CHAPTER V

INSTRUMENTS OF MONETARY MANAGEMENT (General) I.

CHAPTER V

INSTRUMENTS OF MONETARY MANAGEMENT (General I)

Introduction :

The Bank Rate (Introductory)

- Nature of the control measure
- Theoretical underpinning
  - (a) Bank Rate policy in relation to open market operations
  - (b) Perverse 'announcement effects'
- Proposed reforms of Bank Rate Policy.

Bank Rate policy in India :

- General considerations
- Bank Rate policy during 1951-52 to 1959-60 - I
  - The 'bill market' scheme
  - Other repurcussions of Bank Rate variations of November, 1951 and May, 1957
- Bank Rate policy during 1960-61 to 1961-62 - II
  - Policy of 'graded lending rates' (Quota-cum-slab method)
  - Genesis and impact of the scheme of graded lending rates (1960-62)
- Bank Rate policy during 1962-63 to 1965-66 - III
  - The 'minimum net liquidity ratio'
  - The net liquidity ratio and quota-cum-slab methods compared
  - NLR method and Bank Rate Policy (1964-66)
- Concluding remarks.

CHAPTER : V

INSTRUMENTS OF MONETARY MANAGEMENT.

(General) I

Introduction :

It was pointed out earlier that both in regard to goals and instruments, monetary policy has lived through a process of evolution. Contemporary monetary theory has influenced both the nature and contents of 'instruments'. To the extent monetary policy instruments have lived through a process of evolution both in terms of their nature and methods of deployment there is justification in the assertion made by K.N. Raj that "there never was a theory of central banking except in the eyes of those who mistook certain traditions for theory".[1]

C.R. Whittlesey rightly asserts however, that "there is no theory of central banking in the sense of a closely knit logical set of relationships and consequences. Central banking is not a phenomenon, it is policy".[2]

It may be recalled here that Friedman prefers to characterise monetary policy pursued in the pre-war years as 'credit policy'. With him monetary policy implies quantitative management while central banking in the traditional sense has remained an 'art' (to use Hawtrey's term) or discretionary behaviour on the part of authorities. As Hicks observed both with Ricardo and Friedman there could be monetary policy without a Central bank.

---

1. Quoted earlier in Chapter III.
2. C.R. Whittlesey, "Lectures on monetary management", Vora & Co., Bombay (1960) P.6.

Traditionally, instruments of monetary control have been divided into Quantitative and Qualitative or Selective.[1]

F.M. Tamagna[2] in his study prepared for the Commission on Money & Credit prefers to base the classification under

i) Securities operations of the Central banks (open market operations)

ii) Rediscount operations and advances (Bank Rate or Rediscount rate)

iii) Reserve Requirements (Variable Reserve Ratios)

iv) Measures of direct control (all aspects of control such as credit rationing, consumer credit control, control of bank advances, moral suasion etc.)

Tamagna's measures of direct controls would include selective and Qualitative instruments together with moral suasion and even control of capital issues (where relevant). He also adds one more category of instruments as 'extension of monetary controls to non-banking financial institutions' which is self-explanatory. Current literature abounds with assertions that the traditionally known Quantitative (General) instruments have selective (discriminatory as some would put it) effects and Qualitative (Selective) instruments may produce quantitative effects.[3]

We propose to adhere to the traditional classification as it fits in with the approach of the Reserve Bank. Accordingly,

---

1. The Bank of Japan maintains a distinction between Qualitative and Selective controls as we shall see in Chapter seven.

2. "Monetary Management" C.M.C. Study, Prentice Hall (1963) Pp. 1-174.

3. On this count the term 'direct regulation' appears to be plausible as it emphasises the functional character of the control instruments.

we deal with Bank Rate in this chapter; the remaining two 'General' instruments in the next one and take up 'Selective' instruments in Chapter Seven.

Our study covers the three Plan periods (1951-66)[1].

As a preliminary to our discussion pertaining to the use of these instruments we may note, as is evident from Table 5(1), that during the period 1950-51 to 1959-60 money supply[2] rose by 34.4 percent, net national income by 34.1 percent while the wholesale price index (to be referred to as price level hereafter) rose by 4.74 percent (all with 1950-51 = 100 base). Taking the 4.74 percentage rise in price level (about 1/2 percent per year) as insignificant we might say that the 10 year period was more or less one of stability.

On the other hand in the 6 year period that followed (1960-66) net national income rose by 31.6, money supply by 90.1 and price level by 42.96 percentage points, (the rise in price level being about 7 points per year).

Consequently it may be noted that monetary policy measures initiated in 1951 remained in moderate use in the first nine year period and came to be intensively used in the six year period that followed.

---

1. | | | | | |
|---|---|---|---|---|
| First Five Year Plan | : | 1951-52 | to | 1955-56. |
| Second Five Year Plan | : | 1956-57 | to | 1960-61. |
| Third Five Year Plan | : | 1961-62 | to | 1965-66. |

2. The term money supply refers to currency plus demand deposits. The wider definition (inclusive of time deposits) termed by the Reserve Bank as 'monetary resources' will be stated explicitly when used.

TABLE 5(1)

Variations in money supply, net national income and prices 1950-51 to 1965-66

Year end of March	Money - Supply			Net National output at Constant (1948-49) prices			General Price index (wholesale)		
	Rupees Crores	Index Number 1950-51 = 100.	Percentage variation over previous year	Rupees Crores	Index Number 1950-51 = 100.	Percentage variation over previous year	1950-51 = 100 (1)	Percentage variation over previous year	1952-53 = 100
1950-51	2,016	100.00	-	8,850	100.00	-	100.00	-	111.8
1951-52	1,849	91.70	- 8.30	9,100	102.8	+ 2.80	105.55	+ 5.55	118.0
1952-53	1,804	89.4	- 2.42	9,460	105.9	+ 3.99	89.45	- 15.25	100.0
1953-54	1,828	90.6	- 1.35	10,030	113.6	+ 6.27	93.56	+ 4.95	104.6
1954-55	1,955	96.9	+ 6.94	10,280	116.1	+ 2.20	87.12	- 6.88	97.4
1955-56	2,217	110.0	+ 13.45	10,480	118.5	+ 2.06	82.74	- 5.03	92.5
1956-57	2,342	116.2	+ 5.64	11,000	124.3	+ 4.84	94.19	+ 14.93	105.3
1957-58	2,413	119.7	+ 3.01	10,890	123.1	- 0.98	96.96	+ 2.94	108.4
1958-59	2,526	125.3	+ 4.68	11,650	131.7	+ 7.13	100.98	+ 4.15	112.9
1959-60	2,720	134.4	+ 7.66	11,860	134.1	+ 1.85	104.74	+ 3.73	117.1
1960-61	2,869	142.5	+ 5.63	12,730	143.8	+ 7.33	111.72	+ 6.67	124.9
1961-62	3,046	151.1	+ 6.04	13,060	147.5	+ 2.59	111.90	+ 0.16	125.1
1962-63	3,310	164.2	+ 8.67	13,310	150.4	+ 1.91	114.40	+ 2.23	127.9
1963-64	3,752	186.1	+ 13.46	13,970	157.9	+ 4.96	121.02	+ 5.79	135.3
1964-65	4,080	202.4	+ 8.76	15,050	170.0	+ 7.69	136.58	+ 12.88	152.7
1965-66	4,529	224.5	+ 11.20	14,660	165.7	- 2.59	147.70	+ 8.14	165.10

(1) Derived from the original series with 1952-53 = 100 (in the adjacent column) by arithmetic conversion.

Source: "Currency and Finance Reports" and "Basic Statistics relating to India economy" (1950-51 to 1966-67) : Planning Commission.

THE BANK RATE (INTRODUCTORY).

Nature of the control measure:

The term Bank Rate has been in vogue in India in keeping with the British tradition of identifying the rate at which the Central Bank 'rediscounts' bills in accordance with the rules of 'eligibility' and is indicative of the responsibilities and powers of the Central Bank to provide temporary accommodation to commercial banks or 'force them in the Bank' as a 'lender of the last resort'. Since the Bank Rate is related to the process of Central Bank lending in terms of rediscounting of papers or advances, Tamagna chooses to use the term 'Rediscount Operations and Advances' in place of Bank Rate policy. We shall use both the terms interchangebly.

The discount rate mechanism has undergone substantial changes in techniques and uses since it was first developed in the mid-nineteenth century. These changes have been much more marked and have remained of greater importance in the post-war years, particularly after the 'revival of monetary policy'. Most Central Banks the world over have displayed a large measure of ingenuity in the form and substance of their discount rate mechanism.[1] These changes have taken a wide variety of forms

1. Tamagna, op.cit, gives an exhaustive account of these changes.

more prominent of which are policy of rate fixation (there may be single, multiple, fixed, flexible rates) and determination of eligibility criteria (the type of paper, prescribing quotas, liquidity ratios and so on). The question of effectiveness of the Bank Rate policy in India apart, it should be said to its credit that in keeping with the worldwide trend, the Reserve Bank of India has had lot of 'innovating' with its Bank Rate policy after 1951 and more particularly after 1964.

Variations in Bank Rate are supposed to influence economic activity through (i) cost effect, (ii) availability effect and (iii) announcement effect.

A rise in Bank Rate by increasing the cost of borrowing and thus reducing reserves at the Central Bank would work on the cost of lending by the Central Bank and feasibility of credit creation at the commercial bank and thus affect the level of economic activity (restrictive policy); conversely for a fall in the Bank Rate. The third (announcement) effect may work independently by signalling the commercial banks about a tight (easy) credit condition with a rise (fall) in Bank Rate or it may just reinforce the cost and availability effects. Two limitations are often cited in this regard. The first relates to the willingness or reluctance on the part of commercial banks to be indebted to the Central Bank and the other to the 'eligibility rules'. The willingness or reluctance to borrow depends to some extent on the 'personality' and prestige of the Central Bank but is governed by many other institutional factors also. Member banks in the U.S.A. have for years shown a strong attitude of reluctance to be in debt with the Federal Reserve System. Another limitation may appear as the hardened attitude of the Central Bank in granting the 'eligibility' quality to a smaller number or class of papers which is an issue in the qualitative aspect of policy determination, or it may appear in the form of a sheer dearth of bills which could at all be classified as eligible which is a structural constraint. The latter limitation has remained a factor of importance for India.

THEORETICAL UNDERPINNING :

At the theoretical level Discount Rate Policy has come in for criticism on two counts : One is its relation to other measures of credit control, particularly open market operations and the other is the element of perversity in its announcement effects.

(a) Bank Rate policy in relation to open market - operations :

It is generally supposed that Bank Rate variations would support and strengthen the effects of open market operations in the manner that when sales (of securities) by Central Bank reduce reserves of the commercial banks, the banks on having recourse to Central Bank borrowing (to maintain their level of advances) would be forced to pay a higher rate of interest (through increased Bank Rate) and this effect serving as a deterrant to borrowing by commercial banks would help to reinforce the effects of the open market operations. This also pre-supposes that a change in the discount rate follows movements in market rates of interest. It has, however, been argued that discount rates vary infrequently while market rates of interest show continuing movements and there does remain, therefore, a difference between the discount rate and the market rates of interest. Under restrictive monetary policy the relative advantage of borrowing at the Central Bank would increase as the market rates of interest increase faster than the discount rate. Similarly under easy credit conditions when market rates of interest fall faster than the discount rate, the banks may liquidate their idle funds by repaying at the Central Bank and thus lessen the impact of an easy monetary policy.

This frustrating effect (the 'escape valve mechanism') of discount rate policy is however, exaggerrated. For one thing if the banks are reluctant to borrow there should be no cause of worry. It may also be emphasised that if "banks were not constrained to borrow when their reserve positions were impaired by a restrictive policy, they would have to adjust their reserve positions in some other way" (i.e. by contractions of loans or investments)[1]. But so long as the banks borrow there may be some offsetting effect. As W.L. Smith[2] points out "even when one member bank borrows for adjusting its reserve position it adds to the aggregate reserves of all member banks and thus indirectly takes some of the pressure off other banks". This offsetting effect of discount rate policy may then be taken to indicate the need

1. W.L. Smith and R.L. Teigan (Eds) "Readings in money, national income and stabilization policy", Irwin (1965) p. 216.

2. W.L. Smith Ibid.

for a more vigorous open market operations policy. On the other hand those who do not attach much importance to the offsetting effects, argue that there is always some cost involved in borrowing at the Central Bank and there are 'eligibility criteria' to contend with.[3] Accordingly they would assert that "banks indebted to the (Central Bank) generally are under pressure to adopt more conservative lending and investing policies and it is for this reason that the volume of member bank borrowings[4] is frequently a good indicator[5] of the degree of tightness or ease in the banking system."

---

3. Refer 'The Commercial Banking Industry' - a monograph prepared for CMC, Prince Hall (1965) p. 89.

4. as measured by the concept of Free Reserves which are equal to excess reserves minus borrowings from the Central Bank.

5. (i) W.L.Smith (Op.Cit.) is however, very critical of this view and calls 'Free Reserves' an artificial construct which has had the effect of providing a spuriously exact guide to the monetary authorities. He would prefer that the Central Bank "set its proximate goals in terms of interest rate behaviour and growth of total reserves and allow free reserves to seek the levels required to achieve these goals".

   (ii) Tobin shows a compromising attitude in this regard. He agrees that every Net Free Reserve position supports a certain relative constellation of rates (discount rate, federal funds rate, etc). A constant NFR policy during a business expansion would mean that the Fed. is essentially supplying reserves required for whatever expansion of loans and deposits the demands of private sector generates. So for recession also and hence a particular NFR target "could make the monetary system a passive accomplice in inflation or deflation". But as a short term guide to policy to be reviewed and revised in the light of more basic information there should be no objection to its use. "It is difficult to see how great harm can be done by aiming at a particular NFR target for three weeks", the interval between two meetings of the Federal Open Market Committee (Vide Karl Brunner (Ed). "Targets and Indicators of Monetary Policy" Chandler Publishing House (1969) P.168).

(b) Perverse announcement effects :

Bank Rate has often been singled out for its announcement effect. This has been the legacy of the use made of that policy in England. Announcement of Bank Rate variation does seem to have produced beneficial effects on the balance of payments and this is how it has served well countries like Great Britain, and Canada after the Second World War. In regard to the announcement effect of Bank Rate variations on the internal economy there is a strong contention that the effect is perverse (destabilising) in nature. A reduction in Bank Rate taken as a signal of existing conditions of recession may deteriorate business sentiment and intensify depression.

Obviously the announcement effect works by altering the expectations of businessmen and financial institutions. The writers of the monograph on 'The Commercial Banking Industry,'[1] assert that announcement effect produced by Bank Rate variations need not be destabilizing for there are other sources of information with the public for a check up which enables them to hold the expectations with certainty.[2] W.L. Smith on the other hand holds that the "announcement effects of a discount rate adjustment will be of a stabilizing nature if lenders have elastic expectations and borrowers have inelastic expectations" (with regard to the interest rate movement) so that with a rise in Bank Rate lenders with elastic expectations would reduce their supply of loanable funds on the consideration that investment may be done on more favourable terms at

---

1. Study prepared for the C.M.C. (op.cit). p.89.
2. As they argue out "the announcement effects of discount rate changes are probably useful at times and harmless at other times". Ibid.

a later date and the borrowers with inelastic expectations will cut back their demand for possibility of a fall in interest rate in future and these factors together will reduce the demand for and supply of loanable funds. If however, the lenders have inelastic expectations (so that they increase the amount of loanable funds in the present time on consideration of a fall in interest rate in future) and borrowers have elastic expectations (so that they increase their demand for loanable funds for fear of more unfavourable terms in future) the net outcome will be of a destabilizing nature. Alternatively, if both lenders and borrowers have together either elastic or inelastic expectations the net effect is uncertain. Smith thus argues that 'to get favourable reactions on both sides of the market, it is necessary for lenders and borrowers to have the opposite trend of expectations - a phenomenon that does not seem very likely.[1] He, therefore, holds that the use of discount rate as a weapon of psychological warfare is of dubious validity as far as the internal economy is concerned. The Reserve Bank of India, it may be noted, asserts that "the Bank Rate remains a prime regulator of the market rate structure"[2] in India.

PROPOSED REFORMS OF BANK RATE POLICY

It would not be imappropriate to make a passing reference to the 'reforms' proposed for the discount rate policy

---

1. W.L. Smith Ibid p.225. It may be recalled that Keynes had built up his argument for the 'speculative motive' for liquidity preference on this phenomenon of opposite kind of expectations (his Bears and Bulls).

2. "The Reserve Bank of India - functions and working" Reserve Bank of India, Bombay (1958) p.38.

(particularly in the U.S.A.). It has been consistently argued by the officials of the Federal Reserve System that borrowing by member banks at the System is a privilege and not a right. (In India borrowing is a matter of right though in actual operation it is hemmed in with a number of limitations both in the form of dearth of eligible papers and eligibility criteria) When borrowing is a privilege it vests the Central Bank with discretionary powers.[1]

Friedman is of the view that if the discount policy is at all allowed to remain as a 'Safety Valve' (helping members banks in times of crises) borrowing should be a 'Right' rather than privilege - quite obviously because discretionary powers in the hands of the Central Bank are an anethma to Friedman. He however, feels that with the establishment of the Federal Deposit Insurance Corporation the 'lender of the last resort' function has been considerably reduced and hence he would favour elimination of the discount rate policy.

---

1. W. Vickrey points to the potential harm that the policy may do to the stability of the system, for "the quotation of a firm rediscount rate by the Central Bank amounts to an undertaking by it to create as much currency as the banks wish to demand at that rate of interest". And if "commercial banks operated as a monopoly unit the quoted rediscount rate would be an invitation to a very substantial amount of credit expansion". (Vide "Metastatics and Macroeconomics", Harcourt Brace (1964) Pp. 104-08.

   The under-current of opinion in India after nationalisation of fourteen commercial banks has been about heavy borrowing at the Reserve Bank although nationalised banks have not begun to function as monopoly units thus far.

Another proposal is to tie the discount rate to some other specific interest rate so that destabilizing expectational effects of infrequent Bank Rate variations may be removed. It is suggested that the discount rate be tied to the treasury bill rate[1] (in any given proportion) so that when the treasury bill rate is known after each weekly auction the discount rate could also be varied so as to maintain that constant relationship - given differential - and the perverse and unpredictable announcement effect done away with. The question here may be seen as that of choosing the differential which further ramifies in the issue whether Bank Rate should be a penal rate.[2]

It is obvious that the discount rate should be above the treasury bill rate but what should be the height of the differential remains a matter of judgment. Under this system changes in the discount rate will be as frequent as the variations in the Treasury Bill rate and those who still have faith in the 'signalling' effect of the Bank Rate would not support such frequent changes. The Commission on Money and Credit expresses such a view when it states "the discount rate currently serves as a signal of a major shift in monetary policy and this advantage would be lost if the changes occured too often".[3]

---

1. Camda adopted such a policy in November 1956 but discontinued its use in June, 1962 when it became necessary to raise the Bank Rate to a much greater height (6%) in view of the balance of payments situation.

2. In U.K. the Bank Rate has for long been known as a Penal rate so that recourse is had to the Bank only under conditions of stringency. J. Aschheim advocates the

Continued on next page...
(this and foot note 3 also)

BANK RATE POLICY IN INDIA

General Considerations :

The dual character of the Indian money market which gives rise to a wide variety of non-homogenous trade bills, the narrowness of the securities market in terms of (i) the pattern of its ownership and (ii) the optimal portfolio holding of security holders together with the 'eligibility rules' for rediscount and advances are factors that would keep lending operations of the Reserve Bank of India at low level. Thus the Reserve Bank's financial assistance to scheduled banks (including the State Co-operative banks) was barely Rs. 2 lakhs in 1938-39 and it rose to Rs. 21 lakhs in 1947-48.[1]

These structural factors together with a highly comfortable liquidity position enjoyed by the commercial banks during war years and immediately thereafter precluded any effective use of lending operations by the Reserve Bank. The real structural factor of the dearth of a bill market came to be noticed by the Reserve Bank at a later stage when in January 1952 it launched its Bill Market Scheme. The Reserve Bank of India 1934 Act empowers the Bank to undertake lending operations under Section 17. In 1952 the Reserve Bank invoked Section 17 (4c) for the purpose of creating a bill market and the Bank has been providing borrowing

---

continued from previous page -
discount rate in USA to be a penal rate. Refer his "Techniques of monetary control" (John Hopkins) (1961)

3. Report of the C.M.C. Prentice Hall (1961) p.65.

1. "The Reserve Bank of India - Functions and Working" Reserve Bank of India, Bombay (1958) p.33.

facilities to scheduled commercial banks under Sections 17 (3A) (In respect of advances made by banks towards export of goods from India); 17(4A) (Advances against lodgement of approved Govt. Securities) and 17 (4c) (under the new bill market scheme). The genesis of the bill market scheme is that the scheduled commercial banks are required to convert their demand promissory notes accruing to them in respect of the cash credit and overdrafts made by them to their clients into usance promissory notes (bills) maturing within ninety days. These created usance bills would then be lodged with the Reserve Bank of India as security against advances to be made by the Reserve Bank. The new bill market scheme characterised by a roundabout process thus represents an act of providing financial accommodation in form of an advance rather than rediscount of a bill.[1]

The Reserve Bank has claimed that the scheme is doubly advantageous since on the one hand banks are free to replace the bills once lodged (with the R.B.I.) by other bills during the period of maturity and thus minimise their costs of borrowings while, on the other hand, to the constituents of the banks, it affords the advantage of the cash credit system with that of a bill of exchange permitting them to make withdrawals and repayments into the account as often as they did under the simple cash credit scheme.

---

1. On this showing, the scheme was labelled as pseudo-bill market scheme by some critics. The Reserve Bank in offering these borrowing facilities was rather taking steps more in the direction of improving the structural efficienc of the banking system rather than meeting with the liquidity requirements of the commercial banks per se although the latter objective was always being emphasised.

Prior to the establishment of the Reserve Bank of India commercial banks could borrow from the Imperial Bank by pledging their bills with that bank. The Imperial Bank in its turn could borrow from the Currency Department of the Government of India either against its own bills or by pledging the demand promissory notes of its clients as usance bills. The Bill market scheme introduced by the Reserve Bank has some lineage with the practice followed by the Imperial Bank. The status enjoyed by the Imperial Bank as a lender to the commercial banks continued in its importance even after its nationalisation into the State Bank of India in 1955.

Section 17 (2b) of the 1934 Act enjoins the Reserve Bank of India to rediscount bills arising from seasonal agricultural operations or marketing of crops. The Bank is required to make lending operations under this section at a rate below the prevalent Bank Rate, thus making concessionery finance available to the agricultural sector. Bearing in mind this structural background we may review the use of the Bank Rate policy over the three Plans.

Bank Rate policy during 1951-52 to 1955-56 and 1956-57 to 1959-60 (Period I) :

The devaluation of Rupee in September 1949 and the boom following outbreak of Korean War in June 1950 superimposed on the wartime and post-partition conditions of excessive liquidity in the Indian economy had caused concern about the need for some measures of disinflation.

TABLE 5(2)

Credit-Deposit ratios (percentage) of scheduled commercial banks for selected years.			Wholesale price index 1939 = 100 (Selected months).		
Busy Season[1]	1949-50	55.8	September	1949	289.6
Slack "	1950	47.7	January	1950	384.7
Busy Season	1950-51	65.4	July	1950	405.2
Salck "	1951	58.3	March	1951	449.6

As Table 5(2) shows, the precipitate rise in the price level from 289.6 in September 1949 to 449.6 on 31st March, 1951 and record credit expansion by the scheduled commercial banks as reflected in the credit-deposit ratio reaching a level of 65.4% in the busy season of the year 1950-51 but declining by a smaller margin to 58.3% level in the slack season (1951) provided, among other things, the rationale for wielding monetary measures. The Reserve Bank of India announced in November 1951 a rise in its Bank Rate from 3% to 3½%.[2] S.L.N. Simha[3] is of the view that the Bank rate rise was a 'delayed action' and he has it on record to say that

1. The Busy Season runs from November to April while the Slack Season covers the May-October period.

2. At the time of establishment of the Bank, the Bank Rate was fixed at 3½% but soon within about a year's time the rate was lowered by ½% and it remained at the 3% level till 14th November, 1951.

3. S.L.N. Simha "Essays on Finance", Vora & Co., Bombay(1967) Pp. 38-39.

whereas the government had insisted on a reduction in the Bank Rate since 1946, the Reserve Bank had resisted such a move pointing out the dangers of a cheap money policy. P.S.N. Prasad[1] on the other hand records the evidence that the official position of the Reserve Bank of India was not to disturb the government security market through a Bank Rate rise and it was at the instance of Finance Minister, C.D. Deshmukh[2] that the demand for raising the Bank Rate was put through. The Bank Rate policy which thus made a beginning in November 1951 was mainly related to the 'cost' aspect of a Bank Rate variation for the scheduled banks and in part to an important structural aspect of the economy. Borrowings by scheduled banks had risen from Rs. 21 Lakhs in 1948 to Rs. 334 and 839 Lakhs in 1949 and 1950 respectively and then further to Rs. 1241 Lakhs at the end of the year 1950-51. There is thus some truth in Simha's contention that the Bank Rate rise was a 'delayed action'.

The Reserve Bank was however, filling some important structural gap once having invoked an active monetary policy. Two structural gaps were sought to be remedied and we would, therefore, consider the whole package type programme of November, 1951 as an important step in the direction of making the Indian monetary system structurally efficient. In the first place, the Reserve Bank had reoriented its

---

1. P.S.N. Prasad in "A new horizon in central banking" Asia Publishing House (1967) p.viii.

2. Formerly Governor, Reserve Bank of India.

policy of making financial accommodation to the scheduled banks in the busy season by refusing to purchase government securities and instead making only advances against them. The objective of this measure was to impart some degree of continuity in the assets port-folio of the banks and also to keep the government securities market in good order. (We deal with this latter issue in details under our discussion of the open market operations policy in the next chapter).

In the second place, the Reserve Bank initiated the bill market scheme in January, 1952. As S.L.N. Simha[1] puts it "this was an important element in the promotional aspect of central banking". J.D. Sethi has perhaps put the matter in a better perspective : "The introduction of the bill market scheme was of outstanding significance, probably the most important single step since the inception of the Reserve Bank ofIndia towards the development of a proper money market for India."[2]

The Bill Market Scheme

The bill market scheme was in a sense a negation of the policy of increased Bank Rate. Under the scheme initially, advances were to be granted to scheduled banks having deposits of Rs. 10 crores and more and the minimum limit of advances was to be Rs. 25 lakhs while the minimum

---

1. S.L.N. Simha. Ibid P.39.

2. J.D. Sethi "Problems of monetary policy in an under-developed country", Bombay 1960 P. 236.

amount of each individual bill was fixed as Rs. 1 lakh. Banks were to get advances at 3% (while the Bank Rate stood at $3\frac{1}{2}$%) but since the advances were to be made through the special scheme of conversion of demand loans into usance bills the cost of stamp duty had to be taken into account. The Reserve Bank initially agreed to bear half the cost of stamp duty incurred in converting demand loans into usance bills. The question to be asked was whether the effective rate of lending remained below or above (if at all) the Bank Rate. To the extent the effective rate diverged from the official Bank Rate the Reserve Bank had ushered in a policy of multiplicity of lending rates (vide Table 5(4)). To popularise the scheme, further from July 1954 all scheduled banks (irrespective of their deposit holding) were given access to the scheme and the minima in regard to the amount of a loan and an individual bill were reduced to Rs. 10 lakhs (from Rs. 25 lakhs) and Rs. 10,000 (from Rs. 1 lakh).

In the beginning of 1956 the lending rate under the scheme was raised to $3\frac{3}{4}$% (being higher than the Bank Rate); was later reduced to $3\frac{1}{4}$ in March 1956 and again raised to $3\frac{1}{2}$% in November, 1956. These swift adjustments were in larger part a reflection of the restrictive credit policy that the Reserve Bank was intent upon pursuing soon with the commencement of the Second Five Year Plan. In February, 1957 when the Government increased stamp duty on usance bills the effective rate of borrowing went up to 4% and thus stood clearly higher than the Bank Rate. The Reserve Bank of India raised its lending rate under Section 17 (4A) to 4 per cent with a view to avoiding discrimination against borrowing under the bill market scheme, although the Bank Rate remained officially at 3½ per cent. Ultimately the Reserve Bank raised its Bank Rate on 16th May 1957 to 4% to remove the apparent anomaly in its lending rate structure. This rather circituous way of effecting an increase in Bank Rate by ½% was adopted with the intention to avoid causing any disturbance to the government securities market. Whether a straightway rise in the Bank Rate, say in the early beginning of the busy season of the year 1956-57 would not have created greater awareness among the banking community about the need for caution in their advances and whether circituous and delayed methods have robbed the Bank Rate policy of its announcement effect (if such an effect was probable) are matters of minor detail but one implication is clear. The Reserve Bank's policy did provide the portent that it desired its lending policy to take on the character of a Penal Rate.[1] Faster growth in deposits with commercial banks led the Bank to hold the view that more borrowing by banks had to be kept under check.

We may now sum up the impact of the Bank Rate policy operating with the new dimension of the bill market scheme during the period 1951-52 to 1959-60. Table 5(3) gives a

1. The concept of a Penal Rate is not unambiguous. In England certain practices keep the Bank Rate a Penal Rate. But for the U.S. system, as W.L.Smith has so cogently argued out the identification of discount rate as a Penal rate should be made with reference to the rate of return on the lowest yield asset that a commercial bank holds at a given time. Viewed in this way any rate may qualify as Penal Rate.

Continued on next page..

measure of the response the scheme had from the scheduled banks during the period. Figures of gross advances rather than outstandings at the end of each period have been given so as to provide an estimate of the response in its totality. Table 5(4) gives an account of the effective rate of lending under Sections 17 (4A) and 17 (4C) during the period 1951-59.

TABLE 5 (3)

Gross advances (i.e. exclusive of repayments) made by the Reserve Bank (1951-59) to scheduled Banks.

(Amount in Crores of Rupees)

Last Friday of December.	Under Section 17(4A) against Govt.Securities.		Under Section 17(4C) against Usuance bills.		Total Advances.
1951	76.57				76.57
1952	164.25	(66.8)	81.45	(33.2)	245.70
1953	129.58	(66.3)	65.84	(33.7)	195.42
1954	188.70	(56.2)	147.52	(43.8)	336.22
1955	199.94	(47.06)	225.44	(52.94)	425.38
1956	466.95	(51.66)	436.82	(48.34)	903.77
1957	353.78	(46.1)	414.81	(53.9)	768.59
1958	237.57	(60.8)	153.06	(39.2)	390.63
1959	518.20	(86.11)	83.32	(13.9)	601.52

Figures in brackets indicate percentage of each type of advance to total advances.

Source : Trend & Progress of Banking in India 1960 pp.54-55

---

continuing from previous page...

(Refer W.L. Smith - Readings in Money, National Income and Stabilization policy Pp. 212-13).

The interpretation given by the Reserve Bank of a Penal rate is that of the lending rate in excess of the basic Bank Rate. Under the interpretation given by Smith the Bank Rate in India would be a Penal rate since it has ruled above the Treasury Bill rate during all these years. However, the Reserve Bank's practice of identification of the Penal Rate may be accepted.

Perusal of the data in Table 5(3) shows that the scheme was received in good spirit by the banking community despite sporadic comments about its pseudo character. The figures above show mixed variations in the advances under the scheme; sharp rise in the years 1954 to 1957 and small increase during the year 1952; 53; 58 and 59. Obviously the extent of borrowing from the Central Bank is dependent upon deposit growth; credit deposit ratio and so on. The scheme was nevertheless filling in an important - structural gap. Table 5(4) is indicative of the initial policy of providing slightly concessionary finance in the earlier stages which gradually was withdrawn and after the Bank Rate rise in May, 1957 the rate of lending under section 17 (4 C) remained above the rate under section 17 (4 A). Table 5 (3) demonstrates the outcome that in view of the increased costs of borrowing scheduled banks had shown a preference for borrowing larger amounts under section 17 (4 A) relative to borrowings under Section 17 (4 C) during the years 1958 and 1959. (This simple relationship of comparision of cost of borrowing had broken when the Bank Rate Policy was put under a new and sophisticated garb of graded lending rates in October 1960 and later related to the Net liquidity ratio method).

TABLE 5(4)

Bank Rate and rates of lending of the Reserve Bank of India in respect of scheduled banks.

(Percent per annum)

Year	Bank Rate	Rate of interest for advances against Govt. Securities.	Rate of interest for advances against usance bills and Promissory notes.	
			Prime lending rate.	Effective rate (inclusive of stamp duty)
1951-52	3½% (3% upto 14.11.51)	3½ (3% upto 14.11.51)	3	3.025
1952-53	3½	3½	3	3.025
1953-54	3½	3½	3	3.025
1954-55	3½	3½	3	3.025
1955-56	3½	3½	3-3¼ (3¼ from March, 1956)	3.300
1956-57	3½	3½ & 4(a)	3¼ & 3½ (b)	3¼, 3½, 4
1957-58	3½ & 4 (4 from 16.5.57)	4	3½ - 4	4, 4.20(c)
1958-59	4	4	4	4.20
1959-60	4	4	4	4.20

(a) 3½ for April, 1956 to January, 1957.

4 for February and March, 1957.

(b) 3½ from November, 1956.

(c) 4.20 from 15. 5.1957.

Source : "Currency and Finance Reports" 1956-57 (p.128) and 1962-63 (P.S-47)

We had earlier called the 1951 Bank Rate Policy as a monetary weapon with structural dimension as it operated with the bill market scheme. To the extent the Policy made commercial banks more dependent on the Central Bank it was a step in the direction of achieving structural efficiency of the banking system. One way to measure this structural efficiency effect of the policy would be to see variations in the value of bills discounted and purchased by the scheduled banks. It is true that the new bill market scheme did not allow direct rediscount of trade bills and, therefore, any growth in trade bills discounted could not provide the type of measure we seem to suggest. It may nevertheless be argued that by allowing these new borrowing facilities the scheme had enabled the scheduled banks to make their portfolio more diversified than before.

TABLE 5 (5).

Variations in value of bills purchased and discounted by scheduled commercial banks 1951-59.

(Amount in crores of Rupees)

Year Last Friday December.	Inland bills purchased and discounted	Foreign bills purchased and discounted	Total of 1 & 2	Total bank credit (Including advances).	Percentage of (3) to (4)
	1	2	3	4	5
1951	15.58	-	15.58	532.03	3.0
1952	38.76	-	38.76	519.50	7.5
1953	47.44	-	47.44	491.40	9.7
1954	59.78	24.66	84.44	552.23	17.0
1955	66.00	39.91	105.91	603.68	17.5
1956	100.71	47.84	148.55	744.04	20.0
1957	116.19	55.12	171.31	873.74	19.6
1958	87.12	40.64	137.76	892.71	15.5
1959	99.25	39.07	138.32	961.89	14.4

Source:- "Statistical tables relating to banks in India" for relevant years.

After a continuous rise, the ratio of bills discounted to total bank credit rose from 3% in 1951 to 20% in 1956, stagnated to 19.6% in 1957 and declined to 14.4% in 1959 perhaps due to stiffening of the terms of borrowing under the enhanced Bank Rate. Much should not be read into this generalisation; nonetheless the rising ratio from 3% to 19.6% is partly indicative of the way the new scheme had exerted its effects.

OTHER REPERCUSSIONS OF THE BANK RATE VARIATIONS OF NOVEMBER, 1951 AND MAY, 1957:-

We had thus far confined our attention to the bill market innovation aspect of the Bank Rate variation in 1951. Other repercussions which cannot be directly attributed to the Bank Rate variation may be noted in brief. There was hardening of the structure of interest rates consequent upon the Bank Rate rise in 1951.[1] Similar effects were produced by the Bank Rate rise of May, 1957 though due to comfortable liquidity position during 1957 and 1958 there was downward movement for some months. A disquieting feature of the situation was the precipitate fall in price level towards the end of year 1951-52 and again during the year 1954-55. The wholesale price index (with 1939 = 100) which was 449.6 at the end of 1950-51

1. The details are not reproduced here since the call money rates (at all the three centres, Calcutta, Bombay and Madras); Imperial (then State) Bank of India Hundi and Advance Rates and Deposit Rates of Banks had remained consistently above their low levels in 1950-51. We shall look into these details in Chapter Eight.

declined to 434.6 in 1951-52 and further to 380.6 in 1952-53; rose slightly to 397.5 thereafter but again declined to 377.5 and 360.3 in 1954-55 and 1955-56. A reference to table 5(1) above shows that the wholesale price index with 1950-51 = 100 declined to 82.74 at the end of 1955-56. Money supply with public which was Rs. 2,016 crores in 1950-51 recorded decline each year till 1954-55 and rose to 2,217 crores at the end of 1955-56. Net National Income index (with 1950-51 = 100) increased to 116.1 over the period 1951-52 to 1954-55 against a declining trend in money supply; rose further to 118.5 in 1955-56 while the price level between 1954-55 and 1955-56 declined from 87.12 to 82.74. The declining price level was however attributable not to the rise in Bank Rate but to the combined effect of good monsoons and utilization of excess capacity in several industries. The index of agricultural production (with year ended June 1950 = 100) rose to 113.7 (end March 1956) and that of industrial production (1951 = 100) rose to 132.8 (end December, 1956).

The Bank Rate rise of May, 1957 has been described as adjustment of limping official Rate to a Defacto Rate and was feeble in character. On the other hand the launching of the ambitious Second Five Year Plan had created new pressures in the economy. The Reserve Bank to meet the situation, therefore, wielded for the first time selective measures of monetary control (we deal with them in Chapter Seven).

Over the four year period 1956-57 to 1959-60 these new strains were beginning to offset the disinflationary effects created during the First Plan period and having been concerned with these uneasy developments the Reserve Bank initiated a new credit squeeze policy first in March, 1960 and later extended it in the subsequent months of that year.

Bank Rate Policy during 1960-61 and 1961-62 (Period II):-

The year 1960-61 being the last year of the Second Five Year Plan, there was to be a step up in the Development expenditure both by the State and Union Governments necessitating a forward-looking formulation of monetary policy, Current indications in the beginning of March, 1960, therefore, provided some clues to initiate restrictive policy. To safeguard against excessive credit expansion (potential) and undue pressure on the price level, the Reserve Bank initiated its policy of credit squeeze beginning with March 11, 1960. Such an attitude of safeguard was called for in view of the trends in deposits accrual to the scheduled banks. An important change in the deposit liabilities structure of the scheduled banks during the year 1958-59 was that for the first time total of 'time deposits' was greater than that of 'demand deposits'. Time deposits at the end of March, 1959 were Rs. 833.14 crores while Demand deposits were

Rs. 715.73 crores.[1] On top of this relative greater rise during the year 1958-59, the slack season of the year 1959 experienced a record growth of time deposits worth Rs. 159.63 crores. At the same time the ratio of cash and balances with the Reserve Bank of India which was at the level of 8%, 10.5% and 9.3% in the slack seasons of the three preceding years (i.e. 1956-57-58) showed a lower level of 6.2% in the slack season of 1959. It was feared possibly that with a build up in liquidity position and a declining cash ratio the scheduled banks might enter into an 'over extended' loan position. The wholesale price index which was 82.74 had risen to 100.98 in 1958-59 and was at 104 in the beginning of March, 1960 (Table 5(1) above). The Reserve Bank of India, therefore, announced that the scheduled banks would be required to impound with it additional balances equal to 25 per cent of the increase in their <u>total</u> liabilities since March 11, 1960. Simultaneously a ceiling on clean advances was also prescribed and the Bank tightened its Variable Reserve Ratio method of control on May 5, 1960, and November 11, 1960 finally abandoning it in January, 1961. We deal with these measures separately in the next chapter and the one following it.

---

1. During the whole period 1951-52 to 1957-58 demand deposits remained above time deposits. The trend that set in 1958-59 has continued till 1965-66 and thereafter also.

POLICY OF GRADED LENDING RATES (THE QUOTA-CUM-SLAB METHOD):-

The Reserve Bank took a more important policy decision on 21st September, 1960 in introducing a system of gradation in its lending rates to scheduled banks. It may be recalled that the system of concessionary lending that came into being initially with the bill market scheme later on took the form of a penal Rate (inclusive of stamp duties). With the introduction of the system of graded lending rates there was no scope for concessionary financing by the Bank to scheduled banks. Instead, the Bank Rate remained the floor level lending rate and banks could borrow at the basic Bank Rate or a rate higher than that (the lending rate for co-operative banks has remained at a low level right from the establishment of the Bank and so it is not taken into account here). These graded lending rates, therefore, carried further the system of multiple rates and resembled a system of progressive income taxation[1] rather than a composite of rates lower and higher than the basic rate. In introducing ~~the~~ graded lending rates, the Reserve Bank was acting more like a fiscal authority than as a discriminating monopolist[2].

1. Analagous to a system of progressive income taxation with a basic (above exemption limit) rate, with no concessions in terms of status of the taxpayer (married or bachelor; number of children etc.) and rising progressively as income increased.

2. This interpretation has some relevance to the very recent controversy about introducing a system of 'differential interest rates' to be followed by the scheduled banks (nationalised).

Genesis and Impact of the Scheme of Graded Lending - Rates: (1960-62) :-

Effective from October 1, 1960, the scheme entailed assigning for each quarter to each scheduled bank, a Quota equal to half of the average amount of statutory reserves required to be maintained by it under section 42 (1) of the Reserve Bank of India Act, during each month of the previous quarter. Since the quota was positively related to amount of statutory reserves, larger banks were entitled to greater quota than smaller banks. Borrowings within the quota were charged interest at the Bank Rate (which in September, 1960, was 4 per cent) and borrowings above the quota and upto 200 per cent of it were made available at an additional penal rate of 1 per cent (5%), borrowings in excess of 200 per cent of the quota being subjected to an additional penal rate of 2 per cent (6%). Borrowings under Section 17 (4 A) and 17 (4 C) were subjected to the same lending rate structure. Penal rates in excess of the quota thus entailed implicit taxation, the purpose of which was not revenue but discouragement to borrow. To the extent the banks borrowed in excess of the basic rate and passed on the higher rate to their clients the impact was surely on the customers of the banks. It may be added that apart from the inter-bank agreement (under the initiative of the Reserve Bank) for deposit rates that came into force in October, 1958, the Reserve Bank also directed banks to (i) keep a minimum lending rate of 5% for all advances (excluding advances to other banks) and (ii) to raise their average lending rates at least by one half of one per cent. This ensured transmission of increased lending rates of the Reserve Bank to borrowers at the banks. The Bazaar Bill rate[1] carried impact of the new system of graded lending rates alongwith the rise in the cost of borrowing by the banks as could be seen from Table 5 (6).

TABLE 5 (6).

Variations in Bazaar Bill Rate during 1959-60 to 1961-62.

Y e a r	Rate: Per cent per annum		
	Bombay	Calcutta	Madras
1959-60	9.00 - 11$\frac{1}{4}$	9.00 - 10$\frac{1}{2}$	12.00 - 12 $\frac{27}{32}$
1960-61	9.00 - 12.00	9.50 - 13.00	12.00 - 13.92
1961-62	10.50 - 12.00	12.50 - 13.50	13.92

Source:- Currency and Finance Report 1962-63.

During the remaining part of the period (1960-61 to 1961-62) some variations in reserve requirements and abandonment of that policy; withdrawal of the control on 'clean advances' and some liberalisation in the bill market

1. Defined by the Reserve Bank as the "rate at which bills of small traders are reported to have been discounted by shroffs" adding further that "these are unofficial quotations" (vide - Currency and Finance Reports).

scheme in respect of export bills were the other changes. A little important change in Bank Rate policy was made by the Bank to small scale industries whereby banks were entitled, for borrowings at the Bank Rate, a special basic quota of an amount equivalent to the increase in the average of their loans to small-scale industries in the first half of 1961 over the corresponding period of 1960.

Table 5(7) below shows variations in money supply, net national income and the wholesale price index - during the period 1960-61 to 1961-62.

TABLE 5 (7).

(Amount in Crores of Rupees)

Year	Money supply with public	Percentage change over preceding year.	Net National Income.	Percentage change over preceding year	General price index 1950-51 = 100	Percentage change over preceding year.
1959-60	2720	-	11,860	-	104.74	-
1960-61	2869	5.6	12,730	7.3	111.72	6.67
1961-62	3046	6.0	13,060	2.6	111.90	0.16

(Based on Table 5(1)) above.

It might appear that the restrictive policy initiated in March, 1960 operated in the comfortable background of high growth rates in national income - 7.3% (highest level) of percentage change since 1950-51) and 2.6% in the two years respectively. Money supply increased just -

by 11.6 per cent and the price level rose by 6.8 per cent at the end of the period. If we judge the efficacy of the policy in terms of the behaviour of the scheduled banks we may derive some plausible conclusion.

Table 5(8) shows variations in the seasonal trends in some items of the banks.

TABLE 5 (8).

Seasonal trends in some items of scheduled banks.

(Amount in Crores of Rupees)

Year	Aggregate Deposits. (1)	Borrowings from the Reserve Bank. (2)	Cash & balances with Reserve Bank. (3)	Cash Ratio at the end of the period. (4)	Bank Credit. (5)	Credit-Deposit ratio at the end of the period. (6)
Slack 1960	- 23.26	-27.02	+ 4.17	7.6	- 20,31	58.2
Busy 1960-61	+ 9.34	+21.53	-23.24	6.3	+198.53	68.3
Slack 1961	+ 43.85	-31.67	+10.31	7.3	- 76.50	67.6
Busy 1961-62	+157.16	+ 6.17	- 0.44	6.7	+203.87	72.6

Source: Currency and Finance Report 1962-63 P. S-27

As the new policy was initiated at the fag end of the busy season 1959-60, during the slack 1960 the new control measure of impounding additional deposit liabilities with the Reserve Bank had a pronounced effect on net variations in aggregate deposits which fell by Rs. 23.26 crores (such a fall in aggregate deposits was experienced earlier during the slack and busy seasons of the year 1951-52 alone and in no other year thereafter till 1960-61). Simultaneously borrowings from Reserve Bank of India also decreased by Rs. 27.02 crores alongwith a decline in bank credit of Rs. 20.31 crores. Then during the busy season of 1960-61 borrowings increased by Rs. 21.53 crores. The banks having experienced variations in aggregate deposits of only Rs. +9.34 crores (busy season 1960-61) and having been required to finance transactions arising out of a record growth of national income (7.3%) in the year 1960-61, had to take recourse to borrowings from the Central Bank at penal rates and the conclusion may be drawn that the graded lending rate policy succeeded in creating the pinch in borrowing from the Central Bank. However, the abandonment of the 'reserve requirements' control measure in January 1961 and prosperity following the good crop year of 1960-61 brought forth increase in aggregate deposits with the banks of an order of Rs. 43.85 crores in the slack season of 1961 (as against a fall of Rs. 23.26 crores in the previous slack season of 1960) followed by an all time high level of increase of Rs. 157.16 crores in the busy season of 1961-62. This had offset the effect of graded lending rates experienced in the earlier period. Borrowings at the Bank increased by just Rs. 6.17 crores and the all time high increment of deposits enabled them to increase their advances by an all time high level of Rs. 203.87 crores.

The conclusion seems to be that while reserve requirements method does have immediate and pronounced effects, the Bank Rate policy which came in the guise of a graded lending rate system rather than a straight way increase in the Rate could operate only under the static assumption of a given rate and structure of deposit expansion with commercial banks.

Bank Rate Policy during 1962-63 to 1965-66 (III).

This was a testing period for the formulation and operation of monetary policy in India. Politically, conflicts with China (October, 1962) and Pakistan (Sept., 1965) had necessitated diversion of resources for defence purposes in addition to the unsettling effects that hostility with China had on the capital market in particular.[1] Efforts to keep up with the targeted programmes of the Third Five Year Plan in the face of discouraging trends in agricultural production created a major problem of keeping the rising level of prices under check. The process of structural transformation in the pattern of industries that was underway in the Second Five Year Plan continued and created imbalances in aggregate supply in subsequent years. Thus while the index of industrial production

---

1. The table below shows variations in All-India Index (1952-53 = 100) of 'Variable dividend' industrial security prices during the period 1957-58 to 1962-63.

TABLE 5(9)

Year	Index	Year	Index
1957-58	126.6	1960-61	182.6
1958-59	146.8	1961-62	192.7
1959-60	161.7	1962-63	160.3

(1956 = 100) at the end of 1965-66 showed a rise of 32.7% over the year 1961-62, the index of agricultural production for the same period showed a fall of 9% over the year 1961-62. (Vide Table 5(10). Hence it could be said that while the problem in the industrial field was one of overall growth with sectoral adjustments, the problem in the agricultural sector was one of overall scarcity in regard to both food articles as well as raw materials. Table 5(10) shows percentage variations in respect of indices of agricultural and industrial production as well as net national income, money supplya and wholesale prices for the four years of the period of our study alongwith overall percentage variation over the base year 1961-62. As the data in the Table show money supply rose by 48.6% over the base year while net national income having risen by 12.1% the rise in the general price level was 31.8%. We had seen earlier that the quantitative relation (the casual mechanism apart) between money supply national income and price level did not hold during the period of the First Plan. The four year period of our study shows a 'high type'[1] quantitative relationship between these three variables.

---

1. The term 'high type' has been used with a view to emphasising the point that it is based on some simple statistical relationship and not on econometric testing of the relationship among the variables.

TABLE 5(10)

Percentage variations in selected economic indicators - 1962-63 to 1965-66

(Amount in Crores of Rupees)

Indicator	1961-62	1962-63		1963-64		1964-65		1965-66		
		Variation during the year	Percent variation over 61-62	Variation during the year	Percent variation over 62-63	Variation during the year	Percent variation over 63-64	Variation during the year	Percent variation over 1964-65	Percent variation over 1961-62
1. Index of Industrial Production 1956=100	141	152.6	+ 8.2	165.8	+ 8.7	177.0	+ 6.7	186.9	+ 5.6	+ 32.7
2. Index of agricultural production 1950 = 100	144.8	137.4	- 5.0	142.4	+ 3.6	158.4	+ 11.2	131.7	- 16.9	- 9.0
3. Net National income at constant prices 1950-51=100 (Rupees in Crores).	13,060	13,310	+ 1.9	13,970	+ 4.9	15,050	+ 7.7	14,660	- 2.6	+ 12.1
4. Money supply with the public - Outstanding on last Friday (Rupees in Crores)	3,046	3,310	+ 8.7	3,752	+ 13.4	4,080	+ 8.7	4,529	+ 11.2	+ 48.6
5. Wholesale Price Index 1950-51 = 100	111.90	114.40	+ 2.2	121.02	+ 5.8	136.58	+ 12.8	147.70	+ 8.1	+ 31.8

Note:- Index of Industrial production is for end December, 1961 to end December, 1965.

Source:- Currency and Finance Report 1966-67 and Table 5(1)

An important factor (constraint as we called it in Chapter three) that enters the decision-making process of monetary authorities in India is seasonal variations in banks' behaviour. Again exogenous factors such as the budgetary policy of the Government, trends in the capital market, movement in wholesale prices and production trends in agriculture as well as industry have to be taken into account. Beginning with 1956 and later in 1960 the Bank had armed itself with weapons of control so as to be able to pursue vigorous monetary policy. Amendment of the Reserve Bank of India Act in 1962 (in succession of an earlier Amendment in 1956) enabled the Bank to enforce the Bank Rate policy in a more meaningful way. We could say, in general, at the outset that the later two years of the four year period (1962-66) proved more challenging to the monetary authorities although they had rationalised the graded lending rates system by then.

In the first two years (1962-63 and 1963-64) the graded lending rates system was revised five times, sharpening the instrument each time. The change related to variations in the 'quotas' and 'slabs' alongwith putting up of the Bank Rate by ½% (from 4 to 4½%) on January 2, 1963. It must be a bold step on the part of monetary authorities to have put up Bank Rate within 3 months of the declaration of state of emergency following the Chinese aggression of October, 1962. However, as the Reserve Bank conceded "the rate was raised by ½ percent with a view to bringing it in line with the prevailing interest rates in the money and capital markets".[1] The changes in graded lending rates during the first two years (1962-63 and 1963-64) may be noted first.

---

1. Currency and Finance Report 1962-63) P. 42.

	Date of Change.	Quota	Rate
1.	2- 7-62	I Slab = Basic = 25% of S.R.	4% (Bank Rate)
		II Slab = Another 25% of S.R.	5%
		III Slab = Above 50 and upto 100% of S.R.	6%
		IV Slab = Above 100% of S.R.	6½%
2.	31-10-62	I Slab = Basic = 25% of S.R.	4% (Bank Rate)
		II Slab = Another 25% of S.R.	5%
		III Slab = Above 50 and* upto 100% of S.R.	6%
		* Borrowing above 100% not permitted.	
3.	2- 1-63	I Slab = Basic = 50% of S.R.	4½% (Raised Bank Rate)
		II Slab = Upto 100% of S.R.**	6%
		** Borrowing above 100% to be charged a higher rate (it was to be 6½%)	
		(The above three changes related to year 1962-63).	
4.	30-10-63	I Slab = Basic = 75% of S.R.	4½% (Bank Rate)
		II Slab = Above 75% and upto 150% of S.R.***	6%
		*** Borrowings above 150% could be had under the category of 'Special Accomodation' at 6%	
5.	11- 3-64	I Slab = Basic = 75% of S.R.	4½% (Bank Rate)
		II Slab = Above 75 and upto 150% of S.R.**	6%
		** Borrowings above 150% could be had under the category of 'Special accomodation' at 6½%.	

S.R. = Statutory reserves.

One may like to enquire whether these frequent changes in the lending rates were indicative of the flexibility of monetary policy in India or the cautious approach of the Reserve Bank or mere experimentation with the scheme. The judgement appears to be that it is indicative of the cautious approach necessitated by the avowed policy goal of 'controlled expansion'. One way to gauge the effectiveness of this 'restrictive policy' measure is to look into variations in borrowings and credit creation by the banks following announcement of the policy measure. Since both borrowings and credit creation are influenced by the demands of the busy and slack seasons separately, a 'restrictive policy' announcement on the eve of the busy season could not be reflected in contraction of either borrowing or credit expansion. Thus policy changes in October, 1962; January, 1963 and October, 1963 shown above coincided with increased borrowings and expansion. The only conclusion that could be hazarded would be that both these would have been higher in absence of the policy measure but no quantitative estimate of it could be provided. Table 5 (11) gives an idea about this.

TABLE 5 (11).

Variations in borrowings and credit creation by scheduled banks during 1962-63 and 1963-64.

(Amount in Crores of Rupees)

Season	Aggregate Deposits. (1)	Borrowings from R.B.I. (2)	Cash ratio (3)	Bank Credit (4)	Percentage ratio of (2) to (1) (5)	Credit deposit ratio at the end of the period. (6)
S-1962	+ 84.13	- 3.30	6.1%	- 42.10	- 6.2	67.5
B-1962-63	+ 35.68	+21.82	6.2%	+203.25	+61.2	76.1
S-1963	+148.02	-29.41	7.7%	-120.90	-19.9	65.7
B-1963-64	+ 84.51	+43.27	6.1%	+376.24	+51.2	79.5

Source:- Currency and Finance Report 1964-65.

One inference that may be drawn is that the policy change announced in January, 1963 kept down the volume of borrowings and credit creation as reflected in the movements in regard to both these in the slack season of 1963. The October, 1963 policy announcement however, coincided with borrowings of banks by twice (Rs.43.27 crores) the amount of borrowing in the previous slack season (Rs. 21.82 crores) and credit expansion by 1.75 times (Rs. 376.24 crores) of credit expansion in the previous slack season (Rs.203.25 crores) and tampered the effects of the policy change.

The policy of graded lending rates operated in a peculiar way in that with subsequent changes the slabs were being reduced and the basic quota increased. Whether these changes in slabs were inspired by consideration of administrative simplicity or for raising the cost of borrowing is not easily ascertained. Having reached the conclusion that the upward revisions did not exercise any restrictive influence (in absolute terms) but that both credit expansion and borrowings from Bank would have been higher in the absence of these upgraded rates, we may note in Table 5(12) borrowings by banks at various rates during the years 1960-61 through 1964-65.

TABLE 5(12)

Borrowings by scheduled banks at various rates of interest from the Reserve Bank of India.

(In crores of Rupees)
(Rates of interest percent per annum)

Average of Fridays	Total Outstandings at					Weighted average rate of borrowings.
	4%	4.5%	5%	6%	6.5%	
1960-61(a)	14.28		10.81	19.46		5.12%
1961-62	10.39		5.03	6.25		4.81%
1962-63	5.78	20.96	1.63	3.12	6.68	5.19%
1963-64		13.98		4.88	3.68	5.15%
1964-65(b)		14.81		5.15	4.18	5.17%

(a) Average of 23 weeks.
(b) Average of 26 weeks.

Source : Currency and Finance Report 1964-65 P. s-47.

For one thing there was a hike in the weighted average rate of borrowing from 4% (average for 29 weeks) and 5.12%

(average for 23 weeks) in 1960-61 to 4.81% in 1961-62 and about 5% thereafter.

1964-65 to 1965-66 : Variations in the lending rates announced on 11- 3-1964 (as shown above) however, did produce the stabilising effect in the sense that bank credit (outstanding) which stood at Rs. 1817 crores at the end of March declined to Rs. 1706 crores at the end of October, 1964 (Slack of 1964). Bank Rate policy in the two years of 1964-65 and 1965-66 was characterised by a fundamental change. Designing of the Bank Rate policy in its new form in 1964-65 had however, to operate in the next year characterised by severe drought conditions leading to a fall in national income of 2.6 percent. The year 1964-65 on the other hand experienced a growth rate in net national income of 7.7% the highest growth rate to be recorded in the whole period of Planning till then. (Vide Table 5(10)).

Amendment of the Reserve Bank of India Act in 1962 brought forth an important change. The scheduled banks were now required to maintain under Section 42(1) with the Reserve Bank, an average daily balance of 3 percent of their time and demand liabilities in place of separate ratios[1] prescribed earlier. The Reserve Bank was also empowered to vary the reserve requirements between 3 and 15 percent under the amendment as against lower and separate maxima fixed earlier. The scheduled banks were further required to keep under an amended Section 24 a

---

1. Two percent for 'Time' and three percent for 'Demand' Liabilities.

minimum amount of liquid assets (comprising till money, gold, excess over statutory reserves; balances with the State Bank of India and with notified banks and unencumbered approved securities) equal to not less than 25 per - cent of their total time and demand liabilities. This new provision which superseded earlier similar requirement of 20 per cent was to come into force two years later i.e. 25th Setpember, 1964.

The minimum net liquidity ratio :

Advantage was taken by the Reserve Bank of India of the coming in force of the new liquidity ratio requirement in September, 1964. On 25th September, 1964, the Bank Rate was raised from 4½% to 5 per cent. The background for such a change lay in the inflationary pressure to which the economy was being subjected from 1962-63 and more markedly from 1963-64. The wholesale price index (with 1952-53 = 100)[1] which was 124.9 in 1960-61 rose to 125.1 and 127.9 at the end of 1961-62 and 1962-63. The price rise trend however, took the index to 135.3 at the end of 1963-64 finally raising it to 160.1 during the week ended September 19, 1964. The Reserve Bank identifying it with "renewed inflationary pressures" and considering that "the ensuing busy season would experience significant expansion in bank credit" felt the need for "regulation of cost of Reserve Bank accomodation to

1. Based on figures in Currency and Finance Report (1964-65) P. S-22.

scheduled banks."[1] With the rise in the Bank Rate from $4\frac{1}{2}$ percent to 5 per cent on 25th September, 1964 the quota-cum-slab rates system gave way to the minimum net liquidity ratio-cum-differential interest rates system.

The net-liquidity ratio and quota-cum-slab method compared :

In place of the quota of the earlier system was now substituted the net liquidity ratio (NLR) which was defined as the ratio of the total of a bank's cash, balances with the Reserve Bank in current account and all its investments in approved securities less its total borrowings from the Reserve Bank, the State Bank (and later) the Industrial Development Bank of India as well as those made under the Bill market scheme. Now a bank could increase its advances only by reducing any one or more of the above liquid assets or by increasing its borrowings from the Reserve Bank. Either course would reduce its liquidity ratio. The Reserve Bank stipulated in September, 1964 that the minimum NLR was to be 28 per cent. A bank with its ratio at this percentage level or above was entitled to borrow at the Bank Rate. When a point is reached when additional borrowing reduces the liquidity ratio and falls below the net minimum level, further borrowing could be had at a rate in excess of the Bank Rate. The NLR truly provided a flexible tool of monetary policy. It should be distinguished from the earlier system. The NLR had its counterpart in the

1. Ibid P. 13 & 14.

Quota. But the Quota was determined on the basis of the statutory requirements which would be higher for a larger bank and lower for a smaller bank. On the other hand the Quota-cum-slab method was indifferent in its treatment for accommodation between two banks with same deposit liabilities but different credit deposit ratios. A bank with a lower credit-deposit ratio would ipso facto be having a higher investment-deposit or cash-deposit ratio and, therefore, less punishable for credit control purposes and more deserving for accommodation purposes. (The quota-cum-slab system put the Central Bank, so to say, in the guise of a fiscal authority acting on principle of vertical equity but violating the horizontal equity criterion, the NLR system enabled the Bank to fulfil both the criteria)[1]

A more valid distinction between the two methods could be made on the ground that the quota-cum-slab method acted on the basis of deposit liabilities of the banks whereas the NLR method acted on the basis of the portfolio behaviour of the banks. The quota-cum-slab method discriminated in favour of larger banks which would be entitled to larger quotas as compared to smaller banks. The NLR system would discriminate in favour of the banks having a higher liquidity ratio and against one having a lower liquidity ratio if both have same volume of deposit liabilities.

---

1. The analogy cannot be carried further and need not be looked upon in its entirety. It has been stated only to sharpen the distinction between the two methods.

The Reserve Bank of India points to an aspect of the portfolio behaviour of banks that necessitated the change.[1] Under the quota system the banks used to hold treasury bills during slack season (the investment portfolio of banks in India generally rises during the slack season) rather than having dated securities. Since new floatation of government loans would normally take place during the slack seasons this created problems for debt management. But there was another implication of this behaviour for monetary control. In the busy seasons the banks used to seek accommodation either through rediscounting of bills (which of course should be considered a welcome step) or running off of their treasury bills. Had they held dated securities they would have been required to borrow against these securities and this would have reduced their quota.

The NLR system plugged this loophole by relating capacity to borrow to Net liquidity which as the Bank points out was a "truer index of the real liquidity position of a bank".[2]

Under the NLR method, the Bank further claims, the "Bank Rate is a floating rate, a multiple rate and a differential rate".[3]

1. "Evolution of monetary policy in India" Reserve Bank of India Bulletin April, 1966 Pp. 340-61.

2. Ibid.

3. Ibid.

NLR method and Bank Rate Policy (1964-66):

The NLR could thus be varied from time to time. The following changes were made including a rise in Bank Rate to 6% in February, 1965 during the two year period ending March, 1966.

Date of Change		N L R	Rates for borrowing
I	25th Sept. 1964	28% or over	5% (Bank Rate)
		Fall of each percentage point or fraction thereof in NLR below 28%	Bank Rate (5%) Plus ½ per cent on the entire amount of borrowings.
II	17th Feb. 1965	30% or over	6% (Bank Rate)
		Fall of each percentage point or fraction thereof in NLR below 30%	Bank Rate (6%) plus ½ per cent on the entire amount borrowed.
III	22nd Nov. 1965	30% or over	6% (Bank Rate)
		Fall of each percentage point (or fraction thereof) in NLR below 30%	Bank Rate plus 1 per cent.

Source : Currency and Finance Reports 1964-65 & 1965-66.

With the conditions of drought in 1965-66 and the year following it, the food procurement policy was intensified and the portion of bank advances made for this purpose was made eligible for refinance at the Bank Rate. Later, advances made for exports, short term credit to agriculture and small scale industries brought a component of lending by banks to what were designated as

'Priority Sectors' which was made eligible for refinance at the Bank Rate. This led to a rather cumbersome procedure for calculation of liquidity ratio but the method has proved an ingenious measure. This method it could be said fulfilled the 'controlled expansion' goal in a more plausible manner.[1]

The Slack Season of 1964 witnessed expansion of bank credit to the tune of Rs. 138 crores but the ratio of credits to deposits remained at the level of 67.4 per cent to total deposits. The ratio had varied between 65.7 and 67.6 during the three previous slack seasons of years 1961 to 1963. The slack season of 1964 had however, experienced growth in total deposits to the extent of Rs. 210.67 crores (variation in deposits in previous slack seasons since 1951 having remained highest at 148 crores in 1963). Against this rather comfortable liquid position the busy season of 1964-65 opened with bright prospects of a bumper crop. It was truly in the busy season of 1964-65 that the conflicting claims of both 'control' and 'expansion' came out overtly. In a bid to fulfil its task, the Reserve Bank put up the Bank Rate by full one percentage point (from 5 to 6) in February, 1965, and also varied the net liquidity ratio from 28 to 30 per cent together with a hike in (i) ceiling on advances

1. This policy of catering to the need of 'Priority Sectors' which first became concern of the Reserve Bank via its refinance policy later became the basis of argument for 'nationalisation of commercial banks' leading very recently to the policy proposal of 'differential interest rates' to be pursued by nationalised banks in India.

by banks from 9 to 10% and in (ii) maximum and minimum rates of interest on deposits. Despite these measures bank credit expanded by as much as Rs. 407.40 crores (the highest to be recorded in all busy seasons till then) raising the credit deposit ratio to 80.1 per cent. On the other hand, variation in bank deposits remained at a low level of +Rs. 106.41, which was even lower than the immediately preceding slack season variation of +Rs.210.67 crores (Vide Table 5(13). Borrowings from the Reserve Bank of India consequently stood at Rs.124.50 crores, the highest level reached so far.

TABLE 5(13)

Variations in aggregate deposits, borrowings from Reserve Bank of India, cash ratios, bank credit and credit-deposit ratios during 1964-65 and 1965-66.

(Amount in Crores of Rupees).

Season	Aggregate Deposits.	Borrowings from Reserve Bank of India.	Cash ratio at the end of the period.	Bank Credit	Credit Deposit ratio at the end of the period.
S 1964	+210.67	- 43.34	6.1	-138.77	67.4
B 1964-65	+106.41	+124.50	6.1	+407.40	80.1
S 1965	+177.90	-122.81	6.5	- 93.37	71.7
B 1965-66	+213.92	+ 28.48	6.2	+309.53	76.9

Source : Currency and Finance Report (1965-66)

Although the year 1964-65 witnessed the highest percentage rate (7.7%) in national income (at constant prices) and although money supply increased by more or less equal percentage (8.7%) price level at the end of the year rose by 12.9 per cent (1952-53 = 100) despite initiation of a rationalised lending policy and a rise in Bank Rate by the monetary authorities. The end of 1964-65 busy season marks the end of a course of development with more or less of stability in the price level and the beginning of a highly unsettling phase of economic activity witnessed during 1965-66 and the three subsequent years causing suspension of the Fourth Plan.

Are we entitled to say that the monetary authorities during the year 1964-65 should have pursued a policy of 'restraint' during the busy season of 1964-65? For one thing borrowings from the Reserve Bank were Rs. 124.50 crores which was twice the amount of the highest figure of borrowings (Rs. 50.35 crores) reached in 1955-56. In a bumper crop year with a rise in index of agricultural production by 11.2% (Reference Table 5(10)) the volume of seasonal bank credit and its replenishment through borrowings from the Reserve Bank will possibly remain on the high side. Of the total 'secured' advances by scheduled banks of Rs. 369.1 crores during the busy season of 1964-65, Rs. 234.6 (63% of total) were seasonal advances. The villain of piece was, therefore, the slow and comparatively low growth in deposits (Rs. 106.41 crores) during the busy season which was even less than the rather higher growth rate of deposits (Rs. 210.67 crores) during the slack season of the same year. The repercussions of these rather uneasy movements during the year 1964-65 had a telling effect on the subsequent year.

During the slack of the year 1965-66 banks repaid their borrowings of the previous busy season from the Reserve Bank by almost the full amount of it and experienced growth in aggregate deposits by a comfortable figure of Rs. 117.90 crores but the seasonal contraction of bank credit remained at a low level of Rs. 93.37 crores keeping the slack season credit deposit ratio at 71.7%, the highest so far. The movement of the wholesale price index was causing grave concern. The index (1952-53 = 100) which was 152 in the first week of April, 1965 rose to 166 at the end of October, 1965 and reached the level of 171 in the week ending November 20, 1965. The Reserve Bank raised the penal rate on borrowings by one per cent above the Bank Rate for fall of each percentage point in NLR below 30 per cent. The busy season of 1965-66 marked by conditions of severe drought (resulting in fall in index of agricultural production by 16.9% and causing a fall in national income by 2.5%) kept down the level of bank credit to Rs. 309.53 crores accompanied by deposit growth to the extent of Rs. 213.92 crores and borrowings from the Reserve Bank of India at Rs. 28.48 crores. The banking sector and the money market as a whole did feel the pinch of Dear money policy initiated in 1964-65 as can be seen from some money rates on the next page.

TABLE 5(14)

Some Money Rates during the years 1962-63 to 1965-66.

(Per cent per annum)

Year end of March	Call money from banks (Bombay)	State Bank of India.			Reserve Bank of India	Bazar Bill Rate (Bombay)
		Hundi Rate	Advance Rate.	Call Loan scheduled banks.	Weighted average of rates of borrowings by Banks.	
1962-63	4.16	6½-7	5	6-6½	5.19	10.50-12.00
1963-64	3.87	7¼	5-6	6¼-6¾	5.15	12.00
1964-65	4.01	7¼-9¼	6-7	6¾-7½	5.18	12.00
1965-66	6.26	9¼-9¾	7-7½	7½-9	6.87	12.00-15.00

Source : Currency and Finance Report 1965-66 P. S-29.

Despite the stringency and pinch experienced by the money market the wholesale price index at the end of the year 1965-66 reached the staggering height of 165.1 (1952-53 = 100) registering an increase of 8.1% over the previous year. Aggregate money supply during the year rose by 11% which was higher than the previous year rate of 8.7% and accompanied by a fall of national output by 2.5% it exercised a heavy pull on the price level.

Concluding remarks :

The Reserve Bank of India followed a rather steady path of monetary control in wielding its Bank Rate policy during the period under study. It has nevertheless had enough of innovations with the policy in the context of emerging situation. There is a general observation made that Bank Rate variations have been infrequent implying a sort of timid behaviour on the part of the Bank. The real issue however, is not in regard to the element of frequency but the intended effect and size of the policy measure. On this showing it is a legitimate criticism that the Bank has preferred to follow a policy of 'low' rates. This has precluded following of a rational - interest rate policy by the Bank an issue to which we turn in Chapter eight.

The Bill market scheme described by us as the structural dimension of Bank Rate policy was lost half way, first with the gradual eclipse of the system of concessionary finance and later with inclusion of borrowings under the scheme for computation of 'borrowed reserves' to nett out the liquidity ratio.

Although paying attention to it extends a bit beyond the period of our study it may be instructive to note that the Industrial Development Bank of India (established in 1964) which rediscounts bills under less stringent criteria than the Reserve Bank, has shown a rising percentage of 'rediscounts' to 'direct loans'.

TABLE 5(15)

Relative share of 'rediscounts' and 'direct loans' by the I.D.B.I. 1964 to 1968.

(Amount in Crores of Rupees)

Year	Amount disbursed. Direct loans (1)	Rediscounts (2)	Ratio of (2) to (1) (3)
1964-66	19.9	2.1	15.5%
1966-67	20.7	6.1	29.5%
1967-68	18.0	10.6	58.8%

Source: Report of the Industrial Development Bank of India, Bombay, August, 1968 P. 4 and P. 16.

It is true that since the I.D.B.I. is a subsidiary of the Reserve Bank this does not constitute any loss of business to the Reserve Bank but it is equally true that the rising percentage of rediscounts to loans speaks for the need for strengthening and expanding the bill market scheme.[1]

The Bank thus remained lukewarm towards its responsibility as an agent of 'change' first by failing to evolve a rational interest rate policy and second by paying scant attention to the issue of structural efficiency of the banking system.

Before taking up these issues we need discuss the remaining measures of monetary control in the next two chapters.

1. A 'study group' appointed by the Bank in October, 1968 reported about the advisability of expanding the bill market scheme (a reference to this is made in Chapter eight)

   A new bill market scheme has been just launched.