CHAPTER VIII

INTEREST RATE POLICY IN INDIA.

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CHAPTER VIII

INTEREST RATE POLICY IN INDIA.

Introductory :

Our discussion thus far of the use of instruments of monetary management in India led us to pinpoint some aspects of interest rates as they emerged in relation to individual instruments. It is time that we bring forth now the role of interest rates - or an interest rate policy - in a broadened framework. It may not be wholly justifiable to speak of an interest rate policy in the sense of a rationally determined and optimal policy. This inhers in the nature of interest rate, for Haberler had rightly told us that "theory of interest has for a long time been a weak spot in the science of economics,"[1] and Shackle has again had to tell us (after about two decades' time) that "Interest is the most pradoxical of all economic quantities".[2] The role of interest rates in underdeveloped countries however, in so far as they affect the saving-investment process does retain its importance.

A brief reference to interest rate in the money demand hypothesis will be in order at this stage.

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1. G. Haberler "Prosperity and Depression" (1941) P. 195.

2. G.L.S. Shackle "Recent theories concerning the nature and role of interest", Economic Journal, June, 1961. P. 251.

Interest rate in the 'money demand' hypothesis :

We saw in chapter 2 that the elasticity of demand for money to interest rates has been a source of extended controversy, although as Laurence Harris has pointed out "the only regularity on which there is substantial agreement is the existence of some relationship between the demand for money and some rate of interest".[1] - Different authors have tested this regularity with different rates of interest. Meltzer[2] used a long term rate on the ground that inter-relationship among different rates remains such over time that the long rate may be used as a proxy for all relevant rates. D. Laidler however supports the hypothesis that the demand for money is better related to short than to long rate.[3]

We also saw earlier the difficulty in tracing the real rate of interest as distinct from the money rate. However J. Adekunle in his study of the money demand functions in developed and underdeveloped countries observed that :-

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1. L. Harris "Regularities and irregularities in monetary economics" in Whittlesey and Wilson (Eds.) "Essays in money and banking"-in honour of R.S. Sayers, Oxford (1968) P. 107.

2. A. H. Meltzer "The demand for money : the evidence from the time series" Journal of political economy, June, 1963. Pp. 219-46.

3. D. Laidler "Rate of interest and the demand for money : some empirical evidence" Journal of political economy, December, 1966.

(a) "In the developed countries the demand for money relationship is related in a very weak way to expected price changes and is strongly related to expected income and interest rates. The low level of association found in regard to 'price changes' variable is that price movements are reflected in the market rates of interest i.e. in these countries with high inter-sectoral integration, yields on financial and real assets move together".[1]

(b) "In regard to less developed countries interest rates, current real income and expected price changes happen to be important variables in determining the demand for money relationship. In those less developed countries where structural sophistication is less, only income and price change expectations play important part".[1]

H. C. Wallich in a similar study based on cross-country data (covering a large sample of 43 countries)[2] found the demand for money negatively related to the rate of interest but he carefully points out that "interest data are notoriously poor, possibly causing significance levels to be understated. Also because actual rates fluctuate probably more widely than are statistically

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1. J. Adekunle "Demand for money - evidence from developed and underdeveloped economies". I.M.F. staff papers July, 1968. Pp. 220-66.

   There is another sang in regard to the influence of 'expected' interest rates on current rates. Feige has however shown that "the hypothesis that interest expectation elasticity is static i.e. close to unity has been tested and found correct." Edgar L. Feige "Expectations and adjustments in the monetary sector" American Economic Review, May, 1967. Pp. 462-73.

2. India being one of them.

available, the coefficients may possibly be overstated".[1]

This brief reference to the emperical work done suggests that we have so far not found a widely accepted generalisation about the role of interest rates in monetary theory and policy. There is however another and rather more important aspect of the matter, namely that over a large part of their functioning Central banks have used interest rates as an important tool of monetary management. Significantly enough, the post-war period of theoretical controversies inspired by and inspiring empirical evidence has also been the period during which Central Banks the world over have resorted to the use of interest rate mechanism in various forms and degrees and in much large measure than before.

Interest rate policy for India :-

In our assessment of the monetary policy of the Reserve Bank of India, we suggested that legal reserve requirements have been fixed at low levels (3 per cent for aggregate bank deposits) and the choice being restricted to revision in the upward direction the variable reserve ratio method should be resorted to quite infrequently in view of the need to cater to the requirements of an expanding banking system. We also did not favour

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1. H. C. Wallich "Quantity theory and Quantity policy" in "Ten/studies in the tradition of Irving Fisher", John Wiley (1967) Pp. 257-280.

the perpetual type of selective credit control policy and suggested a policy of 'moral suasion' where the policy measure in respect of any specific category required to be repeatedly enforced. Open market operations and Bank Rate both of which have 'interest effects' would then assume significance.[1] We however, grant the position of the Reserve Bank of India that open market operations may have to be conducted with a view to "building up the securities market" rather than as a purely control measure. In consequence, Bank Rate policy assumes greater significance.

In a study conducted in 1956 on the behaviour of interest rates in the underdeveloped countries,[2] U. Tun Wai noted that although central bank lending to commercial banks was not of any great significance leading to

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1. It may be pertinent to note here an observation by Samuelson in this regard. Disposing the argument that the discount window provides an 'escape valve' he argues that this should rather make monetary authorities more courageous in the use of open market operations. Significantly he says "it may well be that the discount window strengthens the efficacy of open market operations despite superficial appearance to the contrary, particularly since it most definitely can strengthen the potency of moral suasion". The argument is not elaborated but it may be presumed that the reference is to the strong and beneficial announcement effects inherent in both. Vide: J. Stiglitz (Ed.) Collected scientific papers of P. A. Samuelson Vol. II P.1357

2. U Tun Wai "Interest rates in the organised money markets of underdeveloped economies". I.M.F. Staff Papers, August, 1956.

small direct dependence of commercial banks on the Central Banks, the latter could influence "rates (in the market) by changes in the Bank Rate because of their economic and legal position" and so "it may be concluded that changes in Central Bank rates in underdeveloped countries influence both the level of interest rates in the organised market and the amount of credit extended by commercial banks".

Earlier, the Reserve Bank made a claim that the Bank Rate in India "remains a prime regulator of the market rate structure"[1]. The instrument has been undoubtedly wielded with a degree of sophistication and ingenuity and we saw rather randomly in Chapter five how Bank Rate variations had produced effects on market rates of interest.

Recently the Bank has reiterated its earlier claim that "the effects of Bank Rate changes are not confined to the banking system and the short-term money market; they produce wider repercussions on the economy as a whole".[2]

Further in view of our proposition that monetary policy in underdeveloped countries operates by its effects on the saving-investment process, we need perforce pay attention to interest rate policy.

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1. "Reserve Bank of India - Functions and working" Bombay(1958) P.38.

2. "Reserve Bank of India - Functions and working" Bombay(1970) P.41.

It would be appropriate to examine the policy under three headings :

(A) Allocation of resources;

(B) Interest-sensitivity of investment; and

(C) Interest-elasticity of savings.

(A) Allocation of resources :

Intertemporal exchange of resources involves consideration of interest as a discount factor. Resource allocation over time is concerned with the choice among different programmes extending into the future. Since the choice involves both a cost in the present and benefit in the future, one condition of efficient choice is to use the 'Social rate of discount (representing society's relative preferences between present and future consumption) and equate it with the marginal productivity of capital.

Interest rate has featured variously in different growth models. The Von Neumann proportional growth model brings out the competitive no-profit equilibrium such that $a = b$ where a is the rate of growth of output and b is the money rate of interest. Then there is a unique value for both a and b. The solution however, may not be unique and there may be many price-output combinations.

Hicks[1] building up his model on the Ricardo type analysis concludes that an optimum growth rate would

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1. J.R. Hicks 'Capital and growth', Oxford (1965)Ch.22.

necessarily keep the rate of profit equal to the rate of interest. Introducing 'monetary complications' in his analysis, he says that there will be a certain basic rate (in-rate) on deposits with the Bank (there may be one Bank to begin with) and this basic rate of interest will be lower than the rate of profit. When the financial system expands and the number of financial intermediaries with a wide variety of assets increases, there will emerge a spectrum of interest rates. We could then say that there is a Basic rate on Deposits (X) and one rate of profit (Y) (also $Y > X$) and in between there will be other rates of interest so that there emerges what may be called a 'gap' between these two crucial rates. Now if the 'gap' is fixed there is a minimum rate of profit (which will be higher than X) at which the system can work. Again this minimum rate of profit is consistent with the maintenance of a particular set of financial institutions, the 'gap' itself is a matter of the particular set of financial institutions. With a different set of institutions, there need not be the same 'gap'. With proliferation of financial intermediation the gap could be compressed but "it is not indefinitely compressible".[1]

The observation that the 'gap' itself is a matter

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1. Hicks raises the pertinent question whether the 'gap' could be removed by the removal of financial intermediaries. Then however, the liquidity will be less and the 'gap' will widen. Financial intermediation varily narrows the 'gap'. Ibid. P.290.

of particular set of financial institutions refers to the costs and liquidity preferences of the financial intermediaries. P. R. Brahmananda, though in a little different context, rightly observes "although there is no point (now) in hanging on the 'liquidity trap', there is a floor to the rate of interest and this is determined by the 'real' costs of financial intermediation".[1]

Whatever the theoretical complexities involved in the relation of interest to growth, the general observation that high consumption (low savings) should denote high interest rates and so also that the rates should be high when capital is more productive seem to hold good. Such a generalisation obscures some fundamental issues relating to the rate of interest in the context of growth models. There are crucial issues pertaining to interest rate as an endogenous variable but that does not minimise the role of interest as a variable having its own 'directional effects' and its determination partly endogenously and partly exogenously (by Central bank policy). To bring out the significance of interest rate policy in the development process we may note its relation to the process of financial accumulation as Gurley and Shaw have recently shown.

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1. P. R. Brahmananda, 'Indian Economic Journal' April-June, 1970. P. 590.

Gurley and Shaw have argued that "as countries rise along the scale of wealth and income their financial - structures usually became increasingly rich in financial assets, institutions and markets".[1] As their incomes per capita increase, countries usually experience more rapid growth in financial assets than in national wealth or national product. The ratio thus has a tendency to rise secularly and is different for different countries. The ratio of financial assets to national wealth was 100 : 100 in 1900 and rose to 450:100 in 1960 in the U.S.A.; and it rose from 10:100 in 1885 to 150:100 in 1960 in Japan. The ratio for India, as estimated by the authors was 35:100 in 1960 which was the same in U.S.S.R. also in the same year. The differences are largely to be explained in terms of differences in per capita income, as well as the type of 'Saving-investment technology' in use. The latter may take various forms such as 'self-finance', 'taxation', 'debt-asset method' and 'foreign aid'. "Each method has a positive (gross yield) and - negative (factor cost)[2] component, the difference between the two being net yield of each method and the optimal combination is attained when no gain in net yield can result from shifting factor inputs between them".[3]

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1. J. G. Gurley and E. S. Shaw "Financial structure and economic development" Economic Development and Cultural Change April, 1967. Pp. 257-68.
2. Such a view is implicit in the arguments of Hicks and Brahmananda about 'Costs of financial intermediation' referred to above.
3. Ibid P. 265.

Equal ratio of financial assets/wealth (35:100) in both U.S.S.R. and India is to be ascribed to lesser resort to the 'debt-asset' method in Soviet Russia. But in a country with decentralised decision making where relative prices guide economic behaviour, the use of the 'debt-asset' method implies that "market rates of interest, as one class of relative prices, bear a heavy responsibility for the rate and direction of investment."[1] Since in India, all the methods have been in use, it should be interesting to observe their relationship over some given period of time. While the long term aim should be to seek the optimum combination there would be need for using one method more intensively than another. On this count, underdeveloped countries may do well to resort to taxation more intensively than other methods for the purpose of resource mobilization. But taxation as well as inflation are methods of 'self-finance', and hence a limit is reached when diminishing returns may set in in regard to these methods. The debt-asset method which involves a process of indirect finance may then become important and interest rate policy will have a role to play here. Both inflation and taxation divert resources to the public authorities but we could not firmly say that this diversion is accompanied by a process of cut in consumption - a part may be just transfer of savings from the private hands to the public authorities. A purposive and rational interest rate policy could, on

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1. Ibid P. 262.

the other hand succeed in coaxing out savings and may have its directional effects in regard to investment also. The general conclusion that savings are income-determined need not be construed as an argument against rational interest rate policy which influences both, the level of savings and the direction of investment. Monetary policy in underdeveloped countries to be - effective has to influence the saving-investment process in some measurable degree and should therefore use the interest rate mechanism towards this end.

We may, therefore, turn our attention now to the relation between interest and inducement to investment and the process of saving.

(B) Interest-sensitivity of Investment :-

Interest rate enters discussion in a growth model as a part of the working of an aggregate economy and takes the company of other co-determining variables. At the disaggregated level, the relationship between interest and the level of investment has been extensively discussed and more significantly, tested empirically also.

The two widely publicised pre-war studies[1] showed a weak link between a change in rate of interest and

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1. (A) J. E. Meade and P. W. S. Andrews "Summary of replies to questions on effects of interest rates" in "Oxford Studies in price-mechanism" (Ed. T.W.Wilson) Oxford (1951) Pp. 16-31.

   (B) J. P. Ebersole "The influence of interest rates upon entre-preneurial decisions in business - a case study" - Harward Business Review Vol. xvii (Autumn 1930) Pp. 35-40.

decision to invest and became a stock argument about the subordinate role for monetary policy. Post-war work done with U.S. data however, has yielded conclusions which establish stronger relation between the two. These works have been done partly to examine the issue in the wake of the skepticism expressed by W.H. White[1] and partly out of the consideration to examine the efficacy of monetary policy vis-a-vis various categories of expenditure such as consumer expenditure, residential construction; business plant and equipment and business inventories. Evidence in regard to the consumer expenditure has shown stronger relation in the post-1960 literature.[2] Interest sensitivity of residential construction and similar categories of expenditure has been more or less found to be quite strong in various studies. The observation that such sensitvity may be conditioned by other institutional factors also, as pointed out by W. L. Smith[3] remaining there, the general conclusion, supported by empirical evidence, emerges that interest rates and credit conditions affect residential and construction expenditures in an influential

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1. W.H.White "Interest elasticity of Investment Demand - the case from business attitude surveys re-examined". American Economic Review, September, 1956. P. 566.

2. Two such studies (A) C. Wright "Interest elasticity of consumption", American Economic Review, September, 1967 and (B) M. J. Hamburger "Interest rate and demand for consumer durables" A.E.R. December, 1967 establish corporate Aaa bond yield elasticities to be between -0.26 and -0.22 in study (A) and -0.85 and -0.17 (for new automobiles and other consumer durables respectively in study (B).

3. W.L.Smith, "Monetary policy and the structure of markets" P. 362 in Readings in Money, National income and stabilization policy (Ed. Smith & Peigen) Irwin (1965).

manner. Interest rate as a cost factor obviously assumes greater importance here. This cost factor which is the interest-incentive effect of the Radcliffe Committee was emphasised by the Committee thus : "the responsiveness of demand to interest rate changes should be at its maximum when the capital goods have the longest life and the greatest certainty is attached to the advantage of holding them and at its minimum when the useful life of the goods is short and hazardous. The demand for house-building and many "public utility" - constructional works is among the most interest-sensitive on these theoretical grounds." However, the committee adds: "the removal of investment decisions relating to some of these capital works from the market to the - administrative sphere has obviously tended to reduce the automatic market effect of interest rate changes on the total pressure of demand."[1]

Interest sensitivity of the third category of expenditure namely business plant and equipment has been a matter of extended controversy. Writing under the shadow of the two pre-war studies and not being in a position to discern any conclusive evidence, Eisner and Strotz in their study prepared for the Commission on Money and Credit reported that "the interest rate has been found to be negatively related to capital expenditures" but that such findings not being general, it was not possible

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1. Report of the Committee on the working of the monetary System (London) P. 131.

to grant "that variable much historical role in influencing the rate of investment".[1] Thomas Mayer has, however, reported[2] that various studies prepared in the post-1960 period have estimated interest elasticity of fixed investment ranging between -0.15 and -0.50. Two reasons are adduced in support of this higher value of elasticity. One is that more sophisticated statistical techniques have succeeded in isolating spurious positive corelations and establishing true negative corelations between interest and investment. Another reason is the change in business practice in the area of investment decision-making. As against the old "payback method" of evaluating investment decisions on the basis of how soon an investment would pay itself off, the more rational method of evaluating them on the basis of the 'internal rate of return' or 'net value' make it necessary to incorporate cost of capital funds and the time value of money in estimating the worthliness of investment expenditure.[3]

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1. R. Eisner and R. Strotz "Determinants of Business Investment" in "Impacts of Monetary Policy" - Prentice Hall (1963) P.192.

2. T. Mayer "Monetary Policy in the United States", Random House, 1968 Pp. 122-23.

3. We abstract from the Modigliani - Miller proposition that the market value of any firm is independent of its capital structure and that the value of company assets is measured by the market value of company debt plus company shares - Vide American Economic Review (June 1958) P. 192.

In regard to the relationship between interest rate and inventory investment there should, on a priori reasoning, prevail stronger negative relation between the two, since interest is an important cost variable in deciding the level of inventory holding. However, fluctuations in expected price and demand conditions are more important determinants. True, if interest is significant as a cost element, monetary policy may counteract excessive fluctuations in inventory holding through interest rate variations. The price expectations effect might however, likely outweight the interest-cost effect. Eisner and Strotz working with the U.S. data opined that "by its very nature, investment in inventories, which is eventually short-run cannot be affected by fluctuations in the rate of interest.[1]

Analysis and empirical testing of interest rate sensitivity to various categories of expenditure seems to give better insight into the effectiveness of interest rate policy as is borne out by the studies made in the U.S.A. To the extent that the money demand hypothesis yields results which do not make interest rates unimportant, there would be justification in adhering to interest rate as one of the monetary policy measures. Then both the aggregative and disaggregation approaches would be said to adduce evidence in support of the measure.

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1. Eisner and Strotz Op.cit. P.229.

Attempting to apply the disaggregation approach to the Indian situation one encounters the general problem of paucity and reliability of data. No firm conclusions could obviously be derived in regard to consumer expenditure or residential construction. Although the latter category of expenditure should remain interest-sensitive, on a priori reasoning, rising rents consequent upon faster pace of industrialisation might swamp the interest-cost effect.

In regard to the influence of interest rates on inventories and fixed investment data availability may not remain the problem but here again no firm conclusions could be drawn for the following reasons.

Bank Rate variation in India has been in the upward direction throughout the period 1951-52 to 1965-66. Quantitative measurement of interest-investment relationship could be more accurately undertaken when the policy changes have been in both directions. This point cannot be stressed much but there is another more important reason. The impetus provided to larger investment through a large scale programme of planned industrialisation and expectations of rising prices and growing demand would swamp any disincentive effect of interest rate variation which has been in the upward direction during 1951-1966. Measurement of the cost incentive effect on investment (both fixed and inventory type) is rendered even more difficult in view of the off-setting effects of other policy measures such as

treatment of interest as a cost for tax deductibility purposes. Thus even if rates harden, enhanced rates of business taxation may induce the entrepreneurs to resort to raising funds through borrowing.[1]

By far however, the most important reason is the government licensing policy in regard to expansion of the existing as well as establishment of new industrial units which makes it necessary to be cautious in arriving at any macrolevel relationship between interest rate and investment. To this may be added the fact of the dichotomous process of investment in the economy in the sense of there being a relatively fast growing public sector which remains more or less immune from variations in the market rates of interest and the private sector which though not immune from interest rate variations is subject to variations in government policy in regard to industrial licensing and controls on capital issues.

Thus when we think of interest sensitivity of investment in underdeveloped countries we have to accept

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1. In regard to influence of interest rates on inventory holding, we suggested earlier that on a priori reasoning, the effect should be important although the price expectation effect cannot be ignored. The Reserve Bank of India holds that "in the field of inventory investment interest rates do have some influence" (vide Reserve Bank of India Bulletin, April, 1966 P. 356).

   Another study of the corporate sector in India for the period 1950-62 reports that "the influence of short term rate of interest on inventories appears to be important in a large number of industries in the time-series analysis where such a variate is used" - Vide K. Krishnamurty and D.U. Sastry, "The Indian Economic Review Vol.I (1966) P.50.

that investment in the public sector will have to be undertaken with due regard to a proper rate of discount and this rate would be normally higher than most of the underdeveloped countries seem to be having. Thus Tinbergen rightly points out (while referring to the 'shadow price' technique) that "an interest rate of 10 percent would seem to be a reasonable figure when it is remembered that developed countries such as Germany have an interest rate of 7 - 8 percent and the U.S. had this rate a century ago whereas personal loans are often made in developing countries at a rate of 25 - 30 percent".[1]

It is again legitimate to suppose that the practice of assessing the worthwhileness of a project in terms of cost of capital should have application in regard to private investments also and hence a rational interest rate policy could well influence the course of investment making in the private sector also. "The fact that business enterprises (in India) borrow from the public at rates lower than they would be required to pay at banks shows that cost has consideration with them".[2]

The tendency to brush aside interest rate as a factor of any importance has been in part a legacy of the findings of the surveys in the prewar years. It may however, be pointed out that in these years rates

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1. J. Tinbergen "Development Planning" World University Library (1967) Pp. 171-72.
2. "Evolution of monetary policy in India", Reserve Bank of India Bulletin, April, 1966. Pp. 340-61 [esp. P. 358]

were so low that any business unit would hardly call it a big cost factor. A realistic and competitive rate of interest would surely force them to reckon interest as a cost element. It may also be pointed out that the emergence and widespread acceptance of 'acceleration based' theories of investment robbed interest rate of any worth it could have in influencing investments. But it was soon recognised that 'finance' could not be neglected and the moment we give credence to this recognition we have to accept the argument of Tobin[1] that the price of funds could not be neglected.

Before we go over to examining the issue of interest-elasticity of savings it would be in order to examine the issue whether an interest rate policy would have its transmission effect in an underdeveloped country like India. To do this, we may examine the influence of Bank Rate variations in terms of ;

1. Variations in Bank Rate and market rates of interest.
2. Variations in interest rate pattern of advances by banks.
3. Variations in borrowings from banks by industry and trade.

1. Variations in Bank Rate and some market rates of interest :

We noted earlier the claim of the Reserve Bank of India about the Bank Rate being a "prime regulator of

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1. J. Tobin quoted in Chapter two above.

the market rates of interest". One way to test the validity of this statement would be to compare movements in the Bank Rate and market rates of interest. Table 8(1) brings out movements of selected rates of interest viz.,

(i) Bank Rate which is the instrument variable (implicit).

(ii) The Government of India Treasury Bill rate (90/91 days)

(iii) Inter-bank call money rate which provides same measurement of variations in liquidity position of banks and is under Indian conditions one of the most sensitive short-term rates of interest.

(iv) Bazar Bill Rate which is a proxy for the rates prevalent in the unorganised money market; and

(v) the yield on 3% Government of India 1986 loan which is a proxy for the long term rate of interest.

As the data reveal, movements in these selected rates of interest showed an upward trend in keeping with the upward movement of the Bank Rate during the period 1950-51 to 1965-66. The call money rate moved from its low of 0.77% in 1950-51 to 6.38 in 1965-66. Whereas Bank Rate increased by 100 percent during the period, the inter-bank call money rate showed about 800 percent increase. Barring downward movement during the years 1957-1959 which was attributable to holdings

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1. Interest rates on 'Deposits' and 'Advances' of scheduled banks have not been included here in view of the fact that they have been subject to agreement and/or official regulation since 1958 and we treat them just hereafter.

TABLE 8(1).

Movements in selected interest rates 1950-51 to 1965-66.

(Per cent per annum)

Year	Bank rate	Government of India Treasury Bill rate (90-91 days)	Inter-bank call money rate	Bazaar Bill rate	Yield on 3% Government of India Loan 1986 (or later).
1950-51	3.0	-	0.77	10.79	3.15
1951-52	3.5	-	1.55	11.04	3.39
1952-53	3.5	2.22	2.43	11.04	3.66
1953-54	3.5	2.45	2.58	11.30	3.64
1954-55	3.5	2.53	2.53	11.30	3.67
1955-56	3.5	2.52	2.95	11.04	3.74
1956-57	3.5	2.53	3.44	11.25	3.99
1957-58	4	-	3.30	11.61	4.18
1958-59	4	2.52	2.92	10.85	4.13
1959-60	4	2.59	3.02	10.73	4.05
1960-61	4	2.65	4.13	11.57	4.06
1961-62	4	2.58	4.15	12.72	4.16
1962-63	4-4.5	2.42	3.96	12.78	4.49
1963-64	4.5	2.35	4.02	13.33	4.66
1964-65	4.5-5-6	2.72	4.32	14.07	4.80
1965-66	6	3.50	6.38	15.70	5.46

NOTE:- Both inter-bank call rate and Bazaar Bill rate are being quoted separately for the three centres, Bombay, Madras and Calcutta. Their average has been shown here.

SOURCE:- Rates other than the Bank Rate are annual averages reported in "Supplement to Banking and Monetary statistics of India (Part II)" and "Currency and Finance Reports" for years 1962-63 and 1965-66.

of P.L. 480 deposits[1] within the commercial banking system, the upward trend remains uninterrupted. The call money rate by its nature is however, subject to day-to-day fluctuations and the much larger variation in its movement relative to Bank Rate should not be taken to mean that the Reserve Bank had successfully launched a Dear-money policy throughout this period. The Bazar Bill Rate showed an overall upward trend rising from the level of 10.79 in 1950-51 to 15.70 per cent in 1965-66 excepting downward movement during the years 1955-56 and 1958-59 to 1959-60. The 'long term' rate of interest however, kept company with the Bank Rate, the variations in the two remaining closer. The treasury Bill rate remained below Bank Rate and the call-money rate above it through all these years.

In a study attempting to "quantify the inter-connection between short and long term rate of interest in the organised money-capital markets of India" and using various combinations of short rates such as the treasury bill rate and three-month deposit rate of scheduled banks together with the inter-bank call rate and Bazar Bill rate, it was brought out that the "Bank rate had a positive effect on the short term rate of interest" and that "one point increase in the Bank Rate would imply nearly 1.4 point increase in short term

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1. Beginning with January, 1960 these deposits were transferred to the Reserve Bank of India.

rate of interest". The period covered by the study was 1948-61.[1]

Statistical relation stated above supports the general argument about the rising trend of interest rates; the relation about a given quantitative change in Bank Rate and other rates of interest adduces further evidence but it does not tell us whether this quantitative relation is pure 'announcement effect' or 'cost effect' or is compounded of both. It may even be partly ascribed to the prestigious status of the Reserve Bank of India. The simple juxtaposition of these rates as in the above Table and the econometric testing of them (periods are different to some extent) just cited go to suggest that the organised part of the Indian monetary system has elements of coherence to render interest rate policy effective. The question of the structure of rates is taken up later in this chapter.

2. Variations in interest rate pattern (advances) of scheduled banks:

We may now look into the transmission of Bank Rate (effective rate of borrowing) variations to rates at which advances have been made by selected scheduled commercial banks. Rates on advances are governed by, among other things, Deposit rates, regulation of

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1. K. Krishnamurty, "Structure of interest rates in India", "Arth Vijnana" June, 1965 Pp. 147-51. Gokhale Institute of Politics and Economics, Poona.

Deposit and Advance rates (in operation from October, 1960) and general conditions of business. It is difficult to isolate these effects. For one thing, as is evident from Table 6(9) in chapter six however, rates on advances (including bills discounted) have been gradually stepped up from 1953 onward from a level of 5.90% in that year to 9.0% in the year 1966. However, advances are generally being distributed among different interest rate brackets and Table 8(2) shows percentage distribution of advances by selected scheduled banks during the period 1960 to 1966. The data in the table reveal that there has been a gradual widening of the interest rate ranges during the period. These data also support the argument about coherence made above.

(3) Variations in borrowings by industry and trade:

To assess the importance of interest rate policy under Indian conditions, a reference to variations in borrowings by trade and industry both of which account for about 9/10th of total borrowings may prove helpful. The extension of interest rate ranges by scheduled commercial banks (vide Table 8(2) need not necessarily produce decelarating influence on volume of borrowings by trade and industry in view of rising expectations following the general programme of planned economic development, Quite the contrary, the intention of the monetary authorities having been to meet with the expansionary trend in credit requirements by industry

TABLE 8 (2).

Advances by selected scheduled commercial banks at various rates of interest.

Year (as on last Friday of March).	Bank Rate	Weighted average rate of borrowing from Reserve Bank.	Percentage share of lending by banks at rates of interest:									
			Upto 4%	Above 4 and upto 5%	Above 5 and upto 6%	Above 6 and upto 7%	Above 7 and upto 8%	Above 8 and upto 9%	Above 9 and upto 10%	Above 10%	Total	No. of reporting banks.
1960	4%	4 %	4.5	26.3	50.4	16.0	2.8				100	15
1961	4%	5.12%	0.5	12.9	45.4	32.1	9.1				100	14
1962	4%	4.81%	0.8	11.9	37.1	36.0	14.2				100	14
1963	4%-4½%	5.19%	0.9	9.5	17.1	45.8	26.7				100	14
1964	4½%-	5.15%	0.8	1.8	9.3	56.0	27.9	3.8	00.4		100	14
1965	4½-5%-6 %	5.17%	0.6	0.2	0.9	9.7	28.6	42.8	16.6	0.6	100	20
1966	6 %	6.81% *	0.7	0.2	0.4	2.3	23.1	39.6	33.3	0.4	100	20

* averaged out of the weighted average of 6.28 for 18 weeks and 7.08 for 34 weeks.

Note : (1) Advances exclude bills purchased and discounted for the years 1960 to 1966, but exclude 'money at call and short notice' and 'due from banking companies' also for the years 1965 and 1966.

(2) Percentage share of advances of these selected banks to all scheduled commercial bank advances was as under for the various years.

1960	1961	1962	1963	1964	1965	1966
75.9%	78.0%	77.3%	78.9%	76.7%	85.6%	85.7%

Source:- "Statistical tables relating to banks in India" for the years 1960 to 1966.

and trade consequent upon the general programme of economic development the question to be considered is whether these requirements were adequately met. But any computation of adequate requirements is beset with difficulties and may take us beyond the scope of this study. For one thing however, excepting the two year period 1952-54 when there was a decline in the absolute volume of advances to Industry as well as Trade, there has been a continuous rise in the amount of advances to these two sectors from a level of 70% of the total advances to 84% of total advances during the period 1951-66. In the Industry-Commerce group however, the ratio of advances to Industry to that for commerce which was about 1:1 in 1951 rose to about 3:1 in 1966. (Vide Table 8(3).

TABLE 8(3)

Sectorwise distribution of scheduled commercial banks advances(outstandings)

(percentage share)

Year (ending)	Sector				
	Industry. (1)	Commerce and trade. (2)	Total (1)+(2) (3)	Rest (4)	Total (3)+(4) (5)
1951/March	34.0	36.0	(70.0)	30	100
1956/March	37.1	36.5	(73.6)	26.4	100
1961/April	50.8	28.6	(79.4)	20.6	100
1966/March	62.7	21.4	(84.1)	15.9	100

Source: "Trend and progress of Banking in India" 1968-69. P.48.

There is another relevant aspect of the matter which has engaged attention of authorities in India and may be briefly dealt with here. We saw that the more or less moderate rise in interest rates had no decelarating effect on bank borrowings by trade and industry. It was felt that the boot is rather on the other leg, that is, industry and trade would seem to have overborrowed under prevalent inflationary conditions. A study group appointed to "examine the subject of 'the extent to which credit needs of industry and trade are likely to be inflated' and how such trends could be checked"[1] reported as under :

Percentage increase over 1960-61 in the value of industrial output at current prices.		Percentage increase over 1960-61 in bank borrowings by industry.	
Year	Percentage increase.	Year	Percentage increase.
1965-66	90.7	1965-66	121.5

Bank borrowings were about 34 percent in excess of the credit requirements of industries as related to their output assuming constant relationship between the two. The study group also found that whereas industries maintained a more or less stable ratio of inventory to sales over the period 1960-61 to 1966-67 their borrowings from banks were in excess of the value of inventories

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1. This refers to the study group appointed by the National Credit Council in October, 1968.

as is evident from Tables 8(4) and 8(5) below :

TABLE 8(4)

Year	Percentage ratio of Inventory (of raw materials, finished goods and stores) to sales.
1960-61	30.6
1961-62	30.8
1962-63	30.5
1963-64	28.9
1964-65	29.7
1965-66	28.9
1966-67	31.9

TABLE 8(5)

Year	Inventories (Rs. in crores) (1)	Short term bank borrowings (Rs. in crores) (2)	Ratio of (2) to (1) (3)
1961-62	815	330 +	40%
1966-67	1466	760 +	52%
Percentage rise	80	130	

+Estimated

Source : Reserve Bank of India Bulletin. November, 1969. Pp. 1792-98.

The study group made some important observations in regard to;

(i) lending practices of banks; and

(ii) diversion of short-term credit for financing fixed assets formation;

and made policy recommendations which could be subsumed under the general objective of inculcating a larger measure of "financial discipline" among bank borrowers.[1]

1. In regard to borrowings by Trade and Commerce the study group came to the conclusion that "there was no evidence of 'excess' bank credit to commerce or trade".

These recommendations furthermore, implied some structural reforms one of which was to exhort banks, industry and trade to 'develop the practice of issuing usance bills... 'where feasible and administratively convenient'. This structural reform need to be accompanied by a high interest rate policy also to subserve the need of financial discipline, an issue on which the committee preferred to remain silent.

Summing up, it may be observed that the transmission effect of Bank Rate variation as observed with reference to selected rates of interest is not insignificant. This however, keeps open the question of linkage between rates in the organised and unorganised sectors of the Indian money market. Furthermore, the pattern of loan rates of the scheduled banks has followed variations in Bank Rate in general, although the relationship is conditioned by interest rate regulation policy of the Reserve Bank also. Variations in the volume of bank borrowings by various sectors have been influenced more by the criterion of 'availability' rather than 'cost'.

(c) Interest elasticity of savings :

The rationale of an interest rate policy in an underdeveloped country would derive greater strength if it could be shown that savings are interest elastic, in view of the need for accelerating the rate of capital formation. Beginning with the Keynesian hypothesis that

savings are income-determined and the observation that there may be perverse interest elasticity of supply of savings for the target savers, the interest-saving relationship has remained an elusive and relatively unimportant problem. M.J. Bailey has however, argued out, and in a cogent manner, that "when a change in the rate of interest is associated with a change in the wealth position of the economy, as with an unexpected and substantial technological advance, the response of aggregate savings will be combined result of a substitution effect (as between current and future consumption) and a wealth effect (wealth-saving relationship)".[1] With regard to arbitrary changes in rates of interest (arbitrary in the sense of having been unaccompanied by any change in real resources or wealth i.e. with constant real resources) however, the substitution effect alone remains and may prove powerful. In the face of a, say, rise in the rate of interest, the individual will have an inducement to change his plans, reduce his current consumption and obtain future goods which have become cheaper relative to current goods. For the individual and the society as a whole, thus, with constant real resources, "additional future goods can be obtained only by an additional sacrifice of current consumption

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1. M.J. Bailey, "National income and the price level". McGraw Hill (International student edition) 1962. Ch. 8.

and the interest elasticity of savings will thus be positive".[1] This piece of reasoning based on the additional assumptions of rational behaviour, continuity of variations in the subjective marginal rates of substitution and absence of distributional considerations may be regarded as having limited operational significance. However, Colin Wright[2] in a recent study has upheld the notion of interest-elasticity of savings being positive. Working with U.S. data covering long periods, he has found an elasticity of saving with respect to rate of interest of about +0.2 indicating that a rise of interest, say from 4 per cent to 6 per cent will, through the substitution effect "provoke an increase in savings of 10 per cent or more."

Though ascertaining such aggregative quantative relation between interest and savings should prove helpful for the planners in designing their overall strategy of resource mobilisation, a more important problem, relevant from the monetary policy point of view, is how the savings of the community are held or what are the instruments for holding these savings. Although the domestic rate of saving has remained notoriously low in India over the three Plan periods, the higher marginal saving-income ratio suggests that if a sound and well thoughtout strategy of savings mobilization, with due emphasis on the type of financial

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1. Ibid.

2. Colin Wright "Saving and the rate of interest" in "Taxation of income from capital" (Ed.) Harberger and Bailey, Brookings Institute, 1969.

instruments, is pursued it would go a long way in speeding up the process of development. Further in India, in the total pool of savings the contribution of the household sector remaining predominantly large (Vide Table 8(6)) an adequate number and varieties of savings instruments have to be provided to suit the widely varying savings attitudes of the household sector. This would concurrently make it necessary to pay due regard to the structure of interest rates or more broadly the yield structure on various financial instruments.

TABLE 8(6)

Pattern of savings in the Indian economy.

(Percentage to national income)

Year (end of March)	Govern-ment sector. (1)	Domestic corpo-rate sector. (2)	House-hold sector (3)	Total 1+2+3 (4)	Percentage ratio of (3)to(4) (5)
1950-51	1.0	0.4	4.3	5.7	75.4
1955-56	1.1	0.6	8.0	9.7	82.4
1960-61	1.7	0.7	7.3	9.7	75.2
1965-66	3.2	0.5	7.2	10.9	66.0

Source : "Currency and Finance Reports" 1965-66 and 1969-70.

Assets structure : Household Sector in India.

A basic tendency of wealth holders in the under-developed countries is to hold on to physical assets in

preference to financial assets for reasons which need not be repeated here. One function of interest rate mechanism would be to veer them away from the former to the latter. Table 8(7) gives the ratios (to national income) of physical and financial assets held by the household sector. Part A of the table gives the respective ratios of both and Part B gives the percentage ratio of physical to financial assets. As is evident, the percentage ratio of physical to financial assets which was as high as 2050 in 1950-51 came down to 53 in 1965-66. This may be taken to mean that the process of financial accumulation has made its dent.

Breakdown of the financial assets : Household Sector:

Breakdown of holdings in financial assets is given in Table 8(8) in terms of three asset groups (i) currency and bank deposits (ii) Provident fund and Insurance (which are more or less contractual savings) and (iii) claims on Government and corporate and co-operative shares and securities as at the end of each Plan period.

TABLE 8(7)

Savings of the household sector in physical and financial assets.

Figures in Part A are percentage ratio to national income.

Year	Part A			Part B
	Physical assets (1)	Financial -assets (2)	Aggregate holding (1) + (2) (3)	Percentage Ratio of (1)to (2) in part A. (4)
1950-51	4.1	0.2	4.3	2050
1951-52	3.0	0.2	2.8	1500
1952-53	2.7	0.4	3.1	675
1953-54	3.5	0.8	4.3	437
1954-55	3.3	3.2	6.5	103
1955-56	4.1	3.9	8.0	105
1956-57	4.6	2.8	7.4	164
1957-58	2.7	2.8	5.5	96
1958-59	3.3	2.7	6.0	122
1959-60	3.5	3.0	6.5	117
1960-61	4.2	3.1	7.3	74
1961-62	3.0	3.2	6.2	94
1962-63	3.2	3.2	6.4	100
1963-64	4.0	4.1	8.1	98
1964-65	3.9	3.7	7.6	105
1965-66	2.5	4.7	7.2	53

Source:- "Currency and Finance Reports" 1964-65 and 1969-70.

TABLE 8(8).

Holdings of savings (Net) in financial assets by the household sector.

(Percentage to total)

Year (end of March).	Currency and bank deposits. (1)	Insurance and Provident fund. (2)	Claims on government and corporate & co-operative shares and securities (3)	Total (4)
1955-56	49.4(53.6)	29.4(16.7)	21.2(29.7)	100.0
1960-61	35.4(43.8)	46.0(28.8)	18.6(27.4)	100.0
1965-66	59.3(62.2)	30.2(25.4)	10.5(12.4)	100.0

Note:- Figures in brackets show percentage ratios of gross savings in financial assets i.e. (assets without being offset by corresponding liabilities).

Source: "Currency and Finance Reports" 1965-66 and 1969-70.

The relative gain of currency and bank deposits to equity type of holding (Col. 3) after 1960-61 is to be accounted for partly by trends in the capital market, partly by inflationary pressure and to some extent due to the process of monetisation.

As between currency and bank deposits there has been a shift in favour of bank deposits over each Plan period. Table 8 (9) throws light on this.

TABLE 8(9).

Ratio of holdings of Savings in form of currency and bank deposits by the household sector : average for three plans.

(Amount in Crores of Rupees)

	Average annual amount of saving (gross and net) held during the plan period.				
	Currency	PART A		PART B	
		Bank Deposits (Net)	Percentage ratio of (2) to (1).	Bank Deposits (Gross)	Percentage ratio of (4) to (1).
	(1)	(2)	(3)	(4)	(5)
First Plan.	32.6	1.46	4.5	32.2	98.8
Second Plan.	100.0	29.2	29.2	112.0	112.00
Third Plan	182.7	157.7	86.3	304.8	166.8

Source:- Currency and Finance Reports 1965-66 and 1969-70.

It is to be seen that the average annual holding of financial assets (net of corresponding liabilities) in currency and bank deposits reflects the general disposition of the community to hold relatively larger volume of currency (which is also reflected in the higher currency component in money supply and which

we observed, quoting Pesek (Vide Chapter II) as carrying the heavy burden of "Summarising the tremendously complex forces exerted on the market by the public, the business sector and Commercial banks").

Data in Table 8(9) show that the average annual holding of financial assets in form of currency increased from Rs. 32.6 crores (average for the First Plan) to Rs. 182.7 crores (average for the Third Plan). As against this the average annual holding of bank deposits (net of liabilities) which was at a low level of Rs. 1.46 crores (First Plan average) increased to Rs. 157.7 crores (Third Plan average). While thus the holding of financial assets in form of currency has remained higher in absolute value (Plan averages) over the 15 year period, the differential has narrowed down as can be seen from variations in the percentage ratio of Bank Deposits to currency from its low level of 4.5 in First Plan (5 year average) to 86.3 in Third Plan (5 year average) - vide Col. 3 -.

Part B of Table 8(9) shows (Under Column 4) volume of saving in financial asset like Bank Deposits (gross). It indicates that Bank deposits (gross) were more or less equal in amount to currency (First Plan) but - remained above currency at the end of the period (Third Plan average). Similarly the percentage ratio of bank deposits (gross) to currency rose from its 98.8 level (First Plan) to 166.8 level (Third Plan) as revealed by Column 5.

Relationship in Part B may be said to be reflective of the extent of the process of financial intermediation.

If we compare the variations in percentage ratios under columns (3) and (5) we might observe that the process of using bank deposits as a form of saving (variation from 4.5 to 157.7 per cent) has remained ahead of the process of the banking system serving the saving-investment process (variation from 98.8 to 166.8 per cent). How far the higher percentage ratio of column 3 is attributable to attractive rate of interest on bank deposits could not be easily ascertained. It may be due to bank deposits being one of the few savings media available in the underdeveloped countries.

Probing further and using more sophisticated statistical methods we may know the respective income

and interest elasticities of savings in India but there does seem to be a valid presumption that interest sensitivity of savings is not so low as to rule out any role for interest rate policy. If the lessons of South Korea and China (Taiwan) is to be any guide these countries have successfully used a high interest rate policy with favourable effects on the volume of savings.[1] One of the reasons for comparative stagnation in the savings/income ratio in India can thus be directly attributed, among other things, to lack of rational and purposive interest rate policy. One of the reasons for lack of such a policy has been the tendency on the part of the Reserve Bank to follow a policy of low and stable interest rates, labouring under the impression of the general proposition that savings are income-determined being perhaps another. As P.R. Brahmananda has so well argued out "unless it can be proved that the ceiling on growth rate has actually been reached in India one cannot dispute the role of additional savings in the growth process. Granted this role and objective of attaining high growth rates the case for high interest rates (in India) automatically follows".[2]

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1. For relevant data and advocacy for purposive interest rate policy refer A.G. Chandavarkar "Finance and Development". Washington, March, 1970. Pp. 19-27.

2. P.R. Brahmananda in "Economic policy and programme" - a symposium. Indian Merchants Chamber, Bombay. (January, 1970) P. 24.

It could be argued that while a 'high' rate policy may succeed in coaxing out more savings, its repercussions on (i) interest cost of government debt (ii) deterioration in balance sheet positions of financial institutions and (iii) disincentive effects on private investment could not be overlooked. In regard to (i) the increased cost of borrowing should be on a priori reasoning be weighed against the advantage of rational selection of projects and saving of resources from being diverted to less efficient projects. The advantage of operating in a captive market together with the selection of an appropriate maturity pattern could help keep down the cost. As we saw in chapter six in regard to discussion of open market policy the maturity pattern is rather favourable for a rise in the interest rate. In regard to (ii) the fact about it may be noted that structure of ownership of government securities is such that a large part of it is held to maturity (vide chapter six). In so far as the disincentive effect on private investment is concerned this effect is often exaggerated; if any effect exists it should be weighed against the gain in financial discipline and more productive use of cash and capital resources.

It should however, be noted that a rational and purposive interest rate policy has to run along consideration of the structure of interest rates rather than a particular 'level' of the rate - when we speak of

'high' or 'low' interest rates, the reference is obviously to 'the' rate of interest with the underlying assumption that the inter-connection between different rates is more or less of a stable nature.

The Radcliffe Committee, it is now well known, had emphasised the structure of interest rates as the - 'centre piece of monetary action' although the committee was guilty of over-emphasising this aspect of policy "in preference to same notion of the supply of money."[1] Their concept of the 'three gears' of 'the' rate of interest is of more practical relevance to the policy makers.

Our discussion thus far has, on the one hand, brought out that the general level of interest rates has shown an upward trend together with a doubling of the Bank Rate between 1951 and 1966. The quantitatively greater upgrading of some market rates (vide Table 8(1)) relative to the Bank Rate is due to the very low levels these rates had reached during the war and immediate post-war years subsequent upon the initiation and continuance of cheap money policy under the British rule. Relatively greater emphasis on role of fiscal policy and the need to keep down costs of government borrowing further strengthened the case of low interest rates in

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1. Radcliffe Committee Report, London (1959) P. 134.

the background of the professional skepticism about low interest elasticities of demand for investment and supply of savings.

In reporting about the Bank Rate rise of February 1965 (and the directive to banks to increase their deposit rates) the Reserve Bank stated that "increasing use was ... made of the mechanism of interest rates so as to promote savings in the economy".[1] If this line of thinking had any weighing with the Bank it would not have resorted to a cut in the Bank Rate by one full percentage point later in March, 1968 which P.R.Brahmananda had rightly characterised as "the most untimely and unkindly cut".[2]

The general level of interest rates remaining thus lower than what a capital scarce economy would need, the structure also was one which demands concern.

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1. "Currency and Finance report" 1964-65 P. 13.

2. P. R. Brahmananda 'Bank Rate : The most unkindest cut', Commerce Weekly, Bombay, March 9, 1968 P.637.
   It is true that the cut in Bank Rate was occasioned by peculiar conditions of 'inflationary recession' prevailing then. As Brahmananda had argued out, these were due to steep drop in foreign aid rather than inhibiting cost of credit. We cannot pursue the matter further here. A point may nevertheless be made here. Assessment of different methods (self-finance ... debt asset) of savings-investment technology* in terms of their relative costs and benefits over the plan periods in India, an important field of enquiry by itself, could point to a proper policy mix (the Mundell criterion may then be relevant here). We may hazard the conclusion that monetary policy has been assigned unduly lower weightage in this optimal combination.

   * The term is due to Gurley and Shaw.

STRUCTURE OF INTEREST RATES.

Analytically, the structure of interest rates has been discussed with reference to the term structure of interest rates implying that the long term rate should normally exceed the short rate.[1] The 'expectations' theory considers that current rate structure forecasts future rate structure. It is then necessary that the current form of structure provides unbiased forecasts of subsequent rates. Keynesians emphasised that the lenders' behaviour as risk avertors and their greater concern with stability of principal rather than with stability of income explains better the excess of the long over the short rate.

David Meiselman has tried to rationalise the 'expectations' hypothesis by "introducing an error-learning model of expectations according to which expectations about the future are not assumed to be correct, but are instead assumed to be corrected in the light of experienced error in the present."[2] What is more, this -

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1. The analysis, it should be noted, is carried in terms of default-free loans. Loans in underdeveloped countries bear this characteristic to a much larger extent and hence the need for caution in applying such theory to underdeveloped countries.

2. (A) L. C. Telser "A critique of some recent empirical research on the explanation of the term structure of interest rates", Journal of Political economy, August, 1967 (Part II) P.546.

   (B) H. G. Johnson, Essays in Monetary Economics, (1967) P. xiii.

hypothesis has yielded good statistical fits when examined against U.S. data. The basic assertion of the expectations theory however, being that loans with different maturities that are similar in other respects are perfect substitutes in the aggregate, leaves out of consideration forces that may arise due to certain institutional characteristics, market imperfection and so on. Since these latter elements would characterise underdeveloped countries the structure of interest rates in these countries could not be rationalised in a simple manner or along either of the 'expectations' or 'liquidity preference' approaches. A more useful approach towards understanding the rate of structure in underdeveloped countries would be to bring out the nature of demand and supply functions of interest-bearing securities.[1]

Ronald Robinson[2] dealing with the problem at the brass track level suggests that the structure could be

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1. J. M. Culbertson proceeding along such lines lists a wide range of factors (real and financial) promoting large desired security holding in relation to income (long run 'securities demand function') and those tending to cause a large supply of debt in relation to income (long run 'securities supply function'). Many of these factors would be relevant to underdeveloped countries. Vide J.M.Culbertson "The interest rate structure : Towards completion of the classical system" in Hahn and Brechling (Eds.) "The theory of interest rates" Macmillan 1965 Pp. 173-205. In particular Pp. 186-89 and P. 192 foot note.

2. Ronald Robinson, "Money and Capital Markets" McGraw Hill (1964) Pp. 77-81.

classified on basis of (i) maturity 'short' and 'long', (ii) type of instrument (iii) tax status of the instrument, (iv) geographic areas and (v) negotiated and open market rates. Again within a given class of assets factors like risk differential, capital certainty etc. would bring further differentiation in the structure.

At any point of time, the interest structure comprises of the range of returns on loans of different kinds. These returns then are determined by all the factors like the term of the loan, the marketability of loan, tax status, risk differential and so on. Some of these rates are determined in the capital and some in the money market.

Monetary authorities aiming at stabilization policy operate on the market via changes in the short term - (Bills only policy) or both long and short rates (open market operations and Bank Rate) or by 'twisting' the structure through two different policy measures ('tight money' - 'easy budgets') or through a policy of graded lending rates during 1960-64 and differential lending rate structure for co-operative banks, priority sectors etc. as operating with the Reserve Bank of India. It may also affect the structure through regulation of rates on bank deposits and advances and so on. Monetary authorities operating within a given financial environment and the web of regulation would bring about changes in the structure of rates. These aspects of financial

environment and web of regulation being given, market forces would bring about a structure which would be instrumental in allocating resources and may even - produce distributional effects.[1]

Interest (yield) structure in India :-

Table 8 (10) gives an idea about the rates that prevailed in the organised market,[2] at the end of each Plan period (terminal year of each Plan). The table also shows average rate for each Plan period.

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1. 'Interest' is normally supposed to be a bad 'redistributive' policy measure. Arguing against low interest rate policies and bringing out the distributional effects of a high interest rate policy, H. G. Johnson however observes that government borrowing at 2½ to 3 per cent rates 'promotes wasteful investment' and 'tends in the long run to promote inequality of income'. "It may be preferable to stimulate private savings by offering high interest rates rather than by forcing savings into the hands of the State by taxation and inflation". The poor or small savers are mainly confined to low-yielding fixed-interest investments which are safe and easily available while the larger savers can invest in high-yield stocks. By offering higher interest rates on the savings media of the poorer class the government can stimulate savings and improve distribution of income. H.G.Johnson "Money Trade and Economic Growth" Haward University Press 1962 Pp. 160-61.

2. We refer here to rates prevalant in the organised money market. Rates in the unorganised market are by hypothesis, higher. The Bazaar bill rate has as such always stood higher than rates in the organised sector. We however refer to this aspect of the matter in our discussion of the issue of 'integration' in the next chapter.

TABLE 8(10).

Interest (yield) structure in India.

(Annual averages : per cent per annum).

	Bank Rate	:	3½	4	6
			1955-56	1960-61	1965-66
1.	Treasury bill rate	:	2.52 (2.32)	2.65 (2.58)	3.50 (2.71)
2.	Bank Deposits (Scheduled banks) (12 - months)	:	2.39 (2.18)	3.31 (3.22)	5.50 (4.43)
3.	Post Office Savings Bank	:	2.00	2.00	4.00
4.	Bank Advance Rate	:	5.5 (5.6)	6.6 (6.0)	8.3 (7.2)
5.	Inter-Bank call money rate	:	2.95 (2.41)	4.13 (3.16)	6.38 (4.56)
6.	Yield on 3 per cent (1986) Govt. Security	:	3.74 (3.60)	4.06 (3.90)	5.46 (4.71)
7.	Bazaar Bill Rate	:	11.04 (11.14)	11.57 (11.11)	15.70 (13.92)
8.	Yield on variable dividend industrial securities	:	5.01 (5.57)	4.88 (5.81)	8.11 (5.90)
9.	Lending rate by statutory financial corporations	:	---------- 9-10 ----------		

Note:- (i) Rates are annual averages for the given years which were the terminal years of each Plan.

(ii) Figures in brackets show the simple arithmetic average of the annual averages of each year for each Plan.

(iii) Bank advances rates (4) are for calender years and are based on Table 6 (9) in chapter six.

Source:- "Supplement to Banking and Monetary statistics of India (Part II)"and "Currency and Finance Reports for period upto 1960-61" and "Currency and Finance Reports" for the remaining period.

It may be seen that yields at Nos. 8 and 9 belong more properly to the capital market and the rest to the money market. It may be observed that over the third Plan period rates in the money market increased more sharply than yields in the capital - market. The trends in capital markets which are influenced by a variety of economic and extra-economic forces need not concern us so much here. But the relative upgrading of rates in the money market is partly reflective of strained liquidity position of banks; interest regulation policy and a host of other factors. This upgrading in the money market rates deserves attention.

Table 8 (11) below shows variations in rates over the period 1951-52 to 1965-66. For purpose of comparison we have taken the average of the five years of the First Plan and the average of the five years of the Third Plan, and measured the excess of the latter over the former for a period of 10 years. This way of comparison has been adopted in view of the fact that rates in 1950-51 ruled -

rather low so that taking the value in 1950-51 and comparing it with the one prevailing in 1965-66 over a period of fifteen years might give some inflated picture of the degree of variation. Hence we have taken the average of the five years of the First Plan as a proxy for the rate ruling at the end of that period and compared it with the average of the five years of the Third Plan as a proxy for the rate ruling at the end of the Third Plan so that rate movements for a ten year period are noted.[1]

It will be observed that interest rates on Bank Deposits have shown the highest average annual percentage growth rate of 10.32 followed by Call Money rate (4.71), Advances rate of scheduled banks (2.8), Bazaar Bill rate (2.50) long term government securities (2.36) and the treasury bill rate (1.68). At the lowest end is the yield on variable dividend industrial securities -

1. Comparing the excess of actual values at the terminal years of the First and Third Plans would yield different growth rates than what are reported above. On making such calculation it has however been observed that the highest growth rate is in Bank Deposits followed by Call money rate (same as above) which are followed by Treasury Bills, variable dividend industrial securities; government security (same order as reported above); Advances and Bazaar Bill Rate.

TABLE 8 (11).

Percentage variations in selected interest rates during the three Plan periods.

	Category	Average for First Plan	Average for Third Plan	Absolute variation (2)-(1)	Percentage variation (2)over (1).	Annual percentage growth - 1955-56 to 1965-66
		(1)	(2)	(3)	(4)	(5)
1.	Treasury Bill rate	2.32	2.71	+ 0.39	+ 16.81	+ 1.68
2.	Bank deposits (12 months)	2.18	4.43	+ 2.25	+103.20	+10.32
3.	Bank Advances Rate	5.6	7.2	+ 1.6	+ 28.5	+ 2.8
4.	Inter bank call money rate	2.41	4.56	+ 2.15	+ 47.15	+ 4.71
5.	Yield on 3 % (1986) Government security	3.60	4.71	+ 1.11	+ 23.57	+ 2.36
6.	Bazaar Bill Rate	11.14	13.92	+ 2.78	+ 24.98	+ 2.50
7.	Yield on variable dividend industrial security.	5.57	5.90	+ 0.33	+ 5.92	+ 0.59

Source: Based on Table 8 (10).

(0.59).[1]

Variations (which have been in the upward direction) in different rates have to be explained in terms of different set of factors influencing the course of movement of each rate - lower rates of variations for Treasury Bills and long term government securities have been the result of degree of liquidity they possess in addition to deliberate policy of raising money by the government in a captive market. On the other hand, the relationship between the long term rate (govt. security) and the short term (call money rate) have shown disparate trends in that the former rate which was above the latter in 1955-56 remained below it in 1960-61 and 1965-66. The Plan averages have been such that the excess of the long term over the short one narrowed down during the Second Plan and both rates virtually came very close 4.71 (long term) and 4.56 (short term) during the Third Plan period [vide Table 8(10)]. A point of clarification need be made here. Positing the call money rate as a short-term rate is procedurally wrong for the behaviour of this rate is subject to day-to-day fluctuations and is reflective of the changes in liquidity positions of all banks. Its relation then is better understood in terms of the rate at which funds could be borrowed from the Reserve Bank. The effective rates at

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1. We have left out of account rate of change in rates on Post Office Savings banks because the rates stated above are flat rates as they prevailed at the end of particular year. Indeed computing the rate of change on the basis of these rates would show that the rate has increased by 10 percent per annum and is in the good company of 12 months deposits with scheduled banks.

which funds could be borrowed from the Reserve Bank and the call money rates were as under at the end of 1960-61 and 1965-66.

Year	Effective rate of borrowing from Reserve Bank. (a)	Call money rate (b)
1960-61	5.12	4.13
1965-66	6.81	6.38

(a) Based on Table 8(2)
(b) Based on Table 8(10)

The narrowing down of spread between these two rates demonstrates the increasing dependence of the banks on the Reserve Bank and their inability to mobilize deposits in the context of expanding economic activities consequent upon planned economic development. The behaviour of the call money rate should demand separate treatment[1]

1. A. The call money rate lies at the lowest end of interest rate structure in U.K.

   B. In the U.S.A. during the years 1952-64 it lay above the treasury bill rate all along the period (Vide J. Van Fenstermaker (Ed). 'Readings in financial markets and institutions" New York (1969) P.68).

   C. For an elaborate treatment refer H. Ezekiel, "The call money market in Japan" I.M.F. Staff Papers, March, 1966 Pp. 26-51. The author notes "as the volume of funds flowing through the market fluctuates sharply from day to day, there are bound to be at times some fairly thin markets in which interest rates quoted are either nominal or quite erratic".

but in the context of conditions prevalent in India, we might say that its narrowing down both in relation to Bank Rate and the long term rate denotes that the banks have not made those efforts for deposit mobilization that were demanded of them in view of the increasing scale of economic activities. The charge may equally be made on the low rates of interest on deposits to which we should now turn.

If we take the treasury bill rate as representative of the short rates then it has remained below the long term rate. But this relation again is an outcome of debt management policy and hence a reference above to the call money rate.

Turning now to the rates on bank deposits these are an outcome of voluntary agreements among commercial banks (after 1958), official intervention towards rationalising the deposit rate structure[1] as well as other market forces. The upward revision in the rate (registering the highest average increase of 10.32% per annum noted above) should not lead us to conclude that the interest rate policy proceeded in the right direction. To understand this properly we may first

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1. Thus for instance, "before September, 1964 '3 days' money obtained 3% while deposits above 91 days but for less than 7 months obtained 3½% while deposits for 1 year fetched 4¼% interest per annum. Now no interest is allowed on deposits upto 14 days and a maximum of 3% for 90 days and minimum of 5% for the period between 91 days and six months have been prescribed" (Vide "Recent evolution of monetary policy in India", Reserve Bank of India Bulletin, April 1966 Pp. 340-61).

look to rates on advances by banks.

For one thing, the rates on bank advances have come closer over years to rates charged by statutory financial corporations - (Col. Nos. (4) and (9) respectively in Table 8(10). Whereas the banks have been providing working capital requirements (with a tiny portion of term loans from 1960 onward) and the statutory corporations providing long term assistance, there should be legitimate excess of the latter over the former. There has been however, narrowing down of the differential over the years which requires explanation. The Reserve Bank beginning with October, 1960 has been regulating lending rates by commercial banks together with regulation of the deposit rate structure. Thus in October, 1960 a minimum lending rate of 5 percent was prescribed and in September, 1964 and February 1965 ceilings on lending rates were fixed at 9 and 10 percent respectively. While the maxima for lending rates were laid down in order to prevent excessive borrowings by banks from the Reserve Bank, the percentage share of lending in the lending rate ranges of 8-9 and 9-10 percent was 59.40 in 1964-65 and 72.9 in 1965-66 (Vide Table 8(2) above). We could not say on a priori reasoning whether this hike in lending rates would have been much greater or less than what it was if there were no official intervention. On the basis of the general presumption that 'maximum price' regulation denotes a situation in which the price would have been higher in the absence

of regulation (in which case regulation amounts to an act of subsidization) and taking in view the fact that there has been a systematic shift in the sectoral distribution of bank credit in favour of industry (Vide Table 8(3) above) it could be said that official regulation has resulted in providing credit at subsidized rates to industry. If we further take into account, the finding of the 'study group' on utilization of bank credit it was reported that "between 1961-62 and 1966-67, the increase in short-term liabilities was utilized for financing the gap between long term assets and long term liabilities - one-fifth of the gross fixed assets formation (was) acquired by expansion in short-term liabilities including bank loans".[1] The statutory financial corporations are recipients of financial support from the Reserve Bank and so it could be said that the interest rate policy - or more properly a lack of it - resulted into pouring of more loan capital with industry (as against equity) and this together with other arguments became the basis of a vehement advocacy for nationalisation of commercial banks. On the other hand, the savers who held their assets in the form of bank deposits did not stand to gain adequate return for their savings. Regulation of deposit rate structure was partly based on the cartel

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1. A reference to this study group was made earlier in this chapter. The findings related to a study of 255 companies and an "industry-wise analysis of the companies on the same lines confirmed the same trend" Vide Reserve Bank of India Bulletin. November, 1969. P.1795.

type of agreement among banks since 1958 and was partly governed by official intervention. The policy of the Bank has been influenced more by considerations of allocation of credit or lending operations of banks and less by consideration of the role of commercial banks as mobilizers of savings. The fact that the call money rate ruled more or less consistently higher than the 12 month bank deposit rate (Vide Table 8(10)) would denote that banks as financial intermediaries were having a better bargain in their operations than individuals holding their deposits with them. The call money rate is truly a highly sensitive market, reflects the day-to-day liquidity strains of banks and may, therefore, carry higher rates but among bank deposits also fixed deposits running for 3 months fetched a higher rate than 12 month deposits for all the years 1950-51 to 1960-61 as seen from Table 8(12).

The Bank became cognizant of this situation as late as 1964 when it tried to rationalise the deposit rate structure by enforcing on the banks, maximum rates for shorter term deposits and minimum rate for longer term deposits. Thus in September, 1964 the Bank imposed ceiling rates of 2.5 and 1.5 percent on interest rates payable on deposits for 46 to 90 and 15 to 45 days respectively. The banks were also advised to pay a minimum of 4 percent on 91 days' deposits. There was further revision in the rate structure in February, 1965 but the need for a ceiling on short term and a floor

TABLE 8(12).

Rates of interest on fixed deposits for 3 months and 12 months (major scheduled banks) during 1950-51 to 1960-61.

(Per cent per annum).

Year	Rate on 3 months' deposits	Rate on 12 months' deposits
1950-51	1.27	1.55
1951-52	1.94	1.73
1952-53	2.64	2.13
1953-54	2.59	2.27
1954-55	2.59	2.39
1955-56	2.39	2.39
1956-57	3.15	2.94
1957-58	3.84	3.29
1958-59	3.68	3.33
1959-60	3.41	3.25
1960-61	3.45	3.31

Note:- Figures above show average of rates quoted separately for the three cities - Bombay, Calcutta and Madras.

Source:- "Supplement to Banking and Monetary statistics of India" P. 52.

for long term deposits indicates that the structure was not rational. Rationally speaking rates on 'short' deposits should be below rates on long deposits. The need for a ceiling on former and a floor to the latter suggests that the normal relationship was reversed. We have not been able to trace the reason for this perversity in the time structure relation of deposit rates but a presumptive argument may be made that those depositing funds at shorter notice would be other financial or non-financial institutions while those depositing funds at long notice would be individuals. Then the higher rate fetched by non-individuals has to be examined in terms of the larger volume of funds per unit of account offered by them.

While the Bank may, therefore, have proceeded in rationalizing the structure, the question of the level remains and this was one of maintaining a low interest rate level. Deliberate policy aiming to maintain low interest rates on government debt is in a way a subtle form of rate regulation; while the regulation of deposit and lending rates by banks are the more overt forms of it. Interest rate policy in India has exhibited these characteristics but in a less purposive and less rational manner. The rationale of interest rate regulation has been extensively discussed during recent years and more vigorously and overtly after the publication in May, 1967 of the report on Bank charges by the United Kingdom Prices and Incomes Board. The Board

recommended removal of all tacit and overt forms of rate regulation. The issue has come up for discussion in West Germany and U.S.A., the former country having allowed in April, 1967 banks to fix their deposit and lending rates, after following a policy of regulation for about 34 years while in the U.S.A. Johnson; Friedman et.al have advocated removal of all regulation including prohibition of interest on demand deposits. Academic opinion thus favours removal of regulation of interest rates while bankers favour its retention.[1] The U.K. board sought to remove the windfall gains to banks (termed by the Board as 'endowment element' in banks' earnings) ensuing from the practice of British banks to step up deposit and advance rates with a rise in Bank Rate by stipulated margins. Such a policy evidently serves as a drag on banking efficiency. Further, under British conditions, current deposits which account for about fifty percent of total deposits. A rise in Bank Rate which steps up the rates on advances does not have any effect on about half of deposits represented by current accounts since current account deposits do not fetch any interest. Again, in view of the increasing competition from non-bank financial intermediaries there was validity in the reasoning of the U.K. Board for removal of interest rate regulation of the type that prevails there.

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1. Refer H.G. Johnson "The Report on Bank charges". The Bankers' Magazine, London. August, 1967.

The argument that banks should be subject to operation of market forces in regard to determination of the costs of their input and prices of their output to ensure optimal allocation of banking funds, is a sound one but needs to be qualified on two grounds. One is that under the impetus of competition banks may indulge in reckless lending policies with mal-allocation of resources sometimes leading to bank failures, and the past evidence is that in many a country people had lost their life time savings under such calamities. However, this contingency is better tackled through a system of inspection and supervision by the monetary authorities and through a system of deposit insurance than by regulation of interest rates. Another qualification is that when savings take place, among other things, as a matter of habit, the market for deposits remains fixed, atleast in the short run, while the market for loans is subject continually to forces of competition. It may then become necessary to have some floor rates on deposits while leaving loan rates to be decided by market forces.

Banks, it was argued earlier, administer the payments mechanism and also function as allocators of savings in different channels of investment. The former function is better ensured through inspection and supervision while the latter must be affected in a general manner by quantitative and selective measures of monetary control than by an overt and rigid

interest rate regulation policy (though in regard to selective controls, regulation of interest rates on a selective basis may be resorted to but this should be for the short run).

A comparison of the behaviour of interest rates on bank deposits, rates on advances and returns on investments of scheduled banks for the period 1953-66 is provided in Table 8(13). Variations in the percentage ratios of (i) rates on bank deposits to advances (Part A) as well as the (ii) rates on deposits to returns of investments (Part B) have been shown in the Table. The margin of return on bank loans and rates of interest on deposits (Col.3) has varied between 4.0 (3.8 for only one year - 1956) and 4.9 over the years. The margin first declined from 4.7 to 3.7 between 1953 and 1961 but it began to rise after 1961. The margin has somewhat ruled steadily over the whole period. Comparison in terms of the percentage ratio of rates on bank deposits to returns on loans shows however, that there has been increase in the ratio from 20.3 in 1953 to 45.5 in 1965-66. There was continuous rise in the ratio from 1953 to 1958 but for the two years 1959 - 60 there was decline. This was period of agreement among banks without official intervention. But after 1961 there was again rise in the ratio reaching 45.5 in 1966. Some implications of this relationship may be drawn.

TABLE 8 (13).

Average rates on deposits, advances and returns on investment in government securities : scheduled commercial banks : 1953 to 1966.

(Percent per annum)

Year	Average rate of interest paid on deposits.	Part A			Part B		
		Average rate earned on bills discounted and advances.	Margin of return on bank loans (2) - (1)	Percentage ratio of (1) to (2)	Average rate of earning on Government securities.	Difference between return on Government securities and rate on deposits. (5) - (1)	Percentage ratio of (1) to (5)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1953	1.2	5.9	4.7	20.3	2.7	+ 1.5	44.4
1954	1.3	5.6	4.3	21.4	2.7	+ 1.4	48.1
1955	1.4	5.5	4.1	25.4	2.8	+ 1.4	50.0
1956	1.5	5.3	3.8	28.3	2.9	+ 1.4	51.7
1957	1.9	5.9	4.0	32.2	2.9	+ 1.0	65.5
1958	2.2	6.2	4.0	35.5	2.6	+ 0.4	84.6
1959	2.1	6.1	4.0	34.4	2.9	+ 0.8	72.4
1960	2.0	6.6	4.6	32.8	2.8	+ 0.8	71.4
1961	2.3	6.5	4.2	35.4	2.9	+ 0.6	79.3
1962	2.5	6.8	4.3	36.7	3.2	+ 0.7	78.1
1963	2.6	7.1	4.5	36.5	3.2	+ 0.6	81.2
1964	2.8	7.4	4.6	37.9	3.4	+ 0.6	82.3
1965	3.5	8.3	4.8	42.1	3.6	+ 0.1	97.2
1966	4.1	9.0	4.9	45.5	3.9	- 0.2	105.1

Source:- "Statistical tables relating to banks in India" for the years 1951, 1957, 1960, 1962, 1964, 1966 : Figures in Col. (2) and (5) are based on Table 6(9) in chapter six. Rates have been arrived at on basis of information provided in "Earnings and expenses" of scheduled banks in the above publications.

The increase in percentage ratio from 20.3 to 35.5 (+15.2 percentage points) during the non-agreement period may indicate that the forces of competition kept the 'margin' (Loans - deposit rates) within some limits but raised the rates on deposits which must be a good indication for banking expansion in underdeveloped countries. It is to be noted that the rise in deposit rates appears to be rather high in relation to rates on lending because the rates on deposits were at their low levels in 1950-51. The interrgnum of agreement-cum-non-intervention kept the ratio low but much should not be read in this generalisation as the period is very short. There is reason to suppose that the cartel type arrangement is normally disposed to keep rates low and is generally impervious to distortions in the interest rates structure. In this situation official regulation which came as a corrective to the cartel type arrangement in removing distortions in the structure (Vide Table 8(12)) may have been useful but free determination of rates would perhaps yield better results. There were reports somewhere around 1968 and 1969 that one of the member banks[1] wanted to break loose from the agreement as it inhibited their competitive power to raise additional deposits.

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1. The Syndicate Bank was possibly disposed to such a view.

The excess of return on 'investments' over rates on deposits (Col.6) has, on the other hand, shown a continuous decline. The percentage ratio of rates on deposits to returns on investments (Col. 7) has increased from 44.1 in 1953 to 105.1 in 1966. This again denotes the way government borrowing programme has been faulitated under conditions of a captive market. If we grant the hypothesis that with a better return on investments (and this is the implication of a captive market) the banks would have paid higher rates on deposits than they did, the conclusion would be that the average depositor was subjected to an implicit tax and keeping in view the fact that savings and time deposits have shown larger rates of growth and that holding of these deposits by 'individuals' is comparatively high, the average household saver may be said to have carried such burden in a larger measure. Table 8(9) (Part B) above shows that household savings in form of bank deposits had increased from Rs. 32 crores during the First Plan (annual average) to Rs. 304.8 crores during the Third Plan (annual average). Further, between December, 1951 and March, 1966, total bank deposits increased from Rs. 821 crores to 3112 crores (about four times) while during the same period 'savings' and 'fixed' deposits held by 'individuals' increased from Rs. 255 crores to 1544 crores (seven times increase).[1] The growth in time and savings

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1. Vide "Statistical tables relating to banks in India" 1967. Pp. 21-23.

deposits is thus to be attributed not to attractive rates of interest but to the fact that in underdeveloped countries where a diversified range of savings media is lacking small wealth holders have a marked preference for holding their savings in bank deposits.

Interest rate policy followed in India has unfortunately remained excessively preoccupied with the allocative aspect of banking resources and has paid scant attention to its positive role in coaxing out a larger volume of savings. This preoccupation about the allocative aspect and taking the supply side of savings as given, became instrumental in the advocacy for nationalisation of banks and has far entrentched itself into the very recent controversy about designing of a policy of 'differential interest rates' to be followed by nationalised banks.

Concluding remarks :

Observations by Haberler and Shackle about interest being a 'weak link' and 'the most paradoxical economic quantity' in the prefatory part of this chapter remind us of the difficulty in pinpointing some neat and very valid generalizations about an interest rate policy. The rate of interest has remained however, and continues to remain, an important measure of control with the Reserve Bank and this, among other things, provides justification for evolution and implementation of an interest rate policy.

The role of interest in growth models has remained a matter of controversy. The Hicksian approach which lays emphasis on the structure of interest rates - the 'gap' concept - and the efficiency of the financial system provides the rationale for an interest rate policy. The Gurley-Shaw emphasis on financial structure in relation to the growth process puts the issue in a larger perspective in which different methods of 'Saving-investment technology' came up for consideration. Gurley and Shaw emphasised that underdeveloped countries may use one method - 'inflation' or 'taxation' more intensively relative to others in the initial stages of growth but there is always an optimal combination to be had, based on considerations of relative net yields (gross yields minus factor costs) in regard to each method. The debt-asset method involves use of interest rates and India having used rather intensively the 'taxation' 'inflation' and 'foreign aid' methods needs paying more attention to the 'debt-asset' method and hence the need for an interest rate policy.

At the disaggregated level interest elasticity of investment to various categories of expenditure - construction, inventory holding, business plant has now come to be recognised as not an unimportant relation as was thought in the prewar years characterised by hasty conclusions from surveys based on crude questionnaire methods. Thus assertion by business fvi

firms that they do not attach importance to interest costs in a period when interest rates are very low would not mean that interest is never a cost factor of importance.

The Bank Rate policy followed in India had its impact in upgrading market rates of interest relative to the base year 1950-51. The upgrading remained however, of a low order inducing industrial units to resort to bank borrowing in excess of their legitimate credit requirements. Revival of the bill market scheme together with a rise in the pattern of interest rates would serve the objective of 'financial discipline' to moderate the borrowing behaviour by firms.

The interest elasticity of savings which remained keynote of the classical analysis came to be de-emphasised by Keynesians but post-war studies and analysis have reinstated this relation in its prestigious status - this is atleast so for the underdeveloped countries. A more important problem from point of view of monetary policy is the form in which savings of the community are held - the assets structure of savings.

In India the share of the household sector in the total pool of national savings fluctuated between 82.4 and 66.0 percent during the three Plan periods. The breakdown of assets-structure of the household sector has shown that there has been veering away from holding savings in form of physical assets to holding them in

financial assets. Share of currency and bank deposits to the total of financial assets has been on the increase representing about 2/3 of the total in 1965-66 and as between currency and bank deposits the latter category has shown increase over the former. In an underdeveloped economy with an underdeveloped financial system, bank deposits would be an attractive medium for holding savings and a rational interest rate policy will obviously have important role to play in this setting.

While thus in an immediate context the case for a hike in interest rates gets strengthened it is essential that due regard is given to the structure of interest rates also. Rationalization of the structure along lines of 'expectational hypothesis' alone would not be relevant for the underdeveloped countries and many factors would be relevant in this regard.

There having occured a general upgrading in the market rates of interest during the three Plan periods, the relative rates of growth in different interest rates may throw light on some characteristics of the structure. Here the rise in rate on bank deposits (12 months) has been highest but this growth rate and the growth rates of other categories of the interest rate structure is to be attributed to the very low levels they had reached in the pre-Planning period. There have been however, divergent trends in the rates in the money market and the yields in the capital market.

Rates on bank deposits which have shown the highest growth rate are again conditioned by the cartel type agreement among banks as well as official intervention.

The percentage ratio of rate on bank deposits to return on loans had shown an increase from 20.3 to 35.5 between 1953 and 1958; during the interrgnum (1959-60) when there was only agreement and no intervention, there was a decline in the ratio which began to rise from 1961. Cartel type agreement avoids instability in the rate structure but may bring about distortions in it. Thus while there may be some room for regulating special categories of - deposits there is a presumption that free determination of rates would better serve the purpose of a fair return to savers and banking expansion in general. On the other hand, there has been dwindling of the margin between return on investments and rate on deposits. This suggests that low rates and captive market for government securities may be taken to mean that rates on deposits would have been higher (in the absence of a captive market) so that the average bank depositor has been subjected to an implicit tax or the constancy or widening of the margin would have helped further banking expansion so that the process of financial development was held in check.

Excessive concern with the allocative aspect of banking resources taking the supply side of savings as given, is a legacy of the old fashioned doctrine of availability vs. price of a loan and amounts to lack

of rational interest rate policy. Interest rate policy in India has to be rational purposive and flexible.

A rational policy seeks to use interest as a price phenomenon - which it is - of the money and capital markets. Such a policy emphasises raising of and allocation of resources on criteria of efficiency. To meet this aspect of policy there is case for levelling up the rates of interest in India in the organised sector consistent with a capital-scarce and high - consumption economy.

Purposive policy seeks to regulate the pattern in accordance with the need of emerging situation and in consonance with the general and selective measures of monetary control. The policy of differential interest rates would be subsumed under this aspect of (purposive) policy but it can ill-afford to neglect the criterian of efficiency demanded by the former (rational) aspect of policy.

It is essential that the policy remains flexible. The general disposition of Central banks in the war and early post-war years to adhere to stable rates has been allowed to far extend itself into the era of rapidly growing economics.

While thus there may be some short-run conflict with the three aspects of policy, evolution of long term policy along these lines seems to constitute one of the determinants of monetary policy making in India.