defect of Indian banking statistics is the complete lack of information about the

economic characteristics of borrowers and the uses for which loans are sought. These gaps should be filled at an early date.

Public Finance

Budgetary statistics in India are at different levels of development. Budgetary data, after due processing, are presented in three different forms:

(a) The Government of India budget is published both in the usual form as well as according to the economic classification adopted by the United Nations. The latter goes back to 1955-56. The usual form of the budget is to present estimates for the ensuing fiscal year along with revised estimates for the current fiscal year and the actual amounts for the preceding year. Following the British practice the budget has two parts: revenue budget and capital budget. Deficit or surplus is shown separately for the two budgets and then combined to show the overall state of balance in the budget.

(b) The state governments' budgets are presented in the form of the revenue and capital budgets with the actual figures for the previous year, the revised estimates for the current year, and the budget estimates for the coming year. So far it has not been found possible to consolidate them in the form of the economic classification adopted by the union government. Therefore as yet there is no consolidated budget for states and union governments conforming to standard definitions and concepts. For local governments even a rough approximation of the aggregate revenues and expenditures for the whole country is not available.

(c) The Central Statistical Organization, however, prepares current and capital accounts for central, state and local governments. The current accounts are separately shown for government administration and enterprises, while the capital account is consolidated for both.[1] But the national accounts data, by their very nature, are highly aggregative and cannot be used for detailed studies. Therefore one has to fall back upon the central and state budgets for estimating totals of tax and nontax revenues, of nondevelopmental, developmental, and investment outlays, etc.

Suggestions for the Improvement of Data

Suggestions for improvement have been confined to only national income and financial data. A few suggestions have been made in the ninth chapter as part of the proposals to make monetary policy more effective. These recommendations are summarized here.

On national income accounting, the emphasis in India so far has been to prepare estimates which include both the monetized and the non-monetized sectors. There are good reasons for doing so.[2] However, from the point of view of monetary policy, the estimates of imputed

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[1] Estimates of National Income, op. cit., pp. 10-19.

[2] See V. K. R. V. Rao, "Some Reflections on the Comparability of Real National Incomes of Industrialized and Underdeveloped Countries," S. Herbert Frankel, "Concepts of Income and Welfare in Advanced and Underdeveloped Societies with Special Reference to the Intercomparability of National Income Estimates," and Frederic Benham, "Income and Product in Underdeveloped Countries. Comments on the Paper by Professor Frankel"; Income and Wealth, Series III, ed. Milton Gilbert (International Association for Research in Income and Wealth; Cambridge, England: Bowes & Bowes, 1953), pp. 178-210, 156-68, and 169-77, respectively.

income are of no use. Since monetary policy can influence money flows and prices of only those products which enter the market, only the monetized portion of real income generated over any period of time, and changes in it, are of significance. In fact the significance of changes in monetary national income is not limited to monetary policy alone. These will also be found useful for fiscal policy, commercial policy and policies directed towards the redistribution of income. It has therefore been suggested that in addition to present accounts a separate set of national income statistics be prepared which is restricted to marketed output. This should be done both at current and at constant prices. After estimates by sectoral origin have been prepared for a few years, efforts should be made to set up detailed accounts on personal income, saving and consumption, and on fixed capital formation and inventory accumulations in the corporate and noncorporate sectors, along with accounts of the public sector and international transactions. The latter two are already being prepared, while the first account can be culled out of the worksheets on national income by industrial origin prepared for the past years by the Central Statistical Organization. The preparation of other accounts will require considerable effort. But at this stage it should not be necessary to justify additional expenditure required for the improvement of statistics.

On financial statistics, data need to be collected on the following items:

(a) The end uses of bank credit. At present the Reserve Bank conducts two surveys, at the end of April and of October, on the purpose of loans. These surveys are reported in the form of accounts, amounts,

and percentages to totals of loans classified by industries, trade and commerce, agriculture, personal, professional, and all others. In addition the Reserve Bank publishes once every two weeks data on securities accepted by banks for the amount of loans against each type and unsecured advances (also known in India as clean advances). These data need to be supplemented on the intended use, and if possible, on the actual use of bank credit. Specifically, information is needed on whether loans were sought for the purpose of adding to the fixed stock of capital or inventories, or for residential houses, or for purchasing stocks, etc.

(b) Data should be collected on the economic characteristics of borrowers and on the numbers of applications accepted in full or part, and those completely rejected.

(c) Data are needed on rates of interest charged according to size of loans, purpose of loan, and type of borrower. This kind of information may, however, be the most difficult to collect.

(d) In addition to the above, the Reserve Bank should also collect and publish data on loans given in different cities and regions classified according to purpose and use. This information can be derive from the existing statistics and the surveys proposed above and therefore will not be too expensive an affair.

(e) As already pointed out, in balance sheet data on classes of banks, borrowings from the Reserve Bank are not shown separately. The same

is true of detailed tables or balance sheets of individual banks. The reasons for this secrecy are not apparent. However, the extent of a bank's indebtedness is an important piece of information to depositors, shareholders and to the general public. It is therefore suggested that this additional information should be included in existing tables.

III

Summary and Conclusions

Since this is a study of the effects of monetary policy on bank assets in the specific context of the Second Five Year Plan, the Plan itself and the tasks of monetary policy are discussed first. These tasks were defined by the Second Plan. With the reliance on deficit financing resulting in money creation, the policy of the Reserve Bank was limited to the achievement of three goals.[1] These goals were: (a) to support the investment expenditure in the public sector; (b) to promote economic development in the private sector; and (c) to restrain inflationary forces by restricting bank credit for speculation.

Within the framework of Plan finances, some increase in prices was unavoidable. At the end of the Second Plan prices increased substantially while the real output fell short of the Plan target by about 20 per cent. The Reserve Bank played its part by letting the money

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[1]In this thesis the term monetary policy will be used interchangeably with Reserve Bank policies of Credit Control and debt management. The definition of deficit financing is given in Chapter 2, p. 39.

supply increase by 33 per cent and by following an ambivalent policy of easing bank reserves on the one hand and controlling the distribution of bank credit on the other. To some extent the effect of budgetary deficits and growth in bank credit on the money supply was offset by the deficit in balance of payments and the increase in time deposits which were partly the result of banking of P.L. 480 funds.[1] Since the policy pursued by the Reserve Bank contained opposite pulls, it was bound to produce contradictory results. Viewed in the context of the doctrine of "controlled expansions," and given the financial basis of the Second Plan, the policy of the Reserve Bank achieved a fair measure of success. Within the framework of the Second Plan the Reserve Bank could not have set more rigorous goals of monetary stability and achieved significantly better results. Thus the goal of reasonable price stability was given less emphasis than the need for stimulating growth. Since some conflict between the two was inherent in the given setting, the Bank adopted the policy of attenuating strategic prices through the use of selective credit controls. This was evidently a compromise, and under the circumstances, seemed wholly reasonable. These constraints on the use of credit control instruments were clearly grasped by the authorities of the Reserve Bank at the very outset of the Second Plan, and in fact governed their decisions during the ensuing period.

In addition to policy limitations, the Reserve Bank was handicapped in two other ways. First, it had to operate through scheduled

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[1]The P.L. 480 funds were, however, reinvested in the government securities and spent by the government, thereby adding to the money supply.

banks only, which of course constitute the core of the Indian money market, and hope that the influences emanating from itself would be transmitted to the rest of the economy through them. The dichotomy of the money market must also have imposed some limitations on the effectiveness of monetary policy. Second, the Reserve Bank's obligation to keep the cost of debt services low and to support the bond market had greatly reduced the arsenal of credit controls which could be deployed effectively. It therefore relied on a variable reserve ratio policy and selective controls, mostly the latter. It had been authorized to use the former only in 1956 and had hardly had any experience with respect to the latter. Thus, barring 1960-61, the Reserve Bank hardly used quantitative controls to regulate bank reserves. Throughout, the main burden for effectuating the policy of "controlled expansion" was borne by selective controls with some support from the selective lending policy of the Bank. However, the Reserve Bank had extensive recourse to moral suasion to regulate credit which sometimes produced perceptible effects. An important conclusion of this study is that the Reserve Bank could not control the bank credit expansion when the demand for loans was high as was the case in 1956-57 and again in 1960-61. The main cause of this failure was the Reserve Bank's inability to control the reserve base of banks.

Our second conclusion is that the Reserve Bank, tied as it was to the objectives of the Second Plan, was caught in a dilemma. When growth in production was slackening, the Reserve Bank was reluctant to control inflation which might have slackened production even further. At other times when output was expanding rapidly the Reserve Bank

introduced credit controls hesitatingly lest they might slow down the economy. The Reserve Bank could not solve the dilemma and forge a policy that would successfully control inflation without hampering production. This failure landed the Reserve Bank's policy in a vicious circle which consisted of letting the money supply increase to finance the growing needs of the productive sectors of the economy which, however, rise with inflation and thereby necessitate further increases in the money supply.

With respect to selective controls it should be said to the credit of the Reserve Bank that these were coordinated with other arms of government policy, especially with respect to food grains and sugar. Generally speaking, selective credit controls were effective in restraining, and in some cases even reducing, the level of bank advances against the securities of the commodities concerned. The effect on prices is, however, less certain. Moreover, there is no assurance that selective controls had any effect on the end-uses of bank credit. In particular, the Reserve Bank until 1960 left an important loophole in the system of selective controls. This was the absence of regulation over unsecured or clean advances. Furthermore, credit restrictions were generally mild and were obviously so formulated as to render it easier for banks to comply with them. They were also slow in coming, which might be due to a paucity of reliable data. The conclusion is that, purely from the technical point of view of compliance with directives, selective controls were successful. Also, the Reserve Bank gained much useful experience in administering controls and eliciting the cooperation

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[1] The main cause for the slackening of industrial production was the shortage of foreign exchange.

of banks. It may be hoped that this valuable experience will make for greater promptness and greater efficacy of selective controls in the future.

So far as the effect of monetary policy on bank credit is concerned, four conclusions are drawn. First, the Reserve Bank was not able to control the expansion of bank credit. This is judged by the fact that banks, on the basis of the criterion set by the Reserve Bank, remained systematically over-loaned throughout the period and no effort was made to lower the bank credit ratio. Second, foreign banks contributed relatively more to bank credit expansion than Indian banks. In particular, class D foreign banks throughout the period showed abnormally high bank credit ratios. The State Bank of India, on the other hand, showed a steady decline in the ratio which prompts the conclusion that this was deliberately done to support monetary policy.[1] Third, although the Reserve Bank could not control the availability of credit, it did succeed in raising the cost of credit. Credit rationing to some extent is also inferred. Fourth, the Reserve Bank successfully brought about shifts in the composition of credit in accordance with the priorities of the Second Plan. This was by far the greatest positive achievement of the Reserve Bank.

The behavior of investment portfolios shows that purely seasonal adjustments in them are determined mainly by the demand for loans and the state of liquidity of banks. Over the Plan period, the government

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[1]This is the biggest commercial bank in India. Prior to its nationalization in 1955 it was known as the Imperial Bank of India.

securities held by the scheduled banks increased during loose years and declined in tight years. This leads to the conclusion that open market policy functioned well in fair weather but became destabilizing when a tight credit policy was required. Even in loose years the increase in securities with scheduled banks is partly explained by the State Bank of India's practice of investing P.L. 480 funds in governments. The State Bank's policy was the main prop of the bonds market from the side of the banking system. Foreign banks have generally shown a lower preference for government securities than Indian banks but the ratio of government investments to deposits is generally more stable in the case of foreign banks than in Indian banks. The main conclusion is that even with support from the State Bank of India, the conflict between debt management and restrictive monetary policy is irreconcilable unless the Reserve Bank does more thinking on devising new methods of credit control which will bring about the needed reconciliation.[1]

The effect of credit policy on bank liquidity is assessed by observing changes in excess reserves and free reserves.[2] The latter, however, can only be used for all banks. The seasonal variations in

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[1]This conflict arises when commercial banks try to shift from the government investments to loans under conditions of general inflation, but cannot be prevented from doing so because of the policy of the Reserve Bank to prevent instability in the government securities' market.

[2]The adequacy of excess and free reserves as a measure of bank liquidity can be legitimately questioned. In fact, the variations in the bank portfolios of government investments have a far more powerful effect on the liquidity of the asset-mix than changes in cash assets. But the liquidity ratio would be swamped if government investments are counted as liquid assets. See Chapter 8 for a fuller discussion of this topic.

liquidity, as measured by free reserves, show that banks were tight throughout the period with the exception of three slack seasons. It was seen that both excess reserves and free reserves can give misleading signals. Therefore, inferences about looseness or tightness should be drawn with due caution.

It was concluded that tightness of banks in 1956 was entirely unrelated to Reserve Bank policy, which was passive, but in 1960 the policy was actively restrictive and partly responsible for rendering banks tight.[1] In other years credit policy was relatively easy and the demand for loans was relatively low. These show up in excess liquidity with banks, as between classes of banks there are significant variations in the levels of liquidity ratios from year to year. Interestingly enough, class D foreign banks generally maintain a liquidity ratio at

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[1] It may be asserted that the central bank can never be passive. This would imply that a policy of inaction is in fact an active policy of rendering assistance to the market forces. Thus in 1956 the Reserve Bank, by not countering the growing demand for bank credit, was deliberately helping the expansionary forces in the economy. This argument is plausible because the prices had been rising from the recessionary levels to which they had fallen in the two previous years. This tendency, therefore, could be interpreted as self-correcting rather than as marking the beginning of a new spurt of inflation.

On the issue of terminology, it is rather difficult to defend one term against another. Perhaps it would be sufficient to adopt one set of terms and to use them consistently. In this thesis it has been stated that the tightness of the banking system during 1956 cannot be causally related to a restrictive credit policy of the Bank. The policy of the Reserve Bank has been called passive because reserves were being acquired by the scheduled banks at their initiative. The Reserve Bank took no effective measures either to accelerate or retard the flow of excess reserves to the banking system. It is doubtful that the Bank possessed the ability to control bank reserves even if it had wanted to do so.

a higher level than any other class of banks, or the average of all banks. On the other hand, the State Bank of India is about on the same level as other banks.[1] This shows that for the State Bank the support to monetary policy did not consist in keeping excess reserves, but rather in keeping the bank credit ratio below and the government's ratio above the average for other banks.

The conclusion is that some banks can consistently maintain excess reserves and at the same time raise the bank credit ratio to abnormal limits.[2] This can be done so long as banks have easy access to reserves. Therefore, Reserve Bank policy should aim at regulation of bank reserves as a method for controlling bank credit expansion.

Lastly, in the concluding chapter it is pointed out that monetary policy may fail to achieve the desired results on account of lags (four of them are listed) and inadequacy of response from the Reserve Bank. The former can be partially remedied with improvement of data and better understanding of the economy, but the latter has to depend upon the judgment of the authorities. With respect to the degree of control that is neither more nor less than adequate for the purpose, no ground rules can be laid down in advance. Monetary policy can, however, be made more effective if inflation control is accepted as a goal of policy and an upper limit on the permissive rate of increase in price level is laid down in advance. Further, in carrying out its policy the Reserve Bank should clearly know its own sphere of action, in respect to which it should be fully autonomous.

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[1]This is the ratio of cash in hand plus excess reserves to total deposits.

[2]Class D foreign banks show this ratio at more than 100 per cent. This can happen when banks are losing deposits and are making it up by increased interbank borrowings and by raising "other liabilities."

As for control over the composition of bank assets the Reserve Bank policy can become more effective by placing greater reliance on marginal reserve requirements (up to the limit of 100 per cent), which should be backed by a higher level of average reserve ratios, fixed at the existing legal maxima. In addition, the Reserve Bank should fix a secondary reserve ratio for all banks consisting of short-term government securities. These policies should be further reinforced by selective lending at penal rates. In emergencies the Reserve Bank should be empowered to freeze the stock of securities held by banks. But these emergency measures should be withdrawn when the need for them has passed.

For greater effectiveness of monetary policy it is necessary that budgetary deficits be progressively reduced and that the debt of long-term maturities, if possible, or nonmarketable securities at higher interest rates be issued to the nonbank investing public. These policies should be pursued unless the Reserve Bank is interested in safeguarding the level of earnings of banks, in which case certain modifications in the above policy are proposed. The State Bank of India can also lend a supporting hand in the conduct of monetary policy by virtually becoming the adjunct of the Reserve Bank and taking restrictive steps at the suggestion of the latter.

CHAPTER II

MONETARY ASPECTS OF THE SECOND FIVE YEAR PLAN

I

Main Objectives of the Second Plan

The Second Five Year Plan which lasted from April 1956 to March 31, 1961 was to be an important link in the series of five year plans. It was designed to step up the pace of growth initiated by the First Five Year Plan.

The principal economic goals were to raise real national income by 25 per cent and create eight to ten million jobs over the plan period. The rate of net investment was to be raised from 7.31 per cent at the beginning of the plan to 10-11 per cent at the end, while the rate of domestic saving was to go up from 7 per cent to 9-10 per cent.[1]

Production targets in the Second Plan were determined on the basis of a scale of priorities The targets for the output of food grains were an increase of 22 per cent, of cotton 31 per cent, of oil seeds 27 per cent, of jute 25 per cent, and of sugarcane and brown sugar 22 per cent. The area irrigated was to rise by 31 per cent and the installed capacity of electricity was to go up by 103 per cent. But

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[1]Government of India, Planning Commission, Second Five Year Plan (New Delhi, 1956), p. 74.

there was relatively greater emphasis laid on industrial production. Thus finished-steel production was planned to go up by 251 per cent, machine tools by 300 per cent, cement by 202 per cent, aluminum by 233 per cent and so on.[1] Table 1 gives selected targets and achievements with respect to fourteen products. Even though in most of these targets the developmental effort was initiated in the First Five Year Plan, the Second Plan marked "a shift in priorities with a larger accent on industrialization, especially the development of heavy industry, and the necessary ancillaries like transport."[2]

Expenditure Targets

The total outlay envisaged for the Second Plan was set at 72 billion rupees of which 48 billion rupees were to be spent in the public sector and the remainder in the private sector. The investment outlay in the public sector was fixed at 38 billion rupees; the remaining 10 billion rupees being earmarked for developmental (noninvestment) expenditure. However, as the Plan progressed and prices rose, it soon became evident that the financial resources needed to meet Plan targets in real terms would far exceed the original estimates. The Planning Commissions also realized that it would be unrealistic to expect any increase in the availability of financial resources. Therefore the financial targets were left unaltered, which really meant that the real targets had been reduced by the extent of increase in prices.[3] However,

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[1] Ibid., pp. 58-61.

[2] Ibid., p. 51.

[3] In this appraisal it was decided to divide the Plan between the

TABLE 1

SELECTED PRODUCTION TARGETS AND ACHIEVEMENTS OF THE SECOND FIVE YEAR PLAN

Serial Number	Products	Unit	1955-56	Target in 1960-61	Actual in 1960-61
		1	2	3	4
A.	Agricultural Production				
1.	Food grains	Million tons	65.8	80.5	79.2
2.	Cotton	Million bales	4.2	6.5	5.3
3.	Oil seeds	Million tons	5.5	7.6	7.1
4.	Jute	Million bales	4.0	5.5	4.0
5.	Sugar cane and brown sugar	Million tons	5.8	7.8	8.0
6.	Index of agricultural production	(1949-50 = 100)	116.5		139.1
B.	Industrial Production				
7.	Finished steel	Million tons	1.7	4.3	3.5
8.	Machine tools	Value in million rupees	7.8	30.0	55.0
9.	Cement	Million tons	4.3	13.0	8.5
10.	Aluminum	Thousand tons	7.5	25.0	18.5
11.	Index of industrial production	(1951 = 100)	132.6		180.5
C	Minerals				
12.	Iron ore	Million tons	4.3	12.5	10.7
13.	Coal	Million tons	38.0	60.0	54.6
D.	Electricity (installed capacity)	Million Kw	3.4	6.9	5.7

Sources: Second Five Year Plan, pp. 58-59; Reserve Bank of India Bulletin (September 1961), p. 1389; Monthly Abstract of Statistics (December 1961), Tables 13-21.

it should be noted that the principal bottleneck in the Second Plan was the shortage of foreign exchange rather than the inadequacy of rupee finance.

Planned and Actual Outlays

Figures pertaining to planned and actual expenditures are set out in Table 2. This table shows that the private sector has exceeded the investment target by 9 billion rupees, while in the public sector the actual fell short of the target by 3.5 billion rupees. Investment in the private sector, however, includes 2 billion rupees of transfer of resources from the public sector. The total investment for public and private sectors combined exceeded the original target at current prices by 5.50 billion rupees. As compared to total investment in the First Five Year Plan the expected investment during the Second Plan was higher by 101 per cent.[1]

The composition of investment outlay in public and private sectors is shown in Table 3. This shows that actual private investment exceeded the target mainly in agriculture and some industries. But public sector investment in agriculture fell short of the planned target, while exceeding it in large-scale industries. Table 3 shows the

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"core" which amounted to 45 billion rupees and the "noncore" which was to be taken up if 3 billion rupees of additional resources were available. Government of India, Planning Commission, Appraisal and Prospects of the Second Five Year Plan (New Delhi, May 1958), pp. 4-5. Also see in the same connection, Government of India, Planning Commission, Second Five Year Plan Progress Report 1958-59 (New Delhi, April 1960), Chapter 11.

[1] See Reserve Bank of India Bulletin (September 1961), p. 1391.

TABLE 2

PLANNED AND ACTUAL OUTLAYS DURING THE SECOND PLAN PERIOD
(in billion rupees)

	Original Target	Revised Target	Likely Actual Amounts	Increase(+) or Decrease(-) over the Original
	1	2	3	4
(1) Investment in the Public Sector	38.00	36.50	34.50	-3.50
(2) Investment in the Private Sector	24.00	24.00	33.00	+9.00
(3) Total Investment (1) + (2)	62.00	60.50	67.50	+5.50
(4) Current Outlay in the Public Sector	10.00	10.00	9.50	-0.50
(5) Total Outlay in the Second Plan (3) + (4)	72.00	70.50	77.00	+5.00

NOTE: This amount is net of 2.00 billion rupees which were transferred from the government to the private sector and included in the latter.

Source: Reserve Bank of India Bulletin (September 1961). See Table 2 on p. 1391.

TABLE 3

INVESTMENT OUTLAYS ON DIFFERENT CATEGORIES IN THE PUBLIC AND PRIVATE SECTORS (PLANNED AND THE LIKELY ACTUAL AMOUNTS) DURING THE SECOND PLAN
(in billion rupees)

Categories of Expenditure	Public Sector		Private Sector		Total for Public and Private Sectors		Increase (+) or Decrease (-) of (7) over (6)
	Planned	Likely Actual	Planned	Likely Actual	Planned	Likely Actual	
1	2	3	4	5	6	7	8
1. Agriculture and Community Development	3.38	1.60	1.75	6.75	5.13	8.35	+3.22
2. Irrigation and Flood Control	4.56	4.20	--	--	4.56	4.20	-0.36
3. Power	4.07	4.45	0.42	0.40	4.49	4.85	+0.36
4. Village and Small-scale Industries	1.20	0.40	1.00	2.25	2.20	2.65	+0.45
5. Organized Industries and Mining (excluding modernization and replacement)	6.70	8.20	5.75	7.25	12.45	15.45	+3.00
6. Transport and Communication	13.35	12.75	0.83	1.35	14.18	14.10	-0.08
7. Social Services and Miscellaneous (including residential buildings and other constructions in the private sector)	4.74	2.90	10.25	10.00	14.99	12.90	-2.09
8. Inventories	--	--	4.00	5.00	4.00	5.00	+1.00
9. Total	38.00	34.50	24.00	33.00	62.00	67.50	+5.50

Sources: Second Five Year Plan, p. 56; Government of India, Planning Commission, Selected Plan Statistics (New Delhi, 1959); Reserve Bank of India Bulletin (September 1961), p. 1394.

increase or decrease of likely actual figures over financial targets in the totals of both sectors for each heading of expenditure. This indicates that the increases occurred in high priority items, while relatively low priority items such as "social services and miscellaneous" fell short of their goals. The increase in inventories in the private sector is worth noting. Interestingly enough, there was no provision for inventory investment in the public sector, which gave rise to the impression that the entire investment was in fixed capital. It is highly unlikely that this happened. But in the absence of data nothing can be said about the order of increase (or decrease) in inventories in the public sector.[1]

II

Some Significant Achievements of the Second Plan

National Income

Compared to the goal of a 25 per cent increase in real national income, the increase has been only 21.0 per cent. A disquieting feature of economic development in India has been its uneven pace of advance. This is brought out by Table 4. Thus three out of five years show impressive rates of growth; one year was marked by stagnation, and in

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[1] In the Third Plan 2 billion rupees have been allotted to inventories in the public sector, which works out at 3 per cent of the total investment. If the same percentage is applied to the likely actual investment in the public sector during the Second Plan, inventory investment would come to slightly more than one billion rupees. For the Third Five Year Plan see Reserve Bank of India Bulletin (September 1961), p. 1394.

TABLE 4

INCREASE IN NATIONAL INCOME AT CURRENT AND CONSTANT PRICES FROM 1955-56 TO 1960-61

Year	National Income at Current Prices (in billion rupees)	National Income at 1948-49 Prices (in billion rupees)	Rate of Increase of Real National Income (per cent over the preceding year)
1955-56	99.8	104.8	
1956-57	113.1	110.0	4.9
1957-58	113.9	108.9	-1.9
1958-59	126.0	116.5	7.0
1959-60[a]	129.4	118.5	1.7
1960-61[b]	142.0	126.9	7.1

[a]Revised estimates.

[b]Preliminary estimates based on partial material.

Source: Government of India, Central Statistical Organization, Estimates of National Income, 1948-49 to 1959-60 (New Delhi, March 1961), p. 1.

another year the national income actually declined.[1] In the two years when national income either stagnated or declined, agricultural output had fallen. On the other hand, increases in national income occurred in years in which agricultural production also rose. This, however, should be expected from an economy where agriculture and allied activities contribute between 45-48 per cent of real national income and where agricultural output still depends to a large extent on rainfall, which is not regular.[2]

Saving and Investment

The Central Statistical Organization, in charge of estimating national income, does not publish data on saving and investment. Therefore one has to tap other sources. The Reserve Bank of India has prepared estimates of saving and investment.[3] These are set out in Table 5. Saving and investment are given at constant prices. The difference between the two is capital inflow from abroad. The ratios of saving and investment to national income are given to bring out the trend over the period.

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[1]The fall in national income should not be mainly attributed to the decline in investment, which proceeded relatively unhampered. In 1957-58 the principal cause was the unfavorable weather condition.

[2]Estimates of National Income, op. cit., see Table 10. 1.

[3]As of now, there are two comparable estimates of saving and investment in India. The other has been done by the National Council of Applied Economic Research, Saving in India, op. cit. However, the RBI estimates have been preferred for two reasons: (i) because these are officially prepared and (ii) because these are extended up to 1958-59, while those of NCAER stop at 1957-58.

TABLE 5

SAVING, INVESTMENT AND THEIR RATIOS TO NATIONAL INCOME, AND THE RATIO OF SAVING BY GOVERNMENT TO TOTAL SAVING

Year	Saving at 1948-49 Prices	Investment at 1948-49 Prices	Net Capital Inflow (2)-(1)	Saving/Income Ratio	Investment/Income Ratio	Ratio of Saving by Government to Total Saving
	(in million rupees)			(in per cent)		
	1	2	3	4	5	6
1950-51	5,910	5,640	-270	6.7	6.4	14.7
1951-52	4,600	6,330	+1,730	5.1	7.0	38.2
1952-53	5,640	5,300	-340	6.0	5.6	15.1
1953-54	5,730	5,580	-150	5.7	5.6	11.9
1954-55	7,310	7,650	+340	7.1	7.4	12.0
1955-56	9,550	9,980	+430	9.1	9.5	7.6
1956-57	9,660	13,130	+3,470	8.8	11.9	12.9
1957-58	7,820	12,170	+4,350	7.2	11.2	13.9
1958-59	9,020	12,460	+3,440	7.7	10.7	10.6

NOTES: Figures on Net Capital Inflow are given at 1948-49 prices.

The definition of Net Capital Income is as follows: Total Current Account Deficit + Retained Earnings of Foreign Companies (their subsidiaries or branches) - the Net Inflow of Gold = NCI. The Current Account Deficit (+) includes unpaid imports but excludes official donations. It also includes half of Errors and Omissions.

Source: Reserve Bank of India Bulletin (August 1961), pp. 1200-13.

This table shows that aggregate saving at constant prices has not been rising since 1956. In fact the first three years of the Second Plan were characterized by some fall in aggregate saving. This shows up in the decline in the saving/income ratio from 9.1 per cent in 1955-56 to 7.7 per cent in 1958-59. Compared to the average ratio of 6.6 per cent during the First Five Year Plan (1951-52 to 1955-56) the saving ratio is somewhat higher at 7.9 per cent during the first three years of the Second Plan. By comparison the ratio of investment to income shows a greater rise. Thus, the average investment ratio during the First Plan period was 7.1 per cent, but went up to 11.3 per cent as the average of the first three years of the Second Five Year Plan. It will be seen in Table 5 that the gap between actual saving and investment was financed by an inflow of capital which showed marked rise during the Second Plan period. On an average the ratio of foreign capital to total investment during the First Plan period was only 7.6 per cent, but increased to 29.8 per cent during the first three years of the Second Plan.

In connection with the share of government saving in the total saving, it should be kept in mind that the years 1950-51 to 1952-53 were extraordinary, being characterized by the Korean War. The bulge in government saving was due mainly to an increase in export earnings which in turn produced higher custom revenues. However, after declining from the peak year of 1951-52 to the lowest in 1955-56, the share of government in aggregate saving began to rise again. For the entire period (1950-51 to 1958-59) the annual average proportion of government saving in total saving comes to 13.9 per cent as compared to 4.7 per cent from

the corporate sector and 81.4 per cent from the rest of the economy.[1]

While complete statistics on saving and investment in the last two years of the Second Plan are not yet available, the Planning Commission has estimated that the rate of saving has been "around 8 per cent of national income."[2] The rate of investment has been about 11 per cent of the national income. This shows that while the goal of the Second Five Year Plan in respect to the rate of investment has been realized, in respect to the saving ratio, the achievements have fallen short of the goal.

III

Finances of the Second Plan

Public Sector

The public sector in the Second Plan was allotted 48 billion rupees as compared to 24 billion rupees only to the private sector. However, the task of raising sufficient finances from the domestic and external sources was beset with difficulties from the very start. The mode of financing originally envisaged along with the expected actual

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[1] In the Reserve Bank study the entire economy outside of the government and the domestic corporate sector has been termed "Household Sector" which is subdivided between rural and urban household sectors. The use of this blanket term is an expression of the inability of the RBI study to separate unincorporated enterprises in trade, industry, and agriculture from the residual estimate. See Reserve Bank of India Bulletin (March 1960), pp. 296-327; ibid., August 1961, pp. 1200-1207.

[2] The target for the Third Five Year Plan is to raise saving to 11 per cent of national income by 1965-66. See "The Third Five Year Plan--A Draft Outline," Report on Currency and Finance, 1960-61, p. 99.

amounts are shown in Table 6. It shows that the Second Plan could not provide for more than 50 per cent of the public sector outlay from sources as included in the budget. However, as it has turned out, about 56 per cent of the public sector outlay has been financed out of these sources.

It may be recalled that the developmental (noninvestment) expenditure in the public sector was originally set at 10 billion rupees which was 2 billion rupees in excess of the expected tax contribution of 8 billion rupees. But the actual tax contribution is likely to exceed the developmental outlay of 9.5 billion rupees by 520 million rupees. It should also be noted that the Planning Commission had underestimated the increase in nondevelopmental expenditure. As a result, the actual contribution of taxation existing at the commencement of the Second Plan (Table 6) has been reduced from 3.5 billion rupees to minus 500 million rupees.

As can be seen in Table 7, it was not due to the lack of tax effort that the Second Plan had to place extraordinary reliance on non-tax sources. The total tax revenues increased by nearly 70 per cent between 1955-56 and 1960-61. The percentage of national income collected in taxation also increased from 7.6 in 1955-56 to 9 per cent in 1960-61. But despite this rather substantial tax effort the contribution of revenue surplus to the financing of the Second Plan could not exceed 22 per cent. Part of the explanation is that the state governments did not put in their best effort in imposing new taxes and improving the administrative machinery of assessment and collection. At the level of the central government, too, there has been a substantial evasion of

TABLE 6

THE FINANCING PATTERN OF THE PUBLIC SECTOR: SECOND PLAN ESTIMATES AND THE EXPECTED ACTUAL AMOUNTS[a]
(in billion rupees)

Serial Number	Sources of Finance	Initially Estimated	Expected
1	Balance from current revenues (on the basis of existing taxation)	3.50	-0.50
2	Additional taxation	4.50	10.52
3	Total contribution by taxation (1 + 2)	8.00	10.02
4	Surpluses from public enterprises[b]	1.50	1.50
5	Loans from the public (net)[c]	7.00	7.80
6	Small savings (net)	5.00	4.00
7	Other budgetary sources	2.50	2.30
8	Total contribution as included in the budget (3 + 4 + 5 + 6 + 7)	24.00	25.62
9	Budgetary receipts corresponding to foreign assistance[d]	8.00	10.90
10	Deficit financing	12.00	9.48
11	Uncovered gap[e]	4.00	--
12	Total	48.00	46.00

[a]Figures in this table are combined totals of the central and state government.

[b]This was the contribution of railways.

[c]This includes investment by the State Bank of India out of P.L. 480 funds.

[d]This includes investment by the RBI of P.L. 480 funds in government securities.

[e]"The uncovered gap" was covered by increased taxation.

Sources: Second Five Year Plan, pp. 77-78; and Reserve Bank of India Bulletin (September 1961), p. 1398.

TABLE 7

THE INCREASE IN TAX REVENUES OF THE CENTRAL AND THE STATE GOVERNMENTS DURING THE SECOND PLAN PERIOD
(in million rupees)

	1955-56	1960-61	Absolute Increase(+) or Decrease(-) (3) - (2)	Percentage Increase(+) or Decrease(-) (4)/(2)
1	2	3	4	5
A. Central Government	4,114.7	6,851.9	+2,737.2	+66.5
B. State Governments	3,495.3	6,059.0	+2,563.7	+73.3
C. Total (A + B)	7,610.0	12,910.9	+5,300.9	+69.6
D. Tax Revenues of States Excluding Transfers from the Central Government	2,759.4	4,271.2	+1,511.8	+54.7

NOTES: The difference between items B and D is the tax revenue levied and collected by the central government and transferred to state governments. The state governments share in the revenues of the income tax, excise duties, estate duty and the tax on railway passenger fares.

Figures for 1960-61 are revised estimates.

Source: Report on Currency and Finance, 1960-61, Statements 57 and 61.

income tax.[1] There are, however, more basic reasons for India's inability to widen the tax net and capture a larger proportion of the national income. These reasons are economic, political, as well as administrative. The principal economic reason is the prevalence of the nonmonetized sector which still produces a significant proportion of the national output.[2] The difficulty encountered in increasing the tax burden on the rural population is presumably political. High administrative cost involved in assessing and collecting relatively small amounts of revenue from a large number of assessees has probably weighed against further extension of the personal income tax to lower income brackets. In addition to these reasons, mention may be made of the defective slab structure and rate schedule of the income tax, the prevalence of self-employment, and the low tax morale of the tax payers.[3] These factors are mainly responsible for the small reliance on taxation for mobilizing the domestic resources for increased investment. Furthermore, in view of the low ratio of taxation to national income which prevailed before the Second Plan, it may be doubted if the government in reality could have significantly achieved more than they did. Moreover, in the realm of public finance it is not the amount of taxation but more often the extent of increase in the nondevelopmental expenditure

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[1]See G. S. Sahota, Indian Tax Structure and Economic Development (1961), pp. 41-51.

[2]The Taxation Enquiry Commission had estimated that for the entire economy 37 per cent of the total consumer expenditure was represented by imputed value. The estimate was 45 per cent in the rural areas and 10 per cent in the urban areas. Government of India, Report of the Taxation Enquiry Commission, 1953-54, I, 65.

[3]G. S. Sahota, op. cit., pp. 33-37.

that limits the contribution of the budget to national savings. As can be seen in Table 6, the unplanned increase in the nondevelopmental expenditure was responsible for reducing the potential contribution of taxation to the financing of the Second Plan.

Deficit Financing

In India deficit financing does not have the same connotation as in the United States. It is not the excess of total budgetary outlay over total tax revenue, but the excess of expenditures over gross revenue (taxes, loans, fee and profits, etc., and foreign aid) which results in expansion of the money supply.[1] Thus budgetary outlays resulting in withdrawal of foreign exchange reserves are treated as offsetting items in order to arrive at the net increase in money supply resulting from deficit spending.[2] This is so because the government issued ad hoc Treasury bills to the Reserve Bank both to secure foreign exchange assets as well as to obtain rupee finance. Only in the case of the latter did the Issue Department of the Reserve Bank print new currency against the backing of Treasury bills. (5 billion rupees of these were later funded into nonmarketable securities.) The government could avail itself of the new currency credited to its account to meet

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[1]See Second Five Year Plan, op. cit., pp. 83-87. The Second Plan states that broadly speaking "a deficit measured in terms of withdrawals of cash balances and net increases in the floating debt gives, on the whole, a reasonably reliable indication of the impact of the budget on the money supply," p. 84.

[2]While the sale of foreign exchange by the Reserve Bank to the government has no effect on money supply, the sale of it to the private sector results in its contraction.

budgetary cash deficits. The actual deficit financing is thus equal to the increase in the floating debt plus the decrease in the government's cash balance. It should be noted here that state governments are not empowered to issue Treasury bills. Hence they can meet their cash deficit only by running down cash balances (see Table 12, row V). Thus, the money supply (demand deposits + currency in circulation) would go up when actual expenditures are made. However, in order to calculate the net effect on money supply more accurately, it is also necessary to take into account the increases in government securities held by banks resulting from the issue of new debt, transactions between banks and other investors, and open market operations of the Reserve Bank.[1] In addition the increase in the supply of one rupee notes, which are issued as government of India obligations, and variations in cash held by government treasuries should also be taken into account. Thus depending upon the choice of the definition, one can arrive at different estimates of deficit financing. But for our purposes the Reserve Bank's estimates will suffice. (Also see footnote 1 on page 50.)

The Private Sector

Unlike the public sector the Planning Commission could not lay down in advance the sources through which the investment outlay of 24 billion rupees in the private sector was to be financed. This was no doubt due to the scarcity of data. The most the planners could do was to

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[1] In particular, the net absorption of securities by commercial banks has an expansionary effect on the money supply.

indicate the likely amounts available for gross fixed capital formation in the organized industrial sector. These estimates along with the likely actual amounts are given in Table 8. No such estimates could be furnished for mining, electric power generation and distribution, plantations, small scale industries, and agriculture. As can be seen in Table 6, the Planning Commission had underestimated the resource-raising potential in the private sector. However, it can be easily seen that saving generated within the private industrial sector (items 3 + 4) accounts for no more than 22.3 per cent of the total outlay. Foreign capital and credit provided 23.5 per cent of the total, which incidentally is about the same as in the public sector (23.6 per cent).

Foreign Capital and the Balance of Payments

The successful implementation of the Second Plan was greatly dependent upon the availability of foreign exchange. A deficit of 11.20 billion rupees had been anticipated in the current account over the Plan period.[1] Moreover, a large part of the deficit was expected to occur in the second and third years of the Plan. This deficit could be partly met by the reduction of accumulated foreign exchange reserves; for the rest the Plan had banked on foreign loans, aid, and the inflow of equity capital. The estimated sources of meeting the deficit in the balance of payments along with actual amounts are set out in Table 9.

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[1]This estimate of the deficit was based on either gross miscalculation or deliberate underestimation of the foreign exchange needs of the Second Plan.

TABLE 8

SOURCES OF FUNDS FOR GROSS CAPITAL FORMATION IN LARGE AND MEDIUM INDUSTRIES IN THE PRIVATE SECTOR
(in million rupees)

Serial Number	Sources of Finance	Second Plan Estimates	Final Estimates
1	Loans from institutional agencies	400.0	800.0
2	Loans and assistance from the government	200.0	200.0
3	New issues	800.0	1,500.0
4	Internal resources	3,800.0	4,000.0
5	Foreign capital including supplier's credit	1,000.0	2,000.0
6	Total	6,200.0	8,500.0
7	Uncovered gap	1,000.0	--
8	Grand total	7,200.0	8,500.0

NOTES: It had been estimated in the Second Plan that 5.7 billion rupees would go into new investments while 1.5 billion rupees would be used in replacement and modernization.

Sources: Second Five Year Plan, pp. 404-405; and Reserve Bank of India Bulletin (September 1961), p. 1401.

TABLE 9

THE DEFICIT IN BALANCE OF PAYMENTS (ESTIMATED AND ACTUAL) DURING THE SECOND PLAN

(in billion rupees)

		Second Plan Estimates	Actual
1.	Total exports	29.65	30.53
2.	Invisibles (net) excluding official donations	2.55	4.20
3.	Capital transactions (net) excluding fresh capital inflow on private and government accounts	-1.00	-1.72
4.	Foreign exchange available for imports	31.20	33.01
5.	Total imports	43.40	48.26
6.	Net surplus or deficit (4)-(5) (+) (-)	-12.20	-15.25
7.	Withdrawal of foreign exchange reserves	2.00	5.98
8.	Foreign assistance	10.20	9.27
9.	Resources in sight	1.92	
10.	Gap to be covered by new loans and aid	8.28	

Notes: This table excludes aid under P.L. 480. These amounted to about Rupees 5.34 billion. The deficit in this table exceeds the estimate given in the Second Plan by Rupees 1 billion. This is due to non-inclusion of item (3) in the estimate (see the table on page 95 of the Second Five Year Plan), although reference to it is made in the text (page 102). Having referred to it once the Planning Commission, it seems, deliberately left it out in estimating the foreign aid needed to cover the deficit.

Sources: Second Five Year Plan, pp. 94-105 and Reserve Bank of India Bulletin (September 1961), p. 1396.

The balance of payments was under severe strain under the Second Plan. The withdrawal from foreign exchange reserves was three times higher than originally contemplated. It was only by recourse to stringent restrictions on imports and much larger help from abroad that the country could survive the severe crisis in foreign exchange. The crisis had erupted in the second year of the Plan and was largely met by the drawing down of reserves and by the International Monetary Fund. However, these sources diminished progressively as foreign loans and grants increased to salvage the Second Plan.[1] Thus in the completion of the Second Plan, foreign aid played a decisive role. In the above table the contribution by the United States under P.L. 480 has been omitted, but in providing resources to the public sector and in augmenting the supply of wage goods its importance cannot be exaggerated. Without it either the investment outlay would have been cut because the government would have been forced to spend foreign exchange in importing wheat and other goods, or alternatively the real consumption of the people would have been cut by higher prices and rationing.

IV

Demand-Pull Inflation

The resource gap in the Plan, manifesting itself in the excess of investment over expected saving and the deficit in the balance of payments was bound to be felt on the level of prices. In particular, financing and restrictions on imports of consumer goods had definite

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[1]See Report on Currency and Finance, op. cit., pp. 103-113.

inflationary potential. This was to some extent anticipated in the Plan. The planners had expected that the money supply would go up by about 66 per cent. But it was plausibly argued that an increase of up to 25 per cent in the money supply should be considered safe in view of the fact that the real national income would go up by the same amount.[1] The remaining portion implied some risk of inflation which, however, had to be undertaken. Assuming further that the ratio of demand deposits to total money supply would remain unchanged, it could be expected that the effect of deficit financing on the secondary expansion of credit by banks would not be excessive. But if credit expansion did exceed safe limits, the Reserve Bank would use credit controls (in particular, selective controls) to check it. Furthermore, should prices rise the government could start open-market sales in food grains and take other administrative measures or change commercial policy to regulate prices in strategic markets.[2] Thus the general attitude of the Planning Commission was to take some risk of inflation, but the government and the Reserve Bank should be vigilant in minimizing price increases.

It should be noted at this stage that the general policy orientation of the Second Plan was to control prices through selective policies aimed principally at essential commodities.[3] These policies in turn would dampen the rate of increase of the general price level. But some inflation is unavoidable because "a policy of playing safe is not

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[1] Second Five Year Plan, op. cit., p. 85.

[2] Ibid., p. 40.

[3] Ibid., p. 86.

always conducive to development.[1] To some extent at least this attitude was due to the behavior of prices during the First Plan period when, in spite of deficit financing, they had declined.

However, as Table 10 shows, the experience of the First Plan was not to be repeated and the increase in prices during the Second Plan period was both continuous and spread over the entire range of goods. Table 9 shows the behavior of the cost-of-living index along with wholesale prices of all commodities and of three most important groups. It will be noted that the increases in the WPI are closest to the price index of food articles. This is so because, out of total weights of 1,000, weights assigned to food articles are 504. Industrial raw materials and manufacturers have weights of 155 and 249, respectively, in the General Index.

Inflation during the Second Plan period can be safely characterized as the "demand-pull" type, being caused by excess of expenditures over current supply (at constant prices). The most powerful contributory factors to an increase in the price level have fiscal and monetary origin. Throughout the plan period money expenditures by the government and in the private sector were sustained at a high level, while the flow of goods into the market varied with fluctuations in real income which in turn responded mainly to changes in agricultural production. In the public sector total outlays were kept rising by budgetary deficits, while in the private sector saving failed to rise along with investment! Higher prices of imported machinery, intermediate goods,

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[1] Ibid.

TABLE 10

INDEX NUMBERS OF COST OF LIVING AND WHOLESALE PRICES

	Cost of Living Index (1949 = 100)	Wholesale Price Index (1952-53 = 100)	Food Articles Price Index (1952-53 = 100)	Industrial Raw Materials Price Index (1952-53 = 100)	Manufactures Price Index (1952-53 = 100)
1950-51	101	111.8	112.5	130.9	103
1951-52	104	- -	- -	- -	- -
1952-53	104	100.0	100.0	100.0	100.0
1953-54	106	101.2	100.1	107.4	100.4
1954-55	99	89.6	82.1	94.6	99.7
1955-56	96	92.5	86.6	99.0	99.7
1956-57	107	105.3	102.3	116.0	106.3
1957-58	112	108.4	106.4	116.5	108.1
1958-59	118	112.9	115.2	115.6	108.4
1959-60	123	117.1	119.0	123.7	111.7
1960-61	124	124.8	120.0	145.4	123.9

Source: Report on Currency and Finance, various issues.

and raw materials also had an inflationary effect by way of higher costs. On the other hand import of P.L. 480 aid was anti-inflationary. By augmenting the flow of consumer goods P.L. 480 aid tended to lower prices. The sales proceeds from these goods constituted withdrawal of money from circulation (and hence purchasing power of the private sector) which was later banked with the State Bank of India as time deposits. But these funds were invested in government securities and respent by the government in the next time period. Thus the purchasing power withdrawn originally by the sale of wheat, etc., was restored to the private sector via government spending. The net effect of these transactions on the money supply was neutral.

However, it is quite evident that increased government expenditures would have some positive effect on national income. The money national income would go up as the initial increase in government expenditures are successively respent. The real income would also rise first, by the amount of increase in consumption made possible by P.L. 480 aid and secondly, by increased production of goods and services made possible by government investment. It, therefore, appears that the main effect of P.L. 480 aid was anti-inflationary. It tended to slow down the pace of inflation in three ways--first, by augmenting the supply of consumer goods in the market; second, by somewhat increasing the time lag involved in the diversion of purchasing power from consumers to the government and back to consumers again; and thirdly, by stabilizing the stock of money.

Government Expenditures

The budgetary deficits of the government of India and the state governments are shown in Tables 11 and 12. These are overall deficits and in the case of state budgets are shown net variations in public debt held outside of the government (but including the Reserve Bank).[1] These deficits were financed to some extent by the reduction in cash balances but predominantly by the sale of Treasury bills. The latter do not include 5 billion rupees of ad hoc Treasury bills issued by the Indian government to the Reserve Bank which were later funded. For the state budgets the entire deficit net of borrowings is deemed to be financed by reduction in cash balances. These deficits were inflationary to the extent that they raised demand in excess of the rate of increase of output. Simultaneously, budgetary deficits added to money supply which rendered possible the increased flow of money expenditures at higher prices.

Increase in Money Supply

The money supply during the Second Plan increased without interruption. However, the rate of increase varied from year to year

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[1]The total deficit of the government of India and the state governments for the Second Plan period adds up to 10.23 billion rupees. (This is the sum of the total of items IV in Table 11 and the total of item V in Table 12.) This figure can be broadly reconciled with the estimate of deficit financing given as 9.48 billion rupees in Table 5. The Reserve Bank made a net open market sale of the Government of India securities of 0.90 billion rupees during the Second Plan period. Deducting this figure from 10.23 billion rupees we arrive at 9.33 billion rupees. The difference of 0.15 billion rupees should be accounted for by the net effect of two variables: (i) Reserve Bank purchase (or sale) of state governments' securities and (ii) variations in the supply of one rupee notes issued by the Government of India as its own liabilities. We have no data on the former.

TABLE 11

BUDGETARY BALANCE OF THE GOVERNMENT OF INDIA
(in billion rupees)

Serial Number		1956-57 (Budget Estimates)	1957-58 (Accounts)	1958-59 (Accounts)	1959-60 (Accounts)	1960-61 (Accounts)	Total for the Second Plan
I.	Revenue Account						
(A)	Revenue	5.63	6.73	6.70	7.78	8.77	35.62
(B)	Expenditure	4.73	6.31	6.75	7.36	8.26	33.42
(C)	Surplus (+) or Deficit (-)	+0.89	+0.42	-0.05	+0.42	+0.51	+2.20
II.	Capital Account						
(A)	Receipts[a]	3.02	2.97	5.90	7.57	11.27	30.75
(B)	Disbursements	6.16	8.43	8.13	9.58	11.00	42.31
(C)	Surplus (+) or Deficit (-)	-3.14	-5.45	-2.22	-2.00	+1.26	-11.56
III.	Miscellaneous[b] (Net)	+0.39	+0.44	+0.05	-0.11	-0.60	+0.18
IV.	Overall Surplus(+) or Deficit (-)	-1.84	-4.58	-2.21	-1.69	+1.16	-9.18

[a]Excludes receipts from the sale of Treasury bills.
[b]Remittances between U.K. and India.

Sources: Report on Currency and Finance, 1960-61, Statement 55, and Reserve Bank of India Bulletin (April 1962), p. 522.

TABLE 12

CONSOLIDATED BUDGETARY BALANCE OF STATE GOVERNMENTS
(in billion rupees)

		1956-57 (Accounts)	1957-58 (Accounts)	1958-59 (Accounts)	1959-60 (Accounts)	1960-61 (Revised)	Total for the Second Plan
I.	Revenue Account						
(A)	Revenue	5.70	7.11	8.12	9.07	10.10	40.12
(B)	Expenditure	6.54	6.83	7.65	8.69	9.96	39.69
(C)	Surplus (+) or Deficit (-)	-0.83	+0.27	+0.47	+0.37	+0.13	0.43
II.	Capital Account						
(A)	Receipts[a]	4.26	4.00	4.41	4.82	5.45	22.96
(B)	Disbursements	4.54	4.32	4.34	5.07	6.46	24.75
(C)	Surplus (+) or Deficit (-)	-0.27	-0.32	+0.06	-0.25	-1.01	-1.79
III.	Miscellaneous (Net)[b]	- -	-0.15	-0.01	- -	-0.04	-0.21
IV.	Overall Surplus(+) or Deficit(-)	-1.09	-0.19	0.52	+0.11	-0.91	-1.57
V.	Budgetary Surplus (+) or Deficit (-) (after allowing for net purchase or sale of securities)[c]	-0.60	-0.12	+0.03	-0.22	-0.14	-1.05

[a]Excluding net purchase or sale of securities.
[b]Consists of remittances.
[c]This item is not part of the consolidated budgetary positions as presented by the RBI. However the budgetary balance is shown net of net sale or purchase of securities so as to put it on a par with the budgetary balance in Table 9.

Sources: Report on Currency and Finance, 1960-61, Statement 56; and Reserve Bank of India Bulletin (June 1961), p. 858.

(see Table 15). The composition of the stock of money also has changed over the Second Plan period (see Table 13). Thus while the money supply increased by 7.22 billion rupees or by 33 per cent, demand deposits increased by 1.88 billion rupees or by only 28.1 per cent. As a result, the ratio of demand deposits to total monetary stock fell from 32.70 per cent in 1956-57 to 30.13 per cent in 1960-61. The decline in the ratio of bank money to total money is also apparent over a longer period. Thus compared to the average ratio of 31.79 per cent during the First Plan period, the average ratio for the Second Plan fell to 31.45 per cent.[1] This shows that the increase in income has been accruing more to those sections of population among whom the banking habit is as yet undeveloped than to those having a higher preference for bank money. Thus the increase in demand for currency in circulation can either be associated with the increase in farm incomes or expansion in the monetized sector of the economy or both. It is probably due to both, although it is impossible to be precise about the relative importance of each factor.

Table 14 lists the factors affecting the increase in money supply between 1956-57 and 1960-61. This shows that by far the most expansionary influence on money supply originated from the government. By comparison the expansion of bank credit to the private sector has been quite small. These expansionary factors were counteracted by the increase in time deposits and the decline in foreign exchange reserves. The increase in time deposits was largely caused by P.L. 480 counterpart funds deposited with the State Bank of India. This practice

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[1]See Reserve Bank of India Bulletin (August 1961), pp. 1214-19.

TABLE 13

CHANGES IN MONEY SUPPLY AND ITS COMPOSITION DURING THE SECOND PLAN
(in billion rupees)

	Outstanding as on March 30, 1956	1956-57	1957-58	1958-59	1959-60	1960-61	Total Increase During the Second Plan Period
1. Currency in Circulation	15.05	+0.51	+0.51	+1.18	+1.38	+1.67	+5.27
2. Demand Deposits	6.67	+0.77	+0.17	-0.07	+0.63	+0.37	+1.88
3. Other Deposits with Reserve Bank	0.12	--	+0.08	--	+0.02	-0.02	+0.06
4. Total Money Supply (1) + (2) + (3)	21.84	+1.28	+0.77	+1.10	+2.04	+2.01	+7.22
5. The Ratio of Demand Deposits to Money Supply	30.54	32.70	32.74	30.97	31.09	30.13	--

NOTES: The ratios in row (5) are averages pertaining to totals in each year.
Figures may not add up to totals on account of rounding off.

Sources: Reserve Bank of India Bulletin (July 1961), p. 1059; ibid., August 1961, p. 1218.

TABLE 14

FACTORS AFFECTING MONEY SUPPLY VARIATIONS DURING THE SECOND PLAN

(in million rupees)

I.	1.	Net increase in the Reserve Bank's holdings of government securities and rupee coins	+11,669
	2.	Add net increase in government securities with banks	+ 1,928
	3.	Add net increase in the government's currency liabilities to the public	+ 170
	4.	Deduct increases in government deposits with the Reserve Bank	- 238
	5.	Total net increase in bank credit to the government	14,005
II.	6.	Net increase in Reserve Bank credit to the private sector	+ 26
	7.	Add net increase in financial assets of banks	+ 7,065
	8.	Deduct net increase in time deposits	+ 6,594
	9.	Total increase in bank credit to private sector (6+7-8)	+ 497
III.	10.	Net increase in foreign exchange assets	- 6,646
IV.	11.	Net increase in other non-monetary liabilities	+ 633
V.	12.	Total increase in money supply	
		= I+II+III - IV = 14,005+497+(-6,646)-(+633)	
			= 7,223

Source: Report on Currency and Finance, 1960-61, Statements 21, 37, 38, and 39.
Reserve Bank of India Bulletin (July 1961), pp. 1045-67.

TABLE 15

RATES OF GROWTH OF NATIONAL INCOME, PRICE LEVEL, AND MONEY SUPPLY, AND CHANGES IN THE INCOME VELOCITY OF MONEY

	1956-57	1957-58	1958-59	1959-60	1960-61
1. Real national income (per cent)	4.9	-1.9	7.0	1.7	7.1
2. Wholesale Price Index (per cent)	13.8	2.0	4.1	3.8	6.5
3. Money supply (per cent)	5.8	3.3	4.6	8.1	7.4
4. Income velocity of money	4.8	4.7	5.0	4.7	4.8

NOTE: The income velocity of money is the ratio of money national income to the stock of money in each year.

Sources: Report on Currency and Finance, 1960-61, Statements 18 and 19, and Estimates of National Income 1948-49 to 1959-60, op. cit., p. 1.

continued until May 12, 1960. Since then these funds have been deposited with the Reserve Bank in exchange for government securities held by the U.S. Embassy. As far as the effect on money supply is concerned, it will make no difference whether these funds are counted as part of time deposits or as part of government balances. Either way, in an accounting sense, the affect on money supply is equally contractionist.

The increase in the money supply enabled the economy to sustain rising levels of money expenditures at higher prices without necessitating the increase in the income velocity of money (see Table 15). The latter occurs when money expenditures rise faster than the increases in monetary stock. But if the latter grows as fast as the rate of expenditures, the income velocity of money remains unchanged. In this connection it should be noted that the income velocity of national income originating in the monetized sector will be higher than can be truly revealed by figures in Table 15. However, as rough indicators, these do show that excepting 1958-59 the increase in monetary stock was always adequate to finance increased spending. In 1958-59 the increase in velocity of money can be partly explained by the shift in the composition of money in favor of currency in circulation. This resulted in the increased transaction velocity of deposit money. The overall rate of turnover of business and individual deposits in 1958-59 rose to the record figure of 17.9.[1] As compared to this year, the rates of

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[1]The overall rate of turnover is calculated by dividing the debts to current accounts, cash credit, and overdrafts by the average outstanding in current account, and effective cash credit and overdraft

turnover in the preceding two years were 17.0 (1957-58) and 17.1 (1956-57). The conclusion is that insofar as the monetary authorities are concerned, the increase in the money supply was allowed to proceed unchecked; otherwise the income velocity and deposit velocity should have increased with rising money expenditures.

To sum up, inflation in India during the Second Plan period was caused by demand-pull conditions. An investment boom accompanied by deficit financing and bank credit expansion had resulted in a large expansion of money supply, which in turn sustained rising expenditures at higher prices. Prices rose mainly because budgetary deficits were not equally offset by voluntary reduction in consumption expenditures. In addition, the supply function of the monetized economy shifted with variations in the marketable surplus, especially of agricultural products. Aggregate demand would be steadily growing with increases in the population and growth in money incomes despite weather fluctuations. This means that prices may fall in some years (when the marketable surplus is unusually high), but on an average they will rise. This will be so because the demand cannot be expected to decline sufficiently to offset the reduction in the marketable surplus in the years of adverse weather. Prices will generally rise even in those years in which the marketable surplus does not fall as long as its average rate of increase lags behind the rate of increase in demand. In such a case increases in the stock of money will perpetuate the inflationary gap and may even

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limits. The rate of turnover relates only to bank offices operating in towns with a population of 100,000 or over. See Report on Currency and Finance, op. cit., Statement 30.

widen it unless a part of the increase in the monetary stock is absorbed in the form of higher cash balances (i.e., reduced income velocity of money).

As can be seen in Table 10, food articles and industrial raw materials led the increase in price level from 1955-56 through 1958-59 with the exception of 1957-58 when prices rose by the smallest extent in the whole period. The food prices continued to rise in the subsequent period, too, but those of the industrial raw materials and the manufactures were rising even faster. Between March 1956 and March 1961 prices of food articles went up by 26.0 per cent, of industrial raw materials by 45.4 per cent, of liquor and tobacco by 44.1 per cent, and of manufactures by 25.8 per cent. The general index of all commodities rose in the same period by 30.0 per cent.[1] This is in marked contrast to the experience during the period of the First Five Year Plan in which the general index of all commodities fell by 18.4 per cent. The main difference between the two Plan periods is that, although money supply increased in both Plans, the economy during the Second Plan was characterized by excess demand conditions, while in the First Plan the main characteristic of the economy was the deficiency of demand.

V

Inflation and Economic Development

The underlying assumption of the Second Plan was that inflation is not only inevitable but a necessary cost of economic development.

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[1] Ibid., Statement 20.

This theory needs to be examined critically because one of the basic assumptions of this thesis is that persistent inflation is undesirable and ought to be controlled.

In theory, as well as in practice, inflation should be clearly distinguished from a once-over change in prices, and also from changes in the structure of prices. The essential characteristic of inflation is that it is a process through time. Inflation is an uninterrupted increase in the price level, except for temporary breaks which may be caused by seasonal, climatic or other noneconomic variables. Inflation, therefore, is basically an economic phenomenon; it originates within the economic system and is kept going by the interaction of economic forces. In the specific context of the Indian economy, it is conceivable that prices at any time may rise due to the shrinkage of supply caused by adverse weather conditions. Such an increase in the price level will not become inflationary, however, unless the rate of aggregate money expenditures continually grows.

Thus defined, any rate of increase in the price level, howsoever small, is termed inflation, provided it continues over a period of time. In theory it is possible to have a rate of inflation of no more than 2 per cent per year, as well as of 10 per cent or more. It is, however, highly unlikely that an open inflation can be stabilized at a fixed rate of 2 per cent. This is so because even a small increase in prices gives rise to inflationary expectations which tend to accelerate its pace, also because in a democratic society there is no assurance that costs will rise at no more than a fixed percentage. Furthermore, the stabilization of a rate of inflation has a practical implication that the

demands of government, businesses, labor, farmers and other active groups in the society will not exceed the output by more than a fixed percentage per year. It may be difficult to guarantee this even in a planned economy.

On theoretical grounds it appears highly probable that an underdeveloped economy, such as that of India, will experience some increase in prices if serious attempts are made to raise the ratio of investment to national income. There are four interrelated reasons why some inflation may be inevitable. First, the marginal propensity to consume will have to be lowered unless the increase in investment is mainly financed by the inflow of foreign capital. This can be achieved by transferring an increasing proportion of additional income to either the entrepreneurs or the government or both. The entrepreneurs' share of the national income will rise via higher profits while that of the government can go up via increased taxation. Profits are likely to rise as the capitalists, with recourse to bank credit, raise the investment outlays, increasing thereby the level of demand of the consuming public. Since the output of consumer goods has remained unchanged, the increased consumption expenditure can only lead to higher prices and profits. Thus, as long as the wages and the costs of raw materials lag behind increasing prices, profits will steadily rise.

The share of the government can, however, be increased without similar increase in prices. This is because a higher ratio of taxation to national income would bring about a decrease in private income and hence expenditures. But if the government is incapable of raising the tax revenue sufficiently, it too might take recourse to bank credit,

i.e., new money creation. This method, however, is potentially inflationary.

Second, the domestic price level is likely to rise as attempts are made to export an increasing proportion of national income and minimize the imports of consumer goods. If it is assumed that the output is at full capacity or can be increased in the short run only at increasing costs, an increase in the level of prices is indicated.

Third, a developing economy is generally expected to encounter specific scarcities and bottlenecks. These scarcities may relate to the skilled labor force, raw materials, etc. Following the emergence of these shortages, costs and prices of the industries affected by them are likely to go up. It is conceivable that rising sectoral prices will be transmitted to the rest of the economy through the resource allocation mechanism, thereby raising the price level.

Fourth, an increase in money supply, which is normal in a developing economy, will facilitate the increased flow of money expenditures via lower interest rates and easier availability of credit. Whether and to the extent that this happens will, however, depend on the policies pursued by the central bank of the country

Given the high probability that some inflation will occur in a developing economy it is preferable to minimize it to the extent possible. On pragmatic grounds it is suggested that the rate of increase in prices should be permitted up to the limit of 2 per cent per year. While no special claim is made for this figure, it is important that some upper limit should be laid down. This will enable the authorities to prepare realistic plans for economic development. The monetary

authorities will be provided with a yardstick to correctly assess their achievements and failures. Moreover, this will impose an overall discipline on the economic policies of the government, which once accepted cannot be lightly disregarded.

It appears that the Second Five Year Plan has been adversely affected by inflation in various ways. At least four distinct effects can be easily recognized. It is not claimed that in respect to each or all of them, inflation has been the sole influencing factor. But directly or indirectly inflation has been affecting the Plan. While nothing can be said with complete certainty, it is probably a safe conjecture that the disadvantages have outweighed the beneficial effects of inflation.

First, the expected increase in the ratio of saving to the national income has not materialized. In fact, the incremental ratio of saving to the national income has declined from 19.1 per cent for the three year period preceding 1955-56 to 14.2 in the three year period following it.[1] These estimates probably contain an unknown margin of error. The underlying assumptions and the methodology used for arriving at these figures have been questioned.[2] But if the figures are correct, even in respect to the broad magnitudes, there should be an explanation for them. One plausible explanation is that there occurred some transfer of real income in favor of the rural sector where the propensity to save

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[1]See Reserve Bank of India Bulletin (August 1961), p. 1208

[2]See K. N. Raj, "The Marginal Rate of Saving in the Indian Economy," Oxford Economic Papers (New Series), XIV, No. 1 (February, 1962), 36-50.

islower than in the urban areas. The increase in income probably took the form of higher real consumption in the nonmonetized sector. Alternatively, perhaps, the consumption function is subject to the money illusion. This means that real consumption increases with money income. The first hypothesis appears to be more plausible. In this case increase in real consumption would reduce the marketable surplus and raise prices. With prices up, the real income of the urban people would go down which in turn would lower their aggregate saving. This probably showed up in the short falls in the collection of small savings. For the Second Plan period the small savings, on a net basis, have accrued to the government at an annual average rate of 800 million rupees as compared to the target of 1 billion rupees per year.[1]

Second, rising domestic prices have weakened India's competitive position in the foreign markets. The level of exports during the Second Plan has generally remained stagnant. The ratio of exports to national income at current prices has dropped from 6.1 per cent in 1955-56 to 4.5 per cent in 1960-61.[2]

Third, inflation has probably diverted a portion of current savings into the acquisition of newly smuggled gold. Saving in the form of gold increased from an annual average rate of 125 million rupees for the three year period preceding 1955-56 to 262 million rupees for the three year period following it.[3] This is probably an underestimate.

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[1] Report on Currency and Finance, op. cit., p. 99.

[2] Ibid., Statement 82; and Table 4 of this chapter.

[3] Reserve Bank of India Bulletin, op. cit., pp. 1200-13.

According to B. R. Shenoy's estimates the gold smuggled during the First Five Year Plan amounted to 1,620 million rupees, or at an average annual rate of 324 million rupees.[1] Since then domestic prices have been going up, which should render the possession of gold even more attractive than before.

Fourth, inflation, by reducing the real income of the fixed income groups, has greatly weakened the welfare objectives of the Second Plan. The Plan had aimed at reduction of inequalities of income and wealth. In the absence of data nothing meaningful can be said on this subject. But general theoretical reasoning leads to the conclusion that the people with fixed incomes and those in the lowest income brackets are most adversely affected by inflation.

On the positive side of inflation it can perhaps be said that it has benefitted farmers and businesses. To that extent inflation may have improved incentives for greater production and strengthened the desire to assume new risks. This advantage is, however, of a dubious nature in the long run. The gains of farmers are determined by the terms of trade between the products they sell and the ones they buy. It is rather doubtful that the terms of trade, under inflationary condition, are favorable to the farmers in the long run. Similarly rising wages and raw material costs are bound to squeeze the industrial profits.

Like the capitalists and the farmers the government too may temporarily gain from inflation. But in the long run rising prices will erode the purchasing power of the government as much as of the people.

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[1] B. R. Shenoy, Problems of Indian Economic Development (Madras: University of Madras, 1958), p. 219.

In fact the government will have to levy new taxes to maintain its share in the national income if the elasticity of tax revenue is less than one. It is thus clear that inflation is not a substitute for taxation; in fact under the Indian conditions, higher taxes will have to follow a protracted period of inflation.

It follows from the above that the gains from inflation to the so-called active groups in the society are only of a temporary nature. But, as stated earlier, small increases in the price level may have to be tolerated as the necessary cost of rapid economic development.

VI

Monetary Policy: Its Tasks and Limitations

Given the heavy reliance on deficit financing in the public sector and given the prospects of the steady increase in investment outlays in the entire economy, the monetary policy of the Reserve Bank could be of assistance in the implementation of the Second Plan in the following three respects:

(a) To promote economic development by assisting the private sector in expanding productive capacity and increasing output. This was done by offering loans at concessional rates to the preferred sectors, such as agriculture and small-scale industries.[1] To a small extent the Reserve Bank also helped the new financial organizations set up by the government to channel funds into modern industries.

(b) To divert bank credit from trading and speculative users to the industrial sector.

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[1]These amounts are small but are on the increase. Thus, the advances made by the Reserve Bank to to the State Cooperative Banks have given up some 132 million rupees in 1955-56 to 882.9 million rupees in 1960-61.

(c) To restrain inflationary forces by using selective controls against the commodities whose prices were rising.

In addition, the Reserve Bank could use quantitative controls and moral suasion to prevent excessive expansion of bank credit. Inflation control was, however, not to be carried to the point when it would begin to hinder production.

The doctrine embodying these opposite pulls was quite aptly termed by the Reserve Bank as the policy of "controlled expansion."[1] In terms of this policy the main problem of the Reserve Bank was not how to control inflation but rather how to keep it to the minimum necessary for the implementation of the Second Five Year Plan. The main limitation of monetary policy in curbing prices, whether selective or general, stemmed from the fact that both the public and the private sector had been bound in the Second Plan to take recourse to bank credit (including Reserve Bank credit). The Reserve Bank had no choice in providing the financial requirements of the Second Plan. It may therefore be said that the limitations of the Reserve Bank policy actually stemmed from the Second Plan itself. It was a major anomaly of the Second Plan that financial outlays had been based on the assumption of constant prices; but the mode of financing the Plan was such that prices were bound to rise. The

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[1] In the Reserve Bank publications the earliest reference to this policy is in Trend and Progress of Banking in India During the Year 1956, pp. 10-11. Cited hereafter as Trend and Progress in Banking in India, 1956. Also see the following: S. L. N. Simha, "Central Banking in India," Central Banking in South and South East Asia, ed. G. Davies (1960), pp. 34-45; B. K. Madan, "The Role of Monetary Policy in a Developing Economy," Reserve Bank of India Bulletin (April 1961), pp. 518-36; H. V. R. Iengar, "Monetary Stability and the Role of the Reserve Bank," ibid., 1960, pp. 1606-13.

Reserve Bank could not possibly assume the role of maintaining price stability when this goal received no explicit recognition in the Second Plan itself.

The Reserve Bank could not offset an increase in investment expenditure by curbing private consumption through selective controls simply because banks in India do not finance consumption expenditure. Nor could the Reserve Bank facilitate the expansion of the public sector by denying financial resources to the private sector. Both sectors had been assigned their due places in the Second Plan and therefore the Reserve Bank was obligated to meet the productive credit requirements of both.

In view of these limitations the Reserve Bank's operational strategy was to rely mainly on selective credit controls bolstered by the higher cost of credit. Selective monetary policy functioned to regulate prices from the side of demand as well as supply. For example, the Reserve Bank, while tightening the flow of bank credit in the trading of food grains, was at the same time engaged in facilitating and providing increased credit for agricultural production. The restrictive credit policy of the Reserve Bank was based on the rather vague distinction between "productive" and "speculative" lending. Even though these terms recur over and over again in the Reserve Bank's communications to scheduled banks, they are never defined. Presumably what these terms mean is that short of abnormal speculative activities which can be easily identified with respect to prevailing prices, all other normal activities are productive. Thus for purposes of selective controls only speculative demand for credit needs to be identified. The Reserve Bank

intervened only when it was felt that bank credit in any line of business was becoming excessive to the point of becoming inflationary. In these situations the Bank would fix the level of allowable credit in relation to the preceding year or some other year that was considered normal.

Evidently with this strategy the Reserve Bank could not exercise effective control over money supply, neither could it regulate the rate of bank credit expansion. This was so because the latter is mainly determined by the effectiveness of the Reserve Bank's control over the volume of bank reserves. This control was rather weak and ineffective. With the exception of 1960 the Reserve Bank did not even feel the need for greater control over bank reserves. These problems will be discussed in subsequent chapters.

CHAPTER III

THE RESERVE BANK AND THE MONEY MARKET

I

The Dichotomy of the Money Market

Financial organization in India can be conveniently divided into two parts. The first, consisting of indigenous bankers and money lenders, has been functioning since ancient times. The other, consisting of both Indian and foreign commercial banks, comprises the modern organized money market. The latter is led and regulated by the Reserve Bank of India, which has been the central bank of the country since its inception in 1935. Between the organized monetary system and the indigenous money market lie the cooperative credit institutions. They have been set up under government sponsorship and with financial support from the Reserve Bank to supplement and eventually to supplant the village money lenders. Their numbers are growing and so are their credit operations. But their progress has been generally slow. They have been unable to provide adequate credit to the farmers. Up to the present they have remained mainly semigovernment agencies, grafted onto the rural soil for the purpose of funneling resources into agriculture and related activities.[1]

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[1]The other agencies of rural credit are professional money lenders, agriculturist money lenders, relatives, traders and commission agents, governments, landlords, and others. Money lenders provide

The links between the indigenous money market and the organized banking system are relatively few and generally weak. Indigenous bankers occasionally borrow from commercial banks to supplement their resources. Most scheduled banks maintain a list of approved indigenous bankers to whom they accord remittance and other banking facilities. Commercial banks are generally willing to discount hundis issued by well known houses, or which carry two signatures.[1] Indigenous bankers tend to lean on scheduled banks mainly during busy seasons when the demand for credit is usually high due to movement of crops from farmers to the dealers and thence to the market.[2] Thus, through the rediscount facilities with banks which in turn have access to the Reserve Bank, the indigenous money market is loosely coordinated with the organized money market. But by and large indigenous bankers are self-reliant and have remained outside the controlling orbit of the Reserve Bank. In this connection it should also be pointed out that, whenever possible, indigenous bankers borrow from their wealthy customers and loan out to others.

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nearly 70 per cent of the total credit while the governments and cooperatives together contribute nearly 7 per cent of the total.

For a comprehensive review of the problem, see All-India Rural Credit Survey. Report of the Committee of Directors, Vol. II, General Report (Bombay, 1954).

[1] A hundi is the Indian bill of exchange. These are drawn by indigenous bankers against each other and are mutually acceptable. Hundis do not show the purpose for which they are drawn. Hundis, however, can be called either on demand, or at the expiration of a fixed time period. They may be freely transferable, or account payee only. See S.R.K. Rao, The Indian Money Market (Allahabad: Chaitanya Publishing House, 1959), pp. 83-84; and The Reserve Bank of India. Functions and Workings (Bombay, September 1958), p. 23.

[2] Ibid., p. 24.

Important Features of the Indigenous Money Market

The unorganized money market, consisting of money lenders and indigenous bankers, has an important characteristic that distinguishes it from modern banks.[1] It is the informality, flexibility and willingness to take risks and come to the succor of needy merchants regardless of time and season. This is their ready availability which has enabled them to withstand competition from the better organized but also more rigid joint stock banks. In fact, for a private borrower, indigenous bankers often function as last-resort lenders. Traders and merchants who find it difficult to obtain financial accommodation from the commercial banks can turn to the indigenous bankers and secure the necessary finance at appropriately high rates of interest.

The rates of interest charged by indigenous bankers vary from place to place and are generally higher than those charged by the commercial banks. This partly reflects the shortage of funds and partly the risk premium, which is generally higher. Poor remittance facilities between

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[1]The standard definitions of an "indigenous banker" and a "money lender" are those given by L. C. Jain. To quote him, "In this enquiry, the term 'banker' will be taken to mean any individual or private firm which, in addition to making loans, either receives deposits, or deals in hundis, or both, each of which functions clearly belongs to the province of banking, while the term 'money lender' will be used for any individual or private firm which makes loans, but usually does not receive deposits or deal in hundis." See L. C. Jain, Indigenous Banking in India (London: Macmillan and Co. Ltd., 1929), p. 3.

indigenous bankers residing in different parts of the country further enhance the effect of scarcity of funds on bazaar rates of interest prevalent in different centers at the same time.[1] Rates of interest also differ with the purpose for which loans are sought and the nature of security offered.

Since most indigenous bankers combine banking with other businesses, it would be difficult to separate their banking assets and liabilities from the balance sheet of their firm or household. So far they have not volunteered to give up other businesses in favor of banking and by doing so have been disqualified to receive financial accommodations and other facilities from the Reserve Bank.[2] As far as the author knows, there are no published statistics on the overall magnitudes of the operations of the indigenous bankers, nor even a broad indication of their total assets and liabilities. In fact we do not even possess up-to-date knowledge of the trends in the functions, the attitudes, and the behavior of this rather important group of financiers. It is, however, known that they accept deposits and permit withdrawals in cash. On the asset side their balance sheets would show loans of various kinds. In industrial centers like Bombay and Ahmedabod indigenous bankers make "deposits" for fixed periods with mills. Often these deposits provide a significant portion of the working capital of the

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[1] V. R. Cirvante, The Indian Capital Market (Bombay: Oxford University Press, 1956), pp. 33-36, 84-85, and 93.

[2] On March 31, 1961 only ten firms of indigenous bankers appeared on the approved list of the Reserve Bank. See Statistical Tables Relating to Banks in India for the Year 1960, p. 187. Cited hereafter as Statistical Tables Relating to Banks in India, 1960.

borrowing firm.[1] These loans are made mostly from the liquid assets owned by the firm. However, sometimes these resources can be augmented by borrowings from friends and commercial banks.

The activities of indigenous bankers are not directly regulated. There are, however, usury laws in various states which are seldom enforced. The problem of enforcement is serious indeed because the government has so far made no effort to require compulsory registration of indigenous bankers and money lenders. Presumably the main difficulty in this respect is to formulate precise legal definitions of these terms which will also be in accord with the actual practices.

Indigenous bankers and money lenders, despite their flexibility and resilience, are probably on the decline. They still play an important role in the credit system of India, particularly in agriculture, and therefore continue to be in demand. However, due to lack of data pertaining to the unorganized money market, it is difficult to correctly appraise either its present position or future prospect.

II

The Organized Money Market

Compared to the unorganized market, modern banking is not only integrated in an organized market but is well developed in terms of the

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[1] The clientele of indigenous bankers consists mainly of traders, merchants and industrialists. They finance the movement of goods between the producing and the consuming centers, provide working capital to industries, and occasionally make loans to meet the personal needs of their customers. See Jain, op. cit., Chapters 2 and 3. Also see Rao, op. cit., pp. 82-83.

functions performed. It is strengthened by the presence of nationwide remittance facilities and institutions such as the call-loan market, the stock market, and the financial intermediaries. Of late, banks have been participating in the capital market, too, thus speeding up the overall integration of the financial system. In this process the Reserve Bank has been playing a role of increasing importance.

The commercial banks doing business in India may be classified into two broad groups: the exchange banks with head offices located in foreign countries, and the Indian joint stock banks. The Indian banks may be further classified into the scheduled banks and the nonscheduled banks. The latter have been subclassified into four groups on the basis of their paid-up capital and reserves. Among the scheduled banks, the State Bank of India should be considered in a class apart.

The foreign exchange banks are the oldest and largely specialize in financing foreign trade.[1] In recent years they have stepped up participation in the financing of internal trade and commerce most of which, however, is limited to assistance in the movement of goods between up-country centers and ports. In 1960 there were sixteen foreign exchange banks in India with sixty-nine branches and aggregate deposit liabilities exceeding 2.3 billion rupees. This came to 11.8 per cent of the total deposits of scheduled and nonscheduled banks combined.

Those Indian banks which appear on the second schedule of the Reserve Bank and have paid-up capital and reserves of at least one-half million rupees are classified as scheduled banks. Excluding the State

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[1]See J. S. G. Wilson, "Banking Business in India," in Banking in British Commonwealth Countries, ed. R. S. Sayers (Oxford: Clarendon Press, 1952), pp. 217-59.

Bank of India there were seventy-six scheduled banks having a total of 3,179 branches in 1960. Together they had 11.37 billion rupees in deposits, which came to 56.8 per cent of total deposits.

Biggest among the Indian banks and also the most unique is the State Bank of India. Before nationalization in 1955 it was known as the Imperial Bank of India. It has traditionally performed both commercial and semiofficial functions.[1] Prior to the establishment of the Reserve Bank of India in 1935 it had acted as the semicentral bank of India. Since then it has been the agent of the Reserve Bank, wherever the latter does not have branches. This bank was nationalized primarily to provide rural credit and banking facilities to farmers, cooperative credit societies, and small scale industries. To achieve the purpose of nationalization the State Bank has opened 416 branches during the five years since July 1, 1955, most of which are in rural and semiurban areas.[2] Since its nationalization, eight State-associated banks have been amalgamated with it and function as its subsidiaries.

In 1960 the State Bank of India had 901 branches in India and its aggregate deposit liabilities stood at 5.77 billion rupees. This was 28.8 per cent of total deposits. With its enormous resources, prestige, experience and clientele, the State Bank has vastly strengthened the hands of the government in controlling the supply and distribution of credit in the economy. At the same time, through its

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[1]For its history and development see S. K. Muranjan, Modern Banking in India (Bombay: Kamala Publishing House, 1952), pp. 95-117. The Imperial Bank of India was called the semi-Central Bank because it acted as the banker's bank and performed some of the functions of the government's bank.

[2]Trend and Progress of Banking in India, 1960, p. 31.

instrumentality, the Reserve Bank has forged another link with agriculture and some of the weakly-organized segments of the economy. By using its network of branches and pay offices, the State Bank has improved remittance facilities throughout the country and thereby increased the mobility of funds.

The nonscheduled banks in 1960 numbered 252 with a total of 789 branches. Their aggregate deposits totalled only 484 million rupees. As a class their importance has been declining. Between 1956 and 1960 the total deposits of nonscheduled banks declined by 252 million rupees. During the same period the number of nonscheduled banks fell by 82 and their branches were reduced by 312.[1]

The commercial banks, traditionally, have been interested in financing trade and commerce. Production credit for agriculture has been and continues to be small. To industries they generally limited themselves to providing working capital. Lately, however, their participation in the provision of industrial finance has grown significantly. This marks a major shift and has been made partly in response to the growing demand for bank credit from an expanding industrial economy, and partly due to the leadership of the Reserve Bank of India.

III

Liabilities of Scheduled Banks

Scheduled banks in India, like other banks, have five principal kinds of liabilities. These are listed below:

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[1] Statistical Tables Relating to Banks in India, 1960, Table No. 2.

(i) Paid-up capital and reserves.

(ii) Demand liabilities.

(iii) Time liabilities.

(iv) Interbank liabilities.

(v) Borrowings from the Reserve Bank.

Paid-up Capital and Reserves

These comprise the capital funds of banks. They provide the ultimate safety to depositors and other creditors. For an individual banker the size of paid-up capital determines the extent to which risk can be allowed to increase alongside the growth in bank credit. Thus banks with a weak capital base would be prudent to keep the ratio of bank credit to deposit at a lower level as compared to banks with a strong capital base. In this respect foreign banks operating in India are generally better placed than Indian scheduled banks.

As Table 16 shows, the capital funds of scheduled banks have not kept pace with their deposit liabilities. As a consequence, the ratio of capital funds to deposit liabilities has come down to 4 per cent.[1] Table 1 shows some decline in reserves in 1959. This appears to have been caused by change in accounting procedures asked for by the Reserve Bank.[2] The small increase in reserves in 1960 was mainly because more

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[1]Recently, through new legislation, steps have been taken to strengthen the capital base of the scheduled banks. Now each bank will be required to transfer each year 20 per cent of profit to its reserve fund for an indefinite period. See "The Reserve Bank of India (Amendment) Act, 1962," Reserve Bank of India Bulletin (September 1962), pp. 1364-71.

[2]According to the annual report of the Reserve Bank, "The

TABLE 16

CAPITAL FUNDS AND THEIR RATIO TO TOTAL DEPOSITS OF SCHEDULED BANKS

Year	Paid-up Capital (in million rupees)	Reserves (in million rupees)	Total Capital Funds (1)+(2) (in million rupees)	Ratio of Capital Funds to Total Deposits (in per cent)
	1	2	3	4
1955	327.0	313.0	640.0	7.0
1956	331.0	324.0	655.0	7.0
1957	345.0	360.0	705.0	6.0
1958	355.0	383.0	738.0	5.0
1959	362.0	359.0	721.0	4.0
1960	368.0	365.0	733.0	4.0

NOTE: Capital funds of foreign banks are excluded. The ratios in Col. 4 relate to Indian scheduled banks only.

Source: Trend and Progress of Banking in India During the Year 1960, Statements 5 and 9.

than half of the increase in gross profits of 37.1 million rupees was offset by increase in the tax liability of 19.2 million rupees. Increase in dividend accounted for another 8.4 million rupees.[1]

Deposit Liabilities

Scheduled banks generally accept three kinds of deposits: (i) demand deposits, (ii) saving deposits, and (iii) other time deposits. The last include fixed deposits and P.L. 480 funds deposited with the State Bank of India. The year and data pertaining to these are shown in Table 17. These figures include interbank deposit liabilities.

Table 17 shows two unmistakable trends. First, demand deposits, as well as savings deposits, show a gradual increase from year to year. The "other time liabilities" show a relatively rapid climb from 1957 through 1959 and then decline in 1960. This is due to the banking of P.L. 480 funds which began to be transferred to the Reserve Bank from July 1960. Second, the ratio of demand deposits to total deposits declines over the period. This trend has been exaggerated by P.L. 480 funds but is not solely due to it.

Demand deposits have tended to increase with increasing real income and as a consequence of deficit financing by the Government. On

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decline in reserves might largely be due to the instructions given to the banks in October 1959 not to include any amount that is in the nature of 'provision' under 'reserve fund and other reserves,' but to show it under the head 'deposits and other accounts, etc.' or 'other liabilities.'" See Trend and Progress of Banking in India, 1959, p. 14.

[1]Statistical Tables Relating to Banks in India, 1960, Table No. 4(ii), p. 16.

TABLE 17

DEPOSIT LIABILITIES OF SCHEDULED BANKS IN INDIA, AND THE RATIOS OF DEMAND DEPOSITS TO TOTAL DEPOSITS

Year	Demand Deposits (in billion rupees)	Savings Deposits (in billion rupees)	Other Time Deposits (in billion rupees)	Total Deposits (in billion rupees)	The Ratio of Demand Deposits to Total Deposits (in per cent)
1951	4.96	1.42	2.54	9.18	54.0
1955	4.88	1.72	4.21	10.82	45.1
1956	4.71	1.93	4.82	11.48	41.0
1957	5.08	2.13	7.06	14.27	35.5
1958	5.44	2.34	8.74	16.53	32.9
1959	5.68	2.60	11.00	19 30	29.4
1960	5.90	2.84	10.77	19.53	30.2

NOTE: Other time deposits include P.L. 480 funds deposited with the State Bank of India. Figures pertain to the last day of the calendar year.

Source: Statistical Tables Relating to Banks in India, various issues.

the other hand, deficits in balance of payments have exerted some contractionist pressure on them.[1] It also appears that, attracted by higher interest rates, some deposits have been transferred from demand liabilities to time liabilities. In India this can be done without impairment of liquidity of depositors because banks ordinarily permit easy withdrawals from saving accounts and are generally prepared to extend overdraft facilities on the security of fixed accounts. As Muranjan points out, this "procedure is tantamount to conversion of a fixed deposit into a current deposit."[2] Such a high liquidity of savings and time deposits tends to blur the distinction between them and the demand deposits. The line drawn between the two kinds of deposit liabilities gets further blurred when it is realized that most commercial banks pay interest on demand deposits if a minimum balance is maintained over a period of time. However, the State Bank of India and foreign banks do not pay interest on current accounts. Actually, they levy a small fee on the depositors to cover the maintenance cost of current accounts.

Banks in India compete with each other to attract deposits by offering higher interest rates. But since October 1958, under the leadership of the Reserve Bank, All-India Inter-Bank Agreements have been signed on the maximum rates of interest on different kinds of deposits. These agreements, renewed annually since then, have succeeded in keeping

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[1]This factor, however, ceased to operate after 1958. This effect had been anticipated in the Second Plan. The Reserve Bank, therefore, did not try to offset it through the open market policy.

[2]S. K. Muranjan, op. cit., p. 125.

interest rates on deposits to the level of 1/4 per cent on current accounts and between 1 and 2 1/2 per cent on savings accounts. Other interest rates have also been stabilized.[1]

Interbank Deposits and Borrowings

Until November 1960 deposits from banks were not shown separately from other deposits. But borrowings from banks have been separated from "other borrowings" in the "consolidated position of scheduled banks in India." Borrowings from the State Bank and the Reserve Bank are also shown separately. On the asset side advances made to banks had not been separated from other advances until November 1960. Thus, interbank assets are shown under the headings of "Balances with other banks in current account," "Money at call and short notice," and "Due from banks."

Interbank liabilities and assets, however, do not balance in the consolidated balance sheet. This is because funds originating in interbank deposits and borrowings are invested in all forms of bank assets and not just interbank assets. In Table 18 interbank borrowings along with borrowings from the Reserve Bank and "Money at call and short notice" are shown. It will be seen in this table that in the years in which borrowings from other banks have declined, as in 1956, 1959, and 1960, those from the State Bank and the Reserve Bank "have increased." There is a plausible explanation for this. As will be shown in subsequent chapters, 1956 and 1960 were years when the banking system was tight.

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[1] Trend and Progress of Banking in India, 1958, pp. 7-8; 1959, pp. 12-13; and 1960, pp. 22-23. For usual interest rates paid on deposits see Statistical Tables Relating to Banks in India.

TABLE 18

INTERBANK BORROWINGS, BORROWINGS FROM THE RESERVE BANK, AND MONEY AT CALL AND SHORT NOTICE OF SCHEDULED BANKS
(in million rupees)

Year	Borrowings from Other Banks	Borrowings from the State Bank of India or a Notified Bank	Total (1)+(2)	Borrowings from the Reserve Bank	Aggregate Borrowings (3) + (4)	Money at Call and Short Notice
	1	2	3	4	5	6
1955	138.0	58.0	196.0	177.0	373.0	180.0
1956	121.0	107.0	228.0	532.0	760.0	120.0
1957	204.0	76.0	280.0	576.0	856.0	273.0
1958	491.0	61.0	552.0	162.0	714.0	502.0
1959	486.0	79.0	565.0	185.0	750.0	345.0
1960	392.0	130.0	522.0	384.0	906.0	287.0

NOTES: The data are as on the last Friday of the year.
Notified banks are those banks with which other banks can keep required reserves. In addition the directors and officers of notified banks have certain privileges which are denied by law to those of other banks.

Source: Trend and Progress of Banking in India, 1960, Statement 3.

In 1959 it was moderately tight. During these years, banks characteristically withdrew call loans and reduced the outstanding interbank indebtedness. This showed up in higher call money rates in Calcutta, Bombay and Madras.[1] The build-up in "borrowings from other banks" in 1958 was mainly due to the prevalence of easy money conditions. As compared to the previous year, eight scheduled banks showed substantial increases in "due to other banks." Among them six banks reduced the outstanding amount of "money at call." A comparison of the year-end balance sheets of these banks gives the impression that the interbank liabilities were used principally to acquire government securities and to make new loans.[2] In 1959, as the stringent conditions began to develop, the interbank borrowings started declining.

Under the prevailing stringent conditions in 1956, 1959, and 1960 banks had to take recourse to increased borrowings from the State Bank of India and the Reserve Bank. Banks have traditionally turned to the State Bank of India and the Reserve Bank. Banks have traditionally turned to the State Bank for accommodation under conditions of monetary stringency and it continues to function, on a limited scale, as the banker's bank, although increasingly the Reserve Bank is assuming this role. However, even now the State Bank's call loan rate is a sensitive barometer of the state of liquidity in the money market.

Since the resources of the State Bank were limited to meet the continued demand for funds in these years, banks had increasingly to

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[1]See Report on Currency and Finance, 1957-58, Statement 31; ibid., 1960-61, Statement 36.

[2]See Statistical Tables Relating to Bansk in India, 1958.

turn to the Reserve Bank. Increased borrowings by banks in the years of tight liquidity was done more to replenish cash reserves than to secure reserves for further loan expansion. At any rate the latter objective has not been of major importance for the Indian banks. But the very fact that banks can maintain the desired cash ratio (including the legally required reserves) through borrowings from Reserve Bank can be interpreted by them as a tacit approval to increase lending. Until 1957 the Reserve Bank was quite keen to expand its role as the "lender of last resort," partly in order to develop a bill market in the country and partly to assume effective leadership over banks.

Assets of Scheduled Banks

Banking assets in India are classified as listed below:

(i) Cash on hand and balances with the Reserve Bank.

(ii) Balances with other banks and money at call and short notice.

(iii) Bills purchased and discounted.

(iv) Loans, cash credits, and overdrafts.

(v) Advances to other banks.

(vi) Investments in government securities including Treasury bills.

(vii) Investments in private securities.

Of the seven items listed above items (ii) and (v) are interbank assets. For an individual bank the former are highly liquid assets and are therefore of considerable importance. "Money at call and short notice" performs the same function in India as does the Federal Funds market in the United States. Amounts lent at call in India increase

when banks are relatively easy as in 1958 and diminish in tight years (see Table 18).

Cash on hand and balances with the Reserve Bank include legally required reserves.[1] Scheduled banks, however, maintain excess cash balances which vary seasonally as well as with changes in the demand for credit. The ratio of cash assets to deposits has been falling over a long period. This ratio was 11.1 per cent in 1951, 8.2 per cent in 1956 and 7.5 per cent in 1960.[2]

The amounts of bills purchased and discounted are comparatively meager in India (see Table 19). This is because the number of inland trade bills is rather small. Moreover, a genuine bill market does not exist in the country. Bills are generally held until maturity. In so far as foreign bills are concerned, they are bought and discounted by the foreign exchange banks which rediscount them (export bills) in London.[3]

The most important assets of scheduled banks are loans. These are generally given for a short period although some are renewed. Most loans are secured, but clean or unsecured advances are also given. The difference between loans and overdrafts is that the borrower has to pay interest on the full amount of a loan while in the case of the latter,

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[1]The reserve requirements are stated on page 102 of this chapter.

[2]Trend and Progress of Banking in India, 1960, Statement 3.

[3]There are several reasons for the lack of a bill market in India. These are: the preference for cash credit and overdrafts as the main form of borrowing, lack of uniformity in drawing bills, the paucity of warehousing facilities, etc. See S. L. N. Simha, "Central Banking in India," Central Banking in South and East Asia, ed. G. Davies (Hong Kong: Hong Kong University Press, 1960), pp. 31-52.

TABLE 19

THE BANKING ASSETS OF SCHEDULED BANKS IN INDIA

(in million rupees)

Year	Cash on Hand	Balances with the Reserve Bank	Total (1)+(2)	Investments in Government Securities	Inland and Foreign Bills Purchased and Discounted	Advances (loans, cash credits, etc.)	Total Bank Credit (5)+(6)
	1	2	3	4	5	6	7
1955	340.0	523.0	862.0	3,652.0	1,059.0	4.980.0	6,039.0
1956	368.0	509.0	877.0	3,640.0	1,485.0	5,955.0	7,440.0
1957	388.0	732.0	1,120.0	3,648.0	1,713.0	7,024.0	8,737.0
1958	396.0	839.0	1,235.0	5,177.0	1,377.0	7,550.0	8,927.0
1959	427.0	738.0	1,165.0	6,902.0	1,384.0	8,236.0	9.619.0
1960	480.0	945.0	1,426.0	7,296.0	1,575.0	9,496.0	11,071.1

Source: Trend and Progress of Banking in India, 1960, Statement 3.

interest is paid only on the amounts actually utilized. Moreover, loans may be of longer periods while overdrafts are allowed to run for six to twelve months only.

The difference between cash credits and overdrafts lies only in the nature of security acceptable to banks. In the case of overdrafts the security takes the form of shares, gilt-edged securities or bullion, or other assets such as accounts receivables, etc., while cash credits are obtained by the hypothecation of commodities.[1]

Banks invest a sizeable proportion of their deposits in government securities. While in absolute amounts government securities outstanding with banks are growing, the ratio of governments to total deposits has tended to fall. Thus, the average of the five-year period (1951-55) was 37.04 per cent, but it came down to the average of 35.04 per cent during the ensuing five years (1956-60).[2]

This trend is due to an increase in demand for loans relative to growth in deposits. Since advances are more profitable than governments, banks in some years have not hesitated to switch from the latter to the former. Thus, to some extent government securities may be considered as a residual form of investment.

The investment of banks in private securities is insignificant. However, total private investments outstanding have increased from 302 million rupees in 1955 to 634 million rupees in 1960. Private investments have been slightly more than 3 per cent of deposits in recent

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[1]S. G. Panandikar, Banking in India (9th ed. rev.; Calcutta: Orient Longmans, 1959), p. 187.

[2]Trend and Progress of Banking in India, 1960, Statement 3, pp. 60-61.

years.[1] Until recently the policy of the Reserve Bank has been to encourage banks to increase medium-term loans to banks but has discouraged them from venturing into long-term investments. Lately, there has been some rethinking on this subject.[2] As a result it is likely that the larger scheduled banks may now start making term loans.[3]

IV

Seasonal Variations in Liabilities and Assets

A significant feature of the consolidated balance sheet of scheduled banks is that it shows distinct seasonal variations both on the assets and the liabilities sides. Seasonally the year can be roughly divided into two parts. The busy season lasts from November through April while the remaining months (May through October) comprise the slack season. During the busy season, as the crops are harvested and moved, the demand for currency increases and bank credit rises. To meet this demand banks sell governments and borrow from the Reserve Bank to replenish cash lost through currency drains. Thus, during the busy seasons bank credit and borrowings from the Reserve Bank rise while governments and cash tend to fall. During the slack seasons the reverse happens. As the ebb in economic activity sets in, currency returns to banks and bank deposits rise. The volume of outstanding bank credit

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[1] Trend and Progress of Banking in India, 1960, Statement 5.

[2] See S. L. M. Simha, The Capital Market in India (Bombay: Vora and Co. Publishers Private Ltd., 1960), pp. 124-40.

[3] See the Report of the Working Group on the Appraisal of Applications for Term Loans (Summary), Reserve Bank of India Bulletin (May 1962), pp. 693-97.

declines as old loans are repaid but new loans fall off. Thus banks find cash accumulating with them which enables them to reduce their indebtedness to the Reserve Bank and to buy government securities.[1]

The Reserve Bank, as the manager of public debt, floats new issues on behalf of the central and state governments during slack months. In doing so it takes advantage of excess reserves piling up with banks which they are quite anxious to invest in governments.

With increasing industrialization and growth in urban population the seasonal variations have somewhat diminished recently. This has shown up in longer and stronger busy seasons and relatively shorter and weaker slack season. Up until now the seasonal swing has been heightened by the predominance of cash transactions in the economy. But in the future, as payments by checks become more popular, the seasonal swing should be reduced still further.

V

The Reserve Bank As the Promoter of the Money Market

At the apex of the organized money market stands the Reserve Bank of India which was brought into existence on April 1, 1935 as a share-holder's bank. After India's independence, the Bank was nationalized on January 1, 1949. The change in the legal status of the Bank has meant its complete subordination to the policies and decisions formulated by the government of India. However, the Bank is frequently consulted

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[1]See The Reserve Bank of India, Functions and Workings, op. cit., pp. 16-19.

in the formulation of economic policies. Also, in day-to-day operations the Bank has been left undisturbed.

The primary responsibility of the Reserve Bank "is to regulate the monetary system of the country so as to promote the maintenance of economic stability and to assist the growth of the economy within the framework of the general economic policy of the government."[1] In the discharge of its responsibilities, the Bank exercises the sole right of note issue and controls the banking and credit system of the country. It not only acts as a banker to commercial banks but to some other financial institutions also, such as the state cooperative banks. Moreover, it performs the normal duties of a central bank, *viz.*, as a banker to the central and state governments and as a control over foreign exchange reserves and debt management. The Reserve Bank, in addition, has been called upon to engage in several promotional activities.

From the long-run point of view the promotional activities of the Reserve Bank, aimed at forging links between submarkets and reducing the dichotomy of the financial system, are perhaps the most important. Its success in the development of rural credit and a bill market has, so far, not been spectacular. But it has improved the working of the organized money market, strengthened the banking system in various ways, and made considerable progress in integrating the money market and the capital market. It has aimed at achieving effective leadership over the banking system and, barring the unorganized market, has made perceptible progress.

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[1] *Ibid.*, p. 7.

The Bill Market Scheme

The Bill Market Scheme was launched in January 1952. This was done to increase the contact of the Reserve Bank with the market and to facilitate the flow of credit to banks and from them to the business community. The main feature of the Scheme has been that the scheduled banks convert demand promissory notes of their constituents into usance bills maturing within ninety days. These bills are then discounted with the Reserve Bank at a concession rate of one-half per cent below the Bank rate. The Reserve Bank also agreed to bear half of the cost of stamp duty incurred in converting demand bills into usance bills. But since March 1956 these concessions have been gradually withdrawn. Lending under the Scheme has also become more selective. At the same time the scope of the Scheme has been widened to include export bills. The principle of selective lending was introduced with a view to restrict expansion in bank credit. This was a compromise between the goal of improving the efficiency of the money market and the goal of monetary stability which required that the banks access to the Reserve Bank be restricted. On this subject more will be said in the next chapter. The purpose of including export bills in the Scheme was to enable banks "to extend credit facilities to exporters on a more liberal basis."[1] However, due to procedural difficulties these facilities have remained practically unutilized.[2]

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[1]DBO No. BM 66531C 297A-58, October 1, 1958, "Extension of the Bill Market Scheme to Export Bills" in Trend and Progress of Banking in India, 1958, pp. 106, 107-109.

[2]See "Amendments to the Reserve Bank of India Act, 1934 and the Banking Companies Act, 1949," Reserve Bank of India Bulletin (September 1962), p. 1364.

Other Promotional Activities

In this regard mention should be made of the Reserve Bank's lending operations to the rural sector via the State Cooperative Credit Banks. These advances have steadily risen from 132 million rupees in 1955-56 to 882.9 million rupees in 1960-61.[1] Advances are made for short and medium-term agricultural operations at a concessional rate of 2 per cent below the Bank rate. All other advances are made at the prevailing Bank rate.[2]

As far as industrial finance is concerned, the Reserve Bank has assisted the Industrial Finance Corporation and various state financial corporations by providing them with initial capital and borrowing facilities. Moreover, it assists them in their organization and working.[3] The Reserve Bank has also been associated with the Refinance Corporation for Industry set up in 1958.[4] Through these activities the Reserve Bank has sought to achieve greater integration between the organized money market and the capital market. In these respects the activities of the Reserve Bank have been consistent with the policy doctrine of "controlled expansion." In building up the capital market and

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[1]See Report on Currency and Finance, 1960-61, Statement 24.

[2]The Reserve Bank of India, Functions and Workings, pp. 80-81.

[3]Ibid., pp. 94-104.

[4]The purpose for setting up this corporation was to channel P.L. 480 counterpart funds into medium-sized industries. In addition it can borrow from the government. This corporation is a mixed enterprise, being jointly owned by the Reserve Bank of India, the State Bank of India, the Life Insurance Corporation of India (all of which are owned by the government), and the other scheduled banks, both Indian and foreign. See Simha, op. cit., pp. 186-90.

supporting the institutions set up by the government the Reserve Bank was furthering the goals of the Second Five Year Plan with respect to capital formation in the private industrial sector. At the same time it was helping the government in laying the foundations for more rapid expansion in the future. In deciding to do so the Reserve Bank quite naturally subordinated its concern for minimizing short-run instability to the longer-run objectives of promoting economic development.

VI

The Reserve Bank and the Management of Public Debt

From the standpoint of monetary policy the size, composition and the ownership of public debt is of vital importance. However, it is not the overall size of public debt but only the internal marketable debt that has crucial significance. Total public debt including Treasury bills, small savings, and other obligations of the government of India stood at 54.62 billion rupees in 1961.[1] But the marketable debt[2] consisting of rupee loans was only 22.55 billion rupees.

In Table 20 the pattern of ownership of the combined central and state government securities is given for a period of five years. This

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[1]See Report on Currency and Finance, 1960-61, Statement 65; also Statement 72.

[2]The figure of 22.55 billion rupees differs from that given in Statement 65 of Report on Currency and Finance, 1960-61 where it is placed at 25.71 billion rupees. The two figures can be easily reconciled by deducting 3.00 billion rupees of nonmarketable debt and 15.5 million rupees of 5-year Interest Free Prize Bonds outstanding on March 31, 1961, from the latter. These items are excluded from the former but included in the latter. See Reserve Bank of India Bulletin (April 1962), pp. 517-18.

TABLE 20

PATTERN OF OWNERSHIP OF THE COMBINED CENTRAL AND STATE GOVERNMENT SECURITIES

	End December 1957		End December 1958		End March 1959		End March 1960		End March 1961	
	(in million rupees)	(in per cent)	(in million rupees)	(in per cent)	(in million rupees)	(in per cent)	(in million rupees)	(in per cent)	(in million rupees)	(in per cent)
1. Governments	2,180	10.9	2,268	10.1	2,290	10.2	2,629	10.2	2,675	9.6
2. Reserve Bank of India (own account)	3,118	15.6	3,059	13.7	3,133	14.0	4,669	18.1	7,070	25.4
3. Total (1) + (2)	5,298	26.5	5,327	23.8	5,423	24.2	7,298	28.3	9,745	35.0
4. Commercial and Cooperative Banks	4,777	24.0	6,392	28.6	6,186	27.7	7,325	28.4	6,010	21.5
5. Insurance Companies	2,698	13.5	3,015	13.5	3,085	13.8	3,344	12.9	3,860	13.8
(a) Life Insurance Corp. of India (gov't owned)	2,461	12.3	2,751	12.3	2,818	12.6	3,057	11.8	3,569	12.8
6. Provident Funds	1,098	5.5	1,334	6.0	1,415	6.3	1,732	6.7	2,175	7.8
7. Industrial Finance and State Finance Corp.	32	0.2	33	0.1	28	0.1	32	0.1	48	0.1
8. Reserve Bank of India (held on account of others)	274	1.4	326	1.5	392	1.8	412	1.6	384	1.3
9. Nonresident	359	1.8	339	1.5	339	1.5	345	1.3	343	1.2
10. Others (residual)	5,407	27.1	5,598	25.0	5,510	24.6	5,317	20.6	5,269	18.9
11. Total	19,942	100.0	22,364	100.0	22,378	100.0	25,805	100.0	27,838	100.0

NOTES: (i) Percentages are of individual figures with respect to totals. (ii) Percentage totals may not add up to 100 because of rounding. (iii) Debt held by the Reserve Bank (own account) excludes 3 billion rupees of nonmarketable debt issued by the Government of India against cancellation of ad hoc Treasury bills in July 1958. (iv) Data previous to December 31, 1957 are not available. The first survey on the ownership of public debt covered data from December 1957 onwards.

Sources: Reserve Bank of India Bulletin (March 1961), p. 331; ibid., April 1962, p. 516.

table shows that the total marketable rupee debt had gone up from 19.94 billion rupees in December 31, 1957 to 27.83 billion rupees on March 31, 1961.[1] However, not all of it constitutes the obligations of the government to the private sector. If one includes the Reserve Bank of India in the public sector, then 35 per cent of the total marketable debt was held by the government and the Reserve Bank together. By comparison, at the end of March 1959 the public sector holdings of the government debt were only 24.2 per cent. This means that in 1960, from the point of view of monetary management, the responsibility of the Reserve Bank was restricted to only 18.09 billion rupees rather than 27.83 billion rupees. It also means that the interest payment on 9.74 billion rupees was in the nature of intergovernmental transfer, rather than transfer payments to the private sector.[2]

As Table 20 shows, the commercial banks and the cooperative banks together own about 25 to 28 per cent of public debt. The decline in 1961, as will be explained later, was partly due to the shift of banks from governments to loans and partly due to transfer of government securities from the State Bank of India to the Reserve Bank. This was done to enable the State Bank of India to transfer P.L. 480 funds from its time deposits to the Reserve Bank.

The next group of investors in order of importance is insurance companies. Its share has remained steady at 13 to 14 per cent of the

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[1]The share of state governments in this amount is 5.22 billion rupees. The remaining 22.55 billion rupees is the marketable rupee debt of the government of India.

[2]Cirvante, op. cit., p. 160.

total. However, in this connection two points should be borne in mind. First, the Life Insurance Corporation of India which is a nationalized undertaking of the government of India owns the bulk of the securities held by insurance companies. Second, according to the Indian Insurance (Amendment) Act, 1950, insurance companies are required to keep 25 per cent of their adjusted liabilities in government securities and another 25 per cent in either government or approved securities.[1] Therefore, to some extent insurance companies provide a captive market for government securities. This is even more true of Provident fund contributions which, as required by the law, are entirely invested in government securities.[2]

The remaining investors account for small shares each. In the residual group are included Joint Stock Companies, local authorities, trusts, and individuals.

The maturity pattern of public debt is shown in Table 21. This table shows that the share of short-term debt has tended to diminish while that of long-term debt has been increasing. However, under Indian conditions this does not have the same significance for the effectiveness of monetary policy as would be the case in the United States. This is so because the Reserve Bank is generally ready to buy securities and

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[1]Simha, op. cit., pp. 31-32, 77.

[2]The reason for calling it intergovernmental transfer is that the interest paid on the amount of 9.74 billion rupees of public debt goes to the Reserve Bank of India and to the central and state governments. Thus, this amount is retained within the public sector. In this context the Life Insurance Corporation of India and the State Bank of India are not counted as part of the public sector.

TABLE 21

MATURITY DISTRIBUTION OF THE COMBINED MARKETABLE RUPEE DEBT OF THE CENTRAL AND THE STATE GOVERNMENTS

(in percentages)

Date	0 - 5 Years	5 - 10 Years	10-15 Years	Over 15 Years	Non-terminable Debt	Total
December 31, 1957	31	37	12	7	13	100
December 31, 1958	36	33	13	7	11	100
March 31, 1959	36	33	13	7	12	100
March 31, 1960	35	30	17	7	10	100
March 31, 1961	34	36	10	11	9	100

Source: Reserve Bank of India Bulletin (March 1961), p. 337; ibid., April 1962, p. 512.

endeavors to maintain stable prices in the market. Thus the Reserve Bank considers it a duty

> . . . to create in the gilt-edged market conditions favorable for the successful implementation of the Government's borrowing and refunding operations. On the other hand, the Government's loan operations themselves are so arranged as to be in harmony, as far as possible, with general stability of the money and capital markets."[1]

As a result of this policy the liquidity of investors remains unimpaired. Thus longer debt under Indian conditions would not mean greater effectiveness of restrictive credit policy.

VII

The Reserve Bank As the Regulator of Bank Credit

As the regulator of the banking system, the Reserve Bank enjoys wide powers of controlling the activities of banks as a whole, of a class of banks, or even individual banks.[2] As a regulator of bank credit, the Bank has made use of general or quantitative controls as well as selective or qualitative controls. During recent years it has placed greater reliance on the latter than on the former. The working of general and selective credit controls will be reviewed in the next two chapters. At this point it will be sufficient to list them and explain some of the limitations that arise from the institutional

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[1] Reserve Bank of India, Functions and Workings, op. cit., p. 40.

[2] These powers are given to the Reserve Bank by The Reserve Bank of India Act, 1934 as amended through April 30, 1960 and the Banking Companies Act, 1949. See Hans Aufricht, Central Banking Legislation (Washington, D.C.: International Monetary Fund, 1961), pp. 343-79.

peculiarities and the undeveloped state of money market and capital market in India.

The general controls available to the Reserve Bank are as follows: (i) Bank rate changes, (ii) open market operations, and (iii) variable reserve ratio requirements. The last was added to the existing controls at the inception of the Second Plan (October 1956).

The Bank Rate Policy

Because of the lack of a bill market the Bank rate is more in the nature of a lending rate than a discount rate. Until about a decade ago banks did not much avail themselves of the lending facilities of the Reserve Bank. When they were in need for short-term accommodation, they preferred to go to the Imperial Bank of India. However, with growing demand for loans they are increasingly turning to the Reserve Bank. These loans are repayable on demand or at a fixed period which does not exceed ninety days. Most advances are made either against government securities or, since 1952, against demand promissory notes supported by usuance bills executed by the bank's constituents.[1] Banks also borrow to subscribe to new issues of public debt.

The Reserve Bank's lending rates have been above or below the Bank rate depending upon the prevailing conditions and upon the policy of aiding or restricting the given sectors of the economy. The Bank rate itself has changed very infrequently. In November 1951 it was for the first time raised from 3 to 3 1/2 per cent. The second and the

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[1]Reserve Bank of India, Functions and Workings, op. cit., pp. 28-38.

latest increase was effected in May 1957 when the Bank rate went up to 4 per cent. The main reasons which account for the reluctance of the Reserve Bank to change the Bank rate more often are the policy to keep the cost of debt services low and to maintain stable prices in the government securities market.

Open Market Operations

The Reserve Bank's open market policy is generally restricted mainly to central government securities although it is legally empowered to deal in state government securities too. In the absence of a well-developed market in Treasury bills the open market operation in India has been mainly in bonds.

The Reserve Bank buys securities during busy seasons and generally sells them during slack seasons.[1] These seasonal operations are made mostly at the initiative of banks themselves. The switch operations of the Reserve Bank, which consist of selling securities of one maturity against the purchase of securities of other maturities, are aimed at maintaining the desired pattern of yield. The refunding operations of the Reserve Bank are also done in such a manner as to disturb

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[1]It may be noted here that unlike the Federal Reserve policy in the United States, the Reserve Bank does assume the responsibility of meeting the seasonal needs of commercial banks. This is due through the open market operations rather than by way of loans and rediscounts. The discount facilities of the Bank are hardly availed of due to the meager supply of trade bills. The Reserve Bank makes loans to scheduled banks mainly under the Bill Market Scheme. These loans generally increase when banks are tight and diminish when they are loose (see Chapter 8).

market prices as little as possible. Thus the Reserve Bank starts acquiring securities months before their date of redemption. An additional purpose of making these purchases is to prepare the ground for the flotations of new loans.[1]

As a weapon of monetary control, open market operations have only limited usefulness in India. Although the market in government securities is not as wide as in advanced countries, it is active and developed enough to facilitate open market operations. However, increased borrowings by the central and state governments have made it necessary to tailor open market policy to debt management with a view to facilitate smooth absorption of new issues by the market. Secondly, banks in India do not maintain stable cash ratios. This renders the effect of open market operations quite uncertain. However, over the last ten years the cash ratio has tended to decline, which has correspondingly increased the efficacy of open market policy. But, as will be shown later, the Reserve Bank has not been able to swim against the current. As a result its open market purchases have softened the impact of other restrictive policy measures.

Reserve Ratio Requirements

Commercial banks are required by law to maintain minimum cash reserves of 5 per cent against their demand and 2 per cent against their time liabilities. The Reserve Bank of India (Amendment) Act, 1956,

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[1]"Open Market Operations of the Reserve Bank of India" in the Reserve Bank of India Bulletin (June 1960), pp. 795-801.

empowered the Bank to raise them up to 20 per cent of demand and 8 per cent of time liabilities.[1] Subject to these overall ceilings, the Reserve Bank could also impose marginal reserve requirements of increases in deposits calculated with reference to a specified date.

This is admittedly a powerful weapon and can be used either in lieu of the Bank rate policy and open market operations or in addition to them. The Reserve Bank, however, did not have occasion to use it during the first four years of the Second Plan. Marginal reserve requirements were, for the first time in India, imposed on March 11, 1960. Ten months later, however, these were withdrawn. These measures were introduced to tighten credit but abolished for the plausible reason that these were restricting "the availability of credit for the legitimate needs of industry and trade."[2]

Selective Controls

Selective controls are used mainly to affect the distribution of credit rather than its availability. However, selective controls do have general impact, as the quantitative controls have selective incidence on the uses of credit. The experience of India, as also of other countries, shows that for purposes of credit restriction the efficacy of selective controls can be greatly enhanced provided they are combined with general controls.

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[1]The statutory reserve requirements have now been changed to 3 per cent of the total of time and demand deposits. The cash ratio can now be raised up to 15 per cent of total deposit liabilities. The new regulations have been effective since September 16, 1962.

[2]See Report of the Central Board of Directors, Reserve Bank of India Bulletin (August 1961).

In India selective controls have taken the form of directives from the Reserve Bank to the scheduled banks prescribing the ceilings on credit and the margins to be maintained against the commodity in question. The affected commodities have been food grains, sugar, cotton textiles, jute, and shares. In addition clean or unsecured advances have also been controlled. Selective controls have been used in a flexible manner, and in the case of food grains were also applied on a regional basis, thus increasing the degree of selectiveness.

Moral Suasion

In addition to the general and selective controls listed above the Reserve Bank has also made effective use of moral suasion. This has taken the form of meetings between the Governor of the Bank and the leading representatives of the banking community in which the former would impress upon the latter the need for vigilance and cooperation to prevent the use of bank credit in speculative ventures, etc. The Governnor has also addressed letters to banks calling upon them to restrict overall credit and even to bring it down to a specified level. However, such requests were made only during slack seasons when the prospects of banks' cooperation were expected to be the highest.

VIII

Institutional Limitations of Monetary Policy

From the standpoint of effectiveness of monetary policy there are three principal institutional limitations in India. First, the lack

of effective control of the Reserve Bank over the bazaar money market, and the decision taken on administrative grounds not to directly control nonscheduled banks, have prevented the full effect of credit restrictions from being felt. These leakages in the credit control system are probably small, although it is difficult to be precise about their real extent. In the same context should be listed some other sources of credit such as trade credit which cannot be controlled by the Reserve Bank and which to some extent can offset the effects of credit restrictions, especially of selective controls.

Second, the Indian money market lacks an adequate flow of short-term assets such as commercial and Treasury bills, promissory notes, etc., which will be acceptable to banks and in which active submarkets exist. The absence or undeveloped states of these submarkets hinders the working of monetary policy inasmuch as the Bank cannot effectively operate through them and secure sensitive responses.[1]

Third, for the success of open market operations two conditions should be present. One of these is the stable cash ratio of banks and the other is the existence of a broad and active market in securities. Furthermore, the central bank should be free to conduct open market operations regardless of the repercussions on the prices of government securities and the consequences to the refundings and flotations of new debts.[2] In the case of India the first and third conditions are not

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[1]See S. N. Sen, Central Banking in Undeveloped Money Markets (3d ed. rev.; Calcutta: Bookland Private Ltd., 1961), Chapter 2, pp. 14-32.

[2]On this point one can legitimately object that perhaps no central bank (not excluding the United States) can totally disregard the

present while the second is only partially present, which renders open market policy quite ineffective, especially during the restrictive phases of credit policy.

These limitations are partly responsible for the inability of the Reserve Bank to exercise effective control over the reserve base of the banking system through the use of Bank rate and open market policies. This leaves reserve ratio requirements as the only effective instrument of controlling bank reserves. But this is a drastic weapon of control; moreover, the Bank was new at it. Nevertheless the Bank tried it for a short time, which, as will be seen later, brought out its strength as well as weaknesses. But in view of the general institutional limitations pointed out above, it seems that changes in reserve ratio requirements have the greater potential usefulness for achieving the general objective of monetary policy.

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repercussions of its policies on the prices of government securities. However, for most purposes open market policy need not be pushed to the point where it will begin to disrupt the market. In India, on account of the narrowness of the securities market the risk of disruption is presumably so great that open market policy cannot be freely used as a credit control instrument.

CHAPTER IV

THE WORKING OF GENERAL MONETARY CONTROLS

I

The Limitations of Quantitative Credit Controls in India: Some General Considerations

While appraising the working of general controls, it is worth inquiring at the very outset as to what the Reserve Bank could or could not achieve within the four corners of the Second Plan and within the existing institutional framework. This is necessary so as not to evaluate Reserve Bank policies on the basis of criteria that are perhaps more appropriate for the U.K. and the U.S.A. but which cannot be applied to Indian conditions. For instance the Reserve Bank could not use Bank rate policy to mitigate balance of payments disequilibrium as has been tried recently in the U.K. Further, given the narrowness of the capital market and given its policy to prevent instability in the government's securities market the Reserve Bank could not employ open market operations to effectively regulate bank reserves and to influence the spending decisions of investors.

Moreover, in an economy like India where the ratio of bank money to the stock of money is not only low but actually diminishing, the policies of the Reserve Bank can only have a limited effect.[1] This is

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[1]The ratio of demand deposits to money supply was 44 per cent in 1938-39, 36 per cent in 1946-47, 34 per cent in 1951-52 and about 30 per cent in 1960-61. See Reports on Currency and Finance for these years.

so because a large part of the economy using the currency in circulation is outside the controlling orbit of the Bank. The organized banks serve mainly the modern sectors of the economy. Therefore, if expenditures in the rest of the economy remain uncontrolled while the use of bank money is being restricted, the incidence of monetary policy will fall inequitably on the modern sectors of the economy. The progressive sectors, such as modern industries, which rely heavily on banks will be forced to suffer all or most of the cuts in money outlays. In the long run this is bound to hamper the progress of banking and hence the development of the economy. Considerations like these are not unimportant and might weaken the resolve of the Reserve Bank to adopt restrictive general controls. There is, however, no concrete evidence that during the Second Plan these aspects of the problem weighed with Reserve Bank in downgrading general controls. But the possibility, nevertheless, exists.

At present, perhaps 50 per cent of the total finance, required by industry and trade combined, both in the organized and the unorganized sectors, is provided by the organized banking system.[1] Broadly speaking, this is the area that can potentially be controlled by the Reserve Bank. But even here--in a growth setting--the Bank can operate only on a restricted basis. The Reserve Bank cannot deny credit for normal financing of trade and industry. If the Bank restricts the reserve base of commercial bank credit, it will either have to take elaborate measures to ration credit between productive users or leave it to banks to ration it according to normal business considerations.

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[1]This is no more than a good guess and is cited here on the authority of the Governor of the Reserve Bank. See his speech published in Reserve Bank of India Bulletin (August, 1960), p. 1105.

The former approach will bring undue regimentation to banks and might not be conducive to their efficient working. Moreover, it is doubtful if the Reserve Bank even has the adequate administrative staff to enforce the policy effectively. Therefore, the possibility of elaborate rationing of credit can be rejected as neither feasible nor desirable. The alternative course of leaving the decisions pertaining to the distribution of credit to banks is not advisable either, the reason being that industries accorded high priority by the five-year plan may not receive the same priority at the hands of banks. Therefore, if the reserve base of banks is tightened by general controls and nothing is done to regulate the distribution of credit, it may go into the hands of speculators or into the low priority sectors.

The Strategy of the Reserve Bank and Its Basic Weakness

Thus, the feasible alternative that remains is to use selective controls to prevent its going into the hands of speculators. In addition the Reserve Bank can employ moral suasion to gradually modify the lending preferences of banks so as to harmonize them with the scale of Plan priorities. This policy would minimize the use of general controls. But in this setting the Reserve Bank would be mainly concerned with checking inflationary pressures generated by speculative holdings of goods by placing selective curbs on the flow of bank credit into the affected sectors. In this manner the Reserve Bank can--provided selective controls are adequate, introduced at the right time, and effectively implemented--partially eliminate the speculative component of demand for

goods. This policy can, at best, prevent distortion of price structure but will have either little or no effect on the level of prices. However, general controls may be used if and when bank credit expansion is deemed to be excessive.

The above strategy (called by the Reserve Bank the policy of "controlled expansion") has a built-in weakness which should be pointed out. Let us assume that the Reserve Bank has generally undertaken to provide the needed credit to fulfill the investment and production targets assigned to the private sector in the Second Plan. The question is, how far can it go in this direction if the price level continues to rise? The demand for credit for purely productive purposes will rise pari passu with increasing prices. But steady growth in the volume of credit would further facilitate increase in prices. Evidently, the Reserve Bank cannot allow this situation to go so far that it will amount to complete relinquishment of the objective of monetary stability. Should such an attitude prevail on the part of a Central Bank it would be highly deplorable and is surely not expected of the Reserve Bank.

Policy Based on Fallacious Reasoning

To put it differently the question that should have been asked is: "How far can prices be allowed to rise before general controls are introduced to reduce the flow of expenditures in the private sector?" In the official pronouncements of the Reserve Bank and the speeches of its officers there is no indication that such a question was asked and its implications firmly grasped.[1] The nearest that the Bank came to

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[1] It is not the implication of the above remark that the Reserve

raising this question was as early as 1958. The Governor of the Reserve Bank, Mr. H. V. R. Iengar, referring to a recent increase in prices said: "The picture as a whole, however, poses the question as to whether superimposed on the effect of relative shortages of supply, we are beginning to witness the impact of inflationary pressures which had hitherto been kept in check by forces that are no longer operative to the same extent as before."[1] He emphasized that there was no room for complacency. At the same time he pointed out that the role of monetary policy should not be exaggerated. But the reasons given were rather odd. To quote him further:

> No amount of monetary control can take the place, for example, of increased food production. Likewise, monetary control cannot by itself deal effectively with the unsocial elements who indulge in hoarding and blackmarketing, and exploit a situation of scarcity by charging exorbitant prices.[2]

But he further went on to declare that the objective of monetary policy "is to mop up liquid resources to the maximum extent practicable, and thereby to keep down the pressure of money on goods in relatively scarce supply."[3] Then commending the open market sales of the Bank in the previous year the Governor declared that in the future if and when required appropriate monetary techniques will be used. As he said: "For carrying out its task as the monetary authority, the Reserve Bank

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Bank was not even aware of the danger of inflation. But until 1960 the Bank did not consider it serious enough to use the only general control that could be effectively employed, i.e., marginal reserve ratio requirements.

[1]See H. V. R. Iengar, "Current Price Situation and the Role of Monetary Policy," in Reserve Bank of India Bulletin (August, 1958), pp. 897-99.

[2]Ibid. [3]Ibid.

has a great many statutory powers. It would not hesitate to exercise these powers whenever it finds it necessary to do so."[1]

A few comments on this speech are called for. First of all the central bank in no country is expected to raise food production or control anti-social elements. In a demand-pull inflation higher prices are caused by excess demand. If the supply of goods at constant prices was to rise as fast as increase in monetary demand, there would be no inflation. Prices rise not because goods are scarce, but because demand is excessive. It is, therefore, untenable logic to support increasing volume of expenditures by deficit financing and bank credit expansion, and at the same time hold scarcity of goods responsible for rising prices. If the aggregate money demand were to remain unchanged, a reduction in supply of goods would only cause a once-over increase in prices. But inflation is caused by the persistent excess of flow of demand against the flow of goods and services. Thus inflationary rise in price level is a process through time. This cannot be mistaken for temporary increase in prices caused by shortage of goods.

The Governor of the Reserve Bank was also mistaken in assuming that monetary policy could check inflation by wiping out excess demand in individual markets. In India black marketeers and speculators could not be held responsible for causing prices to rise; they were only aggravating it. True, the speculators and black marketeers are the proverbial black sheep who can be legitimately blamed for anti-social activities to which Mr. Iengar quite properly objected. But they thrive

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[1] Ibid.

precisely because fiscal and monetary policies are proving inadequate to either wipe out or substantially reduce the flow of excess demand in the economy. Their activities are superimposed on a general inflationary situation. Therefore, their misdeeds cannot be effectively eliminated by attacking individual markets alone.

The proper role of a central bank is to regulate the market from the side of demand. This can be done by reducing the liquidity of the economy; and the first step quite naturally will be to eliminate deficit financing. But if it cannot be done or brought down to noninflationary level, the burden for maintaining monetary stability will have to be largely borne by the private sector. For this purpose the Reserve Bank will have to exercise effective control over bank reserves and thereby limit the expansion of bank credit. If this is not done, the increases in price level will proceed unchecked.[1]

It should, however, be said that within the framework of the Second Plan the above policy was out of the question. The amount of deficit financing could not be curtailed, and therefore the entire burden of reducing liquidity had to be borne by the private sector. This too was impossible because the private sector had been assigned an important place in the Second Plan, the assumption being that the needed

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[1] An intriguing aspect of Mr. Iengar's speeches was his effort at making international comparisons in price increases and to draw favorable conclusions for India. Furthermore he argued that, in view of the scale of deficit financing, the extent of price increases could not be considered immoderate. From these premises the logical conclusion followed that the Reserve Bank need not adopt more stringent policy measures in order to slow down further advances in price level. See H. V. R. Iengar: "Current Economic Situation and the Role of Banks" in Reserve Bank of India Bulletin (August 1959), pp. 1008-12. Also see his speech delivered as President of the Indian Institute of Bankers in Reserve Bank of India Bulletin (August 1960), pp. 1101-1107.

credit would be forthcoming from banks--and with the cooperation of the Reserve Bank. Therefore, the reluctance of the Reserve Bank to control the reserve base of scheduled banks was based on the realization that such policies would hamper the progress of the private sector and come in the way of fulfilling the Second Plan targets. This appears to be the only explanation for the peculiar stand taken by Governor Iengar on the question of inflation. He maintained that while there was no room for complacency, the increase in prices so far had not been excessive or immoderate either as compared with foreign countries, or in relation to the amount of deficit financing incurred. Hence, the conclusion that the role of monetary policy was not so much to control the rate of increase of prices as "to prevent a continuing distortion of the price level."[1] In this strategy, general controls were clearly not needed to prevent distortions in the structure of prices.

It may, however, be argued that a higher cost of borrowing could have curbed the demand for bank credit for the purpose of financing speculative inventory accumulation. But the Governor, in the speech referred to above, maintained that the effect would be negligible. According to him,

> . . . the effect of a variation in the bank rate in this sphere is largely conditioned by the general outlook or prospect regarding the future course of prices; and the bank rate itself may not be expected to achieve significant results.[2]

In other words, if speculators expect future prices to rise, they will forthwith proceed to accumulate inventories and will not be

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[1] Ibid., p. 1105.

[2] Ibid., pp. 1106-1107.

deterred from doing so by a higher Bank rate. Since the Bank rate could not be raised often enough to render speculation unprofitable, the Reserve Bank thought it prudent not to raise it even more than once. Thus, for all practical purposes, control over prices--by way of placing restrictions on speculative demand for credit--was sought to be achieved mostly through reliance on selective controls.

To summarize and conclude, the Reserve Bank did not take extensive recourse to general controls for several reasons. These reasons were in part based on the institutional limitations, on grounds of equity, and on the misunderstanding of the nature of inflation. To some extent the authorities in the Reserve Bank were convinced that the speed of inflation was not excessive and could be corrected through the judicious use of selective controls. But, to a degree, the reluctance of the Reserve Bank to use more effective use of general controls was based on the understanding that its primary responsibility was to see the Plan through rather than to maintain monetary stability.

In any case, the Reserve Bank could not have changed the Bank rate more often or used open market operation to tighten bank credit, this being because these two policies had been subordinated to public debt management. The only effective tool remaining with the Bank was to vary marginal reserve ratios. But as already pointed out, for the Reserve Bank this was a novel instrument of control. Moreover, it is admittedly a very powerful weapon. These reasons account for the apparent decision of the Reserve Bank authorities to use it sparingly and for short periods only. One should keep these limitations of the Reserve Bank policy in mind while reviewing the working of general credit controls.

II

Definitions and the General Approach

In this chapter, as well as in subsequent chapters, scheduled banks as a class will be considered loose when they add government securities to their portfolio, reduce their indebtedness, and show increase in free reserves or excess reserves. In this situation the ratio of bank rate to aggregate deposits will be expected to fall and that of government investments to aggregate deposits to rise. If most of these circumstances are present in any year, the banking system will be considered loose. On the other hand, banks will be considered tight when they reduce their holdings of government securities, increase their indebtedness, and the free reserves or excess reserves tend to rise. When banks are tight, the ratio of bank credit to aggregate deposits will be expected to rise and the ratio of governments to deposits to fall. For the banking system to be adjudged tight, it is sufficient if most of the conditions listed above are present in any year.

Excess reserves are defined to be equal to the difference between the sum of cash on hand and balances with the Reserve Bank and the legally required reserves of banks. Free reserves are equal to the difference between excess reserves and the outstanding amount of banks' borrowings from the Reserve Bank.

Monetary policy will be considered easy when the ratio of required reserves to deposit falls. If the Reserve Bank is buying securities and lending reserves to banks in the face of rising demand for credit, monetary policy will be considered easy. If the ratio of

required reserves to deposits increases and the Bank takes steps to restrict lending, regardless of whether it succeeds or not, monetary policy will be considered restrictive or tight.

There are years in which it is difficult to be precise on whether monetary policy is restrictive or easy. If banks are loose because the demand for credit is low and, therefore, the Reserve Bank is selling securities, the situation cannot be attributed to restrictive monetary policy. These years are rather difficult to characterize. The characterization of monetary policy during this period will, therefore, depend upon what the Bank tried to do, rather than what it actually accomplished. In this respect the Reserve Bank's policies with respect to selective controls and moral suasion should also be borne in mind, along with the use of general credit controls.

The remainder of this chapter will be devoted to a year by year review of the working of general credit controls and moral suasion. Selective controls will only be referred to but not discussed. That is done in the next chapter.

III

The Review of Monetary Policy

Prices in India had started rising from a low level ten months prior to the commencement of the Second Five Year Plan (April 1, 1956). The first year (1956-57) was marked by a strong investment boom, excess demand for products, and rising expectations of traders and investors resulting in sharp increases of deposits and bank credit. In fact, the

demand for loans led banks to sell securities and borrow from the Reserve Bank.

In order to weaken the rising demand for accommodation, the Reserve Bank raised the cost of borrowing by withdrawing half the concession of 1/2 per cent below the bank rate (3 1/2 per cent) that scheduled banks were entitled to under the Bill Market Scheme. Thus, commencing from March 1, 1956, the lending rate of the Bank under the Bill Market Scheme became 3 1/4 per cent compared to 3 per cent previously. At the same time the concession with respect to stamp duty was also withdrawn.[1] However, with a view to relieve stringency in the money market, the Reserve Bank suspended the weekly auction of the Union Government Treasury Bills from April 3, 1956.

The ensuing slack season developed relatively easier conditions which were taken advantage of by the Union and the State government to float new loans. They raised cash to the extent of 897 million rupees. However, it appears that a part of the cash for subscribing to loans was obtained by way of advances from the Reserve Bank. This is evidenced by the fact that outstanding scheduled bank borrowings increased by more than 19 million rupees (see Table 22).

With the start of the busy season, the Reserve Bank on November 21, 1956 raised its lending rate to 3 1/2 per cent, thus bringing it on a par with the Bank rate. With the raising of stamp duty the effective

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[1]Under the Bill Market Scheme, the Reserve Bank used to bear half the cost of stamp duty incurred in converting demand bills into usance bills. Henceforth the Bill Market Scheme will also be known as "the scheme." See "Press Communique dated February 3, 1956," Trend and Progress of Banking in India, 1956, pp. 106-107.

TABLE 22

SCHEDULED BANK CREDIT AND RELATED DATA FOR THE YEARS 1956-58
(in million rupees)

	(Financial Year) 1956-57	1957-58	Slack Season of 1956	Busy Season of 1956-57	Slack Season of 1957	Busy Season of 1957-58	Outstanding April 1958
1. Total Deposit Liabilities (net)	+1,322	+2,759	+245	+1,331	+1,430	+1,485	1,512
2. Borrowings from Reserve Bank of India	+381	-612	+19	+149	-429	-99	199
3. Cash Reserves	+35	+168	+10	+160	+402	-107	1,328
4. Investment in Government Securities	-127	+933	+167	-270	+497	+504	4,446
5. Bank Credit	+1,388	+627	+37	+1,484	-419	+893	9,565
6. Money Supply	+1,289	+771	-1,056	+2,402	-822	+1,673	24,469

Source: Report on Currency and Finance, various issues.

lending rate went up to 4 per cent as of February 1, 1957. Three months later, on May 16, 1957, the Bank rate itself was raised to 4 per cent; but at the same time the stamp duty was lowered to one-fifth of 1 per cent so that the effective lending rate to scheduled banks was established at 4 1/5 per cent.

Quite characteristically, while the Reserve Bank was raising the cost of borrowing, it was at the same time easing the availability of funds. This was done, beginning November 1956, by making discriminating purchase of government securities--a policy that had remained under suspension for the last five years. At the same time lending under "the scheme" was somewhat liberalized. As a result, scheduled banks operating in a boom economy were not hampered by a higher cost of borrowing. They went ahead to supplement higher volume of deposits by more advances from the central bank and in addition sold government securities. This enabled banks to increase credit to the private sector by nearly 1.4 billion rupees--about the same as the previous year.

The Second Year (1957-58) of the Plan was different from the first in several respects. While the year 1956-57 was marked by growth in industrial and agricultural production (8.8 and 6 per cent respectively over the preceding year), the second year experienced a slowing down of the former and a sharp reduction in the latter.[1] During 1957, industrial production rose by only 3.5 per cent while agricultural production fell by 7.3 per cent. Compared to the boom of the preceding two years, the economy during 1957-58 was actually receding.

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[1] Report on Currency and Finance, 1957-58, pp. 11-19.

In this year the volume of aggregate investment both at constant and current prices declined below the level in 1956-57. At constant prices it declined from 13.13 billion rupees to 12.17 billion rupees, while at current prices it fell from 13.49 billion to 12.72 billion rupees.[1] As a result of this slow-down, the national income at constant prices in 1957-58 declined by 1.1 billion rupees as compared to 1956-57.[2] But at the same time it was under greater stress and strain, which had been developing over recent years. This was felt most keenly in an adverse balance of payments which tight import controls were an attempt to mitigate. In the domestic sphere, the government, badly in need of funds, had levied new taxes of far-reaching importance in the budgets of 1956-57 and 1957-58. Together they were expected to yield about one billion rupees annually. Also, deficit financing had been steadily rising. Consequently, investment in the public sector increased while that in the private sector declined. The net effect on the economy was some reduction in effective demand which resulted in a slight decline in the Wholesale Price Index. The WPI for all commodities in March 1958 was 105.4 as compared to 105.6 in March 1957.[3]

The money market, which had experienced acute stringency in the early part of 1957, gradually gave place to general easiness. Both money supply and bank credit grew at smaller rates (3.2 and 7 per cent in 1957-58 as compared to 5.9 and 18 per cent, respectively, in 1956-57).

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[1]See Reserve Bank of India Bulletin (August, 1961), p. 1209.

[2]See Estimates of National Income, op cit., p. 22

[3]Report on Currency and Finance, 1957-58, Statement 18.

Bank resources, especially time deposits rose spectacularly; this was principally due to the accretion of counterpart funds of U.S. aid under P.L. 480. Banks mainly used their increased cash resources to pay back the Reserve Bank loans and to acquire government securities.

Apart from raising the Bank Rate to 4 per cent (referred to above), credit policy consisted of moral suasion and selective controls. The Reserve Bank repeatedly expressed concern at the rising trend of prices and tamely asked banks to reduce their dependence on the Bank. Moral suasion was, however, actively used in July and August 1957, when the Governor held conferences with the Bank's representatives and insisted that outstanding credit before the start of the next busy season be reduced by about one billion rupees. In view of the low demand for loans combined with abundant reserves, banks had no difficulty in carrying out the wishes of the governor.

Table 22 shows that the busy season of 1957-58 was distinctly weaker than the preceding year. Money supply and bank credit grew by smaller absolute amounts. Generally, easy money conditions prevailed as growth in deposits far surpassed the growth in bank credit.[1]

The Wholesale Price Index, which had been steadily declining from August 1957, reached its lowest in February 1958 when it stood at 104.7 (base: 1952-53 = 100) and thereafter rose uninterruptedly to 116.5 in September 1958. Then it gradually declined for the next three

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[1] Most of the increase in deposits was due to banking of P.L. 480 counterpart funds in time deposits with the State Bank of India. These funds were mostly invested in government securities. See the Report on Currency and Finance, 1957-58, p. 25.

months, reaching a low of 110.7 in the first week of January 1959. Thereafter, it rose and fell, reaching 111.7 in the last week of March. From then on, barring minor breaks, prices rose continuously for the next two years.

The major factor responsible for the fall in price during the busy season of 1958-59 was the expectation of good crops, which fortunately was fully realized. Agricultural production during the year 1958-59 rose by 14.3 per cent. Food production increased by 17.6 per cent. However, industrial production continued to stagnate throughout 1958.

This is shown by the behavior of the index number of industrial production (seasonally adjusted series, 1951 = 100). In January 1958 the index number stood at 147.7, fell to 131.1 in June and rose to 140.3 in September. It rose again in December but at 145.9 was still below the level prevailing eleven months previously.[1] In spite of stagnation in the industrial sector, national income was led by agricultural production to rise by 7.3 per cent.

In the wake of the substantial dose of inflation in the first half of 1958 the government announced a series of steps to hold the price line. The government was especially concerned to stabilize food prices and therefore took recourse to wide-ranging administrative controls. These included controls over the consumption, the movement, marketing, and hoarding of food grains. The most important move in this direction was the decision to start state trading in food grains.[2] In

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[1]See the Reserve Bank of India Bulletin (May 1959), Table No. 33. p. 618.

[2]The decision to introduce state trading was part of a long-run program to control prices as well as to raise revenues. From the short-

addition, state governments opened fair price shops and speeded the formation of consumers' cooperatives. Monetary policy supported these moves by imposing tighter selective controls on food grains, sugar, ground nuts and shares.

In respect to general controls, monetary policy continued to be vigilant. However, its restraining effect was not perceptible. The Bank did nothing either to raise the cost of borrowing or to limit the availability of funds to scheduled banks. As before, Banks bought government securities during the slack season and sold them in the busy season. But this year, due to rapid expansion and greater liquidity of banks during the greater part of the year, banks made net additions to their government securities portfolio. The Reserve Bank open market operations over the financial year resulted in the net absorption of securities by the public to 900 million rupees.[1]

So far as money supply goes, the effect of monetary policy hitherto had been either nil or perverse. In 1958-59 the stock of money increased by more than one billion rupees, compared to a smaller expansion of 760 million rupees in the preceding year. Curiously enough, demand deposits actually declined, while currency in circulation increased by 1.17 billion rupees (which was actually more than the

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run point of view it had hardly any effect. This is so because at the time a decision on trading was announced (November 1958), prices had already started falling. See Report on Currency and Finance, 1958-59.

[1]The Governor of the Reserve Bank also used moral suasion, impressing upon scheduled banks the need to restrict expansion of bank credit and reduce reliance on itself, but the banks paid hardly any attention. See DBO No. Sch. 1487/C 218-59 dated February 23, 1959, Trend and Progress of Banking in India, 1959.

increase in the stock of money). The main reason behind this curious phenomenon lies in the seasonal ebb and flow of funds that accompany agricultural operations. In this year, due to bumper crops, the flow of money to rural areas was abnormally high, resulting in a large demand for currency notes relative to bank deposits. This caused some currency drain and reduction in the volume of bank money.

As might have been expected, inflationary forces continued to gather strength throughout the period 1959-61. While monetary expansion continued to be fed by budgetary deficits and rising demands for bank credit, it was only partly offset by balance of payments deficits and growth in time deposits.

The Reserve Bank conducted open market sales of 606 million rupees during 1959-60 which were well below the level of 890 million rupees in 1958-59. The central and the state governments also were less successful in netting cash receipts from the issue of new debts in this year than in the previous year. Thus the cash receipts, excluding the subscription of the Reserve Bank, amounted to only 603 million rupees as compared to 825 million rupees in 1959-59 and 1.05 billion rupees in 1957-58.

The supply side of the product market suffered new setbacks during this year. Agricultural production fell by 3.9 per cent because of unprecedented heavy rains and floods accompanied by drought in large parts of the country. The index of agricultural production (1949-50 = 100) moved down from the record level of 132.3 in 1957-58 to 127.2.[1]

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[1] Reserve Bank of India Bulletin (October 1960), pp. 1498-1500.

The fall in agricultural production was, however, offset by industrial production which during the calendar year 1959 increased by as much as 8.2 per cent.[1] As a result real, national income showed a slight rise of 1.7 per cent only.[2]

The increase in the money supply was nearly twofold and in the bank credit more than twofold over the previous year. Although the economy as a whole did not show greater vigor, yet aggregate deposit liabilities continued to grow. Most of the increase in time deposits was accounted for by the State Bank of India (as in previous years) to which were accruing P.L. 480 counterpart rupee funds. These deposits, in turn, were as before invested mainly in government securities. But unlike the previous year, demand deposits also expanded. The reason for the reversal in demand deposits is not hard to find. With the fall in agricultural production the demand for currency in rural areas declined, and the money flowed back to urban areas and into the banks. As industrial output during 1959-60 was increasing, the demand for bank credit was also rising. Because people in urban areas are more accustomed to using bank money, the currency drain in the process of credit expansion is smaller. As a result of return of currency from rural areas and expansion of bank credit, there occurred the greatest increase in demand deposits since 1956-57. These had declined by 80 million rupees in 1958-59 but rose by 661 million rupees in 1959-60.

This year was notable for the highest rate of expansion in money supply of any year of the Second Plan. Compared to a 4.6 per

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[1] Report on Currency and Finance, 1959-60, pp. 15-19.

[2] Reserve Bank of India Bulletin (March 1962), p. 376.

cent increase in the previous year, money supply in 1959-60 went up by 8.2 per cent. In absolute terms the order of increase was over two billion rupees, compared to 1.1 billion rupees in 1958-59 and only 770 million rupees in the year prior to that. The seasonal swing in money supply was, however, smaller in 1959-60 than in 1958-59.[1]

The year 1959-60 was notable for another reason. The slack season began to show symptoms of gradual contraction, or so it was interpreted by the Reserve Bank. Both bank credit and money supply declined appreciably less in this slack season than in the previous years. Increased demand for bank credit was primarily due to the resurgence of the private industrial sector which was once again rapidly forging ahead. Rising prices of raw materials and manufactures were also partly responsible for the increase in bank credit. But the main reason for the gradual weakening of the slack season was the gradual extension and diversification of the industrial sector and the shift in the composition of bank credit in its favor.[2]

The continued rise in prices in 1959-60 began to cause anxiety to the Reserve Bank authorities. On March 1960 the WPI was up by 5.7 per cent over the level one year before. So far the increase in WPI since the commencement of the Second Plan had been 21 per cent.[3] The government was trying to meet the situation by selling imported food grains in the open market, by banning forward trading, and by restricting

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[1]See Report on Currency and Finance, 1959-60, pp. 26-29.

[2]This point is further developed in Chapter 6.

[3]Report on Currency and Finance, op. cit., pp. 20-26 and Statement 19.

interstate movements of food grains, etc. The Government also moved to check speculation in raw jute and jute goods, raw cotton, oil seeds, and sugar. Price controls and other administrative measures were also taken to stabilize the prices of important raw materials.[1]

The Reserve Bank's credit policy became more active and restrictive during this year. Selective controls were either introduced or extended to limit the flow of bank credit and thereby discourage speculation, especially in food grains, oil seeds, sugar, and shares. In respect to food grains and oil seeds the Reserve Bank tried to coordinate its selective control measures with the administrative policies announced by the Government.

As in the previous years the Reserve Bank tried moral suasion with banks, which consisted mainly of the Governor's conferences with scheduled banks' representatives in which they were asked to reduce outstanding bank credit by about one billion rupees during the slack season. This goal would have been achieved but for the fact that the busy season started earlier than before. As a result, the contraction in bank credit between June and September came to only 810 million rupees.[2]

In addition to moral suasion the Reserve Bank conducted open market sales which, as noted earlier, were smaller than those of the preceding two years. The Reserve Bank also restricted its lending facilities to banks under "the scheme." The most important move of the Reserve Bank, however, came at the very end of the financial year. For the first time the Reserve Bank invoked its power to vary cash ratios of

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[1] Ibid., pp. 24-26.

[2] See Trend and Progress of Banking, 1959, pp. 7-8.

banks. In effect as of March 11, 1961, the Bank required scheduled banks to maintain additional reserves equal to 25 per cent of the increase in total liabilities.[1] Through a subsequent notification, effective on May 5, the ratio of additional required reserves was raised to 50 per cent.

The justification for this drastic move was provided by a continued increase in prices even in the face of rising production. The Reserve Bank was finally convinced "that the major inflationary factor was rather the high level of aggregate demand, which needed to be curbed. The boom on the stock exchange contained some unhealthy elements and the liquidity of the banking system was also substantial, and these required corrective action."[2]

The policy of varying cash ratios contained three important features which deserve to be noted. First, control was exercised only on additions to the prevailing level of deposits rather than on the entirety of them. Second, the same ratio was prescribed to demand as well as to time deposits, even though the prevailing ratios at 5 and 2 per cents, respectively, discriminated between them. Third, the Reserve Bank agreed to pay interest on impounded reserves. At first, the interest to be paid by the Reserve Bank was to be equal to the average rate of interest paid by a bank for a half year on its total deposits. Later, effective on July 1, 1960, it was decided that the Reserve Bank would pay interest at one-half per cent above the average rate of

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[1]DBO No. Sch. 1895/C 110-60 (March 11, 1960); and the next circular, DBO No. Sch. 3336/C 110-60 (May 5, 1960); Trend and Progress of Banking in India, 1960, p. 132 and pp. 136-37, respectively.

[2]Report on Currency and Finance, 1959-60, p. 33.

interest paid by a bank on its total deposits, subject to the maximum of 4 1/2 per cent.

Of the features listed above, the first and the second were designed to increase the efficacy of credit control. From the standpoint of the lending ability of banks, the distinction between demand and time deposits has hardly any relevance. The third feature was probably necessary to make it more acceptable to banks. Its effect was to reduce their lending capacity without curtailing their earnings too much.

Soon after the imposition of marginal cash ratios in March 1960 the new credit control, due mainly to its drastic nature, was immediately registered by the stock exchange, and the stock market reacted very adversely. But urged on by expansionary forces, the stock market revived and the earlier bullish trend was resumed. Prices too remained stable in March 1960; in fact the Wholesale Price Index declined by 0.7 per cent. However, in April the index rose by 2.1 per cent and continued to rise thereafter.[1] To arrest further price increases the Bank was obliged to raise the additional reserve ratio to 50 per cent. About the same time in May, the Governor wrote a letter to banks asking them to reduce credit during the slack season. He specifically asked that outstanding credit be brought down by 1.1 billion rupees or slightly less than 10 per cent.

This time the request of the Governor failed completely, and bank credit continued to rise through June and July but fell somewhat in

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[1]See Report on Currency and Finance, 1960-61, Statement 19; and Trend and Progress of Banking in India, 1960, p. 15.

August only to rise again in September. Altogether, the contraction in the slack season was negligible and began to cause grave anxiety to the Reserve Bank. The main reason for the failure of the additional reserve requirement and moral suasion was quite simple. Scheduled banks continued to have free access to the Bank. They sold government securities and shifted into loans and advances. They were tempted to do so by the high level of demand for bank loans from the industrial sector. In fact, banks shifted their portfolio somewhat and increased credit to industries by reducing it against seasonal agricultural commodities. Thus pulled by demand for funds from the private industrial sector and supplied by funds through free access to the Reserve Bank, banks had no difficulty in defeating the seemingly drastic control measures that had recently been imposed upon them.

This trend pushed the Reserve Bank to tighten general credit controls still further in September 1960. The Reserve Bank imposed slab rates for scheduled bank borrowings and also directed them to raise their lending rates. Prior to this the Bank had restricted credit limits to banks under the Bill Market Scheme. The introduction of penalty rates was made effective from October 1, 1960.

In the new regulation banks were assigned borrowing quotas from the Reserve Bank on a quarterly basis. The quota of each bank was equal to half of the average amount of statutory reserves kept by it with the Bank in the previous quarter. Borrowings in excess of this quota up to 200 per cent were charged a penalty rate of one per cent over the Bank rate. Borrowings in excess of 200 per cent of the assigned quota were charged interest at 2 per cent over the Bank rate. In order to ensure

that the higher cost of borrowings was passed on to bank clients. Also, to discourage them from making new applications for loans, the Reserve Bank directed that banks should raise their lending rates effective from October 1, 1961. The Reserve Bank fixed the minimum lending rate at 5 per cent on all loans, existing or new, clean or secured, and at the same time required that banks raise their average lending rates by at least one-half of one per cent. Later, on December 13, 1960 the Reserve Bank exempted from the above stipulation banks which had been charging an average lending rate of 9 per cent per annum. Furthermore, in order to discourage banks from raising their resources by mobilizing idle funds, the Reserve Bank issued a directive which in effect forbade banks from paying more than 2 per cent on short-term deposits repayable in twenty-one days.

These measures, harsh as they were, had some effect. Even though the busy season had commenced, bank credit declined in October and November. The main effect of higher cost of borrowing was reflected in the higher cost at which private parties could secure loans from banks. But the actual decline in bank credit was not really very impressive. Compared to the increase in September by 347 million rupees, the decline in October was 218 million rupees and in November only 45 million rupees. This decline was more than made up by increase in bank credit of 744 million rupees in December.[1] Banks, although encumbered by higher costs of borrowing, were quite free to sell government securities which they did throughout the period of tight credit policy. They had been

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[1]See Report on Currency and Finance, op. cit., Statement 28.

accumulating investments in past years, but in 1960-61 they sold them on a fairly large scale. With the Reserve Bank ready to buy them in any volume, there had been no risk in buying securities in previous years and none whatsoever in selling them now.

In Table 23 the data for 1960-61 are compared to the previous two years. This brings out marked differences in 1960-61 with respect to government investments, cash reserves, and bank deposits.

The behavior of banks in respect to government securities has already been discussed. The rise in cash reserves was mainly due to higher reserve requirements which were maintained throughout the slack season. However, as the busy season got under way, the strain on banks grew, which forced them to use up their cash reserves. Another factor bearing upon the banks' cash position was the considerable decline in time deposits. The decline in time deposits was caused by the new arrangement for keeping P.L. 480 counterpart funds, both old and new, with the Reserve Bank. Fall in time deposits was, however, partially made up by growth in demand deposits.

In contrast to the slowing down of deposits during the year, bank credit showed record expansion. Compared to any previous years, the increases in bank credit during the busy season of 1960-61 were greater. But continuous expansion in bank credit in the face of the slackening trend in deposits had begun to show up in the strained liquidity position of banks, a factor which forced the Reserve Bank to re-examine its position.

In order to ease the situation and to enable banks to meet the seasonal demand for credit, the Reserve Bank started relaxing controls

TABLE 23

SCHEDULED BANK CREDIT AND RELATED DATA FOR THE YEARS 1958-61

	Financial Year			Slack Season	Busy Season	Slack Season	Busy Season	Slack Season	Busy Season
	1958-59	1959-60	1960-61	1958	1958-59	1959	1959-60	1960	1960-61
1. Total Deposits	+1,838	+2,670	-214	+643	+1,159	+1,065	+1,309	-233	+93
2. Borrowings from RBI	+199	+176	+151	-176	+249	-134	+298	-270	+215
3. Cash Reserves	+27	+452	-363	+137	-146	-211	+297	+42	-232
4. Investment in Government Securities	+1,729	+1,014	-1,562	+1,748	-32	+1,780	-525	-523	-1,263
5. Bank Credit	+509	+1,142	+2,084	-1,179	+1,817	-790	+1,889	-203	+1,985
6. Money Supply	+1,100	+2,049	+2,015	-1,582	+2,928	-1,124	+2,758	-856	+2,545

Source: Report on Currency and Finance, various issues.

on bank reserves. This was done in two steps: with effect on November 11, 1960, further impounding of bank reserves was suspended, and about half of the reserves already impounded were released. This was done by refixing additional reserves at 25 per cent, with retrospective effect, for the period between March 11 and November 11. Subsequently, on January 13, 1961, the remaining additional reserve requirement was completely revoked. In this manner the Reserve Bank released 260 million rupees to banks. However, the state of monetary stringency continued. This led the Reserve Bank to remove the ceiling of 2 per cent on twenty-one-day deposits that was earlier imposed to restrict banks from mobilizing idle funds. The latest and last relaxation was made effective from February 22, 1961.

The Reserve Bank at the end of the financial year had retreated in relation to general controls, practically to where it was about a year ago. The only difference was that banks continued to pay penalty rates on borrowing in excess of the quota. However, this was hardly a deterrent since banks were free to sell securities and secure loans at the Bank rate under the Bill Market Scheme. In fact, they were not even making full use of the quota granted to each bank under "the scheme." Thus, the greater part of the money that the Reserve Bank was prepared to put at the disposal of banks was not even utilized. But the decision of the Bank on higher lending rates had enabled banks to raise interest rates across the board. Bank customers, now hard pressed for funds, were in no position to turn to alternative channels. Thus a move which was primarily meant to reduce overall lending was used by banks as a cover to raise their earnings.

Though the higher cost of borrowing initiated by the Reserve Bank and followed by the State Bank of India on interbank loans had not produced any noticeable effect on the aggregate volume of credit, it is probably true that it had hurt some marginal investors with low credit standing. It may also be true that the higher cost of borrowing discouraged some potential investors from applying for loans, or at least to the extent that they might have applied for them if the interest cost had been lower. Perhaps some speculators were also cut off along with marginal investors. Furthermore, higher interest rates presumably diverted resources from less profitable to more profitable and hopefully to more urgent needs of the society. Therefore, the continuation of higher lending rates, although ineffective in the short run, was likely to be helpful for the long-run development of the economy. As tools of monetary control, there was, of course, never any doubt that higher lending rates were desirable. The question is whether in themselves, unaided by other general controls, they are effective enough to produce the desired results.

IV

The Behavior of Interest Rates

The short-term interest rates during this period show a slow movement in the upward direction (see Table 24). As discussed earlier in this chapter, the rising interest rates during 1955-56 and 1956-57 reflect the acute stringency in the money market caused by the excess of investment expenditures over the current rate of savings in the economy.

TABLE 24

THE SHORT-TERM INTEREST RATES IN INDIA
(in percentages)

Year	Bank Rate	Treasury Bill Rate	Interbank Call Money Rate in Bombay	State Bank of India Hundi Rate	Bazaar Bill Rate in Bombay
	1	2	3	4	5
1955-56	$3\frac{1}{2}$	2.51	3 - $2\frac{1}{4}$	$4\frac{1}{2}$	$9\frac{3}{4}$
1956-57	$3\frac{1}{2}$	2.53	$4\frac{7}{16}$ - $3\frac{1}{4}$	5	$10\frac{1}{2}$
1957-58	4	--	$4\frac{7}{16}$ - $2\frac{49}{64}$	$5\frac{1}{2}$	$11\frac{1}{4}$
1958-59	4	2.52	$4\frac{1}{4}$ - $3\frac{1}{8}$	$5\frac{1}{4}$	9 - $9\frac{3}{4}$
1959-60	4	2.58	$4\frac{1}{2}$ - $2\frac{1}{2}$	$5\frac{1}{4}$	9 - $10\frac{3}{16}$
1960-61	4	2.65	5 - $4\frac{1}{4}$	$6\frac{1}{2}$	12.00

NOTES:

The Treasury bill rate is the average rate of discount on auction sales.

The interbank call money rates are for the last day of December in each year.

The State Bank of India hundi rate and the bazaar bill rates are the averages of December.

Sources: Reserve Bank of India Bulletin, various issues; Statistical Tables Relating to Banks in India, 1955-60.

This increase was most pronounced in the interbank call money rates. But the stringency was also felt by the bazaar money market.

When money conditions began to ease in 1957-58, the interest rates also softened. But in the meantime the announcement of a higher bank rate had already imparted a higher floor to the structure of interest rates. Thus, when the new spurt of demand for funds came early in 1959 the interest rates easily moved up. The growing tightness in the money market had the effect of raising the Treasury bill rate as well as the call money rates and the bazaar rates.

The average rate of interest charged by the scheduled banks on loans and advances slightly declined from 5.68 per cent in December 1957 to 5.50 per cent in June 1958. But thereafter it rose continuously. It reached 5.68 per cent in December 1958, 5.70 per cent in December 1959 and 5.78 per cent in June 1960.[1] The rising trend in the interest rate on advances was, however, in accordance with the Bank's policy of "controlled expansion." It was the policy of the Reserve Bank to allow an increase in the volume of bank credit and at the same time raise the cost of credit. The fulfillment of this policy was probably due to a greater increase in the demand for credit as compared to the rise in bank deposits. In addition to this factor, it is probably true that the banks could not augment their reserves rapidly enough to keep pace with the growing demand for loans. The rising cost of credit nationally had

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[1]See "Average Rates of Interest Paid on Deposits and Earned on Advances by Scheduled and Nonscheduled Banks," Reserve Bank of India Bulletin (October 1960), pp. 1469-80. Also see "Interest Rates on Deposits and Advances of Scheduled Banks During 1957, 1958 and the First Half of 1959," Reserve Bank of India Bulletin (October 1959), pp. 1254-64.

some restraining effect on private spending. It is, however, necessary to point out that in raising the structure of interest rates, the policy of the Reserve Bank played only a subsidiary role. Market forces which were mostly outside the control of the Reserve Bank were dominant in this respect. The policy of the Bank was, however, clearly decisive in determining the behavior of the long-term interest rates. It was the policy of the government and of the Bank to keep long-term interest rates as low as possible. This was dictated partly by the desire to stimulate private investment, and partly by the policy of minimizing the cost of servicing the debt. In fact, in conducting open market operatives the authorities of the Reserve Bank were mainly concerned with the maintenance of orderly conditions in the securities market. In effect this policy was tantamount to the stabilization of a given pattern of yields on government bonds.

V

An Appraisal of the Reserve Bank Policy

During the Second Plan period bank credit of scheduled banks grew from 5.93 billion rupees in 1955 to 11.30 billion rupees in 1960. This is an increase of 90 per cent over a period of five years. Such an increase in bank credit was bound to be inflationary, even though some of it was needed to facilitate higher production and marketing of larger volume of goods. More than half of this increase in bank credit took place in 1956 and 1960. In these two years bank credit rose by 3.63 billion rupees or about 67 per cent of the total increase. These were

also the years in which the economy showed the highest rates of advance. At the same time price increases were also substantial.

But in a significant sense 1960 was different from 1956. Although the economic expansion in both the years was led by the private sector, in 1956 the excess of monetary demand was partly absorbed by import surpluses.[1] Moreover, until one year before prices had been declining. Hence the rapid increase in price level was viewed as corrective to the deflationary trend prevailing previously. This accounts for the fact that monetary policy in 1956-57 was generally passive. The Reserve Bank, however, had taken no more than the first steps in respect to general and selective controls. As will be seen in subsequent chapters, the banking system in 1956 became tight in spite of the fact that the Reserve Bank was buying securities and had imposed no restrictions on lending to scheduled banks. It may, therefore, be concluded that the banking system had reached the limit of expansion. The prevailing monetary stringency in 1956-57 was in no way due to the Reserve Bank policy.

In 1960-61, on the other hand, expansion of the economy took place with a background of sustained inflation. The increase in bank credit was caused partly by increased demand from the industrial sector to expand production, and partly by higher and rising prices of industrial raw materials and semi-finished goods. In addition, there was the speculative demand for hoarding scarce commodities. In both years boom

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[1]This holds true for the entire economy, although the drafts on the foreign exchange by the government did not have an offsetting effect on the money supply.

conditions had at least partially been created by the optimistic expectations generated by the larger five-year plans. But in 1960 the Reserve Bank was not taken unaware. It acted to control bank liquidity during the slack season by using a marginal reserve ratio policy, whereas in previous years only moral suasion and an open market policy had been relied upon.

In 1960, as in 1956, the Reserve Bank was buying securities, thereby supplying banks with excess reserves. In 1960 this was obviously quite contrary to the restrictive measures adopted to control bank credit. One may thus conclude that--with the exception of the sale of government securities by the State Bank of India--the open market purchases of the Reserve Bank were entirely passive. But the combined effect of credit controls adopted by the Bank were responsible for tightening the liquidity position of banks. The impounding of increases in deposits had forced banks to sell securities, and it was also affecting their lending operations. According to the annual report of the Reserve Bank:

> The money market had become acutely stringent and it was felt that banks might not be able to meet the genuine requirements of the ensuing busy season. The Bank, therefore, relaxed the directive issued on May 5 regarding maintenance of additional statutory reserves with it.

The report then lists the measures taken to ease the situation and concludes as follows:

> As already mentioned, in the calendar year 1960 as a whole credit expansion was more than double than that in 1959. Thus it is evident that the legitimate credit requirements of the economy were adequately met, though in a fast-developing economy there is always a fringe of unsatisfied demand.[1]

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[1] Trend and Progress of Banking in India, 1960, p. 18.

It may, therefore, be concluded that the Reserve Bank took a deliberate risk in not tightening banks liquidity in the midst of an inflationary situation. This risk was taken because the Reserve Bank was far more concerned with the fulfillment of the production targets of the Second Plan than with stability of prices.

As for other years, most of the burden of monetary policy was borne by selective controls. Since banks were generally loose and had no difficulty in making net purchases of government securities, the Reserve Bank did not consider it necessary to use anything more than moral suasion to carry out the intent of its policy.

VI

Conclusions

A careful study of general monetary policy during the Second Plan period leads to two principal conclusions. First, the Reserve Bank deliberately did not try to restrict the reserve base of banks because it was apprehensive that such a policy might hinder the progress of the Second Plan. It had, therefore, subordinated but not relinquished the goal of monetary stability to economic development. Second, the Reserve Bank was faced with a real dilemma. When growth in production was slackening, the Bank was naturally reluctant to control bank credit and money supply which might slacken the economy even further, while at other times, when output was growing rapidly, credit controls were introduced hesitatingly lest they might slow down the expansion. In other words the Reserve Bank was not willing to control inflation to the point where it might begin to hamper production.

Thus, in the course of implementing the policy of "controlled expansion," monetary authorities created their own vicious circle. One has heard of numerous vicious circles plaguing underdeveloped countries. The one formed by the Reserve Bank of India is a new one. The vicious circle consists of letting money supply expand to finance the growing needs of the productive sectors of the economy, while at the same time trying to deny it to the speculators. This facilitates the progress of inflation which in turn raises the financial needs of the productive sectors. So to meet the legitimate needs of the economy still more money is supplied which in turn produces more inflation. Since a growing economy is beset with general shortages due mainly to insufficiency of foreign exchange reserves, speculation naturally thrives. Once speculation is sought to be controlled through tight money policy the productive investors are also hurt. This is so because their need for finance is a rising function of inflation. Therefore, within the framework of this policy, there is no escape. Thus production and prices escalate together, but the latter stays ahead of the former. The Reserve Bank, on its part, would be compelled to finance both.

CHAPTER V

THE WORKING OF SELECTIVE CONTROLS

I

Among less developed countries selective controls have been experimented with in several Latin American countries. These have generally been employed in the atmosphere of inflation and exchange rate instability and with rather limited usefulness.[1] The common experience of these countries has been that selective controls can be fairly successful when supported by effective general credit controls and buttressed by anti-inflationary fiscal policy.

Objectives of Selective Controls

Selective controls are needed primarily to influence the distribution of credit, although in the process of doing so the volume of credit is also affected. Thus restrictive selective controls tend to

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[1]See Peter J. Fousek, Foreign Central Banking: The Instruments of Monetary Policy (New York: Federal Reserve Bank, November 1957), pp. 66-81. Also see the following articles: W. J. Seiwitz and F. H. Schott, "Monetary Controls and Their Relative Usefulness in Different Economic and Financial Environments," Jorge Marshall, "Advance Deposits on Imports," and Robert L. Sammons, "Some Aspects of Consumer Installment Credit, with Particular Reference to Latin America"; Meeting of Technicians of Central Banks of the American Continent, Memoria 3 (Bogota: Imprenta Del Banco De La Republica, 1957), pp. 45-80, 125-45, and 175-98, respectively.

tighten credit, especially when the demand in uncontrolled sectors is weak or when the number of credit-worthy clients in them is small. Selective controls are, however, mainly intended to influence the allocation of aggregate expenditure between the various sectors of the economy.[1]

Monetary authorities have made use of selective controls either for correcting short-run instability or as adjuncts to a broad longer-run developmental policy. In the short-run their principal advantage lies in their reversibility. Selective controls are helpful in correcting specific cases of market disequilibrium, provided the causes that lead to their use are themselves of a temporary nature.[2] Thus selective controls have been effectively used in the United States for checking speculation in the stock market. In India, control of speculation has been the principal objective of these controls.

The long-run effectiveness of selective controls depends mainly upon the extent to which they are harmonized with other arms of government policy, such as fiscal policy, capital issues policy, and import policy. Given this harmony selective controls can be employed to the greatest advantage of economic planning in three ways:

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[1]I. G. Patel, "Selective Controls in Underdeveloped Countries," International Monetary Fund Staff Papers, IV, Nol. 1 (September 1954), 73-84; and S. N. Sen, op. cit., pp. 163-218 and pp. 275-90.

[2]This has been the case in the United States where in the past selective controls have been employed to restrict the purchase of securities, of durable goods, and of houses. At present securities alone are subject to control. See David L. Grove, "Selective Credit Controls," The Federal Reserve System, ed. H. V. Prochnow (New York: Harper & Bros., 1960).

(i) In correcting the structural imbalance in the economy. For instance, in India credit is made available to farmers at a concessional rate of 2 per cent below the Bank rate. At the same time food prices are controlled by restricting bank advances against the security of food grains.

(ii) By aiding exports and discouraging imports. The former can be done either by exempting exporters from the provisions of control directives or by lending advances to them at concessional rates. The former has been tried in India but not the latter. For reducing imports, advance deposits up to 100 per cent of the value of imports may be prescribed as in some Latin American countries.

(iii) Selective controls can also conceivably be used for influencing the location pattern of industries. However, so far no country has tried it, presumably because it might not be very effective.

It is clear that in the long run selective controls can at best lend a helping hand to the planning authority in speeding the pace of development along desired lines. Left to themselves they cannot achieve much, nor if various policies of government function at cross purposes.

Effects of Selective Controls

Suppose a central bank imposes a selective control which takes the form of higher margins than customarily stipulated by banks and ceilings on credit limits sanctioned to individual borrowers. Faced with these restrictions the clients may do one of the three things. They may

often with the cooperation of bank managers, secure the desired amount of loans by offering uncontrolled securities or simply seek more clean advances. Borrowers will be tempted to do so if profit prospects are particularly high, and the banks will cooperate if the applicants are too important to be turned down. However, not all prospective borrowers are likely to be equally important and not all bank managers are expected to cooperate with them. Therefore some restriction on credit is likely to result, although it may not be up to the desired extent.

If the bank managers cooperate with the central bank rather than with their clients--or to the extent that they do so--credit control will be obviously effective. Bank advances will be curtailed and the prospective borrowers will be forced either to draw down their cash balances, convert liquid assets into cash, or do both. Alternatively, they can cut their expenditures elsewhere and use the released resources to finance speculative ventures. It is obvious that resources so released will be limited and can be increased only with increasing difficulty. In this case selective control will become effective only after a time lag. However, within a relatively short period some unintended effects may be expected. When idle balances are being reduced, liquid assets are turned into cash, or expenditure is cut in certain directions, the rate of interest will rise, capital losses are likely to be experienced, and the prices of affected goods will probably fall.[1]

The third possibility is one where the imposition of selective controls leads to reversal of expectations and abandonment of

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[1]S. N. Sen, op. cit., pp. 276-78.

speculators' plans. As a result, speculators will either have to divert resources into other sectors or to keep them as idle balances. In the former case the prices of controlled commodities will probably go down while those of some other commodities will probably go up. Such a possibility is likely to emerge under conditions of a general shortage of goods. Consequently, selective controls will be chasing speculative demand for goods from one sector into another. Under these circumstances the success of selective controls will be temporary and nominal. Total success will be achieved only in the limiting case when speculators give up their plans and add their released funds to idle balances.

From the above discussion it logically follows that selective controls in an actual situation can only be partially successful. Success is more likely to be achieved if commercial banks cooperate with the central bank or if the latter can effectively enforce controls upon the former, and provided that general monetary controls can set an upper limit to the lending ability of banks.

Limitations of Selective Controls

A major limitation of selective controls is that while the allocation of bank credit can be controlled there is no assurance that the expenditure of borrowed funds can also be controlled. Second, central banks may succeed in discouraging certain types of bank credit but may fail in inducing banks to lend their freed resources in the desired directions.[1] Third, "leakages" may occur because of imprecise

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[1]Arthur I. Bloomfield, "Monetary Policy in Underdeveloped Countries," Public Policy, eds. C. J. Friedrich and S. E. Harris, VII (Cambridge, Mass.: Graduate School of Public Administration, Harvard University, 1956), 258-61.

definitions of different types of loans so that even well-meant selective controls may fail in practice. Fourth, bank credit is not the only source of finance, although more frequently this is the most important one, so selective controls may drive borrowers to tap alternative sources of finance, such as trade credit or loans from the indigenous money market. Finally, selective controls may create a general impression that something is being done while actually they may be producing more complacency than concrete results.

In spite of these limitations selective controls have been increasingly employed by central banks in underdeveloped countries. This is partly because the very imperfection of money markets makes it possible to successfully apply pressures to comparatively narrow sectors of the economy, and also because the opportunity for applying selective controls is much greater than for applying general controls.[1]

II

Selective Controls in India

In India selective controls have been systematically used mainly since the inception of the Second Five Year Plan. They have been employed to curb speculation in principal commodities markets and the stock exchange. It was thought that by controlling speculation a measure of stability would be imparted to the prices of commodities concerned and through them to the general price level. Selective

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[1]R. S. Sayers, "Central Banking in Underdeveloped Countries," Central Banking after Begehot (London: Oxford University Press, 1958), p. 131.

controls are thus imposed only when the Reserve Bank is convinced that bank lending against a security is getting abnormally high and is contributing to the increase in prices.

The Reserve Bank has operated these controls by issuing directives to scheduled banks. These directives contain the margin requirements that banks are expected to enforce on existing as well as new credit limits. Ceilings on existing loans and new loans are prescribed which in some cases may actually be below the prevailing levels. These ceilings are fixed mostly on individual credit limits but, if necessary, have been extended to the aggregate credit that a bank may sanction against the affected security. To ensure that these directives are followed in practice, the Reserve Bank requires scheduled banks to submit fortnightly returns giving details of loans to each individual party. This has generally sufficed to ensure compliance, but in some cases defaulting banks had to be warned of disciplinary action.

Objects of Selective Controls

Selective controls in India have been directed mostly against agricultural commodities. The most important of these controls and also the most prolonged have been regulations of advances against the security of food grains. The following is the list of commodities against which selective controls have been directed:

I. Food Grains

(i) Rice and Paddy
(ii) Wheat
(iii) Other Food Grains

II. Oil Seeds

(i) Groundnuts
(ii) Other Oil Seeds

III. Sugar

IV. Cotton Textiles Including Yarn

V. Raw Jute and Jute Goods

VI. Shares and Clean Advances

In addition to these the Reserve Bank's lending policy has been selective too. This took the form of concession rates to agriculture, exemption of exportable goods from the provision of selective controls, and discretionary lending under the Bill Market Scheme. These aspects of monetary policy will be briefly touched upon, but will not be covered in detail.

In controlling bank advances against the securities of affected commodities the Bank was careful to accord preferential treatment to newly-opened branches. This was done so as not to hinder smooth functioning of the banking system. The Bank also tried to tailor its policy to the procurement needs of state governments, especially in cases of paddy and rice and wheat. Furthermore, considering the economic and geographical diversity of India, the Reserve Bank issued, if and when necessary, different sets of regulations to banks in different states depending upon whether they were "deficit" or "surplus" in the commodity concerned.

So as not to hinder exports, the Reserve Bank generally adopted a policy of exempting exporters from the provisions of control directives. Similar exemptions or preferential rules were applied to

industrial borrowers on the assumption that they would be employing credit for productive purposes alone. Also, with a view to encouraging the use of government warehousing facilities, bank loans granted against the pledges of warehouse receipts were exempted. In such cases, it was further assumed that goods lodged with warehouses were not likely to be used for speculative trading. In addition, the Reserve Bank exempted the security of demand documentary bills drawn in connection with the movement of goods, the justification being that monetary policy should not interfere with the free movement of goods.

These exemptions were perhaps necessary and justified on one ground or the other. But to the extent that these concessions were made they modified the impact of credit controls and made them less effective in restraining speculative demand in the markets concerned. Since credit restrictions were expected to reduce speculative demand only to the extent that it was financed by bank credit, it is obvious that numerous exemptions would increase the aggregate resources of speculators. This would enable them--or at least the more resourceful of them--to divert resources to speculative trading and thereby prevent credit controls to achieve their desired objective to the fullest extent.

Keeping these features and limitations of selective controls in mind credit regulations against each commodity mentioned above are now discussed. Food grains are taken together and, in view of their importance, receive most attention.

III

Credit Restrictions on Trading in Food Grains

Controls over credit supplied against the security of food grains

were initiated at the commencement of the Second Five Year Plan and continued to be in force even after its termination. The Reserve Bank devoted itself most thoroughly to food grains and, learning by experience, proceeded to make them increasingly comprehensive. The initial steps were halting, even shakey. But within a year the Bank was moving with confidence. The chronological account and details of directives are summarized in the Appendix.

Credit controls against paddy and rice were introduced in May 1956. For some past months the increase in food prices had been alarming. The price index of food articles on March 31, 1956 was 22.5 per cent above the same date a year previous.[1] This was held to be partly caused by a poor harvest and partly by bank credit financing. This is shown by the fact that scheduled bank advances against paddy and rice had increased by 23.4 per cent between April 1955 and April 1956 (see Table 1).

Restrictive measures produced an immediate effect. Partly due to these but also due to the onset of a slack season, bank advances declined up to October. However, with the commencement of the busy season bank credit started rising again. Meanwhile, credit restrictions had been extended to wheat and other cereals. However, the steady fall in bank advances during the slack season deceived the Reserve Bank into withdrawing controls from paddy and rice in November. This was a hasty move and was soon reversed. The decision to withdraw controls in November was all the more surprising because throughout the slack season the level of advances had remained higher than the previous year. But once

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[1] Report on Currency and Finance, 1956-57, Statement 17.

the mistake was realized credit restrictions against paddy and rice became tighter upon reimposition in February 1957.

In 1957 the Reserve Bank tried to bring down aggregate advances to 75 per cent in the case of paddy and rice and 66 per cent in the case of wheat and other cereals of the level prevailing in the corresponding week of the previous year. But, as can be seen in Table 25, these directives were not complied with. The Reserve Bank also learned that banks while reducing their outstanding advances on an overall basis had allowed them to remain disproportionately high in surplus states. To counteract this tendency the Bank tightened regulations on bank branches operating in surplus states like Madhya Pradesh and Andhra Pradesh. Thus the Bank, for the first time, felt it necessary to introduce regional discrimination in the general technique of selective controls. In December 1958 the same principle was extended to wheat in the state of Punjab. In July 1959 regional selective controls were further widened to cover all food grains and most of India.

Since the purpose of credit restrictions was to arrest any further increases in the prices of food grains, and the same objective was sought by the government procurement policy, the Bank decided to cooperate with the state governments. It liberalized credit restrictions to aid procurement of paddy and rice in Orissa in April 1959, and later for wheat in Punjab and other states. The government efforts to reduce prices by opening "fair price" shops and open market sales which had partly been made possible by the arrival of wheat aid from the United States under P.L. 480, rendered the price situation much easier. The greater availability of food grains weakened the hoarding propensity of

TABLE 25

ADVANCES OF SCHEDULED BANKS AGAINST THE SECURITY OF FOOD GRAINS
(in million rupees)

		February	April	June	August	October	December	Annual Average
1	2	3	4	5	6	7	8	9
1955	R	93.0	112.5	102.1	57.6	38.4	81.1	70.5
	W	43.2	46.8	115.5	112.2	68.2	88.6	77.6
1956	R	194.3	263.0	155.2	74.9	43.4	96.1	139.5
	W	70.8	101.5	206.2	168.0	93.5	91.9	120.5
1957	R	231.8	221.2	168.9	64.4	42.1	61.8	132.7
	W	73.4	96.3	208.0	124.2	98.0	85.5	114.2
1958	R	111.1	139.6	94.1	44.8	34.6	54.0	80.8
	W	63.6	92.0	153.0	93.8	70.0	51.9	88.5
1959	R	108.3	113.7	114.9	74.1	52.6	78.2	89.6
	W	78.4	85.9	185.3	120.9	74.2	67.1	104.1
1960	R	142.5	143.6	131.1	83.2	57.3	73.0	104.8
	W	77.2	111.2	157.9	119.8	107.3	82.3	108.4
1961	R	155.0						145.6
	W	81.8						88.1

Notes: The data are obtained from the Reserve Bank fortnightly surveys of bank advances according to security. The data are not strictly comparable because the number of reporting offices varies from month to month. Figures in column 9 are averages of figures for 12 months. Figures for 1961 are averages of three months only (January to March). Letters "R" and "W" stand for "paddy and rice" and "wheat and other grains", respectively. The data are inclusive of advances which are exempt from the provisions of credit control.

Sources: Trend and Progress of Banking in India, various issues;
Reserve Bank of India Bulletin, various issues.

speculators and led to gradual loosening of credit restrictions during 1960 and the first quarter of 1961.

Effect of Credit Controls on Bank Advances

Unlike the effect of credit controls on prices which cannot be directly ascertained it is possible to assess the effect on bank advances by looking at the published data. The Reserve Bank has derived satisfaction by pointing out that bank advances have generally remained within the prescribed limits, which shows that the credit policy has generally been effective. This data is rearranged and produced in Table 26.

The Reserve Bank's claims for satisfaction are fully borne out by Column 9 which shows that bank advances remained well below the permitted level. This shows that banks have in fact been only too obedient in following Reserve Bank directives. However, Columns 7 and 8 show that the Reserve Bank has been fairly generous in granting exemptions. In fact, actual level of advances has been consistently above the permitted level (including exemptions) and far above the so-called adjusted level. From the point of view of effectiveness of credit policy the difference between actual and permitted levels of advances is more important than the difference between permitted and adjusted levels. It follows, therefore, that the satisfaction expressed by the Reserve Bank[1] over the implementation of its directives is not fully warranted by facts.

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[1]See Trend and Progress of Banking in India, 1960, pp. 21-22.

TABLE 26

SCHEDULED BANK ADVANCES CLASSIFIED BY ACTUAL, PERMITTED, AND ADJUSTED LEVELS
(in million rupees)

Serial Number	Year	Food Grains	Actual	Permitted	Adjusted	(4)-(5)	(4)-(6)	(5)-(6)
1	2	3	4	5	6	7	8	9
1	1958	R	80.8	77.2	60.8	+3.6	+20.0	+16.4
2		W	88.5	50.7	39.5	+37.8	+49.0	+11.2
3	1959	R	89.6	80.5	49.2	+9.1	+40.4	+31.3
4		W	104.1	43.9	45.6	+60.2	+58.5	-1.7
5	1960	R	104.8	85.4	72.4	+19.4	+32.4	+13.0
6		W	108.4	46.4	42.4	+62.0	+66.0	+4.0
7	3-1		+8.8	+3.3	-11.6			
8	4-2		+15.6	-6.8	+6.1			
9	5-3		+15.2	+4.9	+23.2			
10	6-4		+4.3	+2.5	-3.2			

NOTES: The data are annual averages of monthly data. The Reserve Bank obtains this information by fortnightly surveys (as in Table 25). The adjusted level excludes advances which are exempted from directives of the Bank. Letters "R" and "W" stand for "paddy and rice" and "wheat and other grains," respectively.

Sources: Table 25 of this chapter; Trend and Progress of Banking in India, 1960, p. 85.

On comparing the bank advances made against the security of other commodities it will be seen that the former are rather small and only a small fraction of the total bank credit. For instance, in 1960 the actual and the permitted advances were 213.2 million rupees and 131.8 million rupees, respectively. These were no more than 2.24 per cent and 1.38 per cent respectively of the total advances which stood at 9,496.0 million rupees. The corresponding amounts lent against other securities were much higher. For example, the advances against sugar exceeded 554 million rupees, while the clean advances and those made against the security of shares were over 2.26 billion rupees. Evidently, the security of food grains does not appear very attractive to the scheduled banks. One may therefore wonder why so much effort and the administrative energy of the Reserve Bank were devoted to food grains.

There appear to be three reasons for this: first, the stabilization of food grain prices was given high priority in the Second Plan. Moreover, the government was taking numerous steps to regulate food prices. In this task the selective credit controls could render valuable assistance. Second, the selective controls had a better chance of being faithfully implemented because they affected only a small portion of bank credit and consequently did not materially lower the earnings of scheduled banks. Third, the publicity given to these controls could conceivably influence the expectations of not only the dealers in food grains but traders in other commodities too. This might weaken the

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[1]This figure is the average of Fridays and includes loans, cash credits, and overdrafts. See Trend and Progress of Banking in India, 1960, Statement 3.

optimism of some speculators about future prices and the prospects of securing accommodations from banks, and thereby might exert a moderating influence on prices. In this way the credit controls on the bank lending against the security of food grains would lend side support to the entire range of selective controls and also to the price stabilization policies of the central and the state governments. Viewed in this light the controls on lending against food grains assume a strategic importance which is not generally apparent.

IV

Oil Seeds

Speculative tendencies in the market for oil seeds were noticed as early as September 1956. But the Bank did no more than issue a warning to banks urging them not to finance speculative trading in mustard seeds and mustard oil. Selective controls were first imposed on ground nuts in February 1959. The technique of credit control was the same as in food grains. Margins at 45 per cent were fixed on all old and new advances, but the ceiling on bank advances was fixed at a fairly generous level. These restrictions as well as the subsequent ones are summarized in Table 27.

Credit controls were extended to all oil seeds in December 1959, although lower margins at 40 per cent were fixed for "other oil seeds." At the same time ceilings on bank advances against ground nuts were lowered, thus making credit controls tighter. With minor modifications these restrictive measures were continued for the rest of the Plan period.

TABLE 27

CREDIT POLICY WITH RESPECT TO OIL SEEDS SUMMARIZED ACCORDING TO TIMING, OBJECT OF CONTROL, CONTROL MEASURES, AND GENERAL EFFECT

Serial Number	Date	Object of Control	Control Measures	General Effect
1	Sept. 17, 1956	Mustard seeds and mustard oil	Banks advised to be cautious so as not to help finance speculative trading. Bank branches are required to submit fortnightly statements about the number of accounts and amounts of such advances.	
2	Feb. 9, 1959	Ground nuts	(a) Margins at 45 per cent are fixed on all old and new advances. (b) Ceilings on bank advances are fixed at the average of monthly advances of 1957 or 1958, whichever is higher. (c) Banks requested not to give clean advances to parties affected by this directive.	Restrictive
3	Dec. 11, 1959	All oil seeds	(a) Margins of 45 per cent should be maintained on advances made against the security of ground nuts. (b) With respect to "other oil seeds" a margin of 40 per cent should be maintained on all old and new credits. (c) Ceiling on credit against ground nuts fixed at 90 per cent at the average level of credit maintained in the corresponding months of 1957, 1958 and 1959.	Restrictive
4	Feb. 8, 1961	All oil seeds	(a) In addition to regulations 3a and 3b, each bank can lend against ground nuts a sum that shall not exceed the average of credit over the corresponding period of two months in 1960. (b) Ceiling on advances for new bank branches operating in areas where ground nuts are either cultivated or marketed is fixed at 100,000 rupees per office.	Restrictive

NOTE: Vanaspati manufacturers and credit secured against the pledge of warehouse receipts have been exempt from the application of restrictive measures. Exporters of oil seeds and ground nut oil have been either totally exempt or have received favorable treatment. For exporters of ground nuts credit limits could be sanctioned beyond the prescribed ceiling up to a maximum of 66 2/3 per cent of the value of unutilized portion of export quota. In the case of exporters of ground nut oil, the upper limit has been 50 per cent of the value of the ground nut equivalent of the unutilized export quota. Credit restrictions were also relaxed for the new branches of banks subject to certain safeguards.

Sources: Trend and Progress of Banking in India, various issues; and Reserve Bank of India Bulletin, various issues.

The reasons that led to credit controls over oil seeds were the same as in food grains. The WPI of oil seeds (base year 1952-53 = 100) on February 6, 1959 was 38 per cent above the level one year before. This was disquieting because oil seeds are essential raw materials for vanaspati industry (vegetable shortening). Moreover, oil seeds are exported. Continued rise in prices would have affected their export and at the same time raised the costs and prices of vanaspati (vegetable shortening), which is an important object of food consumption. Credit controls were, therefore, amply justified.

Effect on Bank Advances

The effect of credit controls on bank advances was quite salutary. The annual average of bank advances against both groundnuts and other oil seeds in 1960 was well below 1959 (see Table 28). The latter shows an impressive decline after the imposition of credit controls in December 1959.

The effect on prices was also noticeable, though small. Price indices rose but at smaller rates. The price index of all oil seeds had risen by 13.3 per cent from March 1958 to March 1959. A year later the index was up by only 10.2 per cent. The next year, due to an abnormal rise in linseed prices the index moved up by 13.5 per cent. The percentage increase in groundnut prices, however, continued to decline.[1]

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[1] Report on Currency and Finance, 1959-60, Statement 19; Report on Currency and Finance, 1960-61, Statement 20.

TABLE 28

ADVANCES OF SCHEDULED BANKS AGAINST THE SECURITY OF OIL SEEDS
(in million rupees)

Serial No.	Year	Oil Seeds	February	April	June	August	October	December	Annual Average
1	2	3	4	5	6	7	8	9	10
	1958	G	118.4	116.4	72.7	30.3	13.8	91.5	72.2
		O	97.2	176.7	176.4	114.3	86.2	79.2	123.4
	1959	G	200.1	143.3	78.5	22.9	8.8	86.3	91.3
		O	118.0	205.4	272.4	182.0	138.1	116.4	170.0
	1960	G	151.5	118.9	58.7	20.9	12.2	110.7	82.1
		O	112.6	158.9	163.8	108.8	66.9	75.8	112.6
	1961	G	150.6						148.9
		O	78.6						92.5

NOTE: These data have the same limitations as in Table 26. Letters "G" and "O" stand for ground nuts and "other oil seeds." The averages for 1961 in Column 10 are for the first quarter only.

Sources: Trend and Progress of Banking in India, various issues; and Reserve Bank of India Bulletin (May 1961), p. 770.

V

Sugar

Restrictions against sugar were imposed on June 1957, following abnormal expansion in bank advances coupled with a rise in prices. The Reserve Bank fixed margins at 35 per cent and ceilings were imposed on total advances which were later relaxed in favor of sugar manufacturers (see Table 29). As the banks complied and advances declined, the Bank abolished ceilings but continued to prescribe margins on individual loans. These controls continued until December 1960 when margins were lowered to 25 per cent. Controls on sugar were completely withdrawn in April 1961. In fact, sugar became a surplus commodity in this year, and India began to seek export markets.

Effect on Bank Advances

As may be seen in Table 30, bank advances responded to credit controls. The yearly averages of 1958 and 1959 were below 1957. In fact, they show a declining trend. But beginning from December 1959 advances started rising again and in 1960, in every month, remained above any of the previous three years. This increase was mainly associated with an increase in sugar production following a series of incentive measures which the government used to bring it about.[1] These incentives, first announced in October 1959, were extended to 1960-61. Government policy in this respect was also aided by good crops. As

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[1] These included a 5 per cent rebate on excise duty and on increase in the controlled price of sugar and sugar cane in the states of U.P. and Bihar, which account for over 70 per cent of sugar production. See Report on Currency and Finance, 1959-60, pp. 17-18. Also see S. C. Kuchhal, The Industrial Economy of India, 1960 (Allahabad: Chaitanya Publishing House, 1960), pp. 231-33.

TABLE 29

CREDIT POLICY WITH RESPECT TO SUGAR SUMMARIZED ACCORDING TO TIMING, OBJECT OF CONTROL, CONTROL MEASURES AND GENERAL EFFECT

Serial Number	Date	Object of Control	Control Measures	General Effects
1	2	3	4	5
1.	June 29, 1957	Sugar	(a) Banks are asked to maintain 35 per cent margins on existing and new advances. (b) The ceiling on credit fixed at 10 per cent above the level prevailing in the corresponding week of 1956. This should be effective from July 26.	Restrictive
2.	July 15, 1957	Sugar	(a) Credit limits sanctioned to manufacturers are exempted from credit control. (b) The date from which credit ceiling is to be effective is postponed by one week.	Loosening
3.	Dec. 11, 1957	Sugar	(a) The Reserve Bank reiterates the provision of the earlier directive on 35 per cent margin requirements. (b) Ceilings withdrawn.	Loosening
4.	July 18, 1958	Sugar	Margins on existing and new credit limits to be raised to 45 per cent. This includes credit sanctioned to manufacturers in respect to such stocks as have left the factory premises and on which excise duty has been paid.	Restrictive
5.	Dec. 9, 1960	Sugar	Margins are lowered to 25 per cent.	Loosening
6.	April 21, 1961	Sugar	All controls withdrawn.	

Note: In addition to manufacturers, demand documentary bills drawn in connection with the movement of sugar were exempt.

Source: Trend and Progress of Banking in India, various issues.

TABLE 30

ADVANCES OF SCHEDULED BANKS AGAINST THE SECURITY OF SUGAR
(in million rupees)

Serial Number	Year	February	April	June	August	October	December	Annual Average
1	2	3	4	5	6	7	8	9
	1957	443.9	578.8	583.0	430.0	281.4	264.0	426.1
	1958	502.3	634.3	536.8	367.0	215.7	192.8	413.1
	1959	430.8	569.4	459.0	280.7	132.9	206.2	346.5
	1960	533.0	781.4	719.4	545.0	362.0	475.5	554.5
	1961	733.3						761.4

NOTE: The data are inclusive of advances made to manufacturers and other exempted items. It has the same general limitations as in Table 26. The annual average of 1961 covers only the first quarter.

Sources: Trend and Progress of Banking in India, various issues; and Reserve Bank of India Bulletin, various issues.

production increased, the speculator's position was weakened, and prices began to stabilize. This led to complete revocation of credit controls in April 1961.

Cotton Textiles Including Yarn

Selective controls against cotton textiles and yarn were imposed in September 1956 and hurriedly withdrawn in February 1957. They were never reimposed. The principal reason for levying the controls was that bank advances in 1956 were appreciably higher than the previous year (see Table 31).

Credit controls consisted of raising the stipulated margins on existing and new loans by 10 per cent. However textile mills and exporters were exempted.

The Reserve Bank did not give reasons for withdrawing credit controls. Probably the decline in advances between December 1956 and February 1957 convinced the Reserve Bank that the need for credit controls no longer existed. This trend was, however, soon reversed and advances in 1957 exceeded the average for 1956. But this did not show up in the form of higher prices. In fact, in March 1958 prices for yarn were actually lower than the average of March prices in 1957 or 1956. The prices of cotton manufacturers were generally stable. This lends justification to the prompt reversal of policy, although the reasons were not obvious at that time.

Raw Jute and Jute Goods

Steady increase in advances against raw jute and jute goods and abnormal increase in their prices preceded the imposition of credit

TABLE 31

ADVANCES OF SCHEDULED BANKS AGAINST THE SECURITY OF COTTON TEXTILES INCLUDING YARN
(in million rupees)

Serial Number	Year	February	April	June	August	October	December	Annual Average
1	2	3	4	5	6	7	8	9
1	1955	380.7	364.5	341.4	355.8	371.0	363.8	359.8
2	1956	396.6	552.2	569.3	637.8	725.7	811.2	584.8
3	1957	721.7	757.5	763.9	788.7	887.1	863.1	780.4

Note: The data are inclusive of advances made against exempted items. The data have the same general limitations as in Table 26.

Source: Trend and Progress of Banking in India, various issues

controls, on December 12, 1960. This was the very end of the Second Five Year Plan, and the economy was in the grip of a strong boom. Prices of numerous other products had also risen, but the reason for picking the raw jute and jute industry for controls was their importance as earners of foreign exchange.[1]

This time the Reserve Bank did not exempt the jute industry from the application of control measures. However, the margin prescribed on loans to industrial firms was lower at 25 per cent of the value of securities offered compared to 40 per cent for all others. To soften the impact of these measures, the Reserve Bank fixed ceilings on aggregate advances at 130 per cent of the average level prevailing for the corresponding two-month period in 1960. In view of the high level of advances in 1960, this seemed reasonable enough.

Soon after the introduction of controls (December 28), the Reserve Bank agreed to relax margin requirements and ceiling limits in favor of few individual cases of genuine difficulty. This was another departure from the former practice of applying selective controls on a general basis with no relief provided to hardship cases. These controls were, however, met with strong opposition from organized business. So on February 24, 1961 the Bank was obliged to lower the margin requirement from 40 per cent to 25 per cent for established suppliers of raw jute and jute goods.[2] As before, banks were asked to accord higher

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[1]The sharp increase in the prices of raw jute was due to the decrease in output during the two previous years in succession. This was caused partly by reduction in the acreage and partly by unfavorable weather conditions.

[2]Reserve Bank of India Bulletin (March 1961), p. 356.

priority to exporters in allocating credit within the prescribed limits.[1]

Effect on Bank Advances

Table 32 shows advances against the securities of raw jute and jute goods during the busy season of 1960-61. This table shows that monthly advances on both kinds of commodities have remained generally stable after the introduction of credit restrictions. Although the total monthly advances show some increase from January through March 1961, they decline again in April. This shows that, on the whole, credit restrictions have had some steadying effect. However, the four-month period under review here is far too short to permit any safe conclusion.

Shares and Clean Advances

Credit controls on shares and clean advances were different from all other controls discussed in the previous two sections. All other controls were expected to influence the behavior of commodity prices. But control of shares and clean advances were introduced primarily to influence stock prices. Of the two, clean advances had been subject to moral suasion by the Bank. In fact, Bank directives on selective controls contained a request to banks not to lend clean advances to borrowers who might use it to frustrate the purpose of credit restrictions.

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[1] Trend and Progress of Banking in India, 1960, pp. 156-57.

TABLE 32

SCHEDULED BANK ADVANCES AGAINST RAW JUTE AND JUTE GOODS

(in million rupees)

	November 1960	December 1960	January 1961	February 1961	March 1961	April 1961
Raw Jute	162.0	195.7	228.3	218.0	228.5	187.6
Jute Goods	262.4	226.8	200.9	226.0	219.4	222.0
Total	424.4	422.5	429.2	444.0	447.9	409.6

Sources: Trend and Progress of Banking in India, 1960; and Reserve Bank of India Bulletin, various issues.

This shows that the Bank was fully aware that clean advances were in fact being misused by at least some banks. However, so far the Reserve Bank had refrained from specifying credit restrictions to check the scope of such misuse. Such restrictions would have been complementary to other selective controls and to some extent would have rendered them more potent. But until 1960 clean advances did not show any abnormal increase. This meant that the misuse of clean advances was not excessive. The most that could be happening was that some banks were redistributing them in favor of affected parties.

However, when the decision to restrict credit for speculation in the stock market was taken, it was obvious that these controls would have to be extended to clean advances. The Reserve Bank directive stated that in order to make "selective credit control generally more effective it is also considered necessary to restrain any significant expansion of clean loans by the bank."[1]

Prior to March 1960, the Reserve Bank had issued three directives to banks urging them to be cautious with respect to advances against the security of shares. But in view of a 14 per cent increase in one year in the index of variable dividend securities, the Reserve Bank decided to apply 50 per cent margins on shares other than preference shares and fixed ceilings on clean advances (see Table 33). Later the Bank agreed to consider individual cases of genuine difficulty where the parties concerned were either manufacturers or exporters. These

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[1]DBO No. Sch. 1899/C .218-(K)-60 dated March 11, 1960. Trend and Progress of Banking in India, 1960, p. 133.

TABLE 33

CREDIT POLICY WITH RESPECT TO SHARES AND CLEAN ADVANCES SUMMARIZED ACCORDING TO TIMING, OBJECT OF CONTROL, CONTROL MEASURES, AND GENERAL EFFECT

Serial Number	Date	Object of Control	Control Measures	General Effect
1.	April 22, 1957	Shares	Banks urged to be cautious in their lending policy.	
2.	July 10, 1958 and Aug. 25, 1958	Shares	Banks urged to scrupulously avoid giving advances against block shares and to parties "known to be speculatively inclined."	
3.	March 11, 1960	Shares and clean advances	(a) 50 per cent margins should be kept on all shares excepting preference shares and to all parties other than members of recognized stock exchanges. This is to be effective on or before April 11, 1960 for all other parties and June 11, 1960 for members of stock exchanges. Note: (The above restriction does not apply to individual credit limits up to 5,000 rupees. (b) The same margins shall apply on finance provided for "budla" transactions. (c) The ceiling on clean advances will be, beginning from April 1960, equal to the ratio of clean advances to total advances prevailing in the corresponding month of 1960. (d) Parties affected by this directive should be granted facilities by other means.	Restrictive
4.	March 17, 1960	Shares	Credit extended to stock brokers by way of purchase of their demand bills covering stock exchange securities to be dispatched from one center to another will be exempted from controls provided the bills are retired within a week of their purchase.	
5.	April 1, 1960	Shares and clean advances	The Reserve Bank will relax controls for individual cases of genuine difficulty where the parties concerned are either manufacturers or exporters.	

Source: Trend and Progress of Banking in India, various issues.

credit restraints were reinforced by quantitative controls introduced in May and September 1960.

The effect of these controls on advances against shares is not very perceptible. In fact the monthly advances in 1960 were above the corresponding figures in 1959. The average of monthly advances in 1960 was 965 million rupees as compared to 847 million rupees in 1959, which is an increase of about 14 per cent. The average of the first four months in 1961 was higher still (see Table 34). But clean advances declined in 1960, although they started rising in 1961. However, they again remained within the ceilings prescribed by the Reserve Bank. Therefore, technically the Bank directives were carried out.

The effect on share prices was not felt. The index number of variable dividend securities started falling from August 1960 and continued to do so until January 1961.[1] However, from January onward the index steadily went up. It appears that the bullish trend in the stock market which had been apparent since 1958 had suffered a temporary break in the second half of 1960. With the beginning of the new year it had resumed.

VI

The Effectiveness of Selective Controls

The above account shows that, in a purely technical sense, selective controls in India have been fairly successful. Judged by the published

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[1]See Report on Currency and Finance, 1960-61, Statement 48.

TABLE 34

BANK CLEAN ADVANCES AND AGAINST THE SECURITY OF SHARES
(in million rupees)

Year		February	April	June	August	October	December	Annual Average
1		2	3	4	5	6	7	8
1959	C	1238	1368	1358	1326	1464	1399	1356
	S	822	851	828	831	864	912	847
1960	C	1340	1276	1286	1244	1232	1261	1298
	S	969	970	989	985	955	925	965
1961	C	1724	1655					1675
	S	1015	1052					1026

NOTES: Figures in Column 8 are averages of 12 months. For 1961 the averages are for the first four months of the year. These data include advances made against exempted items.
Letters "C" and "S" stand for clean advances and advances against shares, respectively.
Clean advances are calculated by substracting the total secured outstanding advances at the end of the month from the total of all advances for all scheduled banks outstanding on the last Friday of the month.

Sources: Trend and Progress of Banking in India, various issues; and
Reserve Bank of India Bulletin, various issues.

date it seems that scheduled banks complied with the directives issued by the Reserve Bank and to that extent contributed to the success of monetary policy. It also seems, as will be seen in the next chapter, that scheduled banks, taken together, had succeeded in diverting credit from the trading sector to the industrial sector. This result was in accordance with the policies of the Reserve Bank.

On the other hand, controls stipulated in the directives were generally mild and seemed to have been drawn in awareness of the business needs of scheduled banks and their clients. This obviously rendered it easier for banks to comply with the provisions of Bank directives. The Reserve Bank, true to its policy, was mainly concerned with controlling the pace of expansion rather than halting it completely. In this respect its policy was not to restrict the availability of credit "for the legitimate needs of industry and trade" but only to dampen speculative activities, to the extent that it could be done by reducing the supply of bank credit. In this limited sense Reserve Bank's policy should be considered a success. It is, however, difficult to say whether scheduled banks would have shown the same spirit of obedience if the control measures had been relatively harsher. Perhaps at the present stage of development of banking the Reserve Bank was wiser in not testing its strength and in the process jeopardizing the spirit of cooperation that has come to exist between the banks and itself.

However, it does seem that the Reserve Bank waited for months before it could decide whether controls should be instituted and, if so, in what form. This was perhaps inevitable considering that the Reserve Bank wanted to be sure that prices were on a rising trend and that

speculation financed by bank credit was a contributory cause. This caution was, at least in part, due to paucity of reliable economic intelligence and, in part, due to lack of experience on the part of the Reserve Bank in the area of selective controls. Moreover, with each new selective control, the Reserve Bank would have to create the requisite administrative machinery which would supervise the banks with respect to compliance with control directives. Doing otherwise would certainly have been an invitation to general disobedience. But experienced officials with the Reserve Bank are only in limited supply. This factor in itself must partly account for the delay in instituting new controls. In view of these general considerations it is rather doubtful that the Reserve Bank could have achieved significantly more than it actually did.

VII

Conclusions

As discussed previously, selective controls were the chief instruments through which the Reserve Bank gave effect to its policy of "controlled expansion." It has been concluded here that purely from the technical point of view the provisions of the Reserve Bank directives on selective controls were carried out. This shows that the Reserve Bank--with little experience in this matter prior to the Second Plan--was successful in eliciting the cooperation of scheduled banks. This is by no means a mean achievement. But this was not the objective of selective controls. The main purpose was to stabilize prices. In this respect selective controls did not attain their goal. In defense, the

Reserve Bank authorities have argued that . . .

> the effectiveness of monetary policy cannot be assessed precisely by reference to the behavior of general and sectional price levels which are dependent upon a variety of other factors bearing both an aggregate and individual demand and supply position.[1]

The implication was that the Reserve Bank could not be expected to stabilize prices because it did not have the power to control all the factors that determine the supply and demand for goods, either in the aggregate or in individual markets. But the principal cause of failure was not that the Reserve Bank was not omnipotent, but that selective controls did not receive the necessary support from general controls. However, in 1960 the Reserve Bank had realized that

> . . . the buttressing of selective controls by quantitative restrictions was warranted not only by the inherent limitations of selective controls but also by indications that the expansion of aggregate money demand has been one of the important inflationary factors at work.[2]

Even with the support of quantitative credit controls, the selective controls could have succeeded, at best, in restraining individual prices rather than in reducing or completely stabilizing them. But then it would have been confidently concluded that but for the functioning of selective controls, prices would have risen faster. As of now, one cannot make this assertion with confidence.

It should be said to the credit of the Reserve Bank that it used selective controls with flexibility and improvised with new techniques to render selective controls more effective. In 1960, when selective controls were most far reaching in their coverage, they probably had

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[1] Reserve Bank of India, Report of the Central Board of Directors for the year ended June 30, 1960 (Bombay, August 1960), p. 14.

some restraining effect on the aggregate volume of credit. The effect of selective controls was even more pronounced in 1960 on the composition of credit. These conclusions are based on rather rough calculations which show that the annual average level of credit against commodities affected by selective controls in 1960 amounted to more than 21 per cent of total bank credit. But nearly 60 per cent of bank credit was going to trade and commerce.[1] The principal conclusion, therefore, is that the main effect of selective controls was felt on the composition of credit rather than on individual prices. However, this was not the ostensible purpose for introducing selective controls.

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[1]These calculations are rough because the totals of bank credit affected by selective controls is the average of fortnightly figures published by the Reserve Bank. These figures are based on reports on advances made against principal securities by bank offices whose number generally varies. The figure of total bank credit is the annual average of Fridays. As for the total of bank credit going into "trade and commerce," the figure is the average of data reported by a different number of banks in surveys conducted on April 29 and October 28. The percentages in the text should, therefore, be treated as orders of magnitude rather than as precise estimates.

CHAPTER VI

GROWTH AND COMPOSITION OF BANK CREDIT

I

In this chapter the effects of monetary policy on the availability and cost of credit, as well as on its distribution between important users, will be discussed.[1] Since the objective of monetary policy was to use bank credit for furthering the goals of the Second Five Year Plan, we will evaluate these effects against the same criterion. Specifically, monetary policy in relation to the banking system (consisting of scheduled banks only) will be considered successful if banks are forced to ration credit and lend an increasing proportion of a growing volume of credit to the "productive" sectors of the economy.

Since both the monetary policy and the lending policy of banks (pertaining to loans and advances) are related to the investment portfolio and the liquidity of the entire asset mix, the theme of this

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[1]The term "availability" is used in this thesis to mean the quantitative increase in the amount of bank credit made possible by an increase in the reserves of the banking system. It has not been used to denote the quality of credit. In the latter sense an increase in the availability of credit implies relaxation of the credit standards by banks while a decrease in it is taken to mean that the lenders' standards have tightened. Thus, an increase in the availability of credit is associated with the lowering of interest rates by the lenders and a greater willingness on their part to accommodate the borrowers. On the other hand, a decrease in it would signify higher interest rates, or an enforcement of credit rationing by the banks.

chapter will directly lead to the next two chapters. Therefore the conclusions at the end of this chapter may be deemed to be tentative.

Absolute Increase in Bank Credit

The availability of bank credit can be considered in several ways. Annual increases in bank credit, followed by seasonal variations in it, will be discussed. But these are not satisfactory measures of availability. Availability measured in relation to demand for it can be better indicated by the ratio of bank credit to national income. This ratio will show the proportion of national expenditure financed through recourse to bank credit. On the other hand, availability measured in relation to bank resources can be indicated by the ratio of bank credit to aggregate deposits and to deposits excluding P.L. 480 funds (see Table 35).

In absolute terms annual bank credit had started rising from 1953. Between 1955 and 1960 bank credit (= loans and advances + bills discounted) went up from slightly above 6 billion rupees to more than 11 billion rupees. The increase was not uniform and appears to have varied mainly with changes in demand for it. Thus in 1956, 1957, and 1960 the annual increase was over 1 billion rupees; in 1959 it was moderate at slightly less than 700 million rupees, while in 1958 the increase was rather small at 190 million rupees only.

This uninterrupted increase has been made possible mainly by rising deposit resources. Banks were also aided by the Reserve Bank, directly by lending to them and indirectly by letting the ratio of required reserves fall from 3.8 per cent in 1955 to 3.3 per cent in 1959.

TABLE 35

AGGREGATE DEPOSITS, BANK CREDIT, AND RELATED DATA (SCHEDULED BANKS ONLY)

Serial Number	Year (average of Fridays)	Number of Reporting Banks	Aggregate Deposits (in million rupees)	Required Reserves (in million rupees)	Aggregate Deposits Excluding P.L. 480 Funds (in million rupees)	Borrowings from the Reserve Bank (in million rupees)	Aggregate Bank Credit (in million rupees)	Percentage of (8) to (4)	Percentage of (8) to (6)	Percentage of (7) to (8)
1	2	3	4	5	6	7	8	9	10	11
1	1955	89	9,809.8	378.0 (3.8)	9,809.8	177.0	6,039.0	61.5	61.5	2.9
			+879.9		+660.2	355	+1,401.0			
2	1956	89	10,689.7	408.1 (3.8)	10,470.0	532.0	7,440.0	69.5	71.0	7.1
			+1,803.0		+1,390.0	44	+1,297			
3	1957	91	12,492.7	467.8 (3.7)	11,860.0	576.0	8,737.0	69.9	73.6	6.5
			+2,523.0		+1,320.0	-414	+190.0			
4	1958	93	15,015.7	535.1 (3.5)	13,180.0	162.0	8,927.0	59.4	67.7	1.8
			+2,187.8		+1,560.0	23	+692.0			
5	1959	94	17,203.5	575.4 (3.3)	14,740.0	185.0	9,619.0	55.9	65.2	1.9
			+1,929.5		+920.0	199	+1,452.0			
6	1960	94	19,133.0	833.9 (4.3)	15,660.0	384.0	11,071.0	57.8	70.6	3.4

NOTE: Figures in parenthesis in Column 5 are percentages of (5) to (4).

Sources: Trend and Progress of Banking in India, various issues; Statistical Tables Relating to Banks in India, various issues; Reserve Bank of India Bulletin (August 1961), p. 1223.

The ratio of borrowings from the Reserve Bank to bank credit shows two things: first, it may be used as a measure of the direct contribution by the Bank to credit expansion, and second, as an indicator of the attitude of Reserve Bank authorities. In addition, changes in this ratio can also be interpreted as marking shifts in the attitudes of scheduled banks. The last interpretation is especially important because until recently scheduled banks were generally self-sufficient. Also when in need they preferred to borrow from the State Bank of India rather than from the Reserve Bank. However, gradually this attitude has been changing.

As Column 7 shows, the largest increase in Reserve Bank lending to scheduled banks took place in 1956. The ratio of borrowings from the Reserve Bank to bank credit, at 7.1 per cent, is also the highest for the entire period. This was because of three factors. First, the demand for bank credit was far in excess of growth in deposit resources. Second, the Reserve Bank's credit policy was passive, there being no restrictions on the amounts that banks could borrow. Third, banks had to borrow to replenish cash assets which had been running low. Thus, inclusive of borrowings from the Reserve Bank, the ratio of cash at hand and balances with the Reserve Bank to deposits had fallen in 1956 8.2 per cent, as compared to 8.8 per cent in 1955 and 9.5 per cent in 1954.[1]

But in 1957 and 1959, when the increase in deposits was large in relation to the demand for credit, banks borrowed relatively small

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[1]"Consolidated Position of Scheduled Banks in India," Trend and Progress of Banking in India, 1960, pp. 56-61.

amounts only. In 1958, as the demand for loans stagnated, banks actually reduced their indebtedness. The year 1960 is somewhat exceptional. This was the only year when tighter general controls had raised the ratio of required reserves on the one hand and discretionary lending had supplied funds to banks on the other. In this year the Reserve Bank lending policy was to some extent an active determinant of the size of bank credit. Through this policy the Bank was trying to soften the impact of higher reserve requirements so as to enable banks to maintain a steady flow of credit for productive users.

Seasonal Variations in Bank Credit

Even though bank credit grew from year to year, it showed substantial seasonal fluctuations. These fluctuations are recorded in Table 36).

As explained in Chapter 4, the Reserve Bank devised a novel method of controlling bank credit expansion by asking leading banks at the close of the busy season to bring down the aggregate outstanding credit during the ensuing slack season by a specified amount. This would raise cash balances with banks and enable them to subscribe to new government loans which are ordinarily floated in the slack season. Alternatively, they could buy government securities from the portfolio of the Reserve Bank or reduce their indebtedness. The Bank also believed that in this way the increase in the annual average of outstanding credit would be somewhat dampened.

Table 36 shows that the expansion in the busy seasons of 1959 and 1960 was greater than in the preceding two years. The increase in

TABLE 36

SEASONAL BANK CREDIT EXPANSION (SCHEDULED BANKS ONLY)
(in million rupees)

Period	1955	1956	1957	1958	1959	1960	1961
January - April	+856.0	+1,214.0	+1,207.0	+994.0	+1,548.0	+1,659.0	+1,276.0
May - October	-316.0	+37.0	-419.0	-1,176.0	-790.0	-203.0	
November - December	+431.0	+277.0	-101.0	+267.0	+231.0	+710.0	

NOTES: Broadly speaking the period November-April is called the "busy season" and the remaining period, i.e., May-October is called the "slack season."
Bank credit is defined to include (i) inland bills purchased and discounted, (ii) foreign bills purchased and discounted, and (iii) loans, cash credits, and overdrafts. Item (iii) is inclusive of "due from banks."
The latter has been included because the data pertaining to it have been separately available since November 25, 1960 only. The data for 1955 have been compiled to correspond to this definition.

Sources: This table is compiled from the "Consolidated Position of Scheduled Banks in India," Trend and Progress of Banking in India, various issues; and Reserve Bank of India Bulletin (May 1961), p. 745.

bank credit during these busy seasons was primarily in response to the expanding industrial sector and was partly aided by the Reserve Bank. The years that were marked by the greatest advance in the economy were also characterised by stronger busy seasons. However, the increases in bank credit during busy seasons were not fully offset by the contractions during slack seasons. It also appears that the expansion of the industrial sector has tended to weaken bank credit contractions during the slack seasons. Thus, in 1959 and 1960 the contractions in bank credit against seasonal commodities were more than offset by expansions against nonseasonal commodities.[1]

II

Bank Credit and National Income

The ratio of bank credit to national income at market prices may be expected to rise in the long run as the economy develops and becomes more monetized. This may happen because industrial expansion is likely to be accompanied in India with rapid growth in the number of business firms and relatively slower growth in the capital market.[2] Other structural factors, such as the degree of vertical integration in the business sector and changes in the payment practices in the economy,

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[1] See Trend and Progress of Banking in India, 1960, pp. 11-12; and Report of the Central Board of Governors of Reserve Bank of India for the Year Ended June 30, 1959 (Bombay, August 1919), p. 6.

[2] During the Second Plan the capital market has shown significant progress; but it still cannot adequately meet the capital needs of the private sector. The record of accomplishments and a discussion of remaining problems is given with full documentation in S. L. N. Simha, op. cit., pp. 42-207.

will also affect this ratio. The structural changes in the economy are likely to operate over long periods of time. In India this ratio increased from 6.3 per cent in 1955-56 to 8 per cent in 1960-61 (see Table 37). This rather substantial increase cannot be solely due to the long-run changes taking place in the economy. More plausibly these are due to shorter-run variables which operated during the Second Plan.

TABLE 37

RELATIONSHIP BETWEEN BANK CREDIT AND NATIONAL INCOME
(in million rupees)

Year	National Income at Market Price	Bank Credit	Percentage of (3) to (2)
1	2	3	4
1955-56	99,800	6,325	6.3
1956-57	113,100	7,816	6.9
1957-58	113,900	8,908	7.8
1958-59	126,000	8,991	7.1
1959-60	128,400	9,875	7.6
1960-61	145,000	11,602	8.0

Sources: Estimates of National Income, 1948-49 to 1959-60, op. cit., p. 1; Report on Currency and Finance, 1960-61, Statement 28; Reserve Bank of India Bulletin (September 1961), p. 1389.

The increase in the ratio of bank credit to national income from 1955-56 to 1960-61 appears to have been determined by four observable variables. There may be others, too, but the ones listed below are the easiest to identify:

(i) High level of investment in the private sector.

(ii) Increase in speculative activity in the trading and financial sectors.

(iii) Increase in the level of business taxation.

(iv) Easy monetary policy over most of the plan period.

Considering the high level of private investment first, it may be noted that during the Second Plan period it was 83 per cent above the level during the First Five Year Plan.[1] Thus the average annual rate of investment in the private sector during the Second Plan was 6.6 billion rupees as compared to only 3.3 billion rupees during the First Plan. Along with the increase in investment there was bound to be an increase in the demand for working capital, most of which was likely to come from banks.

On speculative activity no figures can be cited. But we can accept the judgment of the Reserve Bank repeatedly expressed in directives to scheduled banks and formalized in selective controls discussed in the previous chapter. The Bank, however, excluded the industrial sector (with the exception of the jute industry) from the coverage of selective controls on the plausible assumption that they did not participate in speculation. It is, nonetheless, quite plausible that some industries might have been engaged in speculative buying of raw materials or semifinished products which was probably financed, in part, by bank credit. This is, however, only a possibility and in the light of the Reserve Bank's judgment was perhaps not very significant.

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[1] "Third Five Year Plan of India," Reserve Bank of India Bulletin (September 1961), Table 2, p. 1391.

As far as taxes on business are concerned, a rough indication can be given by the increases in revenues from the corporation income taxes and the union excise taxes. Between 1955-56 and 1960-61 the yield from the former rose from 370.4 million rupees to 1110.5 million rupees, or by 200 per cent. Over the same period the revenue from excise taxes levied and collected by the union government went up from 1452.5 million rupees to about 4163.5 million rupees, or by 186.7 per cent.[1] Increase in business taxation of such an order was bound to produce ways and means problems in the private sector. Moreover, at a time when the investment climate seems to be good and profitable opportunities are plentiful, investors are generally expected to supplement their resources by borrowings from banks. Higher taxes are likely to accentuate this tendency. Therefore, in principle one might expect that a rise in the level of taxations, if accompanied by a rise in investment, will lead to greater reliance on borrowings. If the capital market is not sufficiently well developed as is the case in India, then the investors will have to lean on banks. As will be seen in Section V, banks in fact have been lending an increasing proportion of their resources to industries.

In this connection it may be mentioned that profits in the industrial sector have, with the exception of 1957, grown throughout the Second Plan period. Thus, aggregate profits before taxes of 1,001 selected public limited companies increased from 1.18 billion rupees in

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[1]See "Revenue and Expenditure of Government of India (on Revenue Account)," Report on Currency and Finance, 1960-61, Statement 57; and Reserve Bank of India Bulletin (April 1962), p. 524.

1955 to 1.87 billion rupees in 1960. However, gross profits as percentages of sales have remained generally stable. This ratio declined from 10.3 per cent in 1955 to 8.0 per cent in 1957 and then moved up to 10.2 per cent in 1960.[1] Increased taxes have rather deeply cut into profits. For the same 1,001 public limited companies, excise duty payments increased from 681 million rupees in 1955 to 1.80 billion rupees in 1960 or by more than 165 per cent. The provision for corporate income tax over the same period increased from 503 million rupees to 719 million rupees or by 42.8 per cent.[2] High taxes, however, with the possible exception of 1957-58, did not adversely affect the optimistic expectations of investors.

In this respect the role of monetary policy was to render the task of banks relatively easier. This was done through a policy of quantitative ease combined with increased facilities to the industrial sector.[3] The policy of selective restriction as discussed in the previous chapter did dampen somewhat the quantitative expansion of credit. But on the whole the restrictive effect was weaker.

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[1]See Reserve Bank of India Bulletin (September 1961), p. 1403; ibid., June 1962, p. 841.

[2]Ibid., p. 847.

[3]In support of the contention that the policy of the Reserve Bank was one of quantitative ease two facts can easily be cited as evidence. First, the ratio of required reserves to the aggregate deposits was allowed to fall from 3.8 per cent in 1956 to 3.3 per cent in 1959. It went up to 4.3 per cent in 1960, when the policy was actively restrictive (see Table 35). Second, the scheduled banks could sell government securities to the Reserve Bank at their initiative and then secure excess reserves in the desired amounts. As stated earlier in this thesis, the policy of the Reserve Bank with the exception of 1960-61 was one of general ease and selective tightness.

A word of caution should be said at this point. The ratio of bank credit to national income or a measure of elasticity of national expenditure with respect to percentage change in bank credit can be quite misleading. This is because bank credit finances no more than a small fraction of the output produced in the urban areas. But national income is most sensitive to variation in agricultural production, which is hardly touched by bank credit. Therefore, ratios for individual years, whether high or low, do not furnish much useful information that can provide added insight into the role of bank credit in the national economy. Nevertheless, a trend in the ratio can be treated as a significant pointer to the changing importance of bank credit.

III

Bank Credit and Aggregate Deposits

From the point of view of banks the ratio of bank credit to deposits furnishes an operational guide to their lending policy. Banks would like to raise this ratio as much as possible subject only to the conventional limits set by prudent considerations for liquidity and solvency. For the same reasons this ratio is of interest for the banking policy of the central bank. Depending upon the customs and traditions in a country the central bank tries to safeguard the interest of banks, the depositors, and the economy by encouraging banks to remain within certain limits. However, once it becomes an accepted practice with banks not to exceed these boundaries set by principles of sound banking, the ratio of bank credit to deposits can be used as a convenient tool of monetary policy.

Under conditions of boom when actual investment is outrunning planned savings, the central bank can apply a brake on spending by reminding commercial banks to rigidly adhere to the standards of sound banking, i.e., to limit bank credit to the specified proportion to deposits. Thus a move supposedly made in the interest of sound banking will in fact function as a tool of restrictive monetary policy. The Reserve Bank, however, has no legal power to enforce a given ratio on all banks. Moreover, some banks have a strong capital base and are sufficiently experienced in the business of banking to warrant the expansion of loans and discounts beyond the traditional limit. It is also conceivable that this can be done without jeopardizing their liquidity. Foreign banks operating in India generally fall in this category. Their banking operations sometimes appear very risky as compared to the normal standards of soundness which are perhaps more relevant to the Indian banks. In fact among Indian banks themselves it may be neither fair nor even feasible to prescribe a maximum ratio of bank credit to deposits for the large and the small banks alike.

In another situation the Reserve Bank may want to allow further increases in the bank credit ratio. This may be justified for the realization of the planned investment targets. However, if banks in general are already operating close to the conventional ceiling the Reserve Bank will be in a quandary. The way out of the predicament is that the Reserve Bank should insist on a higher capital to deposits ratio. This is necessary to save banks, particularly the smaller ones, from insolvency when adverse business conditions develop later on. In other words, it does not suffice for a central bank to merely raise the

ceiling on the bank credit ratio; it should also take further steps to harmonize it with the principles of sound banking. This can be done by raising the ratio of capital funds to total deposits which in turn will facilitate further increases in the bank credit ratio. This shows that the principles of sound banking are flexible in the upward direction. It also means that a possible conflict between a policy of quantitative ease and sound banking can be averted by raising the capital to deposit ratio and the bank credit ratio at the same time. But if a policy of quantitative restriction is desired, a rigid adherence to sound banking may prove neither convenient nor equitable.

The Reserve Bank of India began to face these problems towards the end of the Second Five Year Plan. The Governor of the Reserve Bank warned bankers not to get into "over-loaned" positions. At the same time he asked them to strengthen their capital and reserves base in order to better face the opportunities presented by the Third Five Year Plan. An indication of what might be considered an "over-loaned" position was given by citing the ratio figures in the U.K. and the U.S.A., where banks ordinarily do not go beyond fifty to fifty-five.[1]

Judged by this standard it appears that the scheduled banks have remained systematically over-loaned during every year in the period 1955 to 1960. In Table 35, these ratios are calculated with respect to two series of aggregate deposits. One is shown in Column 4 which is subject to reserve requirements. This is inclusive of P.L. 480 funds which were mostly invested in special government securities. The second is given

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[1]See Reserve Bank of India Bulletin (August 1961), pp. 1220-26.

in Column 6 and is the same as Column 4 but excludes P.L. 480 funds. Corresponding ratios to bank credit are shown in Columns 9 and 10, respectively.

These ratio columns show similar patterns. The ratios rise from 1955 to 1957, then fall in the next two years, and finally rise again in 1960. In particular, the behavior of the ratio of bank credit to deposits excluding P.L. 480 funds is the most instructive. Throughout the period it remained above 65 per cent.[1] But the Reserve Bank did nothing to check it. How is this to be explained?

The Reserve Bank did not act in this matter because it seemed to have been caught in a dilemma. It had to choose between a conventional principle of sound banking, which would have limited the expansion of bank credit, and its monetary policy, which was kept deliberately loose so as to enable the private sector to fulfill the investment and production targets of the Second Five Year Plan. Either choice would have involved a high opportunity cost. A more conventional banking policy might have been more stabilizing but would have limited the growth of private industrial sectors. From a broader point of view, the credit restriction which this policy would have entailed might have hurt small and newly-emerging industries more than large industries with an established credit reputation. So the Bank chose the course of easy monetary policy and shelved the questions of banking policy until

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[1]During the First Plan period (1951-55, both years inclusive) the average ratio of bank credit to total deposits was 61.0 per cent. During the Second Plan period (1956-60) the average ratio of bank credit to aggregate deposits (exclusive of P.L. 480 funds) was 69.6 per cent. Thus even though scheduled banks were over-loaned during the First Plan period, they were much more so during the Second Plan period.

commencement of the Third Plan. By doing so the Bank contributed, even though marginally, to the overfulfillment of investment targets in the private sector. At the same time this policy added some fuel to inflation. However, in retrospect it seems that the Bank chose the better alternative and the risk taken in deciding not to enforce the banking principle was not excessive.

IV

The Relative Position of Banks

Even though the Reserve Bank did nothing to control the bank credit deposit ratio, individual banks had to operate with due regard to the interests of depositors and of the share holders. At the same time they had to be watchful about the possible reaction of the Reserve Bank. But with all these considerations some banks feel greater freedom in lending than others. Similarly some banks will take greater advantage of Reserve Bank's lending facilities than other banks. It is, therefore, reasonable to think that the bank credit/deposit ratio will differ from bank to bank. However, in principle there is no reason why banks with larger deposit resources should show lower bank credit/deposit ratio than smaller banks, or that there should be any difference between Indian and foreign banks having approximately the same deposit resources. But in practice these differences are quite noticeable. Larger banks tend to be more conservative in their lending policies and maintain lower credit ratios than smaller banks. This is presumably because either the latter are more aggressive competitors and less mindful of greater risks involved or are relatively better situated with regard to capital and reserves. In the following paragraphs these differences are

explored, at first between all scheduled banks classified according to the size of deposits and later between Indian and foreign banks in each class. The data pertaining to them are tabulated in Tables 38 and 39.

Table 38 shows the behavior of this ratio for the period 1955 to 1960 for four classes of scheduled banks. In class A each bank has deposits in excess of one billion rupees; in class B each bank has deposits in excess of 250 million rupees but less than one billion rupees; in class C each bank has more than 50 million rupees but less than 250 million rupees; class D consists of banks having less than 50 million rupees in deposits each. Finally class E consists of all scheduled banks. There is an adjoining column for every class showing the number of banks in a given year.

In 1955 two class A banks had 31.3 per cent of deposits of all scheduled banks; but in 1960 four such banks accounted for 52.4 per cent. The share of ten class B banks in 1955 was 43.8 per cent which went down to 28.6 per cent in 1960 for eleven such banks. The number of class C banks went up from eighteen in 1955 to twenty-one in 1960; however, their collective share in total deposits declined from 17.7 per cent to only 13.7 per cent. The performance of class D banks was scarcely better. Their number declined from fifty-nine in 1955 to fifty-seven in 1960 and their share in deposits fell from 7.7 per cent to 5.3 per cent.[1]

It appears, therefore, that class A banks have gained at the expense of all others. This class is, however, dominated by the State

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[1]These percentages have been calculated from the data pertaining to "Liabilities and Assets in India of Banking Companies, 1955-60," Trend and Progress of Banking in India, 1960.

TABLE 38

THE RATIO OF BANK CREDIT TO AGGREGATE DEPOSITS BY THE SIZE CLASS OF BANK DEPOSITS
(SCHEDULED BANKS ONLY)

(in percentages)

As on the Last Friday of the Year	Number of Reporting Banks (A)	(A) Banks with Deposits of 1 billion rupees and above	Number of Reporting Banks (B)	(B) Banks with Deposits over 250 million rupees but less than 1 billion rupees	Number of Reporting Banks (C)	(C) Banks with Deposits over 50 million rupees but less than 250 million rupees	Number of Reporting Banks (D)	(D) Banks with Deposits of less than 50 million rupees	Number of Reporting Banks (E)	(E) All Scheduled Banks
1	2	3	4	5	6	7	8	9	10	11
1955	2	50.9	10	63.8	18	67.3	59	69.9	89	60.8
1956	3	59.6	9	80.1	21	76.0	56	79.0	89	70.8
1957	3	53.7	9	74.7	23	61.5	56	83.8	91	63.2
1958	3	45.0	10	63.7	23	58.9	57	75.2	93	54.8
1959	3	40.0	12	63.3	24	59.4	55	74.4	94	52.2
1960	4	55.3	11	70.5	21	66.8	57	80.4	93	62.5

NOTES: The data are for the end of the year rather than averages of Fridays as in Table 35. Therefore, neither the absolute amounts nor the ratios that pertain to them are identical in the two tables. Bank deposits in Columns 3 and 11 are inclusive of P.L. 480 funds.
In the text each class of banks will be referred to by the capital letters given on top of each column.

Source: This table has been compiled from Trend and Progress of Banking in India, 1960, Statement 5.

TABLE 39

THE RATIO OF BANK CREDIT TO AGGREGATE DEPOSITS FOR THE STATE BANK OF INDIA, INDIAN AND FOREIGN BANKS CLASSIFIED ACCORDING TO SIZE OF DEPOSITS (SCHEDULED BANKS ONLY)
(in percentages)

	A			B				C				D				E			
Year	State Bank of India	Number of Banks	Other Banks (All Indian)	Number of Banks	Foreign	Number of Banks	Indian	Number of Banks	Foreign	Number of Banks	Indian	Number of Banks	Foreign	Number of Banks	Indian	Number of Banks	Foreign	Number of Banks	Indian
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18	19	20
1955	48.1	1	56.8	3	46.6	7	60.7	5	91.1	12	59.9	10	154.1	51	61.9	17	86.3	72	56.6
1956	59.5	2	60.1	3	67.9	6	74.8	6	104.5	15	61.5	8	199.0	48	62.2	17	107.6	72	64.3
1957	47.3	2	61.3	3	101.3	7	64.1	5	69.8	18	54.8	9	146.8	47	62.3	17	95.1	74	57.1
1958	35.9	2	57.9	3	79.2	7	60.5	4	71.1	18	53.5	9	122.7	48	58.0	16	81.7	77	50.8
1959	28.6	2	60.6	3	74.2	10	62.1	5	65.5	19	53.8	8	111.9	46	60.3	16	75.6	78	49.4
1960	40.2	3	55.0	3	82.4	9	66.6	4	84.5	16	57.5	9	140.7	48	64.0	16	88.3	77	58.6

NOTES: These ratios have been calculated on the basis of detailed data for individual and groups of banks. The data are as published in the annual balance sheet of each bank. Therefore, they are different from those used in Table 38.

Source: Statistical Tables Relating to Banks in India, 1955-60.

Bank of India (formerly the Imperial Bank of India) which has always been a giant among banks and has lately been rapidly expanding. It, therefore, deserves special attention.

Table 38 shows that differences exist between class A and all other classes. The ratio is lower in class A in every year compared to any other class and for all banks taken together. But the range of variations in this ratio is much greater in class A than for any class or for all banks. Class D banks maintain the highest ratio and do so with the least variation. Between class B and class C banks the relationship is reversed. The ratio is generally higher in the former, but the variation from year to year is about the same. The picture as it emerges from Table 4 is one of important differences in attitudes and policies of banks placed in different classes. This picture is, however, misleading. To bring the matter to a better focus each class has been further subdivided between Indian and foreign banks (see Table 39). The State Bank of India has also been separated from other class A banks. But the subsidiaries of the State Bank are included in other classes.

Comparison Between Indian and Foreign Banks

All foreign banks are in classes B, C, and D. Table 39 brings out the differences in the ratio of bank credit/deposits between Indian and foreign banks in each of these classes and for all banks (class E). It will be seen that, in general, this ratio is higher in foreign banks in every class compared to Indian banks. The only exception is class B in the years 1955 and 1956. Furthermore, class D foreign banks maintain

higher ratios in every year as compared to foreign banks in any other class. The same thing cannot be said for class D Indian banks. In fact, class D Indian banks are scarcely different from Indian banks in other classes. It is the behavior of foreign banks which puts class D above all other classes.

Among Indian banks this ratio is generally higher in class B than any other class, including class A. The yearly variations are also the greater in class B than in any other class. But if one omits 1956 when the ratio in class B Indian banks reached the peak figure of 74.8, which was not exceeded by any other class in any year, the picture is one of greater stability.

It follows from Table 39 that the concern for sound banking is more relevant for foreign banks than for Indian banks. Also, foreign banks have more fully exploited increased business opportunities than Indian banks. The instability of this ratio in foreign banks in all classes probably shows the extreme elasticity of their operations. Furthermore, it appears that for foreign banks the upper limit to loans is set by the level of demand rather than by any conventional considerations for liquidity and solvency.

There are four reasons which can account for this phenomenon. First, foreign banks with their headquarters located abroad have higher capitalization and therefore can afford to take greater risks. Second, foreign banks can better safeguard their liquidity position by bringing in funds from their head offices, whenever needed. Moreover their prestige and reputation being high, the danger of runs on them can be safely excluded. This very safety and feeling of security enables them to

operate with low secondary reserves and lower cash ratios. Third, foreign banks have an almost exclusive preserve of business in foreign bills. Since these bills are short term and self-liquidating banks dealing in them can afford to maintain lower cash reserves. Fourth, foreign banks have varied experience and wide contacts which gives them a competitive advantage over many Indian banks. In addition there is the aggressive spirit and keen competition among foreign banks which probably explains higher ratios in classes C and D. Incidentally, all C and D foreign banks are non-British.

The State Bank of India

The distinctive feature of class A banks is principally due to the inclusion of the State Bank of India. This bank in spite of its vast deposit resources and unassailable integrity has consistently maintained lower ratios of bank credit to deposits than other class A banks. This is partly due to traditional conservatism and partly due to other reasons. First, the State Bank is expected to maintain a higher ratio of investment in government securities to total deposits than other banks. This, in a way, brings greater assurance to the government that its debt flotations will be adequately subscribed to outside of the Reserve Bank which of course is always ready to take up the unsubscribed portion. Second, this bank, in view of its closeness to the Reserve Bank, is generally expected to follow monetary policy with greater sincerity than other banks. This presumably also involves a willingness to sacrifice prospective profits. Third, the State Bank has been following a policy of branch expansion in areas where banking facilities are

either inadequate or nonexistent. This means that branches are being opened with high administrative costs and low profitability. This is so because a credit-worthy bank clientele has not yet fully emerged, which naturally limits the scope of credit creation. Lastly, it is possible that in view of its government ownership the State Bank has been deliberately following a policy of not engaging in aggressive competition with privately-owned banks and bidding away their customers. These reasons tentatively suggest that the State Bank has been deliberately avoiding the policy of profit maximization for the sake of some larger interests. If so, this alone is a sufficient justification for putting this bank in a separate class.

V

The Cost of Bank Credit

Increased availability of credit does not necessarily mean that the money market is replete with funds nor does it imply that interest rates are falling. In India quite the opposite was true. As bank credit/deposit ratio rose, the banks found it harder to raise it further. As the market became tight, interest rates began to move up. Table 40 shows the percentage of total advances of fifteen scheduled banks at various rates of interest. These banks account for more than 75 per cent of the total deposits for all scheduled banks. The data are based on half-yearly surveys conducted by the Reserve Bank. In interpreting the trend it should be borne in mind that June falls in the midst of the slack season while December lies in the middle of the busy season. Therefore, comparisons should be made between Decembers or between Junes.

TABLE 40

PERCENTAGE DISTRIBUTION OF BANK ADVANCES AT VARIOUS RATES OF INTEREST FOR FIFTEEN SCHEDULED BANKS

Rates of Interest	June 1956 (percentage to total)	December 1956 (percentage to total)	June 1957 (percentage to total)	December 1957 (percentage to total)	June 1958 (percentage to total)	December 1958 (percentage to total)	June 1959 (percentage to total)	December 1959 (percentage to total)	June 1960 (percentage to total)	December 1960 (percentage to total)
1	2	3	4	5	6	7	8	9	10	11
Up to 2%	0.5	0.7	0.6	0.8	0.7	0.6	1.4	0.5	0.4	0.3
Above 2% and up to 3%	0.3	0.3	0.2	1.4	1.0	1.3	0.2	0.5	--	--
Above 3% and up to 4%	28.1	14.7	2.5	3.6	3.2	5.1	3.4	5.0	3.9	0.2
Above 4% and up to 5%	43.4	51.7	39.6	30.1	27.8	27.6	26.3	24.1	26.1	14.2
Above 5% and up to 6%	22.5	26.9	41.4	47.5	48.8	48.2	50.0	50.8	51.0	46.4
Above 6% and up to 7%	4.4	4.7	14.1	14.1	15.8	14.8	15.4	16.1	15.7	30.7
Over 7%	0.8	1.0	1.6	2.5	2.7	2.4	3.3	3.0	2.9	8.2
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Total Advances (in million rupees)	4,929	5,081	6,015	5,932	6,346	6,023	6,858	6,253	7,726	8,064

NOTES: Advances include money at call and short notice and due from banks but exclude bills purchased and discounted. Total advances constitute more than three-fourths of aggregate total for all scheduled banks.

Source: Statistical Tables Relating to Banks in India, 1956-60.

This table shows an unmistakable trend in the direction of higher interest rates. This means that the percentage of total advances in higher interest brackets has risen between 1956 and 1960. For a sharper focus on this aspect, this table has been summarized in two classes: percentage of advances between 0 and 5 per cent and above 5 per cent (see Table 41).

Table 41 shows that the proportion of credit advanced at more than 5 per cent gradually increased from 32.6 per cent in December 1956 to 85.3 per cent in December 1960. This really amounts to a complete reversal of the situation in 1956. Due to the slackness in the demand for loans the interest rates are lower in Junes than in Decembers. But the cost of borrowing during the slack seasons shows the same upward trend as in the busy seasons.

An obvious implication of this trend is that the demand for credit was growing faster than the supply of it. From this one can safely infer that banks were engaged in credit rationing of some sort. In fact some credit rationing is inevitable as the rising cost of credit forces the exclusion of some marginal borrowers. Moreover, in order to make the most effective use of their resources banks themselves are led to closer screenings of applicants, the securities offered, and the purposes for which loans are sought.

Ordinarily, rising interest rates are not associated with easy money policy. But higher interest rates and increased velocity of money are expected under boom conditions. If the investment boom is strong, it generally produces a tight monetary situation which may begin to prevail in spite of the central bank's efforts to ease the reserve

TABLE 41

SUMMARY OF TABLE 40
(percentages to total)

Rates of Interest	June 1956	December 1956	June 1957	December 1957	June 1958	December 1958	June 1959	December 1959	June 1960	December 1960
1	2	3	4	5	6	7	8	9	10	11
5% or below	72.3	67.4	42.9	35.9	32.7	34.6	31.3	30.1	30.4	14.7
Above 5%	27.7	32.6	57.1	64.1	67.3	65.4	68.7	69.9	69.6	85.3

position of banks somewhat. As for the Reserve Bank's policy, it was expansionary for a certain class of borrowers and restrictive for others. On the whole it was mildly loose. But this looseness was not sufficient to neutralize the tightness created by excess monetary demand. In fact the Bank welcomed it on the ground that higher interest rates would weaken speculative demand for credit and force investors to economize on the country's scant financial resources.

The Reserve Bank also took active steps to raise the cost of credit at the same time that it was ensuring its increased availability. This was done first in 1956 when the Bank raised the lending rate under the Bill Market Scheme and withdrew the subsidy on stamp duty, and secondly, in 1957 when the Bank rate and the effective lending rates were raised. The cost of credit was raised again in 1960 when the Bank introduced penal rates and forced banks to raise their rates on loans and advances. In addition, its selective lending policy probably had some effect on the structure of interest rates in the upward direction. Banks themselves were engaged in keen competition to attract deposits which were pushing up the deposit rates. But the Reserve Bank discouraged it under the apprehension that excessive competition would raise deposit rates to uneconomic levels and would lead to bank failures. Therefore, the Bank promoted interbank agreements on deposit rates which have been in effect since October 1958.[1] These agreements have held deposit rates below the level to which free competition among banks would have raised them. This is shown by the fact that the average rate

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[1]See Trend and Progress of Banking in India, 1958, Appendix II, pp. 30-32; and Report on Currency and Finance, 1960-61, pp. 40-41.

of interest on all deposits which had been rising from June 1957 to December 1958 began to fall thereafter. Between these dates the average deposit rate moved up from 1.75 per cent to 2.27 per cent. But it declined to 2.19 per cent in December 1959 and further to 1.95 per cent in December 1960.[1]

There seems to be a more probable auxiliary cause for rising interest rates. The last few years have seen a rapid increase in the number of newly-developed small-scale industries. Their need for credit is high but their credit worthiness is relatively small. Therefore, banks are wary of extending accommodation to them on par with older businesses which are also run along sounder lines.[2] Under the circumstances banks probably started charging special risk premiums on loans that would ordinarily carry normal interest rates. As mentioned earlier, this would also work as a handy device for excluding marginal borrowers.

VI

The Composition of Bank Credit

The distribution of bank credit between sectors shows interesting variations over the Second Plan period. On the whole this change has been in accordance with the Bank's policy of increased lending for

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[1] See Reserve Bank of India Bulletin (October 1959), pp. 1254-64; ibid., October 1960, pp. 1469-80; ibid., September 1961, pp. 1461-63.

[2] A recent study points out that the main reason for the unwillingness of banks to lend credit to small and medium industries is their failure to offer acceptable pledges and hypothecation.

The Reserve Bank in a survey conducted in October 1960 found that the scheduled banks including the State Bank of India extended no more than 6 per cent of their industrial loans to the small scale industries.

See Society for Social and Economic Studies, Capital for Medium and Small-scale Industries (Bombay, 1959), Chapter 3; Trend and Progress of Banking in India, 1960, p. 34.

"productive uses." Table 42 shows that between June 1956 and April 1961 the share of the industrial sector gradually increased from below 40 per cent to more than 50 per cent. By contrast, the relative position of agriculture declined rather sharply from 2 to 3 per cent in 1956 and 1957 to less than one per cent in 1960-61. Assuming that both industry and agriculture would unambiguously qualify as productive users of credit and, therefore, would be treated with impartiality by the Reserve Bank, it follows that the shift from the latter to the former is an indication of the change that has taken place in the investment preferences of banks.

Considering the importance of agriculture in the national economy the niggardly treatment meted out to it by banks should be deplored. But it is understandable considering the facts that most banks do not operate in rural areas and that most farmers would not be considered as good credit risks. It is also a matter of tradition that banks in India have not been organized to meet the credit requirements of farmers. Thus, when banks are forced by a tight monetary situation to choose between borrowers, industrialists are more likely to be preferred to farmers.

The Industrial Sector

Between October 1957 and October 1960 the outstanding credit to all industries increased by 46 per cent. But not all industries shared equally in this increase. As Table 43 shows, the textile industries shrank in importance while the group of iron, steel, and engineering industries improved their respective positions. Industries grouped

TABLE 42

ALLOCATION OF BANK CREDIT BETWEEN SECTORS BY ABSOLUTE AMOUNTS AND BY PERCENTAGES
(SCHEDULED BANKS ONLY)
(in million rupees)

Serial Number	Economic Sectors	June 30 1956	Dec 31 1956	June 30 1957	Oct 30 1957	Apr 25 1958	Oct 31 1958	Apr 24 1959	Oct 30 1959	Apr 29 1960	Oct 28 1960	Apr 28 1961
	No. of Reporting Banks	86	86	87	87	87	86	89	94	91	89	85
1	2	3	4	5	6	7	8	9	10	11	12	13
1	Industries	3,004.0	3,055.0	3,904.0	3,937.0	4,419.0	3,981.0	4,712.0	4,185.0	5,333.0	5,628.0	6,856.0
	% to Total	(39.3)	(38.5)	(42.2)	(43.6)	(45.3)	(47.9)	(46.2)	(44.7)	(47.4)	(51.2)	(52.5)
2	Wholesale Trade	2,483.0	2,708.0	3,041.0	2,541.0	2,933.0	2,124.0	2,955.0	2,519.0	3,195.0	2,683.0	3,530.0
	% to Total	(32.5)	(34.1)	(32.9)	(28.9)	(30.1)	(25.5)	(29.0)	(26.9)	(28.4)	(24.4)	(26.8)
3	Retail Trade & Others	555.0	471.0	486.0	527.0	424.0	413.0	494.0	442.0	498.0	574.0	554.0
	% to Total	(7.3)	(5.9)	(5.3)	(6.0)	(4.3)	(4.9)	(4.9)	(4.8)	(4.4)	(5.3)	(4.3)
4	Financial Sector	526.0	589.0	617.0	691.0	772.0	589.0	694.0	774.0	749.0	696.0	671.0
	% to Total	(7.0)	(7.3)	(6.8)	(7.8)	(7.9)	(7.0)	(6.8)	(8.1)	(6.6)	(6.3)	(5.1)
5	Agriculture	177.0	138.0	229.0	242.0	185.0	216.0	235.0	257.0	194.0	66.0	76.0
	% to Total	(2.3)	(1.7)	(2.5)	(2.7)	(1.9)	(2.6)	(2.3)	(2.7)	(1.7)	(0.6)	(0.6)
6	Personal & Professional	582.0	675.0	611.0	614.0	640.0	663.0	713.0	780.0	889.0	968.0	989.0
	% to Total	(7.6)	(8.5)	(6.6)	(7.0)	(6.5)	(8.0)	(7.0)	(8.4)	(7.9)	(8.8)	(7.5)
7	All Others	313.0	299.0	363.0	354.0	373.0	330.0	400.0	400.0	402.0	386.0	385.0
	% to Total	(4.1)	(3.8)	(3.9)	(4.0)	(3.8)	(4.0)	(3.9)	(4.3)	(3.6)	(3.5)	(2.9)
8	GRAND TOTAL	7,639.0	7,936.0	9,250.0	8,806.0	9,746.0	8,315.0	1,020.4	9,357.0	1,126.0	1,100.0	1,306.2
	% to Total	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)	(100.0)

NOTES: These figures are amounts outstanding on the given dates. Formerly, the Reserve Bank used to conduct surveys of bank advances on the last days of June and December. From Oct. 1957 these dates were changed to the last Fridays of April and Oct. which mark the end of the busy season and the slack season, respectively.

Figures have been rounded off, so they may not add up to the total. The grand totals do not necessarily equal the figure for outstanding advances on these dates for all scheduled banks. These discrepancies may be due to errors and omissions in the surveys themselves. Figures in parenthesis are percentages to the grand total.

Sources: Trend and Progress of Banking in India, 1956-60; and Reserve Bank of India Bulletin (October 1961), pp. 1621-22.

under chemicals, etc. and public utilities also registered improvements, those of the latter being quite impressive. Other industries listed in Table 43 more or less held their ground. An increase in the share of "all others" shows the growing importance of some new industries, e.g., electric goods and some older industries such as plantations and paper.

Although the Reserve Bank is not on record for having preferred some industries to others, it is noteworthy that all the industries which show improvement in Table 43 were accorded relatively higher priorities in the Second Five Year Plan as compared to those which had either slipped or barely maintained their relative positions.[1] This shows that either the higher priority industries have shown greater competitive zeal in securing advances, or banks have accorded them higher preferences, or both. Whether the Reserve Bank was actively interested in bringing this about is not known. But in view of the striking harmony of banks' preferences with the targets of the Second Plan, the outcome must undoubtedly have pleased the Bank.[2]

Trading Sector

The entire trading sector (wholesale, retail, and others) has relatively declined over the period. Thus, from 34.9 per cent in

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[1]See "Programme of Industrial Development," Second Five Year Plan, Chapter XIX, pp. 387-428.

[2]The outcome was partly due to the fact that for the projects included in the Second Plan the foreign exchange permits could be obtained more readily than for others. This is important because the demand for bank credit was directly determined by the availability of foreign exchange for the expanding industrial firms. Therefore, firms both old and new, which could not secure foreign exchange were automatically excluded from making large demands on bank credit. Thus, the Reserve Bank, through its policy of foreign exchange allotments, could also indirectly control the distribution of bank credit.

TABLE 43

DISTRIBUTION OF BANK CREDIT WITHIN THE INDUSTRIAL SECTOR
(percentages to group totals)

(in million rupees)

Serial No.		June 30 1956	Dec 31 1956	June 30 1957	Oct 25 1957	Apr 25 1958	Oct 31 1958	Apr 24 1959	Oct 30 1959	Apr 29 1960	Oct 28 1960	Apr 28 1961
1	2	3	4	5	6	7	8	9	10	11	12	13
1	ALL INDUSTRIES	3,004.0	3,055.0	3,904.0	3,837.0	4,419.0	3,981.0	4,712.0	4,185.0	5,333.0	5,628.0	6,856.0
2	Cotton, jute & other textiles	38.1	42.2	41.6	43.1	39.3	41.0	37.6	37.7	30.9	30.3	28.7
3	Iron, steel & engineering	16.2	21.6	18.5	22.1	19.5	23.5	21.5	26.5	20.7	23.3	20.9
4	Coal, other mining and quarrying	2.2	2.5	2.3	2.3	1.9	2.4	2.4	3.2	2.3	2.5	1.8
5	Cement	1.3	0.9	1.6	2.5	2.2	3.3	3.1	3.4	2.8	2.8	2.6
6	Chemicals, dyes, paints and pharmaceuticals	3.6	4.7	4.1	3.8	3.9	3.5	3.8	4.6	4.8	5.4	4.8
7	Vegetable oil, crushing and refining	4.2	3.4	3.3	2.6	4.0	2.4	4.5	2.8	4.0	2.4	3.9
8	Public utilities	2.3	1.9	1.5	2.0	1.5	1.7	1.5	2.2	4.1	4.5	3.8
9	Sugar and Gur	16.8	10.6	13.8	7.2	13.8	6.0	11.3	4.1	14.3	7.4	14.7
10	All others	14.8	11.8	13.0	14.0	13.4	15.7	13.9	15.0	15.7	20.9	18.3

Sources: Trend and Progress of Banking in India, 1956-60.

October 1957 the share of trade in total bank credit declined to 29.7 per cent in October 1960. Table 44 shows the breakdown of bank credit into subclasses. It is instructive that the relative decline is most impressive in wholesale trade in agricultural commodities. This does not seem to be accidental. Indeed, this should be expected in view of the fact that most selective controls were applied to restricting the flow of credit to traders and speculators in this subsector. Thus, from Table 44 it would appear that monetary authorities were successful in limiting the access of traders to banks.

Other Sectors

The share of credit going to the financial sector remained generally steady throughout the period 1956-59. The high level of advances in 1957-58 was rather exceptional. This brought forth advice of caution from the Bank. On October 30, 1959 the level of advances again reached a peak figure. Interestingly enough it coincided with the high level of advances in the personal and professional categories. This coincidence and subsequent coincidences of similar nature gave rise to the growing suspicion that borrowers were securing clean advances in addition to secured loans for speculating in the stock market. The continuation of this practice for several months forced the Bank to issue a restraining directive in March 1960. This produced a salutary effect as far as advances to the financial sectors were concerned. However, the same thing could not be said for loans under "personal" and "professional" categories.

TABLE 44

BANK CREDIT TO THE TRADING SECTOR, IN ABSOLUTE AMOUNTS AND BY PERCENTAGES TO THE TOTALS FOR ALL SECTORS
(in million rupees)

Serial No.	Trading Sector	June 30 1956	Dec 31 1956	June 30 1957	Oct 25 1957	Apr 25 1958	Oct 31 1958	Apr 24 1959	Oct 30 1959	Apr 29 1960	Oct 28 1960	Apr 28 1961
1	2	3	4	5	6	7	8	9	10	11	12	13
	No. of Reporting Banks	86	86	87	89	87	86	89	94	91	89	85
1	Wholesale Trade	2,483.0 (32.5)	2,708.0 (34.1)	3,041.0 (32.9)	2,541.0 (28.9)	2,933.0 (30.1)	2,124.0 (25.5)	2,955.0 (29.0)	2,519.0 (26.9)	3,195.0 (28.4)	2,683.0 (24.4)	3,530.0 (26.8)
(i)	Agricultural commodities	1,235.0	1,049.0	1,363.0	800.0	1,319.0	619.0	1,278.0	716.0	1,370.0	725.0	1,430.0
	% to Total	(16.2)	(13.2)	(14.7)	(9.1)	(13.5)	(7.4)	(12.5)	(7.7)	(12.2)	(6.6)	(10.8)
(ii)	Nonagricultural commodities	1,247.0	1,659.0	1,678.0	1,741.0	1,614.0	1,505.0	1,677.0	1,803.0	1,825.0	1,958.0	2,100.0
	% to Total	(16.3)	(20.9)	(18.1)	(19.8)	(16.6)	(18.1)	(16.4)	(19.3)	(16.2)	(17.8)	(16.0)
2	Retail Trade	143.0	142.0	137.0	147.0	131.0	126.0	138.0	155.0	166.0	193.0	202.0
	% to Total	(1.9)	(1.8)	(1.5)	(1.7)	(1.3)	(1.5)	(1.4)	(1.7)	(1.5)	(1.8)	(1.6)
3	Others	412.0	329.0	349.0	380.0	293.0	287.0	356.0	287.0	332.0	381.0	352.0
	% to Total	(5.4)	(4.1)	(3.8)	(4.3)	(3.0)	(3.4)	(3.5)	(3.1)	(2.9)	(3.5)	(2.7)
4	Total for All Sectors	7,639.0	7,936.0	9,250.0	8,806.0	9,746.0	8,315.0	10,204.0	9,357.0	11,260.0	11,000	13,062

Sources: Trend and Progress of Banking in India, 1955-60; and Reserve Bank of India Bulletin (October 1961), p. 1621.

The category "all others," consisting of miscellaneous items, seems to have suffered from the same credit squeeze that resulted in the decline of agriculture. The main difference between the two was that for "all others" credit did not decline in absolute amounts as it did for agriculture.

VII

Implications for Monetary Policy

What are the implications of the foregoing paragraphs for the working of monetary policy? First, considering the ambivalent orientation of the Reserve Bank in expanding and restricting credit at the same time the effect on allocation of credit was by and large satisfactory. Monetary policy should, therefore, be considered successful insofar as its effect on the composition of bank credit was concerned.

The Bank's policy was directed at regulating the composition of credit in the expectation that these changes would produce corresponding effects on private expenditures. Ultimately the effect of changed composition of bank credit should be reflected in the changed composition of output, to which should correspond a somewhat changed structure of prices. But in practice the direct and indirect effects of monetary policy are likely to be small and even negligible. This is so for three reasons. First, the effects of monetary policy can be counteracted or even completely swamped by other arms of government policy. In this respect monetary policy can achieve maximum effectiveness if it is completely harmonized with fiscal policy, commercial policy, and capital

issues policy. This may not be easy to achieve in practice. Second, market decisions and results concerning output and prices are, far more than monetary policy, subject to such autonomous variables as climatic changes in relation to agriculture and changes in foreign exchange reserves in relation to industries. Third, the Reserve Bank can directly or indirectly vary the growth rate or the distribution of bank credit of scheduled banks. But there exist alternative sources of finance which are not controlled by the Bank and can, in principle at least, counteract the efforts of monetary authorities. It is possible that these counteracting effects are relatively weak. But at this point nothing more can be said, one way or the other, with any degree of certainty.

The Reserve Bank was fully aware of these limitations and conducted its policy without entertaining exaggerated hopes about the extent of its effectiveness. It nevertheless thought that monetary policy could exert some stabilizing influence in the economy and help the growth of the industrial sector in a vital respect.[1] The Reserve Bank limited itself to controlling scheduled banks because this could be done most conveniently and effectively.

In considering the impact of monetary policy on the growth and structure of bank assets, it should be borne in mind that banks respond not only to central bank directives but also to the demands from the nonbank public. Moreover, sensitive bankers are fully aware of the

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[1]Reserve Bank of India, Report of the Central Board of Directors for the Year Ended June 30, 1958 (Bombay, August 1958); and Trend and Progress of Banking in India, 1959, p. 10.

changes in the economic structure and vary their lending policies in expectation of new changes. It is, therefore, possible that the orientation of monetary authorities was in the same direction as the market induced changes on the lending preferences of banks. On the other hand it might be argued that the targets laid down in the Second Plan, the policies of government lending agencies, and the attitude of the Reserve Bank in combination produced a kind of pressure on banks which led them to change their lending policies. It is probably true that banks were subject to all these pressures. Perhaps the safest thing to say is that changes in the lending preferences of bankers were at least partially induced by monetary policy and in part were caused by market forces. Whatever the reasons, on the whole the Reserve Bank achieved fair success in respect to its principal goals--in increasing the availability of credit at higher cost, thereby enforcing credit rationing by banks; and in changing the allocation of credit in favor of the industrial sector and within it, to the advantage of high priority industries. It, however, did not succeed in controlling the rate of growth of bank credit which showed disturbing amplitude over the period under review.

VIII

Summary and Conclusions

The Second Plan period was characterized by steady expansion in the volume of bank credit outstanding. However, its pace of increase was determined more by the demand for credit than by Reserve Bank policy.

The latter was generally helpful, inasmuch as the ratio of required reserves to deposits fell throughout the period, excepting 1960; and by supporting banks with increased lending when the latter were in need. Bank credit data show that seasonal variations in it have progressively weakened.

Bank credit has tended to finance an increasing proportion of national expenditure. This has been caused by mainly four variables, which have been identified as high level of investment, increase in speculation, increase in business taxation, and easy monetary policy. Other structural changes in the economy have also probably contributed to the increase in the ratio.

The ratio of bank credit to deposit reached record levels during this period--far exceeding the accepted limits of sound banking. The Reserve Bank did not intervene to check it because it was apprehensive that insistence on sound banking might hamper the progress of the Second Five Year Plan.

Comparisons between classes of banks show wide variations in the ratio of bank credit to total deposits. At the one extreme is the State Bank of India which shows a declining trend, which is presumed to be caused by the deliberate policy decision to support Reserve Bank policy. The other extreme consists of foreign banks, especially in class D, which have maintained this ratio at abnormally high levels. This may be attributed to several causes not the least important of which are their stronger capital bases and more business experience as compared to Indian banks.

The Second Plan period is characterized by an increased availability of credit at rising cost. The Reserve Bank policy has contributed to both. In fact this is what the Bank aimed at--to allow credit to expand and at the same time enforce credit rationing so that it may predominantly go into relatively higher priority sectors. Therefore, while the Bank's policy was relatively passive in respect to bank credit expansion (with the exception of 1960), it was active in raising the cost of credit. Thus viewed, the Reserve Bank's policy was successful.

The Reserve Bank's most outstanding success was in affecting changes in the composition of credit in accordance with the priorities of the Second Plan and in terms of its policy of "controlled expansion." The data are indicative of the fact that selective controls were effective. This is shown by the decline in the proportion of bank credit going into the trading and financial sectors. The increase in the share of the industrial sector, and even more so, in those of newly developing industries, is remarkable in view of complete absence of official preferences in the published record. It is, therefore, surmised that this striking result may be partly due to moral suasion by the Bank and partly due to changes in the lending preferences of banks themselves. The conclusion is that, judged by the goals that the Reserve Bank had set for itself, its policy should be considered successful. The Reserve Bank can take the credit for substantially increasing the volume of credit and at the same time preventing its misuse.

CHAPTER VII

THE INVESTMENT PORTFOLIO OF SCHEDULED BANKS

I

The Conflicting Roles of the Reserve Bank

The investment portfolios of scheduled banks consist of government securities including Treasury bills and "other" investments. The latter category includes long-term securities issued by the private sector. Their importance in the investment portfolio varies from bank to bank. But from the point of view of monetary authorities these are not very significant.[1] Therefore only a passing reference will be made to them. Government investments, on the other hand, are of vital importance. The Reserve Bank has been interested in the behavior of banks with respect to government securities in three distinct capacities. As a government's bank it is responsible for the management of public debt; as a bankers' bank it is expected to buy and sell securities to meet short-term needs of banks and to absorb their excess reserves; as a regulator of credit, it is the duty of the Bank to avoid excessive monetary expansion, and insofar as is in its power, to maintain stable conditions in the economy. The Second Plan revealed the inherent

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[1]Following the British practice banks in India make only short-term advances, although a substantial portion of these are reviewed and remain outstanding for a long time.

conflict in performing each of these functions adequately and the necessity of subordinating some functions to one of higher priority.

Faced with a conflicting situation the Bank quite naturally gave the top priority to the needs of the government. The Reserve Bank had to support the borrowing program of the central and state governments which required that prices of government securities be stabilized and ample liquidity be provided to commercial banks to enable them to subscribe to new issues. These were being floated at more than four times the average annual figure for the First Plan. Thus the net market borrowings by the central and state governments between 1956-57 and 1960-61 amounted to 7,468 million rupees or an average rate of approximately 1.5 billion rupees per year. By comparison total borrowings during 1951-52 to 1955-56 amounted to only 1,772 million rupees or an average rate of 354 million rupees per year only.[1]

Even though the Reserve Bank was fully committed to meet the credit needs of the government it could not deny short-term and seasonal accommodation to scheduled banks. Most short-term needs of banks are of course seasonal, arising because of a currency drain during busy seasons and a surplus of cash during slack seasons. Banks therefore sell securities during busy seasons and buy them during slack seasons. These routine seasonal operations were vested with special significance during the Second Plan mainly for two reasons. First, the Reserve Bank, as the agent of the Government, was floating new loans during slack seasons in amounts to which banks were not at all accustomed. Second,

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[1]See Reserve Bank of India Bulletin (March 1961), pp. 328-55; "Market Borrowings of the Government of India and State Governments 1960-61," Report on Currency and Finance, 1960-61, Statement 71.

with a growing demand for credit from the private sector banks were for the first time faced with a real choice between loans and governments. They could not turn down their customers whose requests for credit appeared both reasonable and profitable. But neither could they ignore the pleas of the Reserve Bank to buy government securities, because the Reserve Bank, if necessary, could insist that banks should safeguard their liquidity by adhering to the traditional ratio of governments to deposits. However, ordinarily the assurance of complete liquidity of the government investments provided by the Reserve Bank's willingness to support their prices was a sufficient incentive for banks to extend their cooperation.

The obligation to meet budgetary deficits and to underwrite the loan program of the government, combined with the policy of maintaining orderly conditions in the government securities market, was bound to undermine the role of the Reserve Bank as the regulator of credit. This policy, in effect, carries the implication that the central bank of the country will no longer be able to regulate the volume of bank reserves. The commercial banks can at will monetize the government debt, augment excess reserves and loan them out. If an inflationary situation is developing in the economy it can be fed by the expanding bank credit. However, the central bank, with ineffective weapons of credit control may not be able to prevent the situation from deteriorating further. Conceivably, the inflationary effect of new debt creation could be held down to the minimum if the nonbank public had absorbed most of the new issues. However, as it turned out, a large part of the new debt was held within the banking system (commercial banks and the Reserve Bank).

This shows that the issue of new government securities was in excess of the current savings that were flowing into the securities market. The next best alternative was that banks should voluntarily refrain from selling government investments to the Reserve Bank and agree not to use them as collaterals for excessive borrowings. In fact, this is the most that the Reserve Bank could hope for. From this point of view the stability of interest rates and security prices was desirable inasmuch as banks and other investors would not rush in to sell securities in anticipation of a fall in prices. Actually, a large portfolio of government securities assured them of a stable source of income. However, the crucial determinant of bank behavior is the demand for credit from the private sector. As long as it did not force banks to switch from governments to loans, there was no real conflict between the credit policy and the debt management. But if this did happen the Reserve Bank would find itself in a predicament. During the Second Plan period this situation arose only twice, once in 1956 and later in 1960. In 1956, the Reserve Bank was still in the midst of formulating its strategy for the Second Plan. But in 1960 the Bank was actively pursuing a restrictionist policy. Probably the Reserve Bank tried to discourage banks from selling securities in excessive amounts, but apparently with no effect.

The unenviable situation in which the Reserve Bank found itself was the natural result of the financial policy laid out in the Second Plan. The Bank had dutifully tried to sell government securities and had exerted moral pressure on the scheduled banks to exercise voluntary restraint. But these policies did not aim at the regulation of bank

reserves. When the Reserve Bank actually tried to do so, the basic conflict between the credit policy and the debt management was sharply exposed.

II

Seasonal Variations in the Banks' Portfolios of Government Investments

The seasonal variations in the scheduled banks' assets show on inverse relationship between the government investments and the bank credit. During the busy season the former goes down as the latter goes up. The seasonal changes in the ratio of governments to deposits are determined by two variables: (i) the extent of variations in the demand for bank credit in a given relationship to the existing cash ratio will determine whether the banks will increase or lower the ratio of governments to deposits; (ii) the Reserve Bank policies will determine whether the scheduled banks can vary excess reserves by making or withdrawing loans from them, by varying the lending rates, by open market operations and by changing the reserve ratio requirements.

In India the cash ratio and the investment ratio move in the same direction.[1] They rise in the slack seasons and fall in the busy seasons. This variability implies that the scheduled banks can, to some extent, substitute one for the other. Thus, during slack months some banks may prefer to have more cash than governments, while others may do

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[1]This is the short form of the ratio of the government investments to aggregate deposits.

the exact opposite. On the other hand, in busy months some banks may be willing to reduce excess reserves before selling their investments. Indeed, under the assumption of profit maximization this should be expected from every bank. The reason is that the government securities are highly liquid, but unlike cash these are also earning assets. In practice, however, this does not happen in the case of all banks. The behavior of foreign banks does broadly correspond to the assumption of profit maximization. Their cash ratios are the lowest in India. Their average investment ratios are also far below the average for Indian banks. This enables them to maintain the bank credit ratio at well above the average for Indian banks. The Indian banks cannot strictly adhere to the profit maximization rule because their need for liquidity is much greater than the foreign banks. This is due to the fact that the Indian banks are mostly engaged in the financing of inland business, which is subject to greater seasonal variations and involves relatively heavier currency drains than foreign trade, which is more stable and is almost an exclusive preserve of foreign banks. Therefore, given its preferred cash ratio each bank will have to decide how far it can safely switch from governments to loans in a busy season. When the investment ratio reaches the safety level determined by the liquidity considerations the bank will feel loaned up. But, whether one bank or the banks in general can successfully do so will depend upon the attitudes and the policies of the Reserve Bank. The banks can easily switch from one asset to another if the Reserve Bank is cooperative. If the credit policy is restrictive the difficulties of commercial banks will be greater to the extent that the Reserve Bank measures are effective.

Absolute changes in governments and bank credit as well as their ratios to deposits are given in Table 45. The behavior of cash ratio will be considered in the next chapter. It will seem that, generally speaking, absolute variations in governments and bank credit occur in opposite directions. The same relationship holds for the two ratios.

Barring the slack 1956, the busy 1957-58, and the slack 1960, governments have contracted in every busy season and expanded in every slack season; opposite movements have occurred in bank credit. The slack season of 1956 shows a relatively small increase in investments because of high demand for bank credit. This shows that, faced with a choice between the two, banks generally give higher preference to loans. By contrast the busy season of 1957-58 was weak and the demand for loans was at a low level. This resulted in investment of surplus funds in government securities. The slack season 1960 shows contraction in the government investments because the change introduced in the banking of P.L. 480 funds had forced the State Bank to sell securities and transfer the equivalent time deposits to the Reserve Bank. The State Bank was therefore extinguishing time deposits simultaneously with the liquidation of special securities.

The seasonal behavior of the governments leads to the conclusion that the ratio of investments to deposits passively adjusts to a change in the ratio of bank credit to deposits. The stronger the busy season the greater will be the fall in the ratio of governments to deposits. The decline in this ratio is likely to be greater still when banks have a rigid preference for cash and the monetary policy is restrictive. This will hold true in the reverse situation also. However, different

TABLE 45

SEASONAL VARIATIONS IN GOVERNMENT INVESTMENTS AND BANK CREDIT OF SCHEDULED BANKS, ABSOLUTELY AND IN RELATION TO DEPOSITS

Season	Investment in Government Securities (in million rupees)	Bank Credit (in million rupees)	The Ratio of Investment in Government Securities to Total Deposits (per cent)	The Ratio of Bank Credit to Total Deposits (per cent)
1	2	3	4	5
Busy, 1955-56	-369.3	+1,644.9	33.4	71.2
Slack, 1956	+160.9	+36.7	34.2	70.0
Busy, 1956-57	-269.6	+1,484.2	28.2	74.5
Slack, 1957	+496.7	-418.9	28.9	63.6
Busy, 1957-58	+504.1	+894.2	29.4	63.3
Slack, 1958	+1,747.5	-1,179.1	39.3	53.2
Busy, 1958-59	-31.8	+1,817.0	36.4	60.3
Slack, 1959	+1,780.0	-789.5	44.2	52.3
Busy, 1959-60	-524.9	+1,889.3	38.4	58.6
Slack, 1960	-523.3	-203.1	36.2	58.2
Busy, 1960-61	-1,263.2	+1,985.3	29.4	68.3

Source: Report on Currency and Finance, 1960-61, Statement 27.

banks will behave differently and this general conclusion cannot be safely applied to the behavior of individual banks.

III

Growth in the Government Securities Portfolios

During the Second Plan period scheduled banks steadily acquired government securities from year to year. However, it is rather difficult to be precise about the exact increase in the holdings of scheduled banks. The Reserve Bank publishes three sets of figures. One of these is for the last Friday of the year and furnishes information about government securities as well as "other" investments (see Table 46). This renders it possible to estimate the share of government securities in the entire investment portfolio. The second set of figures is the averages of monthly Fridays which themselves are averages of weekly Fridays (see Table 47). These figures exclude "other investments." The third set of figures pertains to the last day of December which is the date on the annual balance sheets of most banks. Since banks engage in some "window dressing" in preparing a final balance sheet, figures on government investments may not accurately reflect the investment preferences of banks. This data has been used in making a comparison between Indian and foreign banks. But in this section it will not be used.

Between the first and second set of figures (in Table 46 and Table 47, respectively) there exists a considerable difference. The average of Fridays (in Table 47) shows that government investments of scheduled banks increased between 1955 and 1960 by nearly 100 per cent.

TABLE 46

SCHEDULED BANKS' INVESTMENTS IN GOVERNMENT AND OTHER SECURITIES, YEARLY CHANGES, AND RATIOS TO TOTAL DEPOSITS

As on the Last Friday of the Year	Investment in Government Securities (in million rupees)	Other Investments (in million rupees)	Total Investments (2)+(3) (in million rupees)	Ratio of Total Investments to Total Deposits (per cent)	Ratio of Government Investments to Total Deposits (per cent)	Ratio of Government Investments to Total Investments (per cent)
1	2	3	4	5	6	7
1955	3,828.0	302.0	4,130.0	42.3	39.2	92.6
1956	3,642.0	306.0	3,948.0	37.5	34.6	92.2
Absolute change	-186.0	+4.0	-182.0			
Percentage change	(-4.8)	(+1.3)	(-4.4)			
1957	4,329.0	508.0	4,837.0	37.3	33.3	89.4
Absolute change	+687.0	+202.0	+889.0			
Percentage change	(+18.8)	(+66.0)	(+22.5)			
1958	6,370.0	549.0	6,919.0	45.6	42.0	92.0
Absolute change	+2,041.0	+41.0	+2,082.0			
Percentage change	(+47.1)	(+8.0)	(+43.0)			
1959	7,874.0	676.0	8,550.0	48.4	44.5	92.0
Absolute change	+1,504.0	+127.0	+1,631.0			
Percentage change	(+23.6)	(+23.1)	(23.5)			
1960	6,303.0	634.0	6,937.0	38.4	34.8	90.8
Absolute change	-1,571.0	-42.0	-1,613.0			
Percentage change	(-19.9)	(-6.2)	(-18.8)			

Source: Trend and Progress of Banking in India, 1960, Statement 5.

TABLE 47

GOVERNMENT INVESTMENTS, LOANS AND ADVANCES, AND CERTAIN RATIOS
(in million rupees)

Average of Fridays	Government Investments (in million rupees)	Loans and Advances (in million rupees)	Government Investments/ Total Deposits (per cent)	Government Investments/ Bank Credit (per cent)	Government Investments/Loans and Advances (per cent)	Yearly Increase in Governments as Percentage of Previous Year
1	2	3	4	5	6	7
1955	3,652	4,980	37.2	60.4	73.3	
1956	3,640	5,955	34.1	48.9	61.1	-0.3
1957	3,648	7,024	29.2	41.7	51.9	+0.2
1958	5,177	7,550	34.3	57.9	68.5	+41.9
1959	6,902	8,236	40.0	71.7	83.8	+33.3
1960	7,296	9,496	38.1	65.9	76.8	+5.7

NOTE: The difference between "Loans and Advances" and "Bank Credit" is that "bills discounted and purchased" by banks are excluded in the former but included in the latter.

Source: "Consolidated Position of Scheduled Banks in India," Trend and Progress of Banking in India, 1960, pp. 64-69.

Moreover, 1960 shows a small increase over 1959. On the other hand figures on last Fridays (in Table 46 show a smaller increase--only 64.4 per cent. Also, investments in 1960 are lower than 1959. For 1960 the implications of these two sets of figures are exactly opposite. Banks had been tight in 1960 according to the latter and generally loose according to the former.

Data pertaining to government investments, "other" investments, total investments, the ratios of total investments and government investments to deposits, and the share of governments in the investment portfolio are given in Table 46. This table is based on data of the last Friday of the year. Table 47 shows an average of Fridays data for government investments, loans and advances, ratios of government investments to deposits, governments to bank credit and governments to loans. The percentages of yearly increase in the holdings of government securities are also given in Column 7. The ratios of governments to loans are based on the theory that banks will switch from governments to loans if the demand for them in relation to reserves is rising. Bills are excluded because for liquidity reasons banks will buy and discount them in the amounts available. Thus, if banks are tight, the ratio of governments to loans will fall and vice versa. If this ratio falls along with the ratio of governments to deposits, banks are unmistakably tight.

The Loose and Tight Years

Considering the year 1960 first, it should be clear that it is not comparable to other years. The State Bank had started liquidating government securities and time deposits equivalent to P.L. 480 funds

from July on. But until May 12 it was acquiring these funds and investing them in government securities. Therefore, the figure for the average of Fridays for 1960 has an upward bias. On the other hand the figure for the last Friday of the year has a downward bias. However, in Table 47 the increase in 1960 is shown to be only 5.7 per cent as compared to a 41.9 per cent increase in 1958 and 33.3 per cent in 1959. Moreover, the ratio of government investments to deposits is lower in 1960 than in 1959. The same holds for the ratios of government investments to bank credit and to loans and advances. It is therefore safe to characterize 1960 as a tight year. This was also the conclusion reached in Chapter VI.

1956 was the only other year when banks were tight. According to both tables, banks in 1956 sold securities on a net basis. The ratios of governments to deposits decline in both tables. The ratio of governments to loans in Table 47 also registers a decline. By comparison to 1956 and 1960 it can be safely said that during 1958 and 1959 banks were generally loose. The year 1957 is somewhat difficult to characterize. Banks increased their holdings of government investments, but they added proportionately even more to "other" investments. At the same time the ratio of governments to deposits in both tables shows a slight decline. The same holds for ratios in Columns 5 and 6 in Table 47. In 1957 the economy was slowing down and the pace of investment in the latter half of the year had noticeably slackened. Banks were adjusting to this situation and were perhaps mildly tight in the beginning of the year.

IV

New Issues and Open Market Operations

As stated in the first section, the Reserve Bank's policy of ensuring the success of the government's borrowing program, combined with the policy of maintaining orderly conditions in the securities market, had rendered its open market policy generally ineffective. The Reserve Bank was, however, willing to buy securities or give loans to banks in order to enable them to subscribe to a sizeable portion of new issues. The data do not reveal the extent to which banks bought new issues with cash obtained from the Reserve Bank. But the data as furnished by the Reserve Bank does separate the new subscriptions from the open market operations (see Table 48). This table shows that in two years of the Second Plan, viz. 1956-57 and 1960-61, the Reserve Bank was a net buyer of securities. In other years it made net sales of government securities.

Column 1 in Table 48 shows the amount of net borrowings by the central and state governments including the Reserve Bank. The amount subscribed to by investors outside of the Reserve Bank and governments is shown in Column 2. The difference between totals in Columns 1 and 2 is the unsubscribed portion. This comes to 3,805 million rupees, almost 90 per cent of which was absorbed by the Reserve Bank. Through open market operations the Reserve Bank further sold 1,017.0 million rupees worth of securities, most of which must have been bought by banks. Thus the total absorption of securities outside of the Reserve Bank and the government comes to 4,680.0 million rupees. Of this amount nearly

TABLE 48

NET ABSORPTION OF GOVERNMENT SECURITIES BY THE PUBLIC
(in million rupees)

Year	Net Market Borrowings by Central and State Governments (Cash Receipts-Cash Payments)	Net Cash Receipts Excluding RBI and Government	Open Market Purchases (-) and Sales (+) to the Public	Net Absorption (+) of Central and State Government Securities by the Public (2)+(3) (including banks)
	1	2	3	4
1956-57	+1,407.0	+897.0	-191.0	+706.0
1957-58	+707.0	+281.0	+852.0	+1,133.0
1958-59	+2,269.0	+1,056.0	+890.0	+1,946.0
1959-60	+1,747.0	+825.0	+606.0	+1,431.0
1960-61	+1,340.0	+614.0	-1,251.0	-637.0
Total	+7,469.0	+3,673.0	+906.0	+4,579.0

NOTES: Figures are inclusive of P.L. 480 funds. These figures exclude Treasury bills, small savings, and certain other loans of minor significance. Totals are provisional.

Source: Reserve Bank of India Bulletin (April 1962), p. 507.

50.7 per cent was taken up by the scheduled banks. In absolute figures this adds up to 2,375 million rupees.[1]

The fact that nearly 51 per cent of the net absorption of government securities during the Second Plan period went to augment investment portfolios of scheduled banks speaks highly of the cooperation between the latter and the Reserve Bank. However, in this connection two rather important facts should be borne in mind. First, the Reserve Bank was forced to absorb in its own portfolio 37.3 per cent of the net marketed debt. This comes to 2,788 million rupees. This only reflects the unwillingness of institutional investors including banks to take any more than they did. Second, the State Bank subscribed a large portion of new issues taken up by scheduled banks together. This in turn was made possible by P.L. 480 funds which had been banked with the State Bank of India.[2] If the favorable factor of P.L. 480 funds had not been present, it is doubtful if the investment portfolio of scheduled banks would have shown the extent of increase that actually took place.

Another factor helping the Reserve Bank in the marketing of new loans is the traditional preference of banks for government securities. In the past this was mainly the result of a weak demand for loans and

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[1]This figure has been obtained by deducting government securities outstanding on the last Friday of March 1956 from those outstanding on the last Friday of February 1961. The estimate of 2,375.0 million rupees, however, includes Treasury bills held by scheduled banks. Table 48 includes them. The actual figure is likely to be higher still because the Treasury bill holdings of banks were much higher in 1960 than in 1956. Sources: Report on Currency and Finances, 1960-61, Statement 28 and Table 5.

[2]See "Our Public Debt," Tata Quarterly (April 1960), pp. 41-42.

the paucity of liquid assets which the banks could acquire. Moreover, even now for some banks in India there is not much choice in this matter. It is, however, a general rule that the banks acquire government investments in excess of their liquidity requirements only when the demand for loans is at a low level.

Suppose banks in the past years have acquired governments in excess of their liquidity needs. Now if the demand for loans starts rising, some of these securities will be offered to the Reserve Bank for sale. This will immediately put the open market policy to test. Should the Reserve Bank refuse to buy them the banks can sell them to the nonbank public. In their effort to sell governments the market prices will go down and the sellers will have to take capital losses. These losses can be fully made up by higher lending rates which, should not be difficult to bring about if a boom is developing in the economy. Still, there is possibly a limit beyond which this process cannot go. The prospective capital losses will "lock-in" some potential sellers. Those who realize capital losses will have to raise the cost of credit which will eliminate a portion of loan demand. Sooner or later the restraining effect of this policy is bound to be felt. But the Reserve Bank with its present commitments cannot allow this situation to develop. Since it is unwilling to let the bond prices fall, it has no choice other than to buy securities and permit further expansion in bank credit. In other words, this policy renders the public debt virtually as liquid as the money. It also means the relinquishment of the discretionary control over bank reserves.[1]

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[1]The situation is analogous to the one prevailing in the United

V

The Maturity Distribution of Government Investments

Public debt in India consists mostly of bonds of different maturities. Open market operations are mainly conducted in bonds rather than bills as is the practice in the United States and the United Kingdom. Treasury bills are mostly held by the Reserve Bank in exchange for cash or foreign exchange to governments. Commercial banks, however, do possess Treasury bills in small amounts. The small size of Treasury bills in the portfolio of banks is mainly due to the fact that they are offered in the market in small amounts. In the past their auction has been suspended from time to time. Small offerings are due to the lack of a developed market in Treasury bills.

The routine open market operations of the Reserve Bank consist of selling some bonds of one maturity and buying some of another maturity mainly to keep an orderly pattern of yields. In this way it also caters to the needs of different classes of investors.[1] However, the monetary effects of debt operations are insignificant. It may be

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States before the Treasury-Federal Reserve Accord of March 1951. As early as 1945 the Fed realized the inflationary consequences of this policy. See in this connection Ronald I. Robinson, "Monetary Aspects of National Debt Policy," Public Finance and Full Employment, Postwar Economic Studies No. 3 (Washington: Board of Governors of the Federal Reserve System, December 1945).

In India a proposal to withdraw support from the government securities market has been put forward by Tata Quarterly (April 1961), pp. 39-57. However, in view of the adverse consequences that withdrawal of support is likely to have on the government finances the chances of its acceptance are rather remote. In view of its impracticality, it is not supported here.

[1]The Reserve Bank of India, Functions and Workings, 1958, pp. 39-41.

said that lengthening of debt and raising the level of interest rates may have some restrictive effect on spending by the public. But the effect of switch operations on the net liquidity position of investors is probably negligible. The effect on the cost of credit by way of higher interest rates is likely to be positive. But the net effect on spending is probably insignificant.[1]

The maturity distribution of government securities in the portfolio of scheduled banks is given in Table 49. This table shows that banks have disinvested securities of five to ten years maturity more than securities of any other maturity group. In 1956 and 1957 banks reduced the holdings of medium securities and increased the short-term securities, mainly those of one to five years. This can be accounted for by three reasons. First, the suspension of sale of Treasury bills from April 6, 1956 to July 28, 1958 induced banks to divert funds into short-term securities. For banks, which wanted to have some short-term securities, it was a matter of taking what was available. Second, the Reserve Bank had raised its lending rate in March and November 1956 which, together with a strong demand for credit, prompted banks to sell securities. Banks decided to sell medium-term securities, partly because the gilt-edged market was not receiving full support from the Reserve Bank until November 1956. Between medium and long-term securities banks would incur smaller capital losses in selling the former than

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[1]Prof. Warren Smith argues for the United States that the effect of debt operations on aggregate spending by changing interest rates and the liquidity of spenders is either nonexistent or so small that it can be ignored. See Debt Management in the United States, Study Paper No. 19 (Washington: Joint Economic Committee Print, January 28, 1960), pp. 7-9.

TABLE 49

MATURITY DISTRIBUTION OF GOVERNMENT SECURITIES HELD BY SCHEDULED BANKS
(in million rupees)

December 31 of	Government Securities Maturing In					
	1 year	1-5 years	5-10 Years	10-15 Years	Over 15 Years	Total
1	2	3	4	5	6	7
1955	108.5	837.9	2,395.9	465.2	153.4	3,960.9
			(60.5)	(11.7)	(3.9)	(100.0)
1956	50.8	1,356.9	1,531.6	664.3	174.0	3,777.7
	(1.3)	(35.9)	(40.5)	(17.6)	(4.6)	(100.0)
1957	126.3	2,237.4	1,406.4	510.6	192.4	4,473.1
	(2.8)	(50.0)	(31.4)	(11.4)	(4.3)	(100.0)
1958	578.1	2,687.6	2,572.9	560.2	236.7	6,635.5
	(8.7)	(40.5)	(38.8)	(8.4)	(3.6)	(100.0)
1959	976.2	2,480.3	3,150.9	876.3	347.9	7,831.6
	(12.5)	(31.7)	(40.2)	(11.2)	(4.4)	(100.0)
March, 1960	733.9	2,344.1	3,105.0	863.9	331.7	7,378.6
	(9.9)	(31.8)	(42.1)	(11.7)	(4.5)	(100.0)

Source: Trend and Progress of Banking in India, 1955-60.

the latter. Third, the Reserve Bank was trying to lengthen the maturity structure of debt and was anxious to prevent long rates from going up.[1] The net result, however, was that debt held by banks became shorter in 1957 as compared to previous years. After the resumption of support from the Reserve Bank the tendency of banks to shorten their debt holdings seems to have slackened considerably. This is reflected in the increase in securities of medium and long-term maturities in later years.

VI

"Other" Investments

"Other" investments are long-term private securities and can be treated as close substitutes to long-term government securities. Government securities are, of course, safer and more liquid but these advantages can be compensated by higher rates of return on private securities. As can be seen in Column 3 of Table 2, banks acquired these investments in every year excepting 1960 when they disposed of some of their holdings. Two general conclusions can be drawn about the behavior of "other" investments. First, as a proportion of total investments they are generally stable. Therefore, they may be considered a small but nevertheless a permanent part of banks' earning assets. Second, the variations in them are partly caused by the general tightness or looseness of the banking system. These securities are acquired when the demand for loans is low relative to the lending ability of banks. The banks seek them mainly because, as earning assets, government securities

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[1]See Report on Currency and Finance, 1956-57.

are inferior to them. On the other hand, when banks feel tight but cannot sell government securities, the chances are that "others" will be disposed of. Thus banks in possession of "other" investments can operate with greater ease and convenience in meeting the loan demands of their customers without alarming Reserve Bank officials. This appears to have happened in 1960. Banks not only reduced cash reserves, borrowed more from the Reserve Bank, and sold government securities but were further forced to shift from long-term private investments to loans and advances. It follows therefore that change in "other" investments can reflect the extent of tightness in the banking system.

VII

Comparisons Between Classes of Banks

In this section we will consider the relative importance of government investments in four different classes of banks and for all banks. We will also consider which classes of banks were more tight or loose during 1955-60, especially in 1956 and 1960. As in Chapter VI, the classification of banks is based on the size of deposits. These classes will be known by capital letters. Class A is further subdivided between the State Bank of India and other banks, all of which are Indian. The rest of the classes are subdivided between the foreign and the Indian banks. Class E includes all scheduled banks. The data are presented in the form of percentages in Tables 50, 51, 52, and 53. Table 50 presents the ratio of government investments to deposits for the classes of banks ranging from A through E. Table 51 presents the

TABLE 50

THE RATIO OF GOVERNMENT INVESTMENTS TO TOTAL DEPOSITS FOR SCHEDULED BANKS CLASSIFIED ACCORDING TO THE SIZE OF DEPOSITS
(in percentages)

Year	Class A Banks	Class B Banks	Class C Banks	Class D Banks	Class E Banks (all banks)
1955	48.8	36.1	31.3	35.0	39.2
1956	41.0	28.2	31.4	35.3	34.6
1957	41.5	24.5	28.7	30.1	33.3
1958	51.7	33.1	35.7	28.1	42.0
1959	57.4	32.1	36.7	25.7	44.5
1960	40.1	26.0	36.5	26.0	34.8

NOTES: Ratios are calculated for data as of the last Friday of the year. The classification of banks is on the basis of size of deposits which is the same as in Tables 4 and 5 of Chapter 6.

Source: Trend and Progress of Banking in India, 1960, Statement 5.

TABLE 51

THE RATIO OF GOVERNMENT INVESTMENTS TO TOTAL DEPOSITS SUB-CLASSIFIED BETWEEN FOREIGN AND INDIAN BANKS FOR EACH CLASS OF SCHEDULED BANKS, AND THE STATE BANK OF INDIA
(in percentages)

Year	Class A Banks		Class B Banks		Class C Banks		Class D Banks		Class E Banks (all banks)	
	State Bank of India	Other Banks	Foreign	Indian	Foreign	Indian	Foreign	Indian	Foreign	Indian
1	2	3	4	5	6	7	8	9	10	11
1955	47.7	35.6	17.5	26.7	18.5	32.6	12.0	37.0	23.6	38.3
1956	39.3	36.0	23.1	26.7	17.4	33.3	14.1	33.7	20.9	23.7
1957	46.4	26.7	21.6	21.8	15.4	29.9	17.6	30.9	19.0	32.2
1958	56.0	34.2	25.0	27.8	18.5	35.9	16.1	27.9	22.8	40.4
1959	62.1	31.5	20.1	30.8	16.8	38.0	17.0	26.3	18.9	42.1
1960	49.2	21.6	15.8	27.0	18.7	37.8	17.6	26.7	16.6	34.2

Note: Ratios are calculated for data as of the last day of December.

Source: Statistical Tables Relating to Banks in India, 1955-1960.

TABLE 52

THE RATIO OF GOVERNMENT INVESTMENTS TO LOANS OF SCHEDULED BANKS CLASSIFIED ACCORDING TO THE SIZE OF DEPOSITS
(in percentages)

Year	Class A Banks	Class B Banks	Class C Banks	Class D Banks	Class E Banks
1	2	3	4	5	6
1955	113.8	63.8	58.4	57.7	75.2
1956	86.0	41.6	51.1	51.5	59.2
1957	86.6	38.4	56.6	42.8	61.2
1958	126.6	57.3	74.8	43.0	86.5
1959	162.0	57.4	73.1	40.5	97.4
1960	79.0	42.9	63.4	36.1	62.6

NOTES: Loans consist of advances, cash credits, and overdrafts. Loans are equal to bank credit minus "bills purchased and discounted".
Ratios are calculated for the data as of the last Friday of the year.

Source: Trend and Progress of Banking in India, 1960, Statement 5.

TABLE 53

THE RATIO OF GOVERNMENT INVESTMENTS TO LOANS SUB-CLASSIFIED BETWEEN FOREIGN AND INDIAN BANKS FOR EACH CLASS OF SCHEDULED BANKS AND THE STATE BANK OF INDIA
(in percentages)

Year	Class A Banks		Class B Banks		Class C Banks		Class D Banks		Class E Banks (all banks)	
	State Bank of India	Other Banks	Foreign	Indian	Foreign	Indian	Foreign	Indian	Foreign	Indian
1	2	3	4	5	6	7	8	9	10	11
1955	117.9	75.7	38.1	74.5	28.2	43.0	12.4	67.6	33.8	84.5
1956	86.1	73.4	26.6	48.2	22.2	72.3	10.9	61.2	24.3	67.6
1957	110.0	51.1	28.3	40.8	28.1	70.6	16.8	56.4	27.0	67.2
1958	169.2	68.8	35.3	58.9	33.5	83.7	17.4	53.7	33.2	94.1
1959	237.7	62.1	31.3	67.0	32.3	78.9	19.6	49.8	30.4	102.4
1960	131.2	33.4	22.2	53.0	26.4	76.7	17.3	45.3	22.5	68.3

Note: Ratios are calculated for data as of the last day of December.

Source: Statistical Tables Relating to Banks in India, 1955-1960.

same ratio for subclasses as mentioned above. In Tables 52 and 53 are set out the ratios of government investments to the loans of scheduled banks, the former for broad classes and the latter for subclasses.

Table 50 shows that class A banks have a higher preference for the governments than any other class of banks including class E. This is shown by the fact that the ratio for class A banks is higher in each year compared to any other class of banks. In the years 1956 and 1960 class A and class B banks show sharp declines in the ratio of governments to deposits. But curiously enough class C and class D banks register either small increases or no declines at all. However, the ratio of government investments to loans goes down in both 1956 and 1960. Ordinarily the ratios would be expected to fall together. But in 1956 class C banks increased their deposits and acquired governments by nearly the same percentage. Deposits increased by 18.4 per cent while the holdings of governments increased by 18.5 per cent. But bank loans went up by as much as 35.4 per cent. By contrast in 1960 their deposits fell by 5.3 per cent and they dis-invested government securities by 5.6 per cent. .On the other hand the loan portfolio of class C banks rose by only 8.7 per cent. As far as class D banks are concerned, their deposits and government investments declined in 1956 by 5.9 and 5.3 per cents, respectively. At the same time loans increased by 6.1 per cent. In 1960 both deposits and government securities rose by 10.4 and 11.5 per cents, respectively. But their loan portfolio rose sharply by 25.3 per cent.

From the above account it will be clear that the reasons for the stability of the ratio of governments to deposits are quite the opposite

for both classes of banks in 1956 and 1960. Class C banks improved their position in 1956 but declined in 1960, while class D banks registered a decline in 1956 but showed improvement in 1960.[1] Both classes of banks increased loans in 1956 and 1960. This must have strained their reserves. This is shown by the fact that class C banks in 1960 sharply reduced "money at call and short notice" and reduced their holdings of commercial bills--both of which are in the nature of liquid assets. Class D banks in 1956 were forced to reduce vault cash, curtail balances with the Reserve Bank, borrow from other banks, and slightly reduce "other" investments.[2]

It cannot be said that both classes of banks were tight in 1956 and 1960. Table 52 would suggest this. But because class C banks were adding to the government securities portfolios in 1956 and class D banks were doing the same in 1960, neither of them can be considered tight in these years. On the other hand it is quite clear that class C banks were tight in 1960, while class D banks were tight in 1956. In other years both classes of banks were relatively loose. Unlike them, class A and class B banks were tight both in 1956 and 1960.

Comparison Between Indian and Foreign Banks

In this comparison class A banks are excluded because this class has no foreign banks. Tables 51 and 53 give the ratios for each year in

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[1]The above calculations are based on Statement 5, "Liabilities and Assets in India of Banking Companies 1955-60," Trend and Progress of Banking in India, 1960.

[2]It is probable that these banks also borrowed from the Reserve Bank, but due to nonavailability of data this cannot be confirmed.

adjacent columns for foreign and Indian banks in each class. It should be remembered that these tables are based on another set of data (December 31, which is the date of the annual balance sheets of banks) and therefore, strictly speaking, are not comparable with Tables 50 and 52

Foreign banks in general have a weaker preference for government securities than do Indian banks. This is shown by the lower level of the ratios of government investment to deposits and of government investments to loans in Tables 51 and 53. Further, class D foreign banks have a weaker preference for government securities than do foreign banks in classes B and C. Comparing B and C banks nothing can be said with certainty. Shifts of banks from one class to another can account for the fact that in some years class B foreign banks seem to prefer government securities more than class C foreign banks while in other years the reverse is true. The same fluidity in the situation obtains for Indian banks.

Considering the years 1956 and 1960 it will be seen that some banks were tight but others were not. Taking 1956 first, according to Table 51, only class C foreign banks and class D Indian banks were tight. But in Table 53 it appears that all, excepting class C Indian banks, were tight. Since class C Indian banks increased their portfolios of government securities while, on the average, all classes of banks were reducing them, it would be inappropriate to consider them tight. The situation with class D foreign banks is different. Their deposits fell by 23.3 per cent while their loan portfolio registered a rise of 14.6 per cent.[1] At the same time they acquired one million rupees worth of

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[1]These and subsequent figures are based on tables prepared from Statistical Tables Relating to Banks in India for these years.

government securities. This is strange. But in view of the fact that the ratio of bank credit to deposits for class D foreign banks was 199 per cent in 1956 as compared to 154 per cent in 1955 (see Table 29, Chapter VI), it is hardly proper to treat them as loose. These banks were tight but at the same time were more daring than their competitors.

Class B Indian banks should also be considered tight in 1956 because they too disinvested government securities. The ratio of governments to deposits, however, remained unchanged as deposits fell proportionately. This was mainly the result of the change in the status of the second largest Indian bank, the Central Bank of India, from class B to class A. Class B foreign banks also lost in membership. Consequently their deposits as well as government investments declined. It is probable that these banks were moderately tight. However, these banks were perhaps tighter in 1955 than in 1956.

In 1960 the situation appears to be ambiguous for class C foreign banks and class D Indian and foreign banks. In respect to these banks the ratio of governments to loans declined but not the investment ratio. Class C foreign banks were probably tight because they suffered losses of deposits and therefore had to reduce investments in government securities. Concurrently, the ratio of bank credit to deposits rose sharply from 65.5 per cent in 1959 to 84.5 per cent in 1960 (see Table 29 in Chapter VI). The drop in the ratio of governments to loans was also greater than for Indian banks in the same class. Similarly, class D foreign banks were also probably tight even though they bought some government securities. This would be the presumption from the high ratio of bank credit to deposits which in 1960 was at a height of

140.7 per cent. However, for banks of this class it is quite difficult to say when they are loose or tight. As compared to other banks, they are a class apart.

The State Bank of India

The State Bank of India dominates class A banks. It maintains very high ratios of governments to deposits and of governments to loans. Other class A banks also maintain relatively higher ratios compared to other banks, but generally they are closer to class B Indian banks than to the State Bank of India. Both the State Bank of India and other class A banks were tight in 1956 and 1960 and relatively loose in other years. In the case of the State Bank of India, however, the year 1960 should be interpreted with caution. This, as has been repeated earlier, is due to the change in the banking of P.L. 480 funds. In fact, the high ratio of government investments to loans occurred mainly because the State Bank was not free to lend these funds to the private sector. Other than this, the State Bank of India, being owned by the government and the Reserve Bank of India, has to show a higher preference for government securities than other banks in the same class.[1]

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[1]This high preference is shown by the fact that the ratio of governments to total deposits increased from 47.7 per cent in 1955 to 62.1 per cent in 1959, while for Indian banks this ratio went up from 38.3 per cent to 42.1 per cent only (see Table 52). In 1960 the ratio of the State Bank declined relatively more than all Indian banks. But this year is not strictly comparable. The State Bank's higher preference for governments to loans is shown by Table 53.

The importance of the State Bank in absorbing government securities is still better shown by its share in the total held by all scheduled banks. On the basis of the year-end balance-sheet data given in Statistical Tables Relating to Banks in India for the years 1956 through 1960, the average ratio of government securities held by the State Bank

For the State Bank of India 1959 was a peculiar year. Unlike other class A banks, which gained in loans, the State Bank experienced net reductions. Consequently, its bank credit ratio, in 1959, declined to 28.6 per cent which was also the lowest for the period. The State Bank, however, recovered some of its lost position in 1960.

It is clear from the account given in Chapter VI and in the above paragraphs that the State Bank was using its loan and investment policy to support the monetary policy of the Reserve Bank. Under Indian conditions this is an important factor to be borne in mind. The State Bank, being the leading bank, can set an example in cooperating with the Reserve Bank and improve the chances for the success of monetary policy. It is therefore possible that under certain circumstances the State Bank may use its investment policy to oppose the prevailing sentiment among bankers. Thus if there should be a strong selling pressure in the government securities market, the State Bank can relieve the pressure on the Reserve Bank by entering the market as a buyer. This extraordinary circumstance can, however, be postulated only because the State Bank is jointly owned by the central government and the Reserve Bank of India.

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of India to all scheduled banks comes to 41.7 per cent for the Second Plan period (1956-60, both years inclusive). This ratio moved up from 25.1 per cent in 1956 to 47.5 per cent in 1959 and declined to 45.2 per cent in 1960. This is undoubtedly a very high ratio and indicates the extent of support that the Reserve Bank received from the State Bank of India.

It is, however, necessary to point out that these ratios are not on a comparable footing with those given in Tables 46, 47, and 48.

VIII

The Future of Monetary Policy

The discussion so far shows that monetary authorities were fairly successful in achieving their conflicting goals mainly because their policies were not put to a really severe test. Should the experience of 1960 be repeated on a larger scale and over a longer period the weakness of credit controls will be sharply exposed. Perhaps full coordination between the Reserve Bank and the State Bank of India will still be able to stabilize the prices of government securities and at the same time exercise some restraining influence on credit expansion. But it would be better if the weakness in the present policy were realized in time and steps taken to amend the policy should circumstances so warrant.

The chief dilemma for the Reserve Bank is that it can do nothing to slow down spending in excess of currently available resources in the public sector and therefore should either reduce the rate of investments in the private sector or let the latter grow at the risk of inflation. From this dilemma there seems to be no escape. At the same time the central bank cannot completely relinquish its responsibility of maintaining monetary stability in the economy. One possible way of resolving this dilemma is to establish the target rates of expansion in the money supply and the bank credit. The target rate of growth in bank credit should broadly correspond to the investment and production targets in the private sector at constant prices. If bank credit expansion is higher than the target rate but prices are stable, nothing need be done.

However, if it is accompanied or preceded by rising prices, then the Reserve Bank should act to restrict credit expansion. In case some increase in prices is provided for in the Five Year Plan, then the allowable rate of credit expansion will have to be higher. Whatever be the case both the government and the central bank should set up some guide lines to govern the conduct of monetary policy. This should be no more difficult than to set up investment, income and production targets. But somehow the authorities have not so far faced these questions squarely.

Given the target rate of credit, monetary authorities can effectively regulate credit by either imposing a ceiling on total credit allowed to individual banks or, indirectly, by freezing a portion of their portfolios of government securities by forbidding their sale. The Reserve Bank can still go to the help of individual banks, if needed, by offering to make short-term loans. The restrictive effect of these moves on the banking system will be salutary and will perhaps be needed no longer than the duration of a busy season. Moreover, the possibility that such restrictive measures might be taken will in itself have some restraining effect.

IX

Summary and Conclusions

During the Second Five Year Plan, the Reserve Bank's policies of credit control clashed sharply with the policy of debt management. However, the conflict came out into the open only in 1956 and 1960 when

banks switched from the governments into loans, and the Reserve Bank's open market policy resulted in net additions to its portfolio.

The Reserve Bank's open market policy has traditionally been directed at selling securities during the slack season and buying them in the busy season. But during this period the slack season operations were used to float substantially bigger issues than those to which the securities market had been accustomed. Therefore, in some slack seasons the Reserve Bank made loans to banks to enable them to subscribe to new issues. But banks did this on the understanding that the Reserve Bank would buy them unhesitatingly during busy seasons. Generally speaking, the seasonal behavior of governments held by banks shows passive adjustment to changes in the demand for bank credit.

Scheduled banks acquired government securities as well as "other" investments throughout the Second Plan period. In 1956 they sold governments and did again in 1960, although in the latter year it was exaggerated by the transfer of securities from the State Bank of India to the Reserve Bank. The decrease in "other" investments in 1960 is quite significant. This shows that, under the joint impact of restrictive credit policy and high loan demand, banks had to shift out of "others" to some extent in order to increase loans.

Even though scheduled banks made net additions to their government securities portfolio in most years, the Reserve Bank had to absorb more than 37 per cent of the new marketable debt in its own portfolio. Moreover, whatever the success the Reserve Bank achieved was in large part due to the State Bank.

Under Indian conditions the maturity distribution of the marketable rupee debt held by scheduled banks does not have any significance from the point of view of monetary policy. This is because the effect of changes in the structure of the debt on the liquidity of banks is negligible. Changes in the maturity distribution of the debt held by banks should therefore be interpreted to reflect changes in their asset preferences.

Comparisons between Indian and foreign banks show that the former have a higher preference for governments than the latter. These comparisons also bring out the differences between them in respect to responses to changes in the demand for bank credit.

The State Bank of India has lent important support to the Reserve Bank by allowing the ratio of governments to deposits to rise when other banks were doing the opposite. The conduct of the State Bank in the past gives rise to the possibility that in the future it might counteract the selling pressure from other banks. Should that happen the State Bank would become an adjunct to the Reserve Bank in respect to the day-to-day working of monetary policy.

The future of monetary policy will mainly depend on how the Bank resolves the conflict between debt management and monetary policy. In resolving this conflict, as well as in formulating a more effective credit policy, the task of the government and the Reserve Bank will be greatly eased if they can set up some clear guide lines and adhere to them. This should be no more difficult than the setting up of investment, income, and production targets for the Five Year Plans.

CHAPTER VIII

THE LIQUIDITY OF BANK ASSETS

I

Excess Reserves and the Bank Liquidity

In the previous two chapters it was seen that the years in which banks expanded credit most were also characterized by contraction of government investments. This scissor-like behavior of the banks' earning assets was a sure indication of tightness which, when related to restrictive credit policy as in 1960, could be interpreted as an indication of the effectiveness of the policy.

Ordinarily this situation should be characterized by a virtual disappearance of excess reserves.[1] However, since excess reserves on any date can look abnormally plentiful because of bank borrowings from the Reserve Bank or due to technical reasons, one can draw wrong inferences about excess liquidity when, in fact, the general evidence points in the opposite direction. The danger of drawing false conclusions can be mostly eliminated by deducting outstanding bank borrowings from excess reserves, and using the variations in the residual or its ratio to deposits as an indication of general tightness or looseness of banks.

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[1]The definition of excess reserves is as follows: Cash on hand + balances with the Reserve Bank - required reserves = excess reserves. The details are given in Chapter 3.

Variations in free reserves (= excess reserves - outstanding bank borrowings) is therefore a better indicator of the state of liquidity of banks.[1] A still more sensitive indicator of bank liquidity would be the residual obtained by deducting outstanding bank borrowings from surplus reserves and its ratio to deposits.[2] But want of data excludes this possibility. Thus it will be supposed that when free reserves are abnormally low or negative, banks are tight, and loose when they are high. It can be seen that free reserves will tend to decline when bank borrowings from the Reserve Bank are rising, and will correspondingly rise when bank borrowings tend to level off or are actually

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[1]Liquidity is a quality of assets. The greater the ease with which an asset can be converted into cash and spent the more liquid it is considered to be. Thus assets which are readily marketable without involving capital losses to the owner are considered more liquid than those which can be easily sold, but only at a loss. The securities issued by the Government of India are considered highly liquid. Inter-bank assets are also considered very liquid. At the other extreme are buildings and fixtures which are the least liquid.

For the commercial banks in general the need for liquid assets arises from the fact that most of their deposit liabilities can be withdrawn without notice. Therefore each bank, in addition to the primary reserves, keeps a portion of its deposit liabilities in the form of secondary reserves. The latter generally take the form of government securities. But primary reserves and secondary reserves are liquid only in relation to their deposit liabilities. These are not liquid in relation to loans. For the latter purpose banks generally keep government securities over and above secondary reserves. For a full discussion of the various aspects of bank liquidity, see Ronald I. Robinson, The Management of Bank Funds (2d ed.; New York: McGraw-Hill, 1962), pp. 53-128; and Robert G. Rodkey, Sound Policies for Bank Management (New York: The Ronald Press, 1944), pp. 9-52.

[2]Surplus reserves are defined as the sum of excess reserves net of working reserves. Working reserves are the balance kept by banks for precautionary motives. However, Indian banks do not publish data pertaining to them. These may be equal to or in excess of "cash on hand" or vault cash. Since banks in India do not show a firm commitment to a fixed cash ratio (as English clearing banks do), it is difficult to prepare estimates of working reserves. See in this connection E. G. Shaw, Money, Income, and Monetary Policy (Chicago: Richard D. Irwin, Inc., 1950), pp. 126-42.

falling. If the scissor-like behavior of banks' earning assets is associated with falling free reserves, banks should unambiguously be considered tight. This happened in India in 1956 and again in 1960. However, only in 1960 was the tightness of the banking system directly caused by restrictive credit policy. In 1956 the banking system became tight in spite of passive monetary policy.

Alternative Bank Policies

Under conditions of excess demand for loans in relation to available excess reserves banks can conceivably choose between the following five alternative policies:

(i) Sell government bonds while keeping the cash ratio constant;

(ii) Sell governments as well as reduce the cash ratio;

(iii) Reduce the cash ratio while holding constant the ratio of governments to deposits;

(iv) Allow the ratios of cash and governments to deposits to fall to the prudent minimum levels and thereafter increase loans through greater borrowings from the Reserve Bank;

(v) Sell governments and at the same time raise the cash ratio.

It is obvious that individual banks will follow one policy or the other depending upon the increase in demand for loans, the stability of business conditions (or the lack of it), the extent to which an increase in loan demand is expected to become permanent, the attitude of competing banks, the attitude of the Reserve Bank and last but by no means least, the initial liquidity and riskiness of the balance sheet. Depending upon these and other factors one bank will adopt a cautious policy while another will prefer a more expansionary policy.

On such matters broad generalizations for all scheduled banks are neither possible nor even necessary.

As far as the Reserve Bank is concerned, it cannot remain indifferent to which of these alternative policies the banks choose. Even though each policy will result in expansion of bank credit, some will do this less than others. Therefore the policies which are least expansionary should be preferred most. The Reserve Bank, however, might not be in a position to enforce its preferences on banks.[1]

Banks which are committed to maintain a constant ratio of cash to deposits will be selling more governments to increase loans by a given given amount than banks following the second policy. But on a percentage basis banks following the second policy will increase loans more than banks adopting the first policy. The third policy is likely to result in the smallest increase in bank credit. In fact such banks will be increasing their government holdings if deposits increase even marginally to increases in the volume of outstanding loans. Similarly, in the fourth policy, once the ratios have touched the critical minimum levels, banks will be adding to their governments' portfolios and cash as increases in loans result in some additions to deposits. These banks will be borrowing from the Reserve Bank partly to buy governments, partly to increase cash, and partly to increase loans. The fifth policy is less expansionary than the first two but more expansionary than the third and the fourth. Banks following the fifth policy are obviously trying to

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[1]The Reserve Bank cannot do this because its open market policy with respect to banks' reserves is passive and also because scheduled banks can freely change their cash ratios.

maintain the desirable level of liquidity by switching from governments to cash. However, in view of the Reserve Bank's support to the government securities market, this policy does not seem particularly attractive.[1] It is, however, possible that liquidity is not the prime motive behind substitution of cash for governments. If banks should expect, as in the middle of a busy season, that the market for loans is likely to improve while the policy of the Reserve Bank is likely to become more restrictive, then they might consider it farsighted to build excess liquidity now in order to loan it out later. By following this policy they would be avoiding the risk of selling governments at a loss or of facing an unwilling buyer in the Reserve Bank at a time when the loan demand is showing a rising trend. This policy also avoids the future risk of illiquidity stemming from the Reserve Bank's curtailment of lending.

It follows that, in effect, these banks are foregoing current earnings for the sake of higher future earnings. This policy will be adopted only by those banks which think that the sum of the discounted value of future earnings is high enough to warrant the sacrifice of current income. Thus the increase in speculation demand for excess reserves is caused by apprehension that credit policy might become more restrictive and thereby result in the loss of future income, or the decline of competitive position of the bank, or both. It is probable that this policy was adopted by some banks in 1960. The plausibility of this

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[1]The reason is that government securities are earning assets while cash is not. Therefore, switching from governments to cash will reduce banks' earnings without significantly improving their liquidities.

explanation rests on the presence of excess reserves with banks in the midst of a busy season. On the other hand, it is no less plausible that excess reserves were purely accidental or maintained for technical reasons. For instance, in November-December 1960 the Reserve Bank was releasing impounded reserves which were augmenting the cash reserves of banks, but the latter might not have had the time to make a full adjustment to improved liquidity. Yet another possible explanation is that banks wanted to show excess reserves on their year-end balance sheets merely to create a favorable impression on depositors and the authorities. This desire to window-dress the balance sheet was probably reinforced by the news that some important banks had recently gone into liquidation or had experienced serious difficulty. These factors--both expectational and technical--were probably responsible in some measure for excess reserves in several classes of banks in 1960.

II

Forms of Liquid Assets

Commercial banks in India possess four main classes of liquid assets. These are the following: (i) "cash on hand" and balances with the Reserve Bank; (ii) government securities of different maturities; (iii) money at call and short notice, and balances held with other banks; and (iv) short-term commercial papers which are mostly bills of exchange arising in the course of inland and foreign trade. It should, however, be noted that all inland bills are not genuine trade bills. Some of them are promissory notes of banks' constituents which are

converted into ninety-day usance bills so that they can be discounted with the Reserve Bank under "the scheme."

Considering the cash assets first it is clear that from the point of view of monetary policy only excess reserves can be considered as wholly liquid. The required reserves are not really liquid because except in a real emergency banks are not free to use them.

Similarly, the entire portfolio of government securities should not be treated as liquid. Banks in India are required by law to keep a portion of their deposits in the form of liquid assets.[1] The Reserve Bank has been very strict in insisting that banks should always hold "adequate" investments in government securities, alone with other liquid assets.[2] Moreover, in their own interest banks themselves would keep a portion of their demand deposits in the form of government securities as a secondary reserve against unforeseen contingencies.

Therefore, some portion of government investments should be considered wholly illiquid. It is, however, difficult to indicate the exact proportion of liquid and illiquid government investments. As Table 7 in Chapter VII shows, various classes of banks have different

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[1]Section 24 of the Banking Companies Act, 1949, lays down that every bank in India shall maintain 20 per cent of its demand and time deposits in the form of cash, gold or unencumbered approved securities whose value should not exceed the current market price. By the latest amendment to the Act, the liquidity ratio has been raised to 25 per cent. See Reserve Bank of India Bulletin (September 1962), p. 1365.

[2]In 1955 six banks were warned at the time of inspection for holding inadequate government securities and as many as twenty-three banks were found to have meager liquid assets. In 1960 the number of banks holding inadequate government investments went up to twenty and those in possession of meager liquid assets increased to thirty-four. After these defects are pointed out to them, banks generally rectify them before the next inspection is due. See Trend and Progress of Banking in India, 1955, p. 84; and ibid., 1960, p. 114.

preferences for government investments. Because of its special position (with respect to P.L. 480 funds) the State Bank has probably the lowest ratio of liquid governments to its total government investments. But compulsory investment of P.L. 480 funds cannot be put on a par with the secondary reserves which banks generally maintain. It is evident that different banks, both foreign and Indian, whether analyzed individually or as a group, will be found to be fully loaned up at different times at different levels of government investments.

The "money at call and short notice" and other interbank assets, although quite liquid for individual banks, are not of much significance from the point of view of monetary policy. These assets are, however, important in making comparisons between classes of banks. But these will not be considered further partly because their magnitude is small and partly because there appears to be no satisfactory reason why these assets should respond to changes in monetary policy.[1]

Bills of exchange arising in the course of inland and foreign trade are generally considered liquid assets in the U.K. But in India bills are usually held until maturity. Since there is no discount market in India, banks have no other choice. However, export bills held by foreign banks are rediscounted in London. But data pertaining to these are not available. Therefore, for our purposes it would be best not to count trade bills as liquid assets. We may thus conclude that only

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[1]The situation is different in the U.K. where London clearing banks generally try to keep a minimum of 30 per cent of their deposits in the form of liquid assets, including money at call and short notice. When banks are tight, they withdraw "money at call" and thereby force the discount houses to borrow from the Bank of England, which in turn accommodates them at penal rates. See in this connection, W. Manning Dacey, Money Under Review (London: Hutchinson & Co., 1960), Chapters 2 and 3, pp. 40-73; and J. R. Winton, "The Liquidity Ratio," Journal of the Institute of Bankers (February 1959), pp. 65-71.

excess reserves and the "liquid portion" of government securities can be considered as the truly liquid assets of banks.

The Liquidity Ratio

The liquidity of banks can be measured in three possible ways:

(i) The ratio of excess reserves and cash to deposits. This ratio can be readily calculated for the entire banking system as well as for individual banks. But this ratio tends to overestimate the liquidity of banks because, as was pointed out earlier, only surplus reserves can be safely lent out. Therefore, it is possible that banks may be fully loaned up even though their balance sheets show excess reserves.

(ii) The ratio of free reserves to deposits. This is a more sensitive measure of liquidity. By excluding the amount of bank borrowings from the volume of excess reserves, bank liquidity can be shown in a better perspective. But, due to nonavailability of data, this ratio cannot be computed for classes and subclasses of banks.

(iii) The ratio of free reserves plus Treasury bills to total deposits.[1] This ratio is, however, not relevant for Indian conditions primarily for two reasons. First, Treasury bill holdings of banks are quite small. Moreover, open market operations are conducted mainly in bonds. Therefore, Treasury bills in India do not have the same

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[1]G. L. Bach and C. J. Huizenga have used this measure to compare the relative tightness or looseness of banks in the United States during a period of tight money policy (1955-57). See their article, "The Differential Effects of Tight Money," American Economic Review, LI, No. 1 (March 1961), 52-80.

significance for monetary policy as in the U.K. and the United States. Second, Treasury bills are no more liquid than bonds issued by the central government. Therefore, for measuring the liquidity ratio bills as well as bonds should be counted among liquid assets.[1] But this will swamp the ratio. And it is really not necessary to do so because the ratio of governments to deposits or the ratio of governments to loans can indicate the state of liquidity of banks as well.

Between the first two ratios the latter is definitely to be preferred to the former. So the second ratio will be used for indicating the liquidity of scheduled banks as a whole and the first for making comparison between them.

III

Seasonal Variations in Excess Reserves and Free Reserves

The liquidity of banks varies seasonally although these variations do not even out. In Table 54 seasonal variations in cash, excess reserve borrowings from the Reserve Bank, and free reserves are shown. It will be seen that Column 1 gives a misleading impression of bank liquidity; this is to some extent true of Column 2 also. Column 3,

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[1]The Reserve Bank conducts open market operations only in central government securities. So it may be said that central government securities are more liquid than securities issued by state governments. But in fact the market for state government securities is quite stable, mainly because banks can obtain whatever cash they need by selling central government securities. Therefore this distinction is not of much importance.

TABLE 54

SEASONAL VARIATIONS IN CASH, EXCESS RESERVES, AND FREE RESERVES OF SCHEDULED BANKS
(in million rupees)

Seasons	Cash and Balances with R.B.I.	Excess Reserves	Borrowings from R.B.I.	Free Reserves
	1	2	3	4
Busy, 1955-56	-67.4	-82.8	+503.5	-586.3
Slack, 1956	+10.2	-3.9	+19.1	-15.2
Busy, 1956-57	+160.0	+110.0	+149.0	-39.0
Slack, 1957	+402.2	+358.6	-429.4	+788.0
Busy, 1957-58	-107.4	-140.4	-99.2	-41.3
Slack, 1958	+136.6	+136.9	-175.9	+312.8
Busy, 1958-59	-146.1	-182.2	+249.4	-431.6
Slack, 1959	-211.1	-233.4	-133.5	-99.9
Busy, 1959-60	+296.7	+87.2	+298.0	-210.8
Slack, 1960	+41.7	-75.5	-270.2	+194.7
Busy, 1960-61	-232.4	+50.2	+215.3	-165.1

Sources: Report on Currency and Finance, 1960-61, Statement 27; and Statistical Tables Relating to Banks in India, 1955-60.

which shows excess reserves net of borrowings from the Reserve Bank portrays the more accurate picture of variations in bank liquidity during the period under review. It shows that with the exceptions of slack seasons in 1957, 1958, and 1960, scheduled banks have been generally tight.

If comparison is made between excess reserves and free reserves, it will be seen that in three seasons the two show opposite signs. These are the busy seasons of 1956-57, 1959-60, and 1960-61. In these cases the plus signs against excess reserves are deceptive. Banks were actually tight as is shown by their recourse to borrowing from the Reserve Bank and disinvestment of government securities. The government securities portfolios of all scheduled banks showed declines of 269.6 million rupees in the busy seasons of 1956-57, 524.9 million rupees in 1959-60, and 1,263.2 million rupees in 1960-61.[1]

On the other hand, the busy season of 1957-58, when both excess reserves and free reserves show negative signs, was weak, and banks were quite easy. They could actually reduce their indebtedness to the Reserve Bank and increase holdings of government securities. This only shows that the concept of free reserves is not unambiguous and despite greater reliability it can sometimes lead to entirely misleading inferences. Therefore, in determining whether banks in any year were relatively

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[1]In the busy season of 1960-61 the decline in governments was aggravated by transfer of P.L. 480 funds and the government securities in which these were invested from the State Bank of India to the Reserve Bank. Moreover, the Reserve Bank was returning the impounded reserves to banks to facilitate expansion of credit in the busy season. This shows up in the excess reserves of banks. See Report on Currency and Finance, 1960-61, Statement 27, pp. 36-39.

tight or loose the entire situation should be considered, and not merely their position in terms of excess or free reserves. In most cases the latter gives the correct indication but not always.

IV

Trend in Bank Liquidity

The trend over the period of 1955-60 is shown in Table 55. This table shows an average of Fridays' figures for cash and excess reserves (hereafter cited simply as excess reserves), borrowings from the Reserve Bank, free reserves and the ratios of free reserves and excess reserves to total deposits. Since this table averages out the slack and busy seasons, the liquidity situation looks deceptively easy, except in 1956 and 1960 when busy seasons were stronger than average.

Once again Column 2 on excess reserves gives a wholly misleading picture. Column 4 on free reserves provides a better portrayal of the situation. But when both are related to total deposits, it becomes quite evident that (as in Columns 5 and 6) 1956 and 1960 were tight years for all scheduled banks. The negative figures in Columns 4 and 5 for 1956 show that banks had overextended themselves in making loans. This should be attributed to the prevailing passive monetary policy. By comparison banks were restrained in 1960 by the restrictive policies of the Reserve Bank. This clearly shows up in Column 3. The Reserve Bank's policy of making selective loans at penal rates had a restraining effect insofar as banks could not borrow as much as they might have wanted to.

TABLE 55

TREND IN EXCESS RESERVES AND FREE RESERVES AND THEIR RATIOS TO TOTAL DEPOSITS OF SCHEDULED BANKS

Year (Average of Fridays)	Cash and Excess Reserves (in million rupees)	Borrowings from the Reserve Bank (in million rupees)	Free Reserves (2-3) (in million rupees)	Ratio of Free Reserves to Deposits (%)	Ratio of Cash and Excess Reserves to Deposits (%)
1	2	3	4	5	6
1955	484.2	177.3	306.9	3.1	4.9
1956	468.9	531.8	-62.9	-5.8	4.3
1957	652.5	575.5	77.0	6.1	5.2
1958	703.1	161.4	541.7	3.6	4.6
1959	589.5	184.7	404.8	2.3	3.4
1960	591.7	384.0	207.7	1.0	3.0

Note: Total deposits are net of interbank deposits.

Sources: Trend and Progress of Banking in India, 1960, and Statistical Tables Relating to Banks in India, 1960.

Even though banks were tight in 1960, this was not wholly due to restrictive credit policy. As has already been explained in Chapter IV and repeated later, the Reserve Bank had started easing the policy from November 12, 1960. This was done to facilitate the flow of credit to the productive sectors. Credit restrictions, nevertheless, were strong enough to be reflected in rising money rates in the organized money market as well as in the bazaar money market.[1] This shows that the Reserve Bank, restricted though it was by numerous policy constraints, could still display some of the potential power of restrictive monetary policy. This gives rise to hope that in the future, when the need arises, the Reserve Bank will be able to move with greater confidence. This experience also suggests that had monetary policy been more flexible (a purely theoretical possibility under the circumstances) the Reserve Bank could have exercised greater restraint on banks.

V

Liquidity Ratio of Different Classes of Banks

Liquidity ratio in this section measures the ratio of excess reserves to total deposits. In view of the limitations of this ratio, as pointed out earlier, it should be interpreted with caution. It will be supposed that banks are tight if this ratio goes down in any year and

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[1]The call money rate in Bombay moved up from 3.51 per cent in September 1960 to 4.20 per cent in November and 5.18 per cent in January 1961. The Bazaar Bill Rate (being the rate at which bills of small traders are discounted by Shroffs) moved up by 2-3 percentage points to 12 per cent and above. Ibid., Statement 36; and Trend and Progress of Banking in India, 1960, p. 17.

loose if it moves up. Two more points should be noted in this connection. First, Indian banks borrow from the State Bank of India in addition to the Reserve Bank. This borrowing took a sharp upward turn in 1960. Second, the ratios in Table 56 are based on the data as of the last Friday of December which in 1960 happened to be December 30. The date on the annual balance sheets of most banks is December 31. Cash figures on these dates are likely to have an upward bias due to the tendency of banks to "window-dress" their balance sheets. This is probably done by bank managers to present themselves as prudent and sound bankers.

The ratio of excess reserves to deposits for banks classified into four size groups and all banks is shown in Table 56. As this table shows quite clearly, for banks 1956 was the year of tight liquidity. This is shown by the decline in the outstanding amount of excess reserves for all banks (Column 6); and by the fact that, compared to the previous year, the ratio declines for every class of banks. However, the picture is rather confusing in other years and quite misleading in 1960. Curiously enough, 1959 emerges as the year when every class of banks was tighter compared to either 1956 or 1960. This odd possibility can only be due to the fact that these ratios pertain to one date which could be quite abnormal.

Between banks no clear difference is perceptible between classes A, B, and C. However, class D banks show a higher preference for cash than other classes. But to get a clearer picture, banks need to be subclassified into foreign and Indian banks. The State Bank of

TABLE 56

THE RATIO OF EXCESS RESERVES TO DEPOSITS FOR DIFFERENT CLASSES OF SCHEDULED BANKS AND THE AMOUNTS OF OUTSTANDING EXCESS RESERVES FOR ALL SCHEDULED BANKS

Year (As on the Last Friday of)	Class A Banks (per cent)	Class B Banks (per cent)	Class C Banks (per cent)	Class D Banks (per cent)	Class E Banks	
					(per cent)	Amount Outstanding (in million rupees)
	1	2	3	4	5	6
1955	7.0	4.9	7.9	10.3	6.5	635.5
1956	3.9	4.4	6.2	8.8	4.8	513.5
1957	4.1	4.2	5.6	8.9	4.7	619.0
1958	4.4	3.8	5.2	7.7	4.5	695.9
1959	2.4	1.8	4.3	6.9	3.3	585.2
1960	4.4	4.5	4.8	7.2	4.6	842.9

NOTE: Excess reserves have been calculated by deducting the total of 5 per cent of demand deposits and 2 per cent of time deposits from the total of cash and balances held by the Reserve Bank on the last Friday of the year for each class of scheduled banks. For 1960 excess reserves were estimated by deducting 4.3 per cent of the total of demand and time deposits from the cash assets outstanding of each class of banks.

Sources: Trend and Progress of Banking in India, 1960, Statement 5; Report on Currency and Finance, 1960-61, Statement 13.

India, as before, has been separated from other class A banks. The excess reserves ratios pertaining to these subclasses are set out in Table 57.

Comparisons Between Foreign and Indian Banks

The data of Table 57 are based on the year-end balance sheets of individual banks. Therefore, it may be supposed that banks will show some excess liquidity in their balance sheets. These ratios are not strictly comparable with Table 56, because deposits in the former are gross of interbank deposits, but in the latter they are net of interbank deposits. This gives a downward bias to the ratios in Table 57 as compared to Table 56.

Since banks differ from each other in various ways, it should be expected that each bank will have different attitude toward cash. It may be further presumed that banks belonging to each subgroup will display similar preferences towards cash as compared to other liquid assets. This is not logically necessary, but neither is it implausible. Therefore, it should not be surprising that class D Indian banks maintain the excess reserves ratio between 13 and 15.5 per cent while at the other extreme class B foreign banks keep this ratio between 2.5 and 5 per cent only. It may be expected of some banks--as class C foreign and Indian banks show--that the excess reserves ratio will display a declining trend. This shows that opportunities of making loans have been increasing and banks have made profitable use of them. Therefore differences between subclasses, if they are consistent over years, can simply

TABLE 57

THE RATIO OF EXCESS RESERVES AND CASH TO TOTAL DEPOSITS OF SCHEDULED BANKS IN SUB-CLASSES OF FOREIGN AND INDIAN BANKS AND OF STATE BANK OF INDIA
(in percentages)

	Class A Banks		Class B Banks		Class C Banks		Class D Banks		Class E Banks	
Year (Last Day of December)	State Bank of India	Other Banks	Foreign	Indian	Foreign	Indian	Foreign	Indian	Foreign	Indian
1	2	3	4	5	6	7	8	9	10	11
1955	9.3	8.9	3.1	8.4	6.9	13.2	13.9	13.4	5.6	10.2
1956	7.8	7.8	3.6	8.9	18.1	10.8	16.8	15.3	5.9	9.1
1957	7.3	9.0	4.2	10.2	8.6	10.5	25.4	15.1	6.3	9.1
1958	8.3	6.6	2.9	7.2	5.1	9.6	11.6	15.3	4.0	8.4
1959	8.2	6.3	4.9	7.9	3.2	9.5	7.1	15.1	4.6	8.2
1960	7.4	6.4	4.8	6.4	3.7	7.4	6.6	13.0	4.8	7.2

NOTES: Excess reserves were calculated by deducting the sum of 5 per cent of demand and 2 per cent of time deposits from the year-end cash and balances with banks. The ratio was calculated with respect to total deposits which included inter bank deposits. For 1960 excess reserves were estimated by subtracting 4.3 per cent of total deposits from the total cash assets of banks.

Source: Statistical Tables Relating to Banks in India (1955-1960).

be attributed to preferences shared by banks belonging to the group and maintained over time due to the continuation of most banks in a given class.

But when the ratio fluctuates within a wide range as in class D foreign banks, some other factors should account for it. It will be recalled that these banks maintain a bank credit ratio at abnormally high levels (see Table 39 in Chapter VI). In a period of six years the bank credit ratio ranged from 111.9 per cent to 199.0 per cent. However, the ratio of governments to deposits (see Table 51 in Chapter VII), although lower than the average of all foreign banks, has been remarkably steady. This ratio varied from 12.0 per cent to 17.6 per cent only. Moreover, the ratio of governments to deposits tends to rise with years. By comparison, the excess reserves ratio tends to fall from 1958 onwards. These two tendencies suggest that class D banks have been giving higher preference to governments relative to excess reserves for preserving the appropriate liquidity of their assets.

Having raised the bank credit ratio to 199 per cent in 1956 class D banks were forced to take some steps to preserve their liquidity. This they did by sharply reducing "money at call and short notice" and diverting them into cash and governments.[1] In addition they borrowed from the Reserve Bank. The bulge in the excess reserves ratio in 1957

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[1] It is probable that foreign banks brought in funds from their other overseas branches. Most of these funds were, however, brought in by British banks, none of which is in class D. But through the mechanism of interbank loans some portion of these funds might have reached class D banks. This is, however, only a speculative possibility. See Trend and Progress of Banking in India, 1956, p. 16.

was caused by a return flow of cash as loans were repaid, but new demand failed to catch up.

The same explanation appears to hold good for the abnormally high ratio of excess reserves for class C foreign banks in 1956. These banks partly reduced "money at call," partly borrowed from the Reserve Bank, and partly replenished their cash reserves by bringing in funds from abroad.

Indian banks that have no access to foreign funds and whose business is liable to relatively greater seasonal fluctuations show a natural hesitation to jeopardize their liquidity by excessive expansion of the loan portfolios. They generally expand the loan ratio less and maintain higher ratios of governments and excess reserves as compared to foreign banks. Quite apart from these broad differences Table 57 shows that Indian and foreign banks have responded similarly to a high demand for loans in 1956 and 1960 and to restrictive credit policy, as in the latter year. It will be further noticed that in 1958, which was characterized by low demand for bank credit, excess reserves are the lowest. This is so because banks, as pointed out in Chapter VII, used their excess reserves to buy governments and to reduce their indebtedness to the Reserve Bank.

The State Bank of India

Table 57 shows that in the management of cash the State Bank is not much different from other classes of Indian banks. The somewhat higher level of excess reserves ratio since 1958 is partly due to the fact that the State Bank has been taking over the currency chests in

some districts, where formerly government treasuries used to perform this function. Moreover, the State Bank has been increasingly providing remittance facilities to governments, other banks, and the general public. This cash is in a state of transit and shows up in the form of excess reserves. We thus conclude that while the State Bank has probably deliberately refrained from expanding its loan portfolio, this was not done by building up uneconomic excess reserves. Rather, the State Bank refrained from switching from governments to loans.

VI

Implications for Monetary Policy

It is clear from the preceding discussion that excess liquidity of banks is consistent with considerable loan expansion, even to abnormal limits. The banking system or individual banks will, of course, stop expanding bank credit when government investments have reached the floor below which they cannot possibly fall But as long as banks feel that they can dispose of securities or borrow money from the Reserve Bank by pledging usance bills, they can simultaneously add to excess reserves and expand loans. The ultimate limit will be reached when excess reserves have been fully exhausted or earlier when free reserves begin to show a negative sign. But the central bank obviously cannot rely on natural forces to bring the process of credit expansion to a halt. It must act sooner with a view, first, to slow down the pace of credit expansion, and second, to gradually bring it to a halt. This will have to be done, especially when bank credit expansion is a significant factor in an inflationary rise in prices.

Traditionally, central banks in Western countries have tried to achieve this goal by tightening bank liquidity. However, control of bank liquidity is not the objective per se. Rather, by curtailing bank reserves, monetary authorities seek to control bank loans and indirectly the liquidity of spending units. In an advanced country where the economic system relies heavily on the banking system to secure funds for financing current expenditures central banks can hopefully control the latter by controlling banks' abilities to lend. In the Indian economy this can be achieved only to a lesser extent because the economic system does not rely on banks as much as it does in the West. But the Reserve Bank can, in principle at least, make some (though small) contribution to maintain stability. This, however, cannot be done adequately as long as commercial banks have unrestricted access to the Reserve Bank for obtaining fresh reserves. It is true that, as in 1960, the Reserve Bank, by combining the policy of marginal reserve requirements with selective lending at penal rates and moral suasion, could exercise some restraining effect on banks. But it could not prevent banks from selling governments and thus replenishing their reserves and loaning them out. Within less than a year the Reserve Bank saw that its passive open market policy was contributing to the defeat of its general policy of credit control.

For the success of credit control policy, insofar as it relies on controlling excess reserves, two conditions must be fulfilled. These are: (i) banks should maintain a stable ratio between reserves and deposits; (ii) the Reserve Bank should have the power to regulate the

volume of reserves. But in India banks do not maintain a stable cash ratio, and the Reserve Bank does not have the power of controlling bank reserves. The limitations of the Reserve Bank's powers were not tested until 1960 for the simple reason that they were not exercised. Now it is futile to inquire what more the Reserve Bank could have done to make itself more effective. Perhaps the Reserve Bank was wiser in not trying to achieve more; perhaps under the circumstances not much more was called for. But the lessons of past experience should be properly learned and the need for reinforcing the credit controlling power of the Reserve Bank should be clearly stated. It is, therefore, necessary to examine the possibilities of strengthening the hand of the central bank; and this should be done in full realization that the Reserve Bank will probably not have either the flexibility or the autonomy that monetary authorities enjoy in the United States and the U.K. This task is deferred to the last chapter where some old proposals and new possibilities will be discussed in the context of India's needs and problems.

VII

Summary and Conclusions

In concluding this chapter it may be noted that banks in India had excess liquidity in every year excepting 1956 and 1960. This is, however, the result of lumping together slack seasons with busy seasons. Seasonally banks were tight in all excepting the slack seasons of 1957, 1958 and 1960.[1] The Reserve Bank was, however, directly involved in

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[1]In part the explanation for excess liquidity lies in the

controlling bank liquidity only in 1960; and, considering the limitations of its policies, achieved a fair amount of success. In other years the Bank's policy was not directed at regulating the general liquidity of banks, but rather in selective regulation of their lending policy.

The response of banks to the Reserve Bank's policy was mixed. All banks maintained excess reserves. Curiously enough, those banks which maintained the highest ratio of bank credit to deposits also kept higher ratios of excess reserves to deposits. This was partly due to the restraining effect of credit policy (as in 1960) and partly due to the desire to maintain adequate liquidity. The latter could also have been partly motivated by the desire to "window-dress" the balance sheets.

Finally, the inadequacy of the powers of the Reserve Bank to regulate the volume of credit by adjusting bank reserves is pointed out. At the same time the need for strengthening credit controls is shown so that in the future the Reserve Bank may be able to play its part in maintaining stable conditions in the economy. Stronger general credit controls will have to grapple with the instability of the cash ratio and uncontrolled fluctuations in bank reserves.

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shortage of foreign exchange and tight import restrictions which were severely felt by the private sector.

CHAPTER IX

CONTROL OF BANK PORTFOLIO AND THE EFFECTIVENESS OF MONETARY POLICY

I

The Need for a New Strategy

It was explained in the second and the fourth chapters that the Reserve Bank had to subordinate its concern for monetary stability to the overriding need for the successful implementation of the Second Plan. This policy orientation was consistent with the general strategy of the Second Plan, in which some risk of inflation had been deliberately undertaken. Accordingly, monetary policy was aimed at affecting the distribution of credit rather than controlling its rate of growth. As the discussion in Chapters V and VI shows, in this respect, Reserve Bank policy achieved its rather limited objective. It also succeeded in the ancillary objective of raising somewhat the cost of credit. From this it may be inferred that some credit rationing was enforced.

Only between March 1960 and January 1961 did the Bank try to regulate the volume of bank reserves. In the history of the Reserve Bank this was the only time when marginal reserve ratio policy was used and it had practically no effect. The only desirable effect was felt on the cost of credit, which went up. As the Bank later stated, the main cause of defeat of this policy was "the free and unlimited access of

banks to Reserve Bank credit."[1] This was because the Reserve Bank could not prevent banks from selling government securities and it could not avoid buying them. Here lies the major weakness of credit control policy which was sharply exposed in the first real test. The experience of these ten months shows that even a powerful weapon like marginal reserve ratio policy is doomed to frustration unless open market operations can be conducted at the initiative of the Reserve Bank rather than at the discretion of the bond-holding public (including banks). If this cannot be done, the only other alternative is to place legal barriers that will prevent banks from selling governments in excessive amounts.

During this period the Reserve Bank tried to keep the interest cost to the government as low as possible. With this end in view it used its debt management policies to keep the level of interest rates low and to maintain satisfactory yield differentials between the long-term and the short-term maturities. The pattern of yield, as illustrated in Table 58, shows a declining trend. This, however, is not true of yields on all securities, some of which have actually moved in the upward direction. An orderly yield pattern is undoubtedly satisfactory to the government whose borrowing demands are on the increase, and the investing public which naturally likes to combine liquidity with a satisfactory rate of return. But this policy has weakened the effectiveness of credit controls. For the latter a flexible interest rate policy is more desirable.

In order to harmonize the policy of maintaining a fixed pattern of yield with the restrictive credit policy the Reserve Bank will have

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[1] Report on Currency and Finance, 1960-61, p. 33.

TABLE 58

THE TRENDS IN YIELDS ON SELECTED GOVERNMENT OF INDIA SECURITIES AND THE TREASURY BILL RATE

(per cent per annum)

Annual Averages	Nonterminable	Over 15 Years	Between 10 and 15 Years	Between 5 and 10 Years	Under 5 Years	Average Rate of Discount on Treasury Bills
	3% 1986 or later	2 3/4% 1976	3 3/4% 1974	3 1/2% 1967	3% 1964	
	1	2	3	4	5	6
1956-57	3.99	4.02	4.05[a]	3.70[b]	3.88[c]	2.53
1957-58	4.18	4.03	4.41[a]	3.76	4.01[c]	--
1958-59	4.13	4.08	3.89	3.70	3.73	2.52
1959-60	4.05	4.13	3.80	3.56	3.54	2.59
1960-61	4.06	4.18	3.79	3.62	3.61	2.65

[a]This is the yield on the earlier date of redemption of 3% 1970-75 loan.

[b]3 1/2% 1965 loan.

[c]2 3/4% 1962 loan.

NOTES: The yields are gross, i.e., not allowing for the income tax. The annual averages are based on the monthly averages of prices as quoted at Bombay.

Source: Report on Currency and Finance, various issues.

to permit the entire structure of interest rates to move up. If the long-run interest rate is not allowed to rise and the short-term rate is, the yield differential between the two will be narrowed. This will lead to increased speculation as some of the investors will try to borrow long and lend short. In this situation the Reserve Bank will have to permit either an increase in the long-term rate or an increase in speculation. Therefore, it seems rather obvious that for the sake of monetary stability, greater flexibility in the interest rate policy is desirable. However, the experience of the Second Plan does not give rise to the hope that the current policy of low interest rates will be significantly modified.

Now that the Second Plan is over and far more trying years are ahead, it is necessary to learn from past weaknesses and to design tools that will prove adequate for meeting the goals of monetary policy. The basic premises on which the following proposals rest can be simply stated: that monetary policy has an important role to play; but to make it more active and for heightening its effectiveness, it is necessary to modify general credit controls. Furthermore, the entire set of credit controls should be used together promptly and adequately to achieve clearly-defined goals.

II

The Two Fundamental Problems of Credit Control

Aside from the need for better credit control instruments the two most important problems of monetary policy pertain to its timing and

adequacy. In practice, however, the timing of policy and the degree of ease or restraint that would be neither more nor less than required are the two most difficult problems of monetary policy. The first problem relates to various lags of monetary policy that are not typical to India. These lags may be listed as follows:

(a) the lag between the occurrence of an event requiring policy change and its recognition by the authorities;

(b) the lag between recognition of the need for a policy change and the formulation of new policies;

(c) the lag between the formulation of a policy and its implementation on scheduled banks;

(d) the lag between the impact of a new policy on banks and its realization in effecting changes in income and prices.[1]

The main cause of the first lag is the delay in the collection and interpretation of the statistical data and the time spent in working out the policy implications of them. This lag is likely to be longer in India than, say, the United States, because of the insufficiency and unreliability of data in the former compared to the latter. The second lag may be longer or shorter depending upon the efficiency of the administrative apparatus, or upon the general ease or difficulty in making a decision on new policies or changes in an existing policy. The third lag will depend upon the speed of communication between the Reserve Bank

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[1]See Milton Friedman, "A Monetary and Fiscal Framework for Economic Stability," American Economic Review, XXXVIII, No. 3 (June 1948), 245-64.

and scheduled banks. The fourth lag cannot even be guessed because in India income and prices are often subject to far more powerful influences than those emanating from banks.

It is quite evident that the effectiveness of credit control policy will largely be derived from its proper timing. In this thesis an estimation of these time lags has not been attempted. It may, however, be stated that the danger of monetary policy becoming destabilizing is not anywhere as great in India as in the United States or other developed capitalist countries. This is because the Indian economy is not subject to periodic booms and recessions which make the timing of policy the very heart of the matter. Nevertheless, proper timing can thwart a speculative boom from developing, slow down an increase in prices through selective controls, or can make the economic system more or less stable by affecting expectations one way or the other.

The second problem of monetary policy is to determine the degree of restraint or ease to be applied whenever policy adjustments are needed. In this respect it is easier to be wise after the experience has been gained than before it. This was very true for the Reserve Bank which was relatively a novice in coordinating credit policy with the requirements of a developmental plan. But aside from the inexperience of the monetary authorities of India, it does not seem possible, on the basis of theory alone, to lay down ground rules in advance on how far to go in exercising credit controls. This was, however, partly due to the fact that the Reserve Bank was called upon to meet conflicting goals--a point to which attention has already been drawn.

Need for Better National Income Statistics

While it would be impractical to assume that lags in monetary policy will completely disappear, it should not be unreasonable to expect that attempts will be made to shorten them. This can best be done by improving the statistical picture of the economy and publishing it with the least possible delay. Statistics pertaining to national income, prices, and flow of funds have been improving year by year. But as yet they are only a pale shadow compared to the quality and variety of data in advanced countries, such as the United States. This is not a criticism because it is simply not possible for India to achieve U.S. standards in the foreseeable future. Nevertheless, it is necessary, at least, to point out the direction in which further improvements would be most desirable. In order to render the monetary and fiscal policies more effective, the authorities should have a better idea of the changes taking place in the monetized sector of the economy. Therefore a separate set of national accounts should be prepared which will depict only money flows. This can be done without significant additions to the cost currently being incurred in the preparation of national income statistics. Yet the accounts of market economy are likely to be far more reliable than the existing set. These will render invaluable aid in the formulation of correct policies.[1] After all, monetary and fiscal policies affect only those flows which enter the market. The measurement of nonmarketed produce is mainly of importance for making welfare

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[1]These accounts will also bring out the rates at which the market economy in the aggregate and in different sectors has been growing in the past.

comparisons over a period of time but is not of much use in the formulation of policies that are designed to influence money flows. It is, therefore, suggested that a separate set of national product accounts showing money expenditures on each component of Gross National (marketed) Product should be prepared, and if possible a quarterly series should be set up. Corresponding to these, another set of accounts can be prepared showing the deflated values of GNP and its components.

Need for Improvement in Financial Statistics

Along with improvement of national income data, there is need for better financial statistics. At present there are no statistics on the end-use of bank credit, the economic characteristics of borrowers, the rates of interest charged by banks on loans classified by purpose or the type of borrowers, or the regional distribution of bank loans classified by economic sectors, and so on. One would also want to know the number of applicants for loans that were turned down in relation to those accepted by banks.[1] The Reserve Bank will have to put forth extra effort and expense in collecting, processing, and publishing additional data with the least possible delay. But in turn it will help the Reserve Bank in formulating its policies with greater objectivity and clearer vision about immediate targets and ultimate goals. Researchers will find

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[1]It may be argued that these statistics are not published by central banks in other countries and therefore the Reserve Bank has no precedent to follow. In reply it can be said that the Reserve Bank has been called upon to aid economic development with stability for which there is no precedent either. However, it would not matter if these data are published by some private research organization with support from the Reserve Bank.

it easier to evaluate the functioning of monetary policy and in appraising its general or selective effectiveness. In the long run the Reserve Bank and the country can only benefit from informed and objective criticism.

Need for Clear Demarcation of Roles

On the question of what constitutes an adequate degree of credit control nothing more can be said other than that the central bank should exercise its due discretion in the light of objective circumstances and the broad goals of economic policy as laid down in the Plan, or by the government. The effectiveness of credit controls can, however, be greatly enhanced provided the Reserve Bank is assigned its place by deciding in advance the goals it should pursue, and be accorded with the necessary autonomy either through new legislation or a declaration of government policy to determine the policies that will best achieve those goals. This is necessary to avoid the need for frequent consultations with the central government when a developing situation requires prompt action. Thus, while monetary policy will still have to be coordinated with other arms of economic policy, the Reserve Bank will not be handicapped by having to defer to somebody else's judgment in acting within its own sphere. This may or may not induce the Bank to use credit controls more adequately, but it certainly seems to be a necessary step to make monetary policy more effective.

III

Feasible Goals of Reserve Bank Policies

As in the past the Reserve Bank may pitch its policies at two levels. On the one side the Bank has tried to funnel resources into agriculture (through cooperative credit societies) and small-scale industries (through government-owned industrial finance cooperations, etc.), and on the other it has tried to regulate the structure of prices. The former is essentially a long-run function and can be gradually stepped up. This may complicate the task of the short-run policy of maintaining stability in the economy but is considered of sufficient importance to be pursued as an independent goal.

The second function of the Reserve Bank, that is, to maintain reasonable price stability and to prevent financial resources from going into low priority sectors, is the more important as the short-run goal. These tasks can be best performed to the advantage of economic planning if the Planning Commission, the government of India, and the Reserve Bank agree on two things: (i) that avoidance of inflation is a desirable policy; and (ii) that the index number of prices should not be allowed, on an average, to exceed a certain percentage per year. If these policy goals are accepted at the very outset of the Plan period, the task of credit control will be made much clearer, if not easier.

In the Second Five Year Plan the function of Reserve Bank policy was viewed simultaneously, rather broadly to provide the needed liquidity to meet expenditure targets in the public and private sectors, and rather too narrowly to influence the structure of prices through the

instrumentality of selective controls. It is evident that regulation of the structure of prices, even at strategic points, cannot be isolated from policies aiming at stabilization of the price level. Nor can the selective controls do their job adequately if general controls fail to control the reserve base of commercial banks.

For an effective employment of credit controls the problem of stabilizing price level and the control over strategic prices should be viewed as two aspects of the same problem. One feasible way of approaching this problem is to include the maintenance of a reasonable price stability as one of the important objectives in the Five Year Plans. Second, the price level may be considered reasonably stable if variations over a period of one year do not exceed, let us say, 1 1/2 to 2 per cent. If the authorities, including the Reserve Bank, announce their price policy and display convincing loyalty to it, the expectations of consumers, investors and speculators will probably be favorably affected. A clear policy pronouncement on this subject is likely to make expectations in the private sector less inflationary--a factor that will help in the conduct of Reserve Bank policies.

Should the price level in any year rise by more than the allowable maximum rate of increase, the Reserve Bank will be expected to tighten bank credit; and the government should either increase taxation, or reduce expenditure, or do both. If the government does not do its part, the Reserve Bank will be forced to tighten credit still further. This will probably mean that some of the legitimate needs of the private sector will have to go unsatisfied. Reduced availability of bank credit will induce some businessmen to postpone or reduce current expenditure.

Rising interest rates will probably also have some marginal effect in curtailing current spending. This pressure should be kept up until the price level declines and the upper limit of 1 1/2 to 2 per cent has been effectively enforced. Thereafter the Reserve Bank, if it thinks it proper, may decide to ease credit controls.

The place of selective credit controls is now quite clear. Selective controls, as before, should be imposed on those goods which satisfy two conditions: (i) they have significant weights in the index number of prices; or they are important consumer goods and raw materials; and (ii) their prices are rising faster than the average increase in prices. In the case of essential consumer goods selective controls should be imposed as soon as prices increase by more than the tolerable upper limit over a period of a few weeks. Restrictive stipulations that might be stated in the Reserve Bank directive would, of course, vary according to circumstances.

Subject to the stipulation of inflation control, the Reserve Bank should endeavor to meet the legitimate needs of the private sector, to enable them to fulfill their assigned production targets. Since bank credit is a scarce resource, it will be naturally expected that the Reserve Bank will exert its moral influence to persuade banks to give higher preference to the high priority sectors in the Plan. This result was achieved during the Second Plan (see Chapter VI).

IV

Control Over Bank Portfolio Adjustments

If it can be assumed that a five year plan has been realistically formulated and the gap between planned investment and expected saving has

been reduced to the minimum, one may realistically hope that excess demand in the economy will not acquire unmanageable proportions.[1] If there is a foreign exchange gap it is assumed that it can be covered by the inflow of foreign capital. But the main concern here is not with the equilibrium in the balance of payments, although it is undoubtedly very important. Rather the principal preoccupation is with the level of domestic prices. The justification is that monetary policy under Indian conditions can exert some influence as prices but not on the balance of payments. Within this framework, it can now be hoped that monetary controls would be effective in restraining the inflationary expectations from speeding up the flow of expenditures and thereby cause a continually widening inflationary gap. It is, of course, assumed that the Reserve Bank will support the bonds market and will therefore raise the Bank rate with utmost reluctance. So the effectiveness of its policy will rest upon

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[1]These problems are analogous to the ones the United States faced at the end of World War II. The Federal Reserve System was committed to maintain government credit by supporting the market of government securities. This gave rise to considerable fruitful discussion in American journals on what monetary authorities could do to control inflation and at the same time support the bond market. We will be drawing heavily on the literature of the period. Some general references are listed here. Where necessary, individual authors will be referred to later. See Seymour E. Harris (ed.), "The Controversy Over Monetary Policy: Introductory Remarks," The Review of Economics and Statistics, XXXIII, No. 3 (August 1951), 179-200. Also by Harris (ed.), "How to Manage the National Debt," ibid., XXXI, No. 1 (February 1949), 15-32. Also see Edward C. Simmons, "The Monetary Mechanism Since the War," The Journal of Political Economy, LVIII, No. 2 (April 1950), 124-41; M. Bronfenbrenner, "A Loan Ratio for Inflation Control," ibid., LIX, No. 5 (October 1951), 420-33.

the efficiency of credit controls in regulating the growth in bank credit; and in preventing banks from acquiring reserves by either selling governments or through excessive borrowing. In addition the Reserve Bank will take recourse to selective controls as and when necessary. But that is not the difficult problem.[1] The main problem is how to enable the Reserve Bank to exercise adequate discretionary power over bank reserves.

Since the purpose herein is to ensure sufficient control by the Reserve Bank over the growth and the composition of banks' portfolios it will be necessary to make proposals, first, to strengthen existing instruments of credit control, and second, to improvise new instruments which will need legislative action. Specifically, the following proposals are made:

(a) To raise primary reserve requirements to the maximum provided by law which until recently were 20 per cent on the demand deposits and 8 per cent on the time deposits.[2]

(b) The Reserve Bank should have the power, through new legislation, to impose marginal reserve requirements up to the limit of 100 per cent. The power to determine the marginal reserve ratio should be totally unrelated to the average reserve ratio. The existing law

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[1] This may create problems for debt management which are discussed below.

[2] With effect from September 16, 1962 a uniform ratio of 3 per cent on total deposits has replaced the separate ratios mentioned in the text. The new ratio is lower than the effective rate hitherto in force (see Table 35 Chapter 6). But the new upper limit at 15 per cent is higher than permitted previously. See Reserve Bank of India Bulletin (September 1962), pp. 1364-65.

prescribing a ceiling on the ratio of statutory reserves to aggregate deposits should be abolished.

(c) The Reserve Bank may at its discretion determine whether bank reserves should be kept entirely in the form of cash, or government securities, or both.

(d) The Reserve Bank should be given the power through new legislation to require banks to keep a portion of their deposits in the form of government securities. Furthermore, the Reserve Bank should be able to freeze the existing stock of bonds held by one bank or a number of them for a temporary duration.

(e) The Reserve Bank should render its lending policy more selective both in respect to amount lent and the rates of interest charged. This policy should be related to the purpose for which loans are sought rather than the amount of outstanding borrowing in the name of the bank, etc.

(f) Since these policies will provide sufficient liquidity to any bank whose business is conducted along sound lines there is no need for a separate liquidity ratio. The existing liquidity ratio requiring banks to keep 20 per cent of their deposit liabilities in the form of liquid assets is a redundant piece of legislation because it ensures neither the liquidity of banks nor can it be used as an instrument of credit control. Therefore, it should be abolished.[1]

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[1]With the new amendment to the Banking Companies Act 1949 the liquidity ratio has been raised to 25 per cent of the aggregate deposits. This stipulation, however, will be effective only after the expiration of

Proposals (a) through (e) are sufficient to maintain a tight grip over bank credit expansion, but their efficacy will largely depend upon their actual use and the efficiency with which different credit controls are coordinated in practice. With the caution and judgment that one associates with the Reserve Bank, it is highly improbable that these powers will be abused. There is a stronger probability that the Reserve Bank, even though equipped with sufficient authority, may still decide not to use it to the fullest extent. However, to that extent the Reserve Bank will be open to criticism.[1]

V

Variable Reserve Ratio

The need for variable reserve ratios in India is felt largely because of the inadequacy of open market policy as a credit control instrument. This is so because whenever the demand for loans is high, banks will not hesitate to be net sellers of governments as happened twice in recent years--once 1955-56 and again in 1960-61. It follows from past experience that the open market policy can be relied upon only

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two years from the commencement of the Banking Companies (Amendment) Act 1962. The new liquidity ratio will be in addition to the 3 per cent required reserves. After the new rules have been made fully effective the Reserve Bank can raise the overall liquidity ratio to 40 per cent of the total deposits. Ibid., p. 1365.

[1]Central banks have more often been criticized for excessive caution and moderation than for the opposite. For instance, Jacob Viner, who started the discussion on postwar monetary controls, had little confidence that the Federal Reserve authorities would have the "promptness and vigor" to control inflation. As he said, "Central bankers, including the American variety, have traditionally been practitioners of the 'too little and too late,' constantly prone to making a virtue out of excesses of moderation." See Jacob Viner, "Can We Check Inflation?" Yale Review, XXXVII (1948), 207.

in fair weather; but when the need for restrictive policies is felt most, it will function in a destabilizing manner. Moreover, because of the narrowness of the capital market and the prospects of further increase in government borrowing, the Reserve Bank cannot afford to let the governments' prices be determined by free market forces; hence the necessity for placing greater reliance on the variable reserve ratio.

The prevalent required ratios in India are too low and do not impose any perceptible restraints on bank credit expansion. In fact they are well below the level of cash ratios that banks would keep for reasons of prudence. Thus, the average cash ratio of scheduled banks in 1960 was 7.5 per cent as compared to the required reserves of 4.3 per cent only.[1] If the maximum average rates had been applied, the required ratio would have been 12.2 per cent.[2] Such a higher requirement could not but have forced banks to alter their assets structure.

However, if these ratios were enforced on a permanent basis, the ability of the banking system to expand earning assets would be reduced; but banks would still be free to determine the ratio of governments to loans. In other words it is possible that banks may decide to buy less governments than before rather than reduce the amount of bank credit. They may also want to keep excess reserves for the purpose of meeting either an increase in loan demand or a change in reserve ratio policy.

On the other hand, banks will probably try to economize on their cash assets and therefore will perhaps want to invest excess reserves in

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[1] See Table 35 in Chapter 6.

[2] In calculating this ratio the interbank deposits are excluded. See Trend and Progress of Banking in India, 1960, Statement 3, pp. 56-61.

governments which can be liquidated at will. Still, it is conceivable that the effect of higher legally required cash ratios may be felt more on governments than on loans. In addition, if cash is economized, government investments are likely to show greater seasonal variation than at present. This will render open market policy even more passive than it has been so far.

It should, however, be noted that further variations in average ratios are not proposed once these have been raised to their legal maxima. Therefore, the argument that banks will still keep excess reserves to defeat possible future increases in average ratios has no logical basis. In order to impound reserves further the Bank will have to rely on marginal reserve requirements which can go up as high as 100 per cent. It is rather doubtful that any bank will try to keep excess reserves just to defeat marginal reserve requirements. It is more reasonable to assume that the effect of marginal reserve requirements will be felt mainly on government securities. Thus, if loan demand is high and banks are free to sell governments, they will do so. If this happens, the purpose of margin requirements will at least partially be defeated.

There are two possible ways by which banks may be prevented from disposing of governments in excessive amounts. One way is to turn them into a captive market of governments--a situation in which insurance companies in India already find themselves. This needs to be discussed more and will be taken up later. The other way is for the Reserve Bank to pay interest on impounded reserves and thus compensate banks for the loss of earning opportunities, at least partially. On the other hand,

if banks' freedom to switch from governments to loans is restricted and their earnings appear to be satisfactory, the Reserve Bank can apply the credit squeeze even more tightly by not paying interest on required reserves. Thus, banks will be forced by tight liquidity in the face of excess demand for loans to raise their lending rates accordingly.

The main weakness of marginal reserve requirements is that these may have an adverse effect on debt management. From the standpoint of banks, the main criticisms are that high marginal reserve ratios place them in a strait jacket and render the credit system inelastic; that they are inequitous in their incidence in different banks; that they inhibit the expansion of the banking system which is so badly needed by an underdeveloped country. These criticisms can be answered briefly. The purpose of a tight monetary policy is indeed to put banks somewhat in a strait jacket and reduce the "elasticity" of bank credit. As anti-inflationary devices, these hurt banks by reducing the quantity of the "good" they sell and thereby lower their earnings. But banks, in the long run, will only gain if monetary stability is maintained. As for inequity, it is indeed a serious criticism and should be considered as such. But there appears to be no way by which complete equity can be maintained between large and small banks, between mature banks with an established clientele and newly-developing banks, between banks in growing regions and those in relatively stagnant areas, and so on. Therefore, unpalatable as it is, some sacrifice in equity appears inevitable in any program involving effective restraints over the expansion of bank credit.

Considering both the advantages and limitations of combining marginal reserve ratio policy (up to the limit of 100 per cent) with higher average reserve ratios, it appears that on the whole the former far exceeds the latter. In theory there appear to be no administrative limitations that might offset its considerable advantages as a credit control weapon. If anything, the policy of marginal reserve requirements, through its reversibility, renders the Reserve Bank's policy more flexible and potent than it has been in the past.[1]

VI

Debt Policy and Control Over Banks' Liquidity

The Reserve Bank's policies relating to public debt should be governed by two considerations: (i) the market for debt outside of the Bank should continue to grow;[2] and (ii) commercial banks should not be

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[1] In the United States this idea has been vigorously supported by several distinguished economists. However, after the Treasury-Federal Reserve System accord the proposal became defunct. Among others, Goldenweiser supported it as a temporary expedient for controlling inflation. See American Monetary Policy, op. cit., pp. 57-58. E. B. Shaw and Lorie Tarshis included a marginal reserve requirement of 100 per cent on demand deposits as one among a body of controls for speeding up economic mobilization with minimum inflation. See "A Program for Economic Mobilization," American Economic Review, XLI, No. 1 (March 1951), 30-50.

While conducting the post-morten of wartime inflation, Prof. Chandler thought that monetary policy, even though it was a "slave of fiscal policy," could have weakened inflation by requiring banks to hold 100 per cent reserves against the increases in deposits above some base level. See Lester V. Chandler, Inflation in the United States, 1940-48 (New York: Harpers & Bros., 1951), p. 392.

[2] In the long run the market for public debt will grow as private savings increase with the rising real income and are channeled through the financial institutions into the securities' market. In a relatively

able to switch governments unduly when credit policy (in the form of marginal reserve requirements) is tightening their reserve base. These two considerations, however, should not impair purely seasonal adjustments in banks' portfolios which, as we have noted earlier, involve acquisition of governments during the slack season and liquidation during the busy seasons.[1]

Thus, the main problem for the Reserve Bank is to integrate debt management with marginal reserve ratio policy.[2] This integration can be achieved by requiring banks to maintain secondary reserves in the form of government securities. Thus each bank should be legally required to hold some proportion of total deposits in the form of governments.[3]

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shorter period the market for government securities can be enlarged to a small extent, through a better mobilization of current saving. This process, however, can perhaps be aided by a policy of higher interest rates. The underlying assumption is that higher interest rates will probably divert a larger portion of private saving into the securities' market, even though their effect on the marginal propensity to save may be negligible.

[1]Seasonal adjustments cannot be allowed to extend too far because, partly due to a secular trend and partly due to inflation, busy seasons may be getting stronger by the year. Depending upon the strength of each busy season the Reserve Bank will have to decide on the degree of restraint that will be adequate to prevent undue expansion in loans.

[2]In the United States the problem as viewed in the Federal Reserve System was one of integrating debt management with open market operations. See Robert V. Roosa, "Integrating Debt Management and Open Market Operations," American Economic Review, Papers and Proceedings, XLII, No. 2 (May 1952), 214-35; Woodlief Thomas, "Recent Experience with Monetary-Fiscal Measures to Combat Inflation," ibid., pp. 273-88.

[3]The main objective of prescribing a supplementary reserve of government securities against total deposits rather than time deposits alone is to reduce the ability of the banking system to expand loans and

This ratio should be high enough to "lock-in" the most expansive banks from disposing of governments in times of restrictive credit policy. It is rather difficult to be precise in recommending a ratio that scheduled banks should be expected to maintain. Tentatively, it is suggested that this ratio should not be lower than the average ratio of all banks in the busy season of 1960. The upper limit is suggested by the average ratio held by banks in the busy season of 1958, when they were generally loose. This is admittedly a rough method but it does provide us with two limits, i.e., 36.4 and 29.4 per cent as a ceiling and a floor, respectively.

The effect of this measure will be mainly selective. Most Indian banks already maintain this ratio at above 30 per cent. On the other hand most foreign banks keep it below this figure. Therefore, the main effect of this proposal will be to transform these banks into partially captive markets. This may reduce their earnings which, however, can be somewhat offset by subscribing to long-term maturities more than

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thereby create new demand deposits. These requirements will not reduce the total earning assets of banks but merely prevent the monetization of public debt during periods of high loan demand. It may be argued that supplementary reserves should be prescribed only against time deposits because these represent the flow of current savings into the banks. In fact, if supplementary reserves at 100 per cent of time deposits are enforced, it will surely have some restrictive effect. This is because since 1953 average outstanding time deposits have been in excess of government securities. However, if the central bank desires to further restrict credit expansion, then, in principle at least, there should be no objection to the extension of supplementary reserves to demand deposits too. This will not affect the ability of a bank to meet clearing drain because for such purposes it can seek help from the Bank. In other words, the purpose of imposing supplementary reserves is not to reduce the liquidity of individual banks with respect to their creditors, but only to limit the capacity of the banking system to create new debts.

to short term. Furthermore, if the Reserve Bank is keen on safeguarding banks' earnings, it may at its discretion allow some or all banks an option between receiving interest on marginal reserves or investing a portion or all of it in governments. If banks choose the latter option (which is the more profitable), it will cost the Reserve Bank somewhat more than if such an option had not been provided. But this will be the necessary cost for reconciling restrictive credit policy with the accepted long-run objective of promoting commercial banking.

The combined effect of marginal reserve requirements (up to the limit of 100 per cent) and secondary reserve requirements will be to reduce, but not toally eliminate, the possibility of switching from governments to loans. But as compared to the present situation, the capacity of the banking system to expand loans will be severely restricted. Under the proposed arrangements, banks can continue to expand loans in three ways. First, banks may hold onto the prescribed minimum of government securities and dispose of the rest, using the realized cash to expand loans. Or, if necessary, they may sell it to any nonbank investor who may in turn sell it to the Reserve Bank. In either case the banking system will acquire excess reserves which it can loan out, but only once, because as soon as loans reappear in the form of deposits, marginal reserve ratio policy (at 100 per cent) will impound them. Second, commercial banks may sell private investments and loan out the realized cash. Again, as before, only one round of increase in loans will occur; moreover, the net effect on private spending is not likely to be appreciable. This process will probably raise the velocity of money by transferring spending power from those who might be holding it in the form of

idle cash to those who would use it actively. But the capacity of the Indian financial system, in its present state of development, to raise the velocity of money is quite limited. As yet, the capabilities of the financial system have not been tested; therefore hardly anything can be said about the probable dimensions of an increase in velocity following in the wake of a tight credit policy. Third, banks can borrow money from the Reserve Bank and loan it out. If this happens, the purpose of imposing tight restrictions will be fully served, because once banks are lining up before the "discount window" the Reserve Bank will be in a position to lay down its terms. By combining selective lending with penal rates (as in 1960), the Reserve Bank will be able to influence not only the size but also the composition of bank credit.

Unless inflationary situations threaten to get out of hand, the Reserve Bank will probably continue to function as the "lender of the last resort" on a restricted scale. But if price increases far exceed the safe upper limit, the Reserve Bank will be justified in taking emergency measures to halt further expansion of bank credit. This can be done in two ways: (i) by freezing the existing stock of governments held by the banking system, and (ii) by imposing a rigid ceiling on the ratio of loans to total deposits.[1] These together can effectively

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[1] M. Bronfenbrenner has advocated the policy of prescribing a loan-ratio ceiling as the substitute for other policies. He defines the loan ratio as follows:

$$\text{Loan Ratio} = \frac{\text{Commercial Bank Loans}}{\text{Commercial Bank Deposits (other than interbank)} - \text{Commercial Bank Loans}}$$

By so doing he excludes derived deposits arising from new loans and thus

arrest further expansion of bank credit. To satisfy the individual needs of some banks (which will be considered as cases of emergency) the Reserve Bank may lend a helping hand directly or indirectly through the State Bank of India. It is of course understood that such measures, drastic as they are, would be used only as a last resort and withdrawn as soon as fiscal policy and other arms of government policy have had time to reduce excess demand and curb prices.

VII

The State Bank of India and Credit Controls

In earlier chapters it was noted that the State Bank of India, throughout the period of the Second Plan, lent a helping hand to the Reserve Bank in exercising due restraint on credit expansion and supported the public debt policy through steady acquisition of governments. In these roles it has displayed its usefulness in strengthening monetary policy, which deserves to be fully utilized. In the future the State Bank can improve the effectiveness of credit controls in two distinct ways: (i) by buying governments when other banks are selling them, thus

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sharply brings out the expansive nature of loans.

Control over this ratio will probably halt credit expansion sooner than other measures, except that if introduced suddenly, it will have a shock effect on banks. Second, it is not clear where the ceiling would be fixed if the denominator becomes a negative quantity (as will happen in the case of class D foreign banks). Third, if the ceiling is announced well in advance and is above the prevailing level, banks will ignore it, and therefore the policy will fail to dampen bank credit expansion. It is therefore concluded that Bronfenbrenner's claim on behalf of a "ceiling on loan-ratio policy" might hold good as a drastic emergency measure but not as a normal regulating device. See Bronfenbrenner, op. cit., pp. 420-433.

reducing the net sales by the banking system; (ii) by calling in loans given to other banks when they are engaged in switching from governments to loans. The latter should be done only at the advice of the Reserve Bank and to the suggested extent. This policy would be designed to exert pressure on those banks which habitually borrow from the State Bank to refrain from liquidating government investments in excessive amounts. Thus banks would be subject to some moral and some economic pressure to exercise restraint, and therefore the policy might work. It is, however, conceivable that the second policy might produce an unpredictable effect, at least temporarily. Banks, on being forced to reduce indebtedness to the State Bank, might start selling governments in excess of the needed amounts and thereby defeat the purpose of the policy. Moreover, if banks singled out for this purpose received undue publicity, it might shake the depositor's confidence in their stability and result in runs on them. To avoid this danger the State Bank would conduct itself as quietly and discreetly as possible. Perhaps it would not be necessary to actually withdraw loans given to these banks; a threat by the State Bank that noncooperating banks would not receive the same accommodation in the future as in the past would perhaps suffice. At any rate here are certain possibilities for effective utilization of the State Bank as an adjunct of Reserve Bank policy which deserve to be explored further.

VIII

Monetary Policy and Budgetary Deficits

Restrictive monetary policy designed to face the potential danger of inflation can be effective, provided fiscal policy is not unduly

soft, and every effort is made by the government to keep deficit financing to the minimum. This is so because the purpose of restrictive credit policy can be and probably will be defeated if the excess of aggregate spending over aggregate supply (at constant prices) is continually fed by large budgetary deficits. In particular, the policy of requiring banks to keep supplementary reserves in the form of government securities can be misused.[1] This may provide a convenient excuse for not levying additional taxes. On the other hand, if government policy is realistic and is aimed at gradually reducing the size of budgetary deficits, the chances of Reserve Bank policy curbing inflation are improved.

If the government finds it impractical to either eliminate or progressively reduce the size of deficits, it can try to seek a broader market for government securities outside the banking system.[2] Moreover,

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[1] Some European countries have used liquidity ratios (which take the form of prescribing the ratio of governments and cash to deposits) as a substitute for a flexible rate structure. Fousek cites the examples of Belgium, France, and Sweden where minimum liquidity ratios did not have a credit restraining effect because "governments in these countries, faced with large budget deficits, resorted increasingly to the issue of reserve-eligible government securities." See P. G. Fousek, Foreign Central Banking: The Instruments of Monetary Policy, op. cit., pp. 66-67.

[2] However, broadening of a market for government securities cannot be realized in a short period. In fact, the proposal of supplementary reserves may discourage some investors from buying government securities. This difficulty can be solved by the continuation of this policy of unrestricted purchase of government securities by the Reserve Bank from the nonbank public.

However, this will lead to some expansion of deposits followed by a secondary expansion of bank credit. But if the Reserve Bank so desires, this process can be severely restricted through the imposition of marginal reserve ratio requirements up to 100 per cent.

As for the apprehension that creation of a captive market may adversely affect the willingness of investors to buy new issues, the

as far as possible, the government should issue nonmarketable securities which can be redeemed only at maturity,[1] or before maturity at a substantial loss to the owner.[2] This loss in liquidity should be compensated by offering higher rates of interest. But so far as the banking system is concerned, such an incentive is not called for. With supplementary reserve requirements banks will be "locked in" with a portion of governments, and it really does not matter whether they are long or short. So if the level of banks' earnings is not a factor in the determination of policy, the Reserve Bank might as well require banks to hold short-term securities. The government can issue sufficient securities of this nature directly to the Reserve Bank which the latter can pass on to banks. This will result in some saving in debt services to the government. The implication is that governments should issue long-term

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answer is that public securities should be made sufficiently attractive to appeal to them. In addition to complete liquidity government securities may carry higher rates of interest. Thus a policy of lengthening public debt and higher long-term interest rates will attract investors who are concerned about maintaining the real value of their savings. This will also reduce the likelihood of some investors shifting from government to private securities. In fact, the reverse may happen.

[1]The issue of nonmarketable securities should not be confused with forced loans. These will be floated in the market and the public will be free to subscribe to them or not, or to the extent it likes. The main attraction of these securities will be the coupon rate which will be substantially higher than that paid on marketable securities. At present, the outstanding public debt includes both marketable and nonmarketable debts. All that is proposed here is that the proportion of the latter should be increased.

[2]It should be conceded that the proposal for the broadening of market in the nonmarketable securities is not realizable in the near future.

maturities for the nonbank investors and mainly short-term maturities for banks. This should be so, unless it is also the policy of the Reserve Bank to protect the earnings of banks.

It has been the practice in India for banks, which are short of reserves, to borrow from the Reserve Bank with a view to subscribe to new issues of governments. From the viewpoint of monetary policy this system has no apparent advantage. The government and the Reserve Bank may derive the satisfaction that new issues have been adequately subscribed to from outside the Bank. But as can be readily seen, the effect on the money supply would be the same if the Reserve Bank had directly absorbed this issue in its portfolio. In fact, if the latter practice is followed, i.e., the absorption of that portion of a new issue for which there is no genuine market demand by the Reserve Bank itself, there will be the advantage of some saving in debt services. This will be so because the government will pay interest to the Reserve Bank which the latter, after deducting administrative expenses, will return to the Treasury. A side affect of this policy will be that the real magnitude of deficit financing (resulting in an increase in the money supply) will be truly revealed and the amount of borrowing, so-called, will be somewhat reduced. It is doubtful if it will have any effect on either the size of the plan or the share of the public sector involved in it, both of which are politically determined. However, there will be a distinct advantage to the Reserve Bank, inasmuch as the problems of debt management and the conduct of monetary policy can be formulated in more realistic terms.[1]

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[1]Recently the government of India issued 5 billion rupees of

Thus from the viewpoint of monetary policy it would be much better and more straightforward if the government would issue one kind of debt to the Reserve Bank to be used as backing for a note issue which can be directly used for deficit financing, and another kind of debt for sale to banks and nonbank investors. The sale of debt to banks should be done with a condition that the Reserve Bank shall not directly or indirectly provide funds for subscription. By so doing, along with other measures outlined earlier, the Reserve Bank will be able (if it so desires) to exercise the degree of control on bank credit expansion needed for exercising the required check on speculation and private spending, and thus on the price level. However, before these policies are adopted, the Reserve Bank and the government of India will have to do some rethinking on the mode of financing future plans, the importance of controlling inflation, and the role of the central bank in managing public debt and credit controls. The policies outlined above at least provide a basis for further discussion and clarification of the issues involved.

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nonmarketable debt to the Reserve Bank of India in exchange for Treasury bills of an equal amount. This has been described as funding of debt. Three billion rupees were funded in July 1958, 1.5 billion rupees in December 1959 and 0.5 billion rupees in January 1961. See Report on Currency and Finance, 1960-61, p. 97.

It should be stated here that this method of funding of debt has no monetary significance. It has nothing in common with the policy of funding of debt advocated by economists who wanted funding to be done by issuing consols to the nonbank public, thereby converting liquid cash into illiquid assets which cannot be readily converted into money. (See Henry Simons, "On Debt Policy," Journal of Political Economy, LII, No. 4 (December 1944), 356-61.

Prof. Musgrave, who rejects Henry Simons' proposal of issuing either consols or money as too extremist an approach, nevertheless insists that the essence of funding of debt is to render investors illiquid. R. A. Musgrave, "Debt Management and Inflation," Review of Economics and Statistics, XXXI, No. 1 (February 1949), 25-29.

IX

Summary and Conclusions on Proposals for the Future

Considering the weaknesses of credit policy as revealed during the period of the Second Five Year Plan it is proposed that the Reserve Bank be strengthened in respect to quantitative credit controls. As for selective controls, new techniques are not needed; however, there is room for more effective implementation of selective controls. This partly depends on the discretion of the Reserve Bank and partly on the availability of statistical information about the uses of credit. But the best way to improve the working of selective controls is to reinforce them with more effective quantitative controls.

It has been proposed that, for effective control over bank reserves, the main reliance should be placed on reserve ratio policy. Average required reserve ratios should be raised to the legally permissible limits while changes in policy should be effectuated by varying marginal reserve ratio requirements (up to a limit of 100 per cent). Furthermore, banks should be required to maintain a minimum ratio of governments to deposits--and this ratio should be prescribed to all banks, whether large or small, foreign or Indian. However, the main burden of regulating bank credit should be borne by marginal reserve ratio policy. This policy should be supported by the selective lending policy of the Reserve Bank. This policy would normally suffice; but in the case of inflation getting out of hand, the Reserve Bank should have the requisite standby powers to impose a ceiling on the ratio of loans to deposits, freeze the holdings of governments by banks at the prevailing level, or both. This may be done generally to all banks or

selectively to some banks. However, these are only temporary measures and should be withdrawn when the need for them has passed.

Reserve Bank policy can be usefully supported by the State Bank of India. There are certain possibilities but these are not free from limitations. Therefore, it is suggested that these possibilities, by which the State Bank can be made an adjunct to the Reserve Bank, should be explored more fully.

The need for coordination and cooperation between fiscal policy and monetary policy is reiterated. One way of coordinating the two policies is to issue more long-term nonmarketable debt at attractive rates of interest to the nonbank public. Commercial banks do not need to be issued long-term debt unless it is the policy of the government to support banks' earnings. Banks can be rendered illiquid by freezing a portion of their deposits in short-term maturities.

In conclusion, it may be stated that monetary policy cannot and should not be expected to carry the full load of curbing excess monetary demand in the economy. However, it can play its useful part if goals are clearly defined and the Reserve Bank is adequately empowered through legislation to control credit effectively. It is furthermore assumed that there exists proper understanding between the Reserve Bank and the government on goals, spheres of action, and on the importance of resolute but flexible action to achieve the ends of policy.

APPENDIX

APPENDIX

CREDIT POLICY WITH RESPECT TO FOOD GRAINS SUMMARIZED ACCORDING TO TIMING, OBJECT OF CONTROL, CONTROL MEASURES, AND GENERAL EFFECT

Serial No.	Date	Object of Control	Control Measures	General Effect
1	2	3	4	5
1.	May 17, 1956	Paddy and rice	(a) Freeze on existing credit limits and ceiling of rupees 50,000 per person on new advances. (b) Stipulated margins raised by 10%. (c) Ceiling on aggregate advances fixed at 25% above the level of the corresponding week last year.	Restrictive
2.	Sept. 13, 1956	Other food cereals (e.g. wheat, grain, pulses, etc.)	(a) The same as in 1 (a) except that existing credit limits can be increased up to rupees 50,000 per person. (b) Margins on new and old advances raised by 10%. (c) Banks requested to reduce aggregate advances against these commodities.	Restrictive
3.	Oct. 18, 1956	Paddy and rice	Control measures as in (2) extended to paddy and rice.	Restrictive
4.	Nov. 14, 1956	Paddy and rice	Control measures in (1) and (3) withdrawn. Moral suasion.	Loosening
5.	Feb. 9, 1957	Paddy and rice	(a) Margins on existing and new advances raised by 10% so as not to be less than 35% of the value of the security.	Restrictive

APPENDIX (continued)

Serial No.	Date	Object of Control	Control Measures	General Effect
1	2	3	4	5
5. (cont.)			(b) Banks asked to reduce aggregate credit to 75% of the level in the corresponding week of the preceding year.	
6.	June 7, 1957	Other food, cereals	(a) Margins on existing and new advances raised to 40%. (b) Aggregate credit to be reduced to 2/3 of the level in the corresponding week in 1956. (c) Ceiling on credit limits fixed at rupees 50,000 per person.	Restrictive
7.	Dec. 11, 1957	All food grains	(a) Margins are fixed at 40%. (b) Ceiling on individual advances fixed at rupees 50,000. (c) Ceiling on aggregate advances against paddy and rice fixed at 75% of the average of the corresponding month of 1955, 1956 and 1957. (d) Ceiling on aggregate advances against wheat and other food grains fixed at 80% of the monthly advance of the preceding three years. (e) Ceiling on bank advances in the States of Madhya Pradesh and Andhra Pradesh with respect to paddy and rice fixed at 60% of the outstanding credit on the last Friday of the corresponding month in 1957.	Restrictive

APPENDIX (continued)

Serial No.	Date	Object of Control	Control Measures	General Effect
1	2	3	4	5
8.	Sept. 10, 1958	All food grains	(a) Ceiling on bank advances against wheat fixed at 2/3 of the level in the corresponding month of 1957. (b) Ceiling on "other food cereals" fixed at 80% of the level in the corresponding month of 1957. (c) Credit controls against paddy and rice remain unaltered.	Restrictive
9.	Dec. 29, 1958	All food grains	(a) Ceiling on bank advances fixed at the permitted level of the corresponding month in 1958. (b) Rule (a) applies to Andhra Pradesh and Madhya Pradesh with respect to wheat. (c) Existing controls with respect to margin requirements and ceilings on individual advances are continued.	
10.	April 24, 1959	Paddy and rice	Credit restrictions liberalized in Orissa to assist Government Procurement Programme.	Loosening
11.	July 10, 1959	All food grains	(a) Margins of 25% are fixed with respect to paddy and rice in Orissa and wheat in Punjab. (b) The ceiling of rupees 50,000 on individual loans is withdrawn.	

APPENDIX (continued)

Serial No.	Date	Object of Control	Control Measures	General Effect
1	2	3	4	5
11. (cont.)			(c) In Andhra Pradesh and Madhya Pradesh ceilings against paddy and rice fixed at the permitted level in the corresponding month of 1958. (Note: Provided that not more than 2/3 of this credit will go to parties other than rice mills). (d) In Madras the average level of credit against paddy and rice is not to exceed 60% of the level in the corresponding month of 1958. (e) In Orissa not less than 80% of allowable credit should go to rice mills and government procurement agents. (f) In all other states the average level of credit against paddy and rice should not exceed 120% of the level in the corresponding month of 1958. (g) In the states of Punjab, Hemachal Pradesh, Delhi, Jammu and Kashmir bank advances against wheat should not exceed 75% of the average level of credit maintained in the corresponding month of 1958. (Note: Additional credit up to 25% can be sanctioned to help government procurement program).	

APPENDIX (continued)

Serial No.	Date	Object of Control	Control Measures	General Effect
1	2	3	4	5
11. (cont.)			(i) In the States of Madhya Pradesh and Uttar Pradesh advances against "other food grains" should not exceed 75% of the average level of credit in the corresponding month of 1959. (j) In all other States advances against "other food grains" should not exceed the average level of credit in the corresponding month of 1958.	
12.	Jan. 16, 1960	Paddy and rice	(a) Ceilings fixed at the average level of credit in the corresponding month of 1958 or 1959, whichever is higher.	Loosening
13.	Aug. 20, 1960	All food grains	(a) Restrictions liberalized with respect to wheat. Ceilings are fixed at the average monthly level of credit in 1958. (b) With respect to food grains in the States of M.P. and U.P. Ceiling is fixed at 75% of the average level in the corresponding month of 1958.	Loosening
14.	Aug. 21, 1960 and Nov. 23, 1960	Paddy and rice	(a) Banks in Kerala allowed to extend credit up to 200% of the level maintained in the corresponding month of 1959 for a period of five months only (Aug. - Dec.). (It was later extended up to June 30, 1961.)	Loosening

APPENDIX (continued)

Serial No.	Date	Object of Control	Control Measures	General Effect
1	2	3	4	5
15.	Oct. 8, 1960	Paddy and rice	With a view to aid in government procurement banks in Punjab are allowed to lower margin requirements to the minimum of 25%. (Note: This facility is to be restricted to only licensed traders and millers in Punjab).	Loosening
16.	Feb. 8, 1961.	All food grains	(a) Margins are lowered from 40% to 35%. (b) Ceiling on advances against paddy and rice in all States other than Andhra Pradesh raised to 110% of the permitted level in 1960. (c) In Andhra Pradesh the ceiling is fixed at the average level of advances for a two-months period in 1960. (d) For wheat the ceiling is the average permitted level of advances for a two-months period in 1960. The same holds for "other food grains."	Loosening

Notes: Exemptions from these controls were allowed in respect to advances made against the security of (a) food grains used by rice and flour mills, (b) warehouse receipts issued by licensed warehouses, (c) bills originating in the movement of commodities and (d) food grains in those areas where new bank branches have been opened, subject to certain safeguards. Also, traders acting as government agents in the procurement of food grains were treated favorably.

Sources: Trend and Progress of Banking in India During the Years 1956-1960, and Reserve Bank of India Bulletin (monthly), 1961.

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