

The Reserve Bank of India



# The Reserve Bank of India

*Volume 4*  
1981–1997



भारतीय रिज़र्व बैंक  
RESERVE BANK OF INDIA  
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# Part A



## Foreword

Established in 1935, the Reserve Bank of India is one of the oldest central banks in the developing world. The Reserve Bank of India Act, 1934, confers a wide mandate on the Bank: “to regulate the issue of Bank notes and the keeping of reserves with the view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.” The interpretation of this wide mandate into specific responsibilities and obligations over time was shaped by global and domestic developments as also evolving international best practices.

In addition to being the monetary authority and issuer of currency, the Reserve Bank has responsibilities for the regulation and supervision of banks, non-banks and large segments of the financial markets. It has responsibilities for the development and regulation of the payment and settlement systems. The Bank plays an active role in the management of the external sector and is the manager of the country’s foreign exchange reserves. The Reserve Bank has always had a development dimension to its mandate, starting from the All-India Rural Credit Survey, 1954 to the most recent initiatives of furthering financial inclusion and financial literacy. Accordingly, the Reserve Bank’s mandate is wider not only relative to that of advanced economy central banks, but also relative to central banks of the peer group of emerging economies.

The history of the Reserve Bank reflects in many ways the economic history of India. Its journey over the past seven or more decades has been marked by a host of historic developments, both at home and abroad. Internationally, there were the aftermath of the Great Depression of the 1930s; the Second World War and the consequent challenges of war financing; the establishment of the Bretton Woods system in 1944; the

unraveling of the gold standard and the oil price shocks of the 1970s; the Third World debt crisis of the 1980s; the Asian Crisis of the mid-1990s; and most recently the global financial turmoil.

There were historic developments on the home front too, and they were varied — starting with the launching of the Five Year Plans and the challenges emanating from one of history’s most ambitious and gigantic experiments in economic development; the after-effects of the two wars in the 1960s; the devaluation of the rupee in 1966; bank nationalisation in 1969; the balance of payments crisis of the early 1990s and the follow on path-breaking economic reforms that moved India into a new economic era. The Reserve Bank is proud of the role it has played in shaping these developments, or responding to them as the case may be, but always with sensitivity and integrity.

It is a matter of pride and satisfaction for all of us in the Reserve Bank that it is one of the few central banks to be documenting its institutional history. We have so far completed three volumes of history covering the period since the inception of the Bank up to 1981. Volume 1, covering the period from 1935 to 1951, highlights the initial efforts to establish a central bank in India, particularly the concrete proposal made by John Maynard Keynes in 1913 to set up a ‘State Bank’ in India by merging the three Presidency Banks to take up some of the functions of a central bank. Volume 2 narrates the Reserve Bank’s role in the process of development planning from 1951 to 1967. The highlight of Volume 3, which covered the period from 1967 to 1981, was its depiction of efforts to deepen banking into the country’s hinterland.

This brings us to the present Volume 4, which covers the period from 1981 to 1997. This was by far one of the most challenging periods for the economy. This volume of history takes us through the difficult times when the Reserve Bank and the Government had to contend with unprecedented strains on the external payments situation. In response to the balance of payments crisis, the Government embarked on a wide-ranging programme of economic reforms that defined a marked reorientation of the philosophy of economic management of the country. The Reserve Bank was a partner in this exciting process, generating ideas, processing proposals and implementing reform initiatives. Chapters 10 to 12 of this volume provide a vivid account of this remarkable phase of the Reserve Bank’s history.

As per the precedent set by the earlier volumes, Volume 4 too is based on official records, published sources and discussions with former senior officials associated with the Reserve Bank during the period under review.

The volume also benefited from the oral history extracts of the recorded interviews of former Governors, Deputy Governors and executives of the Bank as well as government officials of the period. It also draws significantly from internal records that were searched to verify facts and to reflect the flavour of the debates and discussions within the Bank on policy proposals before they were firmed up.

The preparation of this volume was guided by an Advisory Committee on RBI History chaired by Dr Bimal Jalan, former Governor. The Members of the Committee included Dr Subir Gokarn, Deputy Governor, Reserve Bank of India; Dr Rakesh Mohan, former Deputy Governor, Reserve Bank of India; Dr A Vasudevan, former Executive Director, Reserve Bank of India; Dr Amitava Bose, Professor IIM, Kolkata and Dr Dilip Nachane, Professor, IGIDR, Mumbai. Shri Deepak Mohanty, Executive Director, Reserve Bank of India proactively monitored preparation of the volume. I thank all Members of the Advisory Committee, Consultants and the staff of the History Cell for the sense of purpose they brought to preparing this volume.

My sincere thanks and gratitude to Dr Bimal Jalan for his intellectual leadership in steering this volume of history. His passion and professionalism are a continuing source of inspiration for us.

July 2013  
Mumbai

Duvvuri Subbarao  
Governor  
Reserve Bank of India



## Preface

With the publication of this fourth volume, the history of the Reserve Bank of India has been brought forward to the end of 1997. The institutional history of the Reserve Bank was first published in 1970, covering the period from 1935 to 1951, *i.e.*, the formative years. The volume traced the process for setting-up a central bank in India preceding the establishment of the Reserve Bank in 1935 as a shareholders' Bank until its nationalisation in 1949. The Bank's pioneering initiatives and efforts towards policy planning and institution building were in focus in Volume 2 that captured the evolution of the Reserve Bank from 1951 to 1967. This period was marked by the initiation of planned economic development in India with the launch of Five Year Plans. Volume 3, covering the period 1967 to 1981, traced developments in the vast expanse of the financial landscape in India. It also highlighted the realignment of financial and regulatory policies, bringing into sharp focus the bank nationalisation of 1969.

As the monetary authority and a regulatory and development institution performing diversified functions in the area of public policy, the activities and performance of the Reserve Bank are shaped and influenced both by the economic environment and the dominant central banking paradigm of the time. As is well-known, the period of 1981–1997 marks a very eventful phase in Indian economic history in terms of crises and structural changes. Considering that 1991 represented a major shift in economic and financial policies following the balance of payments crisis, the institutional history falls naturally into two distinct phases. The first phase, covering the period 1981–1989, deals with post-1981 developments in monetary policy and macroeconomic reforms. It is titled 'Consolidation

and Early Liberalisation’. The second phase covering the period 1989–1997 is titled ‘Crisis and Reforms’.

The decade of the 1980s remained broadly as the continuation of a mostly inward-looking, planned and administered era of central direction, though several initial attempts were made at liberalising certain segments of the economy. During this period, the country faced many uncertainties including, *inter alia*, a severe drought in 1987, causing supply constraints; erosion in the profitability of banks on the back of the introduction of populist political measures such as the loan *melas*, which engaged the attention of the Reserve Bank towards safety and prudential issues in the commercial banking system; administered interest rates that limited the scope of transmission and efficacy of monetary policy besides the fiscal dominance that further constrained manoeuvrability of monetary policy actions; and the fixed exchange rate regime with limited external sector opening up, leading to build-up of external imbalances.

There were, however, attempts at creating a systematic institutional infrastructure for rural credit with the creation of NABARD, which began operations in 1982. There were attempts to develop financial markets particularly the money market, since the mid-1980s. In parallel, capital market development received a thrust with the setting-up of the Securities and Exchange Board of India. The Committee to Review Working of the Monetary System (Chairman: Prof Sukhamoy Chakravarty, 1985) transformed the policy paradigm with respect to the objectives of monetary policy, regulation over money and credit, interest rate policies and co-ordination of monetary and fiscal policies.

The developments during the 1980s, however, clearly lacked an overarching framework for structural reforms and experienced political uncertainty towards the end of the decade that led to the emergence of macroeconomic distortions culminating in the balance of payments crisis of 1991. The period was characterised by continuous dialogue between the Reserve Bank of India and the Government over reining in fiscal deficit.

The second phase of the volume starts with circumstances, including domestic political developments, leading to the build-up of the balance of payments crisis. The turn of the decade of the 1990s was marked by several uncertainties. The country was grappling with fragile economic circumstances, compounded by an unsure political environment that called for firm policy actions. India thus faced an unprecedented balance of payments crisis in 1991. There was a challenge confronting the economy on the fiscal front. The pressure on external and internal resources posed

a challenge to monetary management and hindered investment. The need of the hour was fiscal correction, monetary stability, inflation control and regaining export competitiveness.

The comprehensive economic reforms, mostly home-grown, that were launched in 1991 with support from multilateral institutions and implemented in a gradual and cautious manner enabled India to gain international credibility. The devaluation of the rupee in 1991 gave a fillip to exports. This, combined with wide-ranging liberalisation efforts in various sectors, helped rather quickly to restore macroeconomic balance in the economy. Policy measures such as the institution of the Liberalised Exchange Rate Management System as a prelude to current account convertibility in 1994, the switch from direct to indirect instruments to improve the efficacy of monetary policy and developing financial markets for greater market integration facilitated the smooth transition of the economy towards a more dynamic and liberal regime.

The implementation of the recommendations of the Narasimham Committee Report (1991) for financial sector reforms was an important part of this transition. Another landmark was the Reserve Bank gaining a certain degree of autonomy and greater space for monetary operations after the agreement with the Government in 1994 to phase out the system of *ad hoc* Treasury Bills and automatic and unlimited monetisation of fiscal deficits effective April 1, 1997. On the regulatory front, attempts at consolidation in commercial banking and the strengthening of supervision in the non-banking segment were in focus during the 1990s.

All these developments have been captured against the backdrop of the organisational evolution of the Reserve Bank. The operations of the Bank emerged out of a diversity of roles entrusted to it and were marked by flexibility enabling the Bank to address the constraints of time. The changes in the composition of the Reserve Bank, signifying its structural transformation, have been woven with its functional progression, since the Reserve Bank was called upon to play a unique role to address the challenges posed by the circumstances. Alongside, there was recognition that central bank communication was an issue that needed to be addressed.

As regards the preparation of the current volume of Reserve Bank history, the primary responsibility for drafting the chapters has been that of Dr N. Gopalaswamy, Dr T.V. Gopalakrishnan and Shri Sudhakar Mohanty, all Consultants, and Gunjeet Kaur, Director, who did a commendable and painstaking job of drafting after sourcing, collecting and collating the relevant information and data. Shri K. Kanagasabapathy

focused on editing the chapters to maintain consistency, besides bringing in interesting insights into several historical episodes. Shri TCA Srinivasa Raghavan also provided editorial support during his brief association with the project at the initial stage.

An internal team of officers comprising Jaya Mohanty, Director; Rajiv Jain and Anand Prakash, Asst. Advisers, DEPR, went through the drafts of various chapters and offered substantive comments. While Dr Renu Gupta copy edited the volume, Shri P.P. Ramachandran gave valuable suggestions on all the chapters. Ashok Kapoor, R.L. Sahoo and P. Ravikiran Pala of the RBI archives pieced together the documents required for writing the history.

The members of History Cell of the DEPR, namely, SVS Dixit, Jayanthi K. Anand and Gunjeet Kaur, supported by M. Seenuvasan, K.M. Thirunavukkarasu, Rajiv Lochan, R.J. Ubale, Ann Verghese, Anil Chodankar, Girish S. Vagal and Geeta Kamath ensured the progress of the drafting of the volume in a time-bound manner, besides providing unstinted secretarial support to the Advisory Committee.

Shri Deepak Mohanty, Executive Director, was closely involved in drafting the volume and monitored the work of the History Cell at every stage. The project of writing the current volume of Reserve Bank history was carried out under the overall supervision of Dr Subir Gokarn, Deputy Governor, who was also a member of the Advisory Committee.

Finally, let me thank Dr Duvvuri Subbarao, Governor, who asked me to chair the Advisory Committee and Dr Rakesh Mohan, former Deputy Governor, who also served as a member of the Advisory Committee, for their continuous support and advice.

I do hope that this volume will serve as a rich resource for all who are interested in studying the evolution of the Reserve Bank of India and a timely and useful addition to the compendium of the earlier three volumes.

July 2013  
New Delhi

Bimal Jalan  
Chairman  
Advisory Committee

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## Abbreviations

AAIFR	Appellate Authority for Industrial and Financial Reconstruction
AAP	Annual Action Plan
ABBCFF	Advisory Board for Bank, Commercial and Financial Frauds
ABFSL	Andhra Bank Financial Services Ltd
ACB	Agricultural Credit Board
ACD	Agricultural Credit Department
ACP	Annual Credit Plan
ACRC	Agricultural Credit Review Committee
ACU	Asian Clearing Union
AD	Authorised Dealer
ADB	Asian Development Bank
AFC	Agricultural Finance Corporation
AFR	Annual Financial Review
AFR	Applicable Federal Rate
AGL	Aggregate Gap Limit
AGM	Assistant General Manager
AIBEA	All-India Bank Employees' Association
AIEAC	All-India Export Advisory Committee
AIRBEA	All-India Reserve Bank Employees' Association

AIRBSOA	All-India Reserve Bank Staff Officers' Association
AIRBWF	All-India Reserve Bank Workers' Federation
AIRDIS	All-India Rural Debt and Investment Survey
ALM	Asset-Liability Management
ALPM	Advanced Ledger Posting Machine
AMC	Asset Management Company
AMR	Aggregate Monetary Resources
ARC	Agricultural Refinance Corporation
ARDC	Agricultural Refinance and Development Corporation
ARDRS	Agricultural and Rural Debt Relief Scheme
ARF	Asset Reconstruction Fund
ASCII	American Standard Code for Information Interchange
ASSOCHAM	Associated Chambers of Commerce and Industry
ATM	Automated Teller Machine
BAF	Bankers' Acceptance Facility
BAFEX	Block Allocation of Foreign Exchange
BANKNET	Data communication network for banking industry
BARC	Bhabha Atomic Research Centre
BCCI(O)	Bank of Credit and Commerce International (Overseas) Ltd
BE	Budget Estimate
BEST	Bombay (now Brihanmumbai) Electric Supply and Transport
BFS	Board for Financial Supervision
BIBOR	Bombay Interbank Offered Rate
BIFR	Board for Industrial and Financial Reconstruction
BIS	Bank for International Settlements
BO	Banking Ombudsman
BoB	Bank of Baroda
BoE	Bank of England
BoI	Bank of India
BoJ	Bank of Japan

BoP	Balance of Payments
BPL	Below Poverty Line
BR Act	Banking Regulation Act
BRBNM	Bharatiya Reserve Bank Note Mudran Private Ltd
BRs	Bankers' Receipts
BSE	Bombay Stock Exchange
BSR	Basic Statistical Returns
BSRB	Banking Services Recruitment Board
BTC	Bankers' Training College
CAB	College of Agricultural Banking
CAD	Current Account Deficit
CAFEX	Composite Allocation of Foreign Exchange
CAFRAL	Centre for Advanced Financial Research and Learning
CAG	Controller and Auditor General
CALCS	Capital Adequacy, Asset Quality, Liquidity , Compliance Systems and Control
CAMELS	Capital Adequacy, Asset Quality, Management, Earnings, Liquidity Systems and Control
Canfina	Canbank Financial Services Ltd
CARE	Credit Analysis and Research Ltd
CAS	Credit Authorisation Scheme
CBDT	Central Board of Direct Taxes
CBEC	Central Board of Excise and Customs
CBI	Central Bureau of Investigation
CBMF	Canbank Mutual Fund
CBTC	Co-operative Bankers' Training College
CCA	Caucasus and Central Asia
CCBs	Central Co-operative Banks
CCEA	Cabinet Committee on Economic Affairs
CCFF	Compensatory and Contingency Financing Facility
CCI	Controller of Capital Issues
CCIS	Comprehensive Crop Insurance Scheme

CD NET	System to enable access to CD-ROMs
CDF	Co-operative Development Fund
CD-ROM	Compact Disc-Read only Memory
CDS	Center for Development Studies
CDs	Certificates of Deposit
CEO	Chief Executive Officers
CEPZ	Cochin Export Processing Zone
CFA	Chartered Financial Analyst
CFS	Committee on the Financial System
CIC	Crop Insurance Corporation
CIDCO	City and Industrial Development Corporation of Maharashtra Ltd
CIF	Cost, Insurance and Freight
CIS	Commonwealth of Independent States
CMA	Credit Monitoring Arrangement
CMD	Chairman and Managing Director
COD	Committee of Direction
COSA	Committee on Security Arrangements
COTELCOOP	Committee on Term Lending through Co-operatives
CP	Commercial Paper
CPC	Credit Planning Cell
CPF	Contributory Provident Fund
CPI	Consumer Price Index
CRAFICARD	Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development
CRAR	Capital to Risk Weighted Assets Ratio
CRDC	Central Records and Documentation Centre
CRISIL	Credit Rating and Information Services of India Ltd
CRR	Cash Reserve Ratio
CSC	Central Security Cell
CS-DRMS	Commonwealth Secretariat-Debt Recording and Management System

CSF	Consolidated Sinking Fund
CSO	Central Statistical Organisation
CVC	Central Vigilance Commission
D.O./DO	Demi Official
DA	Department of Administration
DAD	Deposit Accounts Department
DAE	Department of Accounts and Expenditure
DAP	District Action Plan
DAPM	Department of Administration and Personnel Management
DBOD	Department of Banking Operations and Development
DBS	Department of Banking Supervision
DCB	District Co-operative Bank
DCC	District Consultative Committee
DCCB	District Central Co-operative Bank
DCM	Department of Currency Management
DCO	District Coordinating Office
DCP	District Credit Plan
DEA	Department of Economic Affairs
DEAP	Department of Economic Analysis and Policy
DEBC	Department of Expenditure and Budgetary Control
DEIO	Department of External Investments and Operations
DEPR	Department of Economic and Policy Research
DESACS	Department of Statistical Analysis and Computer Services
DFC	Department of Financial Companies
DFHI	Discount and Finance House of India Ltd
DFI	Development Financial Institution
DGBA	Department of Government and Bank Accounts
DGCI&S	Directorate General of Commercial Intelligence and Statistics
DGFT	Directorate General of Foreign Trade

DGM	Deputy General Manager
DIAL-UP	Internet Access Facility
DIC	District Industries Centre
DICGC	Deposit Insurance and Credit Guarantee Corporation
DIT	Department of Information Technology
DLRC	District Level Review Committee
DM	Deutsche Mark
DNBC	Department of Non-Banking Companies
DNBS	Department of Non-Banking Supervision
DoS	Department of Supervision
DoT	Department of Telecommunications
DPT	Deferred Payment Terms
DRAT	Debt Recovery Appellate Tribunal
DRG	Development Research Group
DRI	Differential Rate of Interest
DRS	Department of Research and Statistics
DRT	Debt Recovery Tribunal
DSB	Returns filed by banks to the Reserve Bank
DSIM	Department of Statistics and Information Management
DTA	Domestic Tariff Area
DvP	Delivery <i>versus</i> Payment
ECBs	External Commercial Borrowings
ECD	Exchange Control Department
ECGC	Export Credit Guarantee Corporation
ECSD	Electronic Clearance Settlement and Depository
ED	Enforcement Directorate
EDP	Electronic Data Processing
EEFC	Exchange Earners' Foreign Currency
EFF	Extended Fund Facility
EFT	Electronic Funds Transfer
EHTP	Electronic Hardware Technology Park
EMEs	Emerging Market Economies

EOU	Export Oriented Units
EPCG	Export Promotion Capital Goods
EPS	Earnings Per Share
EPZ	Export Processing Zone
ERAS	Exchange Risk Administration Scheme
ESAF	Enhanced Structural Adjustment Facility
ESCAP	Economic and Social Commission for Asia and Pacific
Exim Bank	Export-Import Bank of India
F.M.	Finance Minister
F.S.	Finance Secretary
FAD	Foreign Accounts Division
FC(B&O) D	Foreign Currency (Bank and Others) Deposit
FCA	Foreign Currency Assets
FCCBs	Foreign Currency Convertible Bonds
FCI	Food Corporation of India
FCNR(A)	Foreign Currency Non-Resident Account
FCNR(B)	Foreign Currency Non-Resident (Bank)
FCNR	Foreign Currency Non-Resident
FCON	Foreign Currency Ordinary Non-Repatriable
FDI	Foreign Direct Investment
FECT Tax	Foreign Exchange Conservation Travel Tax
FEDAI	Foreign Exchange Dealers' Association of India
FEMA	Foreign Exchange Management Act
FEPZ	Falta Export Processing Zone
FERA	Foreign Exchange Regulation Act
FFSL	Fairgrowth Financial Services Ltd
FIAB	Foreign Intelligence Advisory Board
FIC	Financial Institutions Cell
FICCI	Federation of Indian Chambers of Commerce and Industry
FII	Foreign Institutional Investor
FIIB	First Indo International Bank Ltd

FIMMDA	Fixed Income Money Market Dealers' Association
FIPB	Foreign Investment Promotion Board
FIs	Financial Institutions
FoB	Freight on Board
FRBM	Fiscal Responsibility and Budget Management
FTR	Fast Track Route
FTS	Foreign Travel Scheme
G-3	Free Trade Agreement entered into by Columbia, Venezuela and Mexico
G-5	Group of Five Countries
G-7	Group of Seven Countries
GAIL	Gas Authority of India Ltd
GBP	Great Britain Pound
GCA	General Currency Area
GCC	General Credit Card
GDCF	Gross Domestic Capital Formation
GDP	Gross Domestic Product
GDR	Global Depository Receipt
GDS	Gross Domestic Savings
GFD	Gross Fiscal Deficit
GIC	General Insurance Corporation of India
GLC	General Line of Credit
GM	General Manager
GNP	Gross National Product
GoI	Government of India
GRP	Grievance Redressal Procedure
HCL	Hindustan Computers Ltd
HDFC	Housing Development Finance Corporation Ltd
HFC	Housing Finance Company
HLAS	Home Loan Account Scheme
HP	Hewlett Packard
HRD	Human Resource Development

HRDD	Human Resources Development Department
HUDCO	Housing and Urban Development Corporation
IAS	International Accounting Standards
IBA	Indian Banks' Association
IBM	International Business Machines
IBRD	International Bank for Reconstruction and Development
ICAI	Institute of Chartered Accountants of India
ICD	Industrial Credit Department
ICFAI	Institute of Chartered Financial Analysts of India
ICICI	Industrial Credit and Investment Corporation of India Ltd
ICIM	International Computers India Manufacturing Ltd
ICRA	Investment Information and Credit Rating Agency of India Ltd
IDA	International Development Agency
IDB	India Development Bond
IDBI	Industrial Development Bank of India
IDG	Inter-Disciplinary Group
IDMC	Internal Debt Management Cell
IDMD	Internal Debt Management Department
IDRBT	Institute for Development and Research in Banking Technology
IEA	Indian Economic Association
IECD	Industrial and Export Credit Department
IFC	International Finance Corporation
IFCI	Industrial Finance Corporation of India
IFD	Industrial Finance Department
IFFCO	Indian Farmers Fertiliser Co-operative Ltd
IGIDR	Indira Gandhi Institute of Development Research
IIM	Indian Institute of Management
IIP	Index of Industrial Production
IIT	Indian Institute of Technology

ILR	Internal Lendable Resources
IMF	International Monetary Fund
INFCDR	Incremental Non Food Credit-Deposit Ratio
IOB	Indian Overseas Bank
IOC	Indian Oil Corporation
IOF	Indian Opportunities Fund
IOSCO	International Organisation of Securities Commission
IPO	Initial Public Offering
IRBI	Industrial Reconstruction Bank of India
IRCI	Industrial Reconstruction Corporation of India
IRDP	Integrated Rural Development Programme
ISI	Indian Statistical Institute
ISP	Internet Service Provider
ITC	Import Trade Control
JPC	Joint Parliamentary Committee
JV	Joint Venture
KCC	Kisan Credit Card
KRIBHCO	Krishak Bharati Co-operative Ltd
KVIB	Khadi and Village Industries Board
KVIC	Khadi and Village Industries Commission
LAB	Local Area Bank
LAF	Liquidity Adjustment Facility
LAN	Local Area Network
LBR	Lead Bank Return
LBS	Lead Bank Scheme
LC	Letter of Credit
LDB	Land Development Bank
LDO	Lead District Officer
LERA	Liberalised Exchange Rate Arrangement
LERMS	Liberalised Exchange Rate Management System
LIBOR	London Interbank Offered Rate
LIBSYS	Library System

LIC	Life Insurance Corporation of India
LME	London Metal Exchange
LPG	Liquefied Petroleum Gas
LPM	Ledger Posting Machine
LTFP	Long Term Fiscal Policy
LTO	Long-Term Operations
M.Phil.	Master of Philosophy
M <sub>1</sub>	Narrow Money
M <sub>3</sub>	Broad Money
MAF	Medical Assistance Fund
MBA	Master of Business Administration
MCIR	Monthly Credit Information Review
MCO	Miscellaneous Charges Order
MEPZ	Madras Export Processing Zone
MFI	Microfinance Institutions
MFN	Most Favoured Nation
MIC	Market Intelligence Cell
MICR	Magnetic Ink Character Recognition
MIS	Management Information System
MLA	Member of Legislative Assembly
MMMF	Money Market Mutual Fund
MNBCs	Miscellaneous Non-Banking Companies
MODVAT	Modified Value Added Tax
MOF	Ministry of Finance
MoU	Memorandum/Memoranda of Understanding
MP	Member Parliament
MPD	Monetary Policy Department
MRTP	Monopolies and Restrictive Trade Practices
MSD	Management Services Department
MSP	Minimum Support Price
MT	Metric Tonne
NABARD	National Bank for Agriculture and Rural Development

NAC (LTO)	National Agricultural Credit (Long-Term Operations)
NAC (S)	National Agricultural Credit (Stabilisation)
NAV	Net Asset Value
NBCG	Net Bank Credit to Government
NBER	National Bureau of Economic Research
NBFC	Non-Banking Financial Company
NBFI	Non-Banking Financial Institution
NCBI	National Co-operative Bank of India
NCC	National Clearing Cell
NCDC	National Co-operative Development Corporation
NCOB	New Central Office Building
NDA	Net Domestic Asset
NDP	Net Domestic Product
NDTL	Net Demand and Time Liabilities
NEER	Nominal Effective Exchange Rate
NEIBM	North Eastern Institute of Bank Management
NEPZ	Noida Export Processing Zone
NFA	Net Foreign Asset
NGO	Non-Government Organisation
NHB	National Housing Bank
NHC	National Housing Credit
NIA	Negotiable Instruments Act
NIBM	National Institute of Bank Management
NIC	National Industrial Credit
NICNET	National Informatics Centre Network
NIT	National Industrial Tribunal
NNP	Net National Product
NOBW	National Organisation of Bank Workers
NOC	No-objection Certificate
NODC	Non-Oil Developing Countries
NOF	Net Owned Fund
NPA	Non-Performing Asset

NPL	Non-Performing Loan
NR (E)A	Non-Resident (External) Account
NR(E)RA	Non-Resident (External) Rupee Account
NR(NR)RD	Non-Resident (Non-Repatriable ) Rupee Deposit
NRBI	National Rural Bank of India
NRBICG	Net Reserve Bank Credit to Government
NRC (LTO)	National Rural Credit (Long-Term Operations)
NRC (S)	National Rural Credit (Stabilisation)
NRE	Non-Resident External
NRF	National Renewal Fund
NRI	Non-Resident Indian
NRNR	Non-Resident (Non-Repatriable)
NRO	Non-Resident Ordinary
NRY	Nehru Rozgar Yojana
NSC	National Savings Certificate
NSE	National Stock Exchange
NSO	National Savings Organisation
NSSO	National Sample Survey Organisation
NTS	Neighbourhood Travel Scheme
OBC	Other Backward Classes
OCB	Overseas Corporate Bodies
OCR	Optical Character Recognition
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
OFIs	Other Financial Institutions
OGL	Open General Licence
OIL	Oil India Ltd
OLA	Official Languages Act
OLIC	Official Language Implementation Committee
OMO	Open Market Operations
ONGC	Oil and Natural Gas Corporation Ltd

OPEC	Organisation of the Petroleum Exporting Countries
OSMOS	Offsite Monitoring and Surveillance
OTC	Over the Counter
OTCEI	Over-the-Counter Exchange of India
P&SB	Punjab and Sind Bank
PACS	Primary Agricultural Co-operative Credit Societies
PAD	Public Accounts Department
PAR	Performance Appraisal System
PC	Personal Computer
PC–AT	Personal Computer–Advanced Technology
PCFC	Pre-shipment Credit in Foreign Currency
PD	Primary Dealer
PDM	Primary Dealers’ Market
PDO	Public Debt Office
PDS	Public Distribution System
PERT	Programme Evaluation Review Technique
PEXSEM	Preparing Ex-servicemen for Self-Employment
PF	Provident Fund
Ph.D.	Doctor of Philosophy
PLDB	Primary Land Development Bank
PLR	Prime Lending Rate
PM	Prime Minister
PMIUPEP	Prime Minister’s Integrated Urban Poverty Eradication Programme
PMO	Prime Minister’s Office
PMRY	Prime Minister’s Rozgar Yojana
PMS	Portfolio Management Scheme
PNB	Punjab National Bank
POL	Petroleum, Oil and Lubricants
PPD	Personnel Policy Department
PPF	Public Provident Fund
PRD	Press Relations Division

PRO	Press Relations Officer
PSBs	Public Sector Banks
PSCFC	Post-shipment Credit in Foreign Currency
PSU	Public Sector Undertaking
PWCS	Primary Weavers' Co-operative Societies
QIS	Quarterly Information System
R&D	Research and Development
RBI	Reserve Bank of India
RBIA	Reserve Bank of India Archives
RBINet	Communication Software
RBISB	Reserve Bank of India Services Board
RBSC	Reserve Bank Staff College
RBWO	Reserve Bank Workers' Organisation
RCF	Report on Currency and Finance
RE	Revised Estimate
REER	Real Effective Exchange Rate
REP	Replenishment Licence
Repo	Repurchase Agreement
RFC	Resident Foreign Currency
RIDF	Rural Infrastructure Development Fund
RIFEE	Returning Indian Foreign Exchange Entitlement
RISC	Reduced Instruction Set Computer
RM	Reserve Money
RNBC	Residuary Non-Banking Company
RO	Regional Office
RPA	Rupee Payment Agreement
RPCD	Rural Planning and Credit Department
RPSL	Real Property Security Law
RRB	Regional Rural Bank
SAA	Service Area Approach
SAARC	South Asian Association for Regional Co-operation

SAC	Standing Advisory Committee
SAFB	Specialised Agricultural Finance Branch
SAL	Structural Adjustment Loan
SAMIS	Service Area Monitoring and Information System
SAO	Seasonal Agricultural Operations
SAP	State Action Plan
SBI	State Bank of India
SBICAPS	State Bank of India Capital Market Ltd
SC	Scheduled Caste
SCB	Scheduled Commercial Bank
SCCIF	Standing Committee on Co-ordination of Institutional Finance
SCICI	Shipping Credit and Investment Company of India Ltd
SD	Satellite Dealer
SDDS	Special Data Dissemination Standards
SDR	Special Drawing Rights
SEANZA	South-East Asia, New Zealand, Australia
SEB	State Electricity Board
SEBI	Securities and Exchange Board of India
SEEUY	Self-Employment Scheme for Educated Unemployed Youth
SEPUP	Self-Employment Programme for Urban Poor
SEZ	Special Economic Zone
SFC	State Financial Corporation
SFPP	Special Foodgrains Production Programme
SFT	Store and Forward Telegraph
SGL	Subsidiary General Ledger
SHCIL	Stock Holding Corporation of India Ltd
SHG	Self-Help Group
SICA	Sick Industrial Companies Act
SIDBI	Small Industries Development Bank of India
SIDC	State Industrial Development Corporation

SIIC	State Industrial and Investment Corporation
SJSRY	Swarna Jayanti Shahari Rozgar Yojana
SLBC	State-Level Bankers' Committee
SLDB	State Land Development Bank
SLIIC	State Level Inter-Institutional Committee
SLR	Statutory Liquidity Ratio
SME	Small and Medium Enterprise
SRTC	State Road Transport Corporation
SSI	Small Scale Industry
ST	Scheduled Tribe
STCI	Securities Trading Corporation of India Ltd
STP	Software Technology Park
SUME	Scheme for Urban Micro-Enterprises
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TDICI	Technology Development and Information Company of India Ltd
TMF	Textiles Modernisation Fund
TT	Telegraphic Transfer
U.P.	Uttar Pradesh
UBD	Urban Banks Department
UBI	United Bank of India
UBS	Union Bank of Switzerland
UBSP	Urban Basic Services for the Poor
UCB	Urban Co-operative Bank
UCO Bank	United Commercial Bank
UK	United Kingdom
UNIX	Uniplexed Information Computing System
URL	Uniform Resource Locator
URR	Uniform Regulations and Rules
US	United States
USAID	United States Agency for International Development

USSR	Union of Soviet Socialist Republic
UT	Union Territory
UTI	Unit Trust of India
VDS	Voluntary Disclosure Scheme
VECC	Voluntary Executive Corps Cell
VSAT	Very Small Aperture Terminal
WCTL	Working Capital Term Loan
WMA	Ways and Means Advances
WPI	Wholesale Price Index
WSS	Weekly Statistical Supplement
Y2K	Year 2000
ZTC	Zonal Training Centre

# 1

## Introduction and Overview

This fourth volume of the institutional history of the Reserve Bank of India covers 16 years from 1981–82 to 1996–97, ending shortly before the onset of the South-East Asian crisis in mid-1997. Thus, it covers the 1980s and a major part of the 1990s. It partly encompasses the period of the governorship of Dr I.G. Patel (December 1, 1977 to September 15, 1982) to start with and ends with the governorship of Dr C. Rangarajan. It covers fully the periods of the governorship of Dr Manmohan Singh (September 16, 1982 to January 14, 1985), Shri A. Ghosh (January 15, 1985 to February 4, 1985), Shri R.N. Malhotra (February 4, 1985 to December 22, 1990), Shri S. Venkitaramanan (December 22, 1990 to December 21, 1992) and Dr C Rangarajan (December 22, 1992 to November 22, 1997).

### THE BROAD APPROACH

This is an institutional and official history. The description and analysis of the events, policy developments and operations have been brought out in the historical context. The narrative draws mainly from official documents, such as file notings, official letters and other communications and periodic publications of the Reserve Bank, particularly the Annual Report, Report on Trend and Progress of Banking in India and Report on Currency and Finance. It also draws from the official publications of the Government, such as the Economic Survey and the Union Budget.

In addition, the speeches of the top management of the Reserve Bank were found to be rich sources in highlighting the historical context and policy perspectives. Media reports and research reports that were interpretative are also referred to, where necessary, to give a reasonable balance of different perceptions. Besides, differences in viewpoints at

times between the Government and the Reserve Bank have been brought out to emphasise the underlying spirit of co-operation and co-ordination in policies. File notings within the Reserve Bank that showed different opinions and nuanced arguments by officials, particularly on new policies and approaches, were also taken into account wherever possible and were considered useful for a better understanding of the rationale for the decisions that were finally taken.

This volume is the outcome of about three years' team effort, mostly from the present and former officials of the Reserve Bank guided by an independent advisory committee chaired by Dr Bimal Jalan, former Governor. The volume consists of two parts, *viz.*, Part A and Part B.

## TWO DISTINCT PHASES

The defining event of the period under the purview of the present volume was the balance of payments (BoP) crisis of 1991 that fell almost in mid-course between 1981 and 1997. The period covered in this volume falls into two distinct phases: pre-crisis and post-crisis, or pre-reform and post-reform. The BoP crisis of 1991 and the consequent wide-ranging economic and financial sector reforms represented a definitive and a major structural break in the Indian economic system. It also signified a major shift in the underlying economic philosophy, political thinking and direction, which brought about changes in economic policies and operations. It would not, therefore, be fair to treat the history of this period as a continuum, either functionally or chronologically.

In narrating the events, the approach, as followed in earlier volumes, has been to deal with developments functionally and, within each function, to cover the events according to their significance and not necessarily in a chronological sequence. The chapter titles have been identified accordingly. Given the defining event of 1991, the focus of the chapters varies between the two phases, (*i.e.*, 1981 to 1989 and 1989 to 1997) as also the macroeconomic contexts. The phases are entitled Consolidation and Early Liberalisation: 1981 to 1989 and Crisis and Reforms: 1989 to 1997. Each phase begins with an analysis of the macroeconomic context and ends with concluding remarks to enable readers to capture the fundamental features distinguishing the two periods. The periodisation is broadly indicative and is drawn with a view to trace the turning points in public policy and macroeconomic management. However, data and the events are often referenced across the periods to present the facts in a proper perspective.

With fiscal profligacy overshadowing monetary policy during the 1980s, the Reserve Bank was concerned about the need for reducing the fiscal deficit to improve the efficacy of monetary policy. With the onset of reforms, fiscal consolidation, the activation of public debt management and freeing the Reserve Bank from automatic monetisation of budget deficits became dominant issues, along with sound exchange rate management from the early 1990s. Accordingly, a separate chapter has been devoted to the monetary-fiscal nexus in the first phase, while a chapter on public debt management has been included in the second phase. Monetary management had to deal with the new market-oriented environment by shifting the focus to indirect instruments for policy interventions. Monetary policy also gained significant autonomous status after the phased elimination of automatic monetisation of budget deficits in the latter phase. Alongside, when the external sector was opened up, controlled foreign exchange regime gave way to current account convertibility and liberalisation of the capital account. The 1990s saw significant relaxations in exchange controls and fixed exchange rate system gave way to an increasingly managed float regime of the Indian rupee. This is reflected in the differently-oriented coverage of the external sector between the two phases.

The banking and the financial sectors, devoid of market orientation until the 1980s, witnessed decontrol in several respects, leading to greater operational flexibility combined with elements of competition emerging even within the public sector, with the regulation focusing increasingly on strengthening prudential standards on par with international best practices. While the social objective of banking and the financial system in fulfilling the needs of the priority sector was retained, there was a reorientation of the priority sector in the 1990s, reducing the intensity of cross-subsidisation by freeing lending rates to a significant extent. The liberalisation of markets also meant that the Reserve Bank could devote greater attention to the development of various segments of financial markets, encompassing money, government securities and foreign exchange in terms of instruments, institutions and infrastructure. Hence, a separate chapter on financial markets has been included in the second phase.

While several major structural changes define the break in 1991, it was also thought necessary and equally important to bring out in some detail the prelude to the crisis itself, the political and economic environment leading to it along with the unprecedented, co-ordinated and integrated policy response from the Government and the Reserve Bank to resolve

the crisis during the period from 1989–90 to 1992–93, amidst intense political uncertainty. While this period is not treated as a separate phase in narration, two chapters deal exclusively with the prelude to the external payments crisis, and management and resolution of the crisis.

#### MANAGING CHANGE: PRE-REFORM AND POST-REFORM

The most significant event during this period was the BoP crisis of 1991, providing the major context for the onset of comprehensive economic reforms in India. The two decades thus fall into two phases, namely, pre-reform and post-reform. Since this was signified by a paradigm change and a marked transformation in the underlying philosophy behind economic and financial policies at both the political and executive arms of the Government, the role of the Reserve Bank also logically moved in tandem and the Bank responded to the new challenges posed by this transformation. How the Reserve Bank successfully faced this challenge and handled related policies and operations in harmony with the Government, with occasional dissent with the Government in the larger public interest, is reflected in narration of events covered by this volume.

The Reserve Bank has undergone continuous transformation over time in response to the changing environment while formulating and implementing monetary and financial policies since its inception in 1935. The functions of the Reserve Bank have emerged out of the diverse roles entrusted to it. With the onset of economic planning and structural transformation of the Indian economy, the role of the Reserve Bank expanded manifold. Although it was founded on the pattern of European central banks, “the evolution of its functions has undergone radical transformations from traditional central banking in the formative years to that of building institutional infrastructure during the developmental phase and to ensuring financial sector soundness in the reform phase.”<sup>1</sup>

As the central bank of an emerging independent India, the Reserve Bank had to play a proactive role in the nation-building process in filling the resource gaps of the Government in Plan financing and in creating the necessary financial infrastructure. The Reserve Bank played a crucial ‘supply leading’ role in the development of the financial sector, in contrast with the ‘demand following’ pattern of financial development observed in advanced countries. In the initial years, therefore, the emphasis was

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1. Reserve Bank of India. *Report on Currency and Finance, 2004–05*.

on putting in place the institutional machinery and the base to support development planning. This got a renewed thrust with the nationalisation of 14 major commercial banks in 1969, followed by another 6 banks in 1980.

#### CENTRAL DIRECTION TO MARKET ORIENTATION

The central direction of the economic policies, mostly emanating from the Government, dominated the functions and operations of the Reserve Bank in the pre-reform period. In the absence of operational independence, *de jure*, the Reserve Bank worked in unison with the Government in framing rules and exercising regulation over the banking and financial institutions (FIs) as also in operating its credit and interest rate and exchange rate policy tools. Most of the decisions were announced in close consultation with the Government, even while the Bank expressed its concerns on certain matters in its periodic publications, in particular the Annual Reports.

With the policy paradigm shifting from central direction to market orientation, the imprint of the Government's dominance on the Reserve Bank functioning and policies slackened. This should be viewed as a natural concomitant of the post-reform environment. In a way, this shift meant that the Reserve Bank gained more discretion, operational flexibility and manoeuvrability in exercising powers, and the Government also increasingly recognised the need for granting a rather expanded and delegated role to the Bank. This central thread can be seen through all the chapters of this volume. To the extent that, *de jure*, the Reserve Bank is still not an autonomous institution and works in close co-ordination and harmony with the Government, this change of role could be considered as constrained discretion or independence.

One major gain of the transformed role was the freedom the Reserve Bank obtained from automatic monetisation of government deficit that had characterised the macroeconomic scene right from the mid-1950s. The Reserve Bank also constantly refined its operating procedures and instruments in the direction of developing sound financial markets and financial infrastructure. The Reserve Bank acquired technical expertise and delivery capabilities in handling public debt management and developing the government securities market. This enabled it to efficiently discharge the twin responsibilities of debt and monetary management, while meeting government borrowing requirements and market expectations. Another significant area was exchange rate management, where the Reserve Bank carved out a niche for itself.

## ADAPTATION RATHER THAN ADOPTION

The Reserve Bank had, in the process, to situate itself on a new learning curve with every change that was influencing the global economy, in turn impacting the domestic economic and financial conditions. Fortunately, its culture, built over the years, kept it as a learning institution. This process was substantially strengthened in the post-reform period. The Reserve Bank chose a consultative approach in policy formulation and a number of institutional arrangements were put in place. While constantly absorbing international developments in central banking and finance, India's policies remained essentially home-grown, as the narrative of this volume indicates.

On the issue of integrating the Indian financial markets with the global financial system, India has chosen to proceed cautiously and in a gradual manner, adjusting the pace of liberalisation with the underlying macroeconomic developments, the state of readiness of the domestic financial system and the dynamics of the international financial markets. This stand was not only because of its inherent preference for gradualism but also because of its recognition of the distinctive institutional and legal features. The Reserve Bank took a number of initiatives to strengthen the supervisory and regulatory framework, while simultaneously providing sufficient flexibility to the FIs to respond to the growing competition and take advantage of the business opportunities unfolded by technological advancements. While pursuing the reforms, the Reserve Bank made conscious efforts to improve systemic efficiency by re-orienting its traditional functions including currency management and regulation of payments and settlement systems. All these initiatives facilitated strengthening of the financial sector in India, enabling it to adapt to the emerging environment and this was reinforced by a change in the perception of the world community towards India as an upcoming economic powerhouse after the reforms era beginning in the 1990s.

## REFORMS IN THE 1980s

While 1991 marked the major paradigm shift, it was not a big bang approach to reforms as was the case in many countries during the post-Bretton Woods breakdown period from the late 1970s. The early seeds of liberalisation and reforms were sown during the 1980s, which helped the country to step into the post-1991 phase of relatively sharp and comprehensive reforms seamlessly. In a way, the reforms of 1991 could be viewed as the culmination of several steps taken at both the Government

and the Reserve Bank level, particularly since the mid-1980s, despite the weak political environment and support. The 1980s reforms broadly covered three areas, *viz.*, industry, trade and taxation along with deft exchange rate management. It is pertinent to note that this was the time when similar policies were gaining ground across many countries following the examples of the UK and the US. However, the reforms initiated in the mid-1980s by the Prime Minister, Shri Rajiv Gandhi, were paused due to the uncertain political developments in the late 1980s.

In the year 1985–86, a wide array of industrial policy initiatives aimed at removing constraints on growth and creating a more dynamic industrial environment, which sought to accelerate growth, investment and productivity, were taken. In March 1985, the Government announced delicensing of 25 broad categories of industries. By December 1985, liberalisation was extended to 82 bulk drugs, related drug formulations and to the Monopolies and Restrictive Trade Practices Act (MRTP) and Foreign Exchange Regulation Act (FERA) companies. To those industries remaining within the ambit of licensing, the facility of broad-banding was accorded to allow for rapid changes in their product mix without fresh licensing. Apart from the general policy, a number of important measures were adopted in key sectors of industry.<sup>2</sup> By 1990, the number of delicensed industries rose to 31.

The investment limit below which no industrial licence would be required was raised to ₹ 50 crore in backward areas and ₹ 15 crore elsewhere, provided the investments were located in both cases at stipulated minimum distances from urban areas of specified sizes. Broad-banding, which allowed firms to switch production between production lines such as trucks and cars, was introduced in January 1986 in 28 industry groups. This provision was significantly expanded in the subsequent years and led to increased flexibility in many industries. In 1986, firms that reached 80.0 per cent capacity utilisation level in any of the five years preceding 1985 were assured authorisation to expand capacity up to 133.0 per cent of the maximum capacity utilisation reached in those years. Firms that came under the purview of the MRTP Act were subject to different rules and could not take advantage of the above liberalised policy changes. To relax the hold of the licensing and capacity constraints on these larger firms, in 1985–86, the asset limit above which firms were subject to MRTP regulations was raised from ₹ 20 crore to ₹ 100 crore. As a result, as many

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2. Government of India. *Economic Survey, 1985–86*.

as 90 out of 180 large business houses registered under the MRTP Act were freed from restrictions on growth in established product lines.

A long term fiscal policy (LTFFP) was announced for the first time in December 1985. Major reforms were introduced in the tax system. The multipoint excise duties were converted into a modified value-added (MODVAT) tax, which enabled manufacturers to deduct excise paid on domestically produced inputs and countervailing duties paid on imported inputs from their excise obligations on output. By 1990, MODVAT came to cover all the sub-sectors of manufacturing except the petroleum products, textiles and tobacco. This change significantly reduced the taxation of inputs and the associated distortions. In parallel, a graduated schedule of excise tax concessions for small scale industries (SSIs) was introduced, which reduced incentives for them to stay small.

Industrial reforms were combined with stock market reforms with the establishment of the Securities and Exchange Board of India (SEBI) in 1988–89 and two new mutual funds as subsidiaries of public sector commercial banks. The Unit Trust of India (UTI) floated the India growth fund during August 1988 to provide an opportunity for non-resident Indians (NRIs) and other foreign investors to participate indirectly in the Indian securities market. Another important development during 1988–89 in the field of capital markets was the establishment of a framework for launching venture capital companies and venture capital funds.<sup>3</sup>

On the foreign trade front, in April 1985, the export-import policy was announced for the first time for a period of three years with the objective of imparting continuity and stability to the policy regime. The open general licence (OGL) list was steadily expanded. Having disappeared earlier, this list was reintroduced in 1976 with 79 capital goods items on it. The number of capital goods items included in the OGL list expanded steadily reaching 1,007 in April 1987, 1,170 in April 1988, and 1,329 in April 1990. These changes resulted in significantly expanded scope for imports of machinery and raw materials by entrepreneurs.

Several export incentives were introduced or expanded, especially after 1985, which helped expand imports directly when imports were tied to exports and indirectly by relaxing the foreign exchange constraints. This factor became particularly important during the period from 1985 to 1990 when exports expanded rapidly. In addition to a substantial widening of

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3. Government of India. *Economic Survey, 1988–89*.

the coverage of the products available to exporters against replenishment licences, several export incentives were introduced between 1985–86 and 1989–90.

Beginning in 1986–87, Indian exports grew considerably, faster than growth in world trade and comparable to other developing countries, thanks, *inter alia*, to strategic exchange rate management. Since inflation in India during this period rose faster than that of its trading partners, it was necessary to bring about adjustments in the nominal effective exchange rate (NEER), which meant a considerable change in the official policy towards exchange rate depreciation. Based on the real effective exchange rate (REER), the rupee was depreciated by about 30.0 per cent from 1985–86 to 1989–90.

These reforms contributed to a pick-up in economic growth. Growth during the 1980s was higher than in the preceding decades, with a significantly high growth rate recorded at 7.6 per cent during 1988–1991. Growth in the 1980s, however, was fragile and unsustainable, since the reforms process in the 1980s was limited in its scope and without a clear roadmap. Nevertheless, the reforms process of the 1980s must be viewed as a trendsetter. Further, the 1980s reforms proved to be more enduring and not isolated, sporadic, or subject to quick reversal as in the previous decades. These reforms crucially elevated the confidence at the official level regarding the ability of policy changes to spur growth without disruption. However, as the growth during the 1980s was also propelled by fiscal expansion, it became unsustainable and led to the crisis of 1991.

#### DOMESTIC POLITICAL DEVELOPMENTS

Despite early liberalisation and reforms contributing to higher growth in the late 1980s, India, particularly towards the close of the decade, was afflicted with a series of events causing political uncertainty. In January 1980, the Congress party came to power after a gap of about three years. Smt Indira Gandhi assumed charge as the Prime Minister and Shri R. Venkataraman was appointed Finance Minister. The economic environment, at this point, was not favourable. Inflation was high, running at 22.0 per cent. Foreign exchange reserves, following the second oil crisis of 1979–80, had depleted. There was an unprecedented drought in the country and additional resources were needed to fund the Sixth Five Year Plan.

The budget had no room for manoeuvre in the early 1980s and no major change in the economic paradigm was envisaged. The budget was essentially a fire-fighting one, designed to contain the budget deficit and

the deficit on the external current account. The expectations that the fiscal contraction of 1980–81 could resolve the twin crisis of high inflation and a large current account deficit (CAD) were short-lived. By the time the budget for 1981 came around, it became clear that India was in the middle of a major crisis and that something more was required to be done to overcome the situation.

A loan from the International Monetary Fund (IMF) from its extended fund facility (EFF) was arranged in November 1981 and, helped by a good monsoon and prudent monetary policy, the crisis was resolved by the beginning of the next financial year. Inflation was down to high single digit, the IMF loan had given some breathing space for imports, exports were starting to pick up and oil prices had stabilised.

The three budgets from 1982 to 1984 presented by the Finance Minister, Shri Pranab Mukherjee, steadily raised Plan allocations to all ministries. On October 31, 1984, Smt Indira Gandhi was assassinated. Her place was taken by Shri Rajiv Gandhi, who had a vision to take the Indian economy forward on a higher growth path. Shri V.P. Singh took charge as Finance Minister and the budget of 1985 was marked by several liberalisation measures. He made steep reductions in taxes, liberalised imports, eased the rigours of industrial licensing and decided that, up to a point, the job of resource allocation would be entrusted to the markets. The markets went bullish and a primary issues boom started, which, with a few interruptions, continued for the rest of the decade.

The budget for 1986 carried forward the process that began in 1985 by cutting taxes further, liberalising imports, reducing tariffs, *albeit* marginally, and pumping more money into the system. Better tax compliance and stiff tax administration, it was believed, would help stabilise the fiscal position. Due to internal conflicts surfacing again within the ruling party, in January 1987, Shri Rajiv Gandhi decided to take over the finance ministry himself.

The Government seemed to assume that high fiscal deficits would be sustainable. It did not pay attention to the warnings, including those by the Reserve Bank, especially on the CAD, which was partly a spill-over of the fiscal deficit. Disillusionment with the Government had set in. Shri V.P. Singh resigned from the Government over the Bofors issue in April 1987.

In August 1988, seven opposition parties formed the National Front with Shri V.P. Singh as its convenor. There surfaced several regional and communal tensions across the country. By the end of 1988–89, political stability seemed to have returned and Shri S.B. Chavan took charge as

Finance Minister. By 1989–90, the budget deficits had widened to reach unsustainable levels. It was clear that unless the next Finance Minister, Prof Madhu Dandavate, took some dramatic decisions, a crisis loomed large.

General elections were held in November 1989, followed by the formation of a Government under Shri V.P. Singh as Prime Minister. As this was a coalition Government, there were news reports of intense lobbying for leadership and internal conflict between coalition partners continued to surface till announcement of acceptance of the Mandal Commission report in August 1990. The announcement set off a series of demonstrations and agitations that continued for several months. The fragile National Front coalition faced a nation-wide crisis in the summer of 1990. Shri Chandra Shekhar broke off from the Government and, with the support of the Congress party he took oath as Prime Minister in November 1990. In less than a year, in February 1991, the support was withdrawn and the scheduled budget could not be passed. The former Prime Minister, Shri Rajiv Gandhi, was assassinated in May 1991. General elections were held in May 1991 and Shri Narasimha Rao formed the Government, which took over in June 1991. Thus, within a span of two years, during which the country faced a stressful BoP position, there were three governments at the Centre. This was a major factor that explains some delay in the Government approaching international financial institutions for financial assistance well ahead of the onset of the BoP crisis in 1991.

When the new coalition Government assumed power after a prolonged period of political uncertainty preceding the crisis, under the leadership of the Prime Minister, Shri Narasimha Rao, it was left to the Finance Minister, Dr Manmohan Singh, and his team of bureaucrats to launch and spearhead wide-ranging economic and financial sector reforms. Even after the Janata Government took the reins of political power after 1996, the spirit of economic and financial reforms initiated in 1991 got strongly embedded in the political economy of the country.

## THE ECONOMY AND THE GOVERNMENT

In the prevailing socioeconomic milieu, it was the Government that set the contours of public policy in every sphere and a policymaking body like the Reserve Bank supported such initiatives for best outcomes, although ideally the latter ought to have enjoyed operational freedom in specific domains such as monetary management and regulation of the financial system. The institutional history has to be cognisant of this fundamental and delicate relationship between the Government and the Reserve Bank.

While the macroeconomic contexts of developments are captured in the text, an attempt is made here as part of the introduction to the volume to provide a glimpse of the delicate relationship that explains the interaction between the political economy and the evolution of Reserve Bank policies.

India's development strategy and economic policy was served by centralised planning and direction to help attain rapid growth and ensure equity with distributive justice. The average growth rate during the first three decades after independence was around 3.5 per cent and there was increasing realisation among policymakers that most of the controls and regulations had not delivered in the absence of adequate incentives. Following this recognition, the 1980s were marked by efforts initiated in various directions to restore reasonable price stability through a combination of tight monetary policy, fiscal restraint and some structural reforms. These initiatives were specifically aimed at changing the extant procedures associated with inward-oriented trade and investment practices. Although these shifts were not in the form of a comprehensive package and lacked an overarching framework to ensure reversal of the protectionist bias of the trade regime and other distortions, they started yielding results nevertheless. As a result, the Indian economy moved to a higher growth trajectory during the 1980s as compared with the previous three decades. The average annual growth rate of gross domestic product (GDP) rose to 5.7 per cent during the Sixth Plan period (1980–1985) and was 5.8 per cent during the Seventh Plan period (1985–1990). The high growth performance, however, was not achieved without certain interrelated adverse consequences and macroeconomic distortions.

On the flip side, the developments, *inter alia*, included deterioration in public sector savings from the mid-1980s. Public sector savings constituted about 4.0 per cent to 5.0 per cent of GDP between the mid-1970s and early 1980s. The situation, however, reversed from 1984–85 when public sector savings decelerated from 5.1 per cent during 1982–83 to 1.8 per cent of GDP during 1990–91. These savings improved marginally thereafter to more than 2.0 per cent of GDP, except in 1993–94, and were recorded at 2.2 per cent of GDP during 1996–97. Partly reflecting this trend, the combined fiscal deficit, which was 7.5 per cent of GDP during 1980–81, escalated to 9.4 per cent during 1990–91. The bulk of this deterioration in the fiscal deficit was accounted for by the Centre's fiscal deficit, which worsened from 6.1 per cent of GDP during 1980–81 to 8.3 per cent during 1990–91. The fiscal deficit of the Central Government hereon showed improvement and was recorded at 4.7 per cent in 1996–97.

Second, the country's BoP deteriorated continuously through the 1980s, and significantly from the mid-1980s. The trade deficit remained more or less constant at around US\$ 7.5 billion for the entire decade of the 1980s. However, the CAD deteriorated steadily from an average of (-)1.3 per cent of GDP during the Sixth Plan to (-)2.3 per cent during the Seventh Plan and further to (-)3.0 per cent in 1990–91. The deterioration could be attributed primarily to the rapid increase in interest payments. The bulk of the increase in interest payments emanated from a sharp rise in private capital receipts, in particular external commercial borrowings (ECBs) and deposits by NRIs, which on one hand had a higher interest liability and on the other hand, shorter maturities. As a consequence, the Government had to step up domestic borrowings and its foreign exchange reserves in order to bridge the gap. This was necessitated by the fact that the proportion of CAD financed by external assistance declined substantially from about 75.0 per cent in the early 1980s to about 22.0 per cent in 1990–91. Hereafter, the implementation of structural reforms resulted in the CAD/GDP ratio improving significantly to (-)0.4 per cent in 1993–94. The ratio stood at (-)1.2 per cent in 1996–97.

The above factors culminated in the country's external liabilities rising sharply from about US\$ 23.0 billion in 1980–81 (12.0% of GDP) to US\$ 82.0 billion in 1990–91 (24.0% of GDP). The debt-service ratio (debt-service payments to current account receipts) correspondingly deteriorated from 10.0 per cent in 1980–81 to 30.0 per cent in 1990–91. Several macroeconomic imbalances engulfed various segments of the economic system. The economy thus plunged into a crisis that was unprecedented in the economic history of the nation. Dr I.G. Patel in the Foundation Day lecture delivered at the Indian Institute of Management (IIM), Bangalore, on October 28, 1991 stated:

With the new wave of ushering in the twenty-first century, we had a series of financial excesses — large increases in defence expenditures, unbridled growth of subsidies, a quantum jump in public salaries and indeed a philosophy stated in so many words that money did not matter. It was already clear by 1986 that we were in an internal debt trap which would soon engulf us in an external debt trap. Rather than take any remedial action, we went merrily along, borrowing more and more at home and on shorter and shorter terms abroad. The climate for official and concessional capital had turned irretrievably adverse for many years. But our response to that was not to strive harder for self-reliance but to

increase the amount as well as the proportion of short-term debt in our external indebtedness...We mismanaged macro-economically in the 1980s and compounded the error by liberalising imports before restoring a better fiscal and monetary balance.

#### FISCAL BALANCE

The decade of the 1980s was characterised by government revenue expenditure consistently exceeding revenue receipts. The fiscal deficit of the Central Government had grown to 8.3 per cent by the year 1990–91, financed by a substantial increase in domestic and external borrowings. The external debt situation experienced in 1990–91 was largely a result of this trend. Further, the interest payments on account of additional debt raised domestically by the Government shot up by about 20.0 per cent per annum during the period from 1985 to 1990. The burgeoning deficit levels rendered the stabilisation efforts rather difficult. The Government, therefore, had little option left than to rein in fiscal deficit through increasing tax revenues, reducing revenue expenditures, particularly subsidies, and reducing public investments in infrastructure by encouraging greater private sector participation. To further inculcate fiscal discipline and rein in the temptation to finance the deficit through money creation at relatively low cost, the Government entered into an agreement with the Reserve Bank in September 1994 to bring down the fiscal deficit, in a phased manner, to nil by 1997–98. This was a historic event in the economic history of the country and particularly the institutional history of the Reserve Bank.

The cornerstone of the economic reforms programme was the comprehensive reforms agenda for both direct and indirect tax systems. The tax reforms committee set up by the Government in 1991 (Chairman: Dr Raja J. Chelliah) proposed a reforms package. Important elements of this package, *inter alia*, included a reduction in the average customs duty from above 100.0 per cent in 1990–91 to about 25.0 per cent within a reasonable time frame. It was intended that any reduction in revenue inflow on this account would be made good from other sources. The multipronged strategy for direct tax reforms was based on the principle of moderate rates, a wider base and better tax administration, which yielded substantially higher collections.

In the field of indirect taxes, the committee proposed simplifying and rationalising the tax structure and continuing the move towards moderate rates. This meant avoiding high and multiple rates, narrowing

the exemptions, unifying rates where required, introducing flexibility in the system, expanding the tax base and minimising litigation. After the implementation of recommendations of the tax reforms committee, tax collections, which increased at an average annual rate of 16.5 per cent per annum during 1980–81 to 1990–91, slipped drastically to only 8.2 per cent in the transition phase of 1991–1994. The collections, however, posted an uptrend from 1994–95, when there was a sharp pick-up of 19.3 per cent that was higher than the average growth of the 1980s.

The thrust on curbing government expenditure continued during the 1990s. The total expenditure of the Centre declined from 20.0 per cent of GDP on average during the 1980s to about 18.0 per cent in the post-reform period.<sup>4</sup> The major part of this 2.0 per cent reduction was accounted for by capital expenditure, which shrank from 6.1 per cent of GDP in 1990–91 to 4.4 per cent in 1994–95, *i.e.*, by 1.7 percentage points. As a result, the share of capital expenditure in total expenditure dropped from around 30.0 per cent to 24.0 per cent and further down to 21.0 per cent in 1996–97. Of the components of revenue expenditure, the interest payments posted an increase from 4.0 per cent of GDP in 1990–91 to 4.6 per cent in 1994–95 and to 4.7 per cent in 1996–97. The burgeoning interest payments called for careful monitoring, since these posed a real problem and were anticipated to rise further due to retirement of low-cost old debt and its replacement with high-cost fresh debt in addition to a substantial increase in net government borrowings from ₹ 10,570 crore during 1990–91 to above ₹ 25,000 crore in 1994–95 and further to ₹ 32,892 crore in 1996–97. This was against the backdrop of the Government's decision to reduce the extent of money finance (monetisation) of fiscal deficit in order to control inflationary pressures. As pointed out in the mid-term appraisal of the Eighth Five Year Plan:

The need to contain money finance (monetisation) of the Government's fiscal deficit has been accentuated primarily by the need to contain increase in reserve money and the over-all money supply in the context of a massive increase in the liquidity in the Indian economy arising out of foreign portfolio inflows, as well as the need to prevent a nominal appreciation of the rupee in order to protect the export performance. It appears therefore

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4. Government of India (1996). *Draft Mid-term Appraisal of the Eighth Five Year Plan 1992–1997*. Planning Commission. September.

that the increase in private international liabilities has led to a corresponding increase in public domestic indebtedness, with the positive effect largely being the rapid build-up of foreign exchange reserves. The net outcome, however, is a permanent bulge in the government's interest liabilities which may have adverse repercussions on investments in future.

#### INDUSTRIAL DELICENSING

Industrial licensing was the backbone of the economic regime right from the mid-1950s on the grounds of safeguarding the limited quantum of foreign exchange reserves in the face of high demands for imports of both raw materials and finished goods, to drive growth and to protect domestic initiatives for industrial production. The licensing system, however, led to stifling of incentives to invest as well as to misgovernance. It was, therefore, decided to introduce industrial delicensing, which meant freedom from constraints on output, inputs, technology and location as well as free entry into delicensed category of industries. The first major initiative for delicensing was taken in 1988 when all industries, excepting 26 industries specified in the negative list, were exempted from licensing, subject to investment and location limitations. In June 1988, the Government introduced the growth centre scheme to promote industrialisation of backward areas. Further, in an attempt to transform India into a major partner and player in the global arena, the industrial licensing policy of 1991 abolished industrial licensing for most industries, barring a few that included defence and social and environment protection. Compulsory licensing was required only in respect of 18 industries and the small scale sector continued to enjoy reservation. Automatic approvals for technology upgrading, larger inflow of foreign direct investment (FDI) in high-priority industries, 100.0 per cent FDI in most of the manufacturing industries in special economic zones (SEZs) and restructuring of public sector units were some elements of the new industrial policy.

#### BUILD-UP TO THE CRISIS AND THE REFORMS AGENDA

By 1991, the Government was headed into an internal debt trap as its interest payments on ever-increasing borrowings ballooned. In 1992, these payments accounted for a quarter of all government revenues and the proportion was rising. Externally, the short-term creditors were losing confidence in the economy and beginning to take their money out.

Inflation was at around 15.0 per cent and there seemed no real prospect of getting it under control. The macroeconomic imbalances, partly policy-induced and partly caused by external developments, hastened the severity of the economic crisis that was already lurking around the corner.

In the early 1991, India's holdings of foreign exchange, which are also referred to as forex reserves in this volume, were just US\$ 1.1 billion, enough to cover, despite widespread import restrictions, a mere five weeks of imports. It was obliged to mortgage its gold to the Bank of England (BoE) and impose further and more severe import restrictions. These actions, however, were not enough. The crisis was the result of the confluence of adverse developments in fiscal, monetary, debt and BoP areas, all of them interrelated. The decade of the 1990s marked a paradigm shift from the 1980s in terms of the package of reforms. Whereas the liberalisation measures undertaken during the 1980s lacked an overarching framework, the reforms of the 1990s were part of a well-designed and co-ordinated set of macroeconomic and structural policy measures in a systematic and integrated manner to pull the economy out of a severe economic crisis.

In 1990–91, oil prices escalated sharply as a result of the gulf war. During the year, the trade balance deteriorated sharply by US\$ 2.0 billion and remittances from Indian workers in the gulf also diminished. As a result, the current account balance declined by almost US\$ 3.0 billion and the foreign exchange reserves also plunged to about US\$ 1.0 billion by the end of 1990–91. These adverse developments led to a crisis of confidence in the Indian economy among international lenders. By April 1991, not only was there a significant withdrawal of NRI deposits from India, but several international banks also stopped honouring Indian letters of credit (LCs) for import transactions. Serious inflationary pressures posed a threat to the stability of the system against the backdrop of scarcity of essential commodities and deterioration in fiscal discipline. By June 1991, the annual inflation rate was running at about 16.0 per cent, and the economy was on the verge of a major crisis.

In an effort to resolve the crisis, the Government initiated a series of stabilisation measures in July 1991 with the technical and moral support from the multilateral institutions. As an initial step, a substantial devaluation of the rupee was executed while retaining the controls on foreign exchange on imports imposed by the Reserve Bank. Further, the fiscal deficit of the Central Government was curtailed from 8.4 per cent in 1990–91 to 6.0 per cent in 1991–92. The Government formally approached the IMF and the

World Bank to provide BoP support by way of both financial and technical assistance, which helped ease the situation considerably. A process of structural reforms in trade and industrial policies was commenced, which aimed at correcting the macroeconomic distortions that had developed in the immediate past.

The Eighth Five Year Plan took cognisance of the setbacks suffered by the economy in 1990–91 and 1991–92 and observed:

...in view of the impact of structural adjustment programme, the resource crunch which the public sector is facing, and the need for correcting the fiscal imbalances, it would be prudent to plan more or less for the growth rate achieved during the decade and lay down foundations for higher growth in future.

The growth target and the macroeconomic parameters accompanying the set targets were, therefore, rather conservative compared with what they would have been, had the crisis situation not developed. The Plan envisaged a somewhat lower growth target than the Seventh Plan and placed greater reliance on domestic resources for investments. There was a clear emphasis on reversing the trend of imports growing faster than exports in order to avoid serious BoP and external debt difficulties.

While the economic benefits of reforms were widely recognised, questions were raised about the adverse impact of the reforms, namely, widening inequality among various segments of society and limited impact on poverty alleviation. The multilateral institutions, for their part, underscored the need for providing social safety nets when countries embarked on large-scale structural transformation. It was, therefore, pertinent to work out the medium term mechanisms for the implementation of reforms that would withstand the short to medium term effects on the vulnerable or weaker sections of society and on the economic and social infrastructure of the country, especially during the transition. Further, it was imperative to take steps to counter pessimism about the likely success and outcomes of the reforms in terms of output, investments, employment generation and general living standards.

#### SAVINGS AND INVESTMENT

The Eighth Five Year Plan visualised a significant step-up in the rate of investment in the Indian economy. As the years passed, it was realised that the expectations had not materialised. While the investment rate stood at 26.0 per cent in 1990–91, it gradually slid thereafter. The gross

domestic capital formation (GDCF) was 22.1 per cent in 1991–92 and at 22.5 per cent in 1993–94. This decline caused serious concern since the process of restructuring the Indian economy, as envisaged in the reforms agenda, pivoted around the levels of investment and their efficient use. The intention was to promote the efficiency of productive enterprises and to channelise resources into sectors where the economy had a competitive edge. Sluggishness in the investment rate could thwart such efforts. The rate of capital formation in the private corporate and household sectors was particularly low, declining from 17.4 per cent in 1990–91 to 11.5 per cent in 1993–94. The investment rate, however, showed signs of revival and stood at 25.5 per cent in 1994–95 and 24.0 per cent in 1996–97.

FDI, although highly encouraging when compared with pre-reform level, also did not match the expectations. While the approvals had been on track as envisaged, the actual inflows were not impressive. The receipts ranged from as low as 17.0 per cent of the approvals in 1992 to 33.0 per cent in 1994. This trend mirrored the uncertainty about the progress of reforms resulting in less-than-expected private investments. In this context, it was noted with concern that government investment had lagged behind, and this had serious consequences for the resource availability for infrastructure development with adverse effects on private sector initiatives. The investment rate, it was emphasised at the policy level, had to be maintained in order that the growth objectives were met. A glaring aspect of public investment was in the area of agriculture where public investment had declined by about ₹ 700 crore between 1980–81 and 1992–93, with no offsetting increase in private investment. The share of agriculture in gross capital formation had, as a result, halved from 18.0 per cent in 1980–81 to only 9.0 per cent in 1992–93.

To meet such vast investment requirements in various sectors of the economy, the Eighth Plan had envisaged a substantial step-up in domestic savings. However, the gross domestic savings (GDS) rate, which was at a high of 22.9 per cent in 1990–91, showed steady deterioration and was 21.3 per cent in 1992–93. This was primarily on account of a drop in the savings rate of the household sector from 18.5 per cent in 1990–91 to 16.5 per cent in 1992–93. Corporate savings had shown a rising trend, but public sector savings hovered around 2.0 per cent of GDP during the same period. The GDS rate, however, rose to 23.6 per cent in 1994–95 and stood at 22.4 per cent in 1996–97.

## THE EXTERNAL SECTOR

The country was able to tide over the BoP crisis as a result of far-reaching stabilisation efforts. The BoP situation and foreign exchange reserves position improved considerably from 1991-92 to 1993-94. The CAD, which stood at US\$ 10.0 billion in 1990-91, came down drastically to less than a billion dollars in the years 1993-94 and 1994-95. As a percentage of GDP, it improved from (-)3.0 per cent in 1990-91 to about (-)1.0 per cent in 1994-95. The sharp reduction in the CAD within a short period of three years obviated the need for exceptional external financing.

The improvement in the current account balance was accompanied by a turnaround in the capital account. The measures taken not only helped arrest capital flight, which was underway after the crisis, but also led to a surge in capital inflows, especially in the form of foreign portfolio investment. Foreign investment, which stood at US\$ 103.0 million during the year 1990-91, went up to US\$ 4.1 billion during 1993-94, and continued to rise thereafter, touching US\$ 6.1 billion during 1996-97. A major upsurge took place in portfolio investment, which escalated from a mere US\$ 6.0 million during 1990-91 to US\$ 3.5 billion during 1993-94 and remained flat at around US\$ 3.3 billion during the year 1996-97.

The expansion in capital inflows coupled with a declining CAD resulted in a substantial build-up of foreign exchange reserves (excluding gold and special drawing rights [SDRs]), which increased from about US\$ 5.8 billion at the end of 1990-91 (equivalent to about 1.3 months of imports) to over US\$ 19.0 billion by the end of 1993-94 and further rose to touch a level of US\$ 26.4 billion in 1996-97. The build-up in foreign exchange reserves reflected the positive response of the economy to the stabilisation and adjustment efforts. The policy actions relating to the depreciation of the rupee, easing of restrictions on the capital account, liberalising the current account and special measures to attract NRI deposits and foreign investment were notable in the 1990s. Besides, there was improved international understanding of the challenges of the economy in a constructive and helpful way, with support from the IMF and the World Bank for the policies that were formulated and implemented.

Imports declined consequent to the devaluation of the rupee. However, certain exogenous factors too affected the behaviour of imports. Imports of petroleum, oil and lubricants (POL) in dollar terms declined in the post-reform period, despite the fact that domestic output of petroleum was also falling. The decline occurred primarily in the wake of the fall in

international prices of crude oil in 1991 as a result of the general recovery of world oil output after the dislocation caused by the gulf war. Non-POL non-food imports, however, did not witness much increase on account of recessionary conditions in the real economy. The industrial revival in 1994–95, however, led to a reversal of this trend. Reduction in trade barriers gave a fillip to imports; caution was exercised during the import liberalisation process in order to avoid excessive high growth of imports during the transition phase.

The ratio of exports to GDP showed a gradual but a consistent improvement from 5.8 per cent in 1990–91 to 8.2 per cent in 1993–94 and further to 8.8 per cent in 1996–97. It was considered important to sustain export growth in this scenario so that the external debt burden did not exceed manageable levels. This prompted policymakers to analyse and assess export performance, focusing on the areas of strength, *i.e.*, the traditional items such as textiles and garments, handicrafts and gems and jewellery, and export of machinery and engineering goods. Sluggishness set in thereafter and exports growth was recorded at a low of 5.3 per cent in 1996–97. By 1993–94, the economy had pulled out of recession and the depreciation of the REER of the rupee between 1989 and 1993 also started to reverse. It was envisaged that the increased ‘pull’ of the domestic market in this scenario and the reduced profitability of exports would lead to a slowdown in export growth unless the investment pattern was re-oriented towards the exports sector.

Further, it was envisioned at this point that India’s export growth in the long run would have to be based on achieving competitive advantage through improved productivity and quality, and by focusing on product and market diversification. It was analysed by the policymakers that it was essential to adopt an active exchange rate policy, as it was the only direct instrument available for dynamic export promotion in the short run. Towards this end, the exim policy (1992–1997) stipulated steps for sustained export growth, which, *inter alia*, included enlarging the export promotion capital goods (EPCG) scheme; expanding and liberalising the advance licence scheme; rationalising schemes for export-oriented units (EOUs), export processing zones (EPZs) and electronic hardware and software technology parks; abolishing the advance customs clearance permit; freeing the imports of components and consumer durables; expanding the list of freely importable goods (OGL); and enabling single-window clearance for applications to set up joint ventures (JVs) or

wholly-owned subsidiaries abroad. One specific and critical problem area identified was constraints in exports infrastructure.

#### TRENDS IN INFLATION

The inflation rate, which was at a high of over 16.0 per cent in the beginning of the 1990s steadily declined to 7.0 per cent at the end of 1992–93. However, during the period from 1991 to 1995, the average inflation rate (measured by the wholesale price index [WPI]) stood at 10.7 per cent, which was substantially higher than the 7.8 per cent on average posted in the pre-reform period of 1985 to 1991. This was in contrast to the objectives of the stabilisation programme, which meant to achieve a rather stable price scenario. A critical element of inflation was that food inflation increased substantially in 1990–91 on the back of significant upward revision in the administered prices of food grains effected by the Government during the period from 1990–91 to 1993–94. The rise in the central issue price of rice and wheat was 25.0 per cent and 22.0 per cent, respectively in 1993–94, which was much higher than the corresponding increases during the preceding three years. The increase was necessitated by a sharp increase in the minimum support prices (MSPs) of agricultural commodities on one hand and the need to reduce subsidies in an attempt to rein in the fiscal deficit, on the other. The escalation in the MSPs was the fallout of the reduction in subsidies on all fertilisers in August 1991, which accounted for a substantial component in the cost of cultivation. The upward revision in procurement prices of food grains during the period 1990–91 to 1993–94 exerted upward pressure on the average inflation rate. In tandem with the food grain price escalation, the prices of commodities under the administered control of the Government, such as sugar, *khandsari* & *gur* and cotton textiles, also posted substantial increases from 1990–91 to 1993–94 compared with the pre-reform era.

An upsurge in inflation during the year 1994–95 was, however, experienced in the case of commodities, which showed greater sensitivity to aggregate demand and supply factors. This, therefore, was a matter of grave concern and caused sharp increases in the prices of non-food grain food articles such as fruit, milk, eggs, meat and fish. The overall price behaviour, examined against the backdrop of the macroeconomic environment, showed that in the case of tradeable goods, increased demand was reflected more in increased imports or a decrease in exports, thereby worsening the balance of trade, rather than in price increases. The non-tradeable sectors, however, tended to show high price responses. The

average rate of inflation, which was 8.6 per cent during the Eighth Plan, came under control and was reported at 4.5 per cent during the Ninth Plan.<sup>5</sup>

With the setting in of the reforms process and the liberalisation of imports from 1990–91, the build-up of excess capacities on account of recessionary conditions in the real economy was expected to increase the supply responsiveness of the Indian economy in 1994–95. This, in conjunction with a stable nominal exchange rate and lowering of indirect tax rates, was expected to mitigate the build-up of inflationary impulses in the Indian economy. A rapid rise in imports and high industrial production during 1994–95 seemed to suggest that such a process was under way, although it was not found sufficient to stem inflationary impulses from developing in supply-constrained segments of the system. This indicated a need to address supply constraints in the economy as a long-term resolution. Further, the experience of the mid-1990s confirmed that inflationary pressures also emanated from sharp increases in monetary aggregates on the back of foreign portfolio inflows and the inability of the Indian economic system to utilise them productively.

#### THE MEN AT THE HELM

During the period 1981–1997, the Reserve Bank had six Governors. Dr I.G. Patel's tenure as Governor began on December 1, 1977 and ended on September 15, 1982. Dr Manmohan Singh took the reins on September 16, 1982 and held office till January 14, 1985. Subsequently, after a period of less than a month's interim governorship of Shri A. Ghosh, Shri R.N. Malhotra took over on February 4, 1985 and remained Governor until December 22, 1990.

A major re-organisation of departments was undertaken by Dr I.G. Patel in the Bank along with the introduction of combined seniority of officers in most departments. It was during his tenure that the Deputy Governor, Shri M. Ramakrishnayya, played an active role in the establishment of National Bank for Agriculture and Rural Development (NABARD) and in improving and strengthening the rural credit infrastructure. During Dr Manmohan Singh's tenure, rural development got a further fillip and, most importantly, the foundations for modern day monetary policymaking that would be consistent with high growth

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5. Government of India, Planning Commission, *Mid-term Appraisal of the Ninth Five Year Plan (1997–2002)*.

and the expansion of financial markets were laid. The setting-up of the Chakravarty Committee (1985) to reform the monetary and financial system was a reflection of this idea. The period, when Shri Malhotra was the Governor, set the stage for reforms in the money and credit markets and the consolidation and diversification of banking and non-banking business. He persistently pursued the issue of fiscal consolidation with the Government. It is relevant to mention that during this period, the Deputy Governor, Dr C. Rangarajan in the area of monetary and credit policy and research and Shri A. Ghosh in the area of banking regulation and supervision, played a crucial role in carrying forward the early reforms.

Along with the onset of reforms in 1991, the Governor, Shri S. Venkitaramanan, had to fire-fight the external sector crisis, besides the irregularities in the securities markets that broke out in April 1992. After his two-year tenure in the Government as a Member of the Planning Commission, Dr C. Rangarajan assumed charge as the Governor on December 22, 1992 and continued until November 22, 1997. He pushed forward monetary and financial sector reforms and ended the four-decade practice of automatic monetisation of the fiscal deficit through active co-ordination with the Government. Dr Bimal Jalan took the reins thereafter and teamed up with the Finance Minister, Shri P. Chidambaram, to carry forward the successful implementation of several far-reaching reforms within the Reserve Bank and in the financial system.

#### REFLECTIONS ON RESERVE BANK POLICIES AND OPERATIONS

After the Bretton Woods system was abandoned in 1971, the Reserve Bank kept a vigil on the radical changes taking place around the world in terms of economic reforms and paradigm shifts in several countries, in particular the Latin American and East Asian countries. The banking, external and financial sector policies during the early 1980s in general followed the legacy of the late 1970s. A plethora of controls and directions regarding financial sector management was the order of the day. Rates of interest were administered, both on the lending and the borrowing sides, and they ran into long lists that rendered the structure too difficult to fathom. Coupon rates on government securities were fixed, remained low and were unrelated to market rates. From the mid-1980s, the Reserve Bank embarked upon liberalisation of the money and credit markets and rationalisation of interest rates.

While India did not embark on any extensive reforms after the oil crisis of 1979, the Government and the Reserve Bank were generally eclectic in their approach and undertook reforms selectively. They preferred to introduce incremental changes, mostly within the existing legislative and institutional framework and remained cautious in their stance.

Two major developments marked the beginning of the Reserve Bank freeing itself from the adverse consequence of the overwhelming fiscal dominance since the mid-1980s. The first was the constitution of the committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty, 1985), which examined the monetary system in all its dimensions and paved the way for strengthening the monetary policy framework. One of the major recommendations of the committee was to look at the budget deficit from the angle of monetisation of the same by the Reserve Bank. The framework of the structure of interest rates proposed by the committee led to introducing a series of measures in changing interest rates, rationalising and reducing the number of administered interest rates, making government securities interest rates inflation-hedged and helping to retrieve the banking system from the gap created by the depreciation of the government securities portfolio. With effect from May 1, 1989, the Indian Banks' Association (IBA) withdrew the ceiling on the call money rate of 10.0 per cent per annum fixed in April 1980. Although the freeing of the call money rate initially resulted in extreme volatility in the interest rates in the call money market, it marked an early step towards interest rate liberalisation. Selective credit controls were gradually dismantled. Interest rates in the money market, in particular the overnight market, were freed. All these reforms augured well when a large-scale overhaul of the financial system was initiated after the Report of the Committee on the Financial System (Chairman: M. Narasimham) came up for implementation in 1991.

The second major development was reforming the money and credit markets. A series of market-based instruments, such as 182-day Treasury Bills, certificates of deposit (CDs) and commercial paper (CP) were introduced, based on the report of the working group on money market (Chairman: Shri N. Vaghul, 1987), along with the setting-up of a discount house to create a market for such bills and instruments. In another development, the direct involvement of the Reserve Bank on credit dispensation for large and medium-sized loans was withdrawn in the late 1980s. In furtherance of the objective of institutional development, on January 1, 1982, Exim Bank was set up to provide a comprehensive package of financial and allied services to exporters/importers. NABARD

was formed to strengthen the structure of and supervision over rural credit systems, and it started operations in July 1982. On July 9, 1988, the National Housing Bank (NHB) was set up under the NHB Act, 1987. The Discount and Finance House of India Ltd (DFHI) also came up during 1988 to improve the efficiency of the money market.

In June 1987, some banks were allowed to engage in the business of mutual funds. These included Canara Bank, the State Bank of India (SBI) and Bank of Baroda (BoB). The Reserve Bank also allowed banks to diversify into activities such as leasing, housing subsidiaries, venture capital and merchant banking. Besides providing operational flexibility, this paved the way for the penetration of universal banking practices into the Indian banking scene.

At the time of the crisis in 1991, inflation was at high levels mainly due to the expansionary fiscal policy. The adverse consequences of inflation were sought to be mitigated by hiking interest rates and restricting credit flow to the commercial sector in various ways. The excess money supply was absorbed by raising cash reserve ratio (CRR) and accommodating government funding through increasing statutory liquidity ratio (SLR). These ratios reached their statutory limits, practically making the monetary policy ineffective. Thus, perhaps the most important and challenging development for macroeconomic policy and management that directly affected the Reserve Bank's role was fiscal prudence giving way to unbridled fiscal expansion. The fiscal deficit widened substantially and automatically and was heavily monetised by the Reserve Bank through the mechanism of *ad hoc* Treasury Bills and direct participation in primary issues of government loans. The seriousness of this issue was known to the Reserve Bank and appropriately voiced in its Annual Reports. The initial steps taken during that period were fixing the limits on *ad hoc* Treasury Bills beginning in 1994–95 and ultimately eliminating these bills in April 1997.

#### MONETARY MANAGEMENT

The Chakravarty Committee report was at the core of the transformation of monetary management practices and a revamp in the existing framework. This led to far-reaching reforms as discussed earlier in this chapter. Further, the task of estimating credit requirements was entrusted to the major commercial banks at their credit budget discussions. The estimates arrived at by the banks were tallied with the Reserve Bank projections to ensure credibility. After this exercise, a view was taken on whether the increase in

money supply or bank credit assessed was desirable from the viewpoint of maintaining price stability and any other designated objective. Against this backdrop, the Reserve Bank took decisions to regulate credit growth. The quantitative targets set for credit deployment were thus flexible, rather than unalterable.

The Reserve Bank through its credit policy measures attempted to moderate the growth of liquidity to the desired levels in order to restrain inflationary pressures without disrupting the flow of credit to vital sectors of the economy. The Bank also had to provide funds for the budgetary operations of the Central Government and for its market borrowing programmes. Thus, monetary policy had to contend with the unenviable task of neutralising the inflationary impact of the growing deficit in the Government's budgetary operations.

The seasonality in the announcement of the monetary policy reflected the agricultural bias and the general pattern of the credit cycle in the economy. In order to make a realistic assessment of the acceptable or desirable increases in bank credit as also its allocation among various sectors, besides the limit up to which the Reserve Bank could support the borrowing programme of the Government, the Reserve Bank prepared monetary and credit budgets at the beginning of each financial year. These proposals were normally reflected in the Union Budget. Also, the estimation of monsoon prospects and their impact on the real sector of the economy were considered, and the forecast was made using rainfall data from previous years. In this context, connect between growth in bank deposits and the currency component was derived once the deposit growth had been estimated. While the Reserve Bank's views on the market borrowing programme were an input into budgetary policymaking, the fiscal policy had other objectives besides non-inflationary financing. The Reserve Bank was aware of this situation and considered the final budget figures, even if they deviated from its own proposals, as decisive ones for the smooth conduct of the borrowing programme after the budget was announced.

In this context, the Reserve Bank maintained close and continuous dialogue with the Ministry of Finance. The Bank's ability to carry out monetary policy depended to a considerable degree on the extent of consensus with the Government to meet the latter's financing requirements in a non-inflationary manner. The appropriate public debt management policies and agreements for financial accommodation were indeed integral and crucial factors for the efficacy of monetary policy.

In tune with the monetary policy objectives of the 1980s, the policy stance during the eventful period beginning in 1992, with the advent of economic reforms, remained multi-dimensional, with equal emphasis on growth, and price and financial stability. Towards this end, the perception within the Reserve Bank was that monetary growth had to be consistent with the expected growth in output and a tolerable rate of inflation. In pursuance of the dual objective, monetary policy had to be flexible enough to make strategic adjustments to the market disequilibria and the surge in capital inflows.

From 1991–92, the Reserve Bank and the finance ministry worked in unison and this resulted in monetary policy formulation that was in sync with the economic and fiscal policies. The co-ordination strengthened over the years and was formalised with the signing of a historic agreement in September 1994 to phase out automatic monetisation of the budget deficit in three years, which provided the Reserve Bank with a relatively higher degree of manoeuvrability in monetary management as well as in public debt management.

In the liberalised regime, monetary management was vested with the additional responsibility of maintaining orderly conditions in the money, credit, securities and foreign exchange markets. More importantly, the progressive rationalisation and deregulation of the interest rate structure, which was recognised as an integral part of financial liberalisation, was expected to improve the functioning of the financial markets. The process would facilitate close alignment in the interest rates and progressive integration of the financial markets. As a corollary, it required a marked shift in emphasis from direct to indirect instruments of credit control. Open market operations (OMOs) and its derivative, the repos, were actively utilised from 1993–94 to influence the level of reserves with commercial banks and, thereby, the liquidity in the economy. The mechanism facilitated discreet changes in the volume of primary liquidity in the system and served to communicate to the market participants the perceptions of the monetary authority about the conditions in the money and financial markets in a subtle manner.

#### EXCHANGE RATE MANAGEMENT

After the collapse of the Bretton Woods system of fixed rates of exchange, major currencies floated relatively freely in the world currency markets. The developing countries, including India, pegged their currencies to either one of the major currencies or to a select basket of currencies. A

free operation of the exchange markets was considered difficult, and the exchange markets in these economies provided support to trade rather than opportunities for pure exchange trading. Many developing countries could not afford a free float for their currencies, since they did not have the institutional arrangements for establishing the requisite linkages with the international markets and the position of their BoP did not offer such a possibility. Further, the policy with respect to the exchange rate had to be in consonance with the macroeconomic policy objectives.

The typical role performed by central banks in the 1980s included framing the exchange rate regime and supervising the operations of foreign exchange markets on a continuous basis. The Reserve Bank too was in the same mould. Further, Reserve Bank regulations on forward market operations were comprehensive, facilitating need-based market service and discouraging speculation. The Reserve Bank strived to develop an active exchange market with wide participation and facilitate customers to get fine quotes for the traded currencies. Thus, the exchange market in India during the 1980s remained well-regulated, with restrictions on external transactions, barriers to entry, low liquidity and high transaction costs.

The exchange rate in the early 1990s became central to the management of the external sector and played a role beyond issues relating to international trade. The Government was committed to eliminating various trade interventions. The introduction of current account convertibility, on one hand supported market-oriented reforms and, on the other, imparted a degree of discipline to India's exchange rate policy.

The committee on balance of payments (Chairman: Dr C. Rangarajan, 1991) recommended the introduction of a liberalised exchange rate management system (LERMS). It was introduced in 1992 after extensive discussions between the Government and the Reserve Bank. LERMS was a transitional system with dual rates. It subsumed the declared objective of moving towards full convertibility of the current account transactions, keeping in view the macroeconomic developments in the economy and the world trading environment. The system was part of the liberalisation measures and, apart from providing a boost to exports, aimed at enhancing efficiency. Under LERMS, the proportion of official allocation of foreign exchange for the purposes of public good could be steadily reduced, thereby enhancing the proportion of foreign exchange that importers could buy from the market. On March 1, 1993, a unified exchange rate was introduced, wherein the exchange rate was determined by demand and

supply in the Indian foreign exchange market. The Bank, along with the Government, worked internally to prepare the economy for full relaxation of controls on transactions under the current account. Eventually, India was accorded Article VIII status of the IMF in August 1994. In parallel, the Reserve Bank also reduced capital account controls to a considerable extent.

#### BANKING SCENARIO

In 1980–81, banking was beset with a host of difficulties, the most prominent of which were low banking penetration and poor credit facilities. The Government re-oriented the banking policy, transforming the banking system to assume increasing social obligations. In this sense, banking became a social institution and in the process lost its commercial edge. The major flaws of the system at the beginning of the 1980s were that it was overextended, undermanned and undercapitalised. The agenda for the system during the 1980s was to consolidate and usher in commercialisation, and the key elements of the strategy for the sector included, *inter alia*, a slowdown in branch expansion, while covering spatial gaps in rural areas, devising action plans for banks covering various aspects of organisation, housekeeping, training, customer service, credit management, recovery aspects, technology adoption, human resource efficiency, productivity and operational efficiency. Consolidation, therefore, was the key for commercial banking survival and rejuvenation. This also included streamlining the payment and settlement systems and updating the necessary legal framework.

In the agenda for the structural reforms of the 1990s, the financial sector reforms were embarked upon upfront. This was against the backdrop of an external payments crisis rather than any banking crisis. The restructuring elements of the financial system were, however, home-grown, but taking cognisance of international experiences as well. The reforms were carefully sequenced with respect to the instruments and objectives, resulting in the introduction of supervisory and prudential norms early in the cycle. This was followed by interest rate deregulation and a gradual lowering of statutory pre-emptions pursued as a part of banking reforms. Thereafter, the more complex aspects of legal measures and accounting practices were addressed, with the basic tenets of reforms already in place. The Report on Trend and Progress of Banking in India<sup>6</sup> noted:

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6. Reserve Bank of India, 1990–91.

...the changing environment of competition amongst different segments of the financial system would call for a different work and management ethos, much more professionally oriented and goal and performance determined.

The roadmap for these reforms was drawn from the Narasimham Committee recommendations. This also led to the issuing of guidelines in respect of income recognition, asset classification, provisioning by the Reserve Bank and, finally, adoption of the Basel Accord of capital adequacy standards. Other major contributions of the package were the institution of the Board for Financial Supervision (BFS), the induction of more capital in public sector banks (PSBs) for better financial strength with provision for accessing the capital market and permitting the entry of private sector banks into the system, because they were more technologically advanced. The systemic shock of the 1992 securities scam had adverse implications for the financial system and the banking system in particular. The lessons learnt in its aftermath led to far-reaching modifications in market regulation and settlement practices. This provided the requisite justification for the gradualist approach adopted by India to the reforms procedures in the financial sector.

#### FINANCIAL MARKETS

During the 1980s, most of the financial markets in India were characterised by controls, over pricing of financial assets, restrictions on the flow of transactions, barriers to entry, low liquidity and high transaction costs. Monetary policy was also not attuned to the use of market-based indirect instruments. These characteristics severely inhibited the growth of the financial markets and reduced the allocative efficiency of the resources channelled through them.

In the early 1990s, as part of financial sector reforms, the Reserve Bank embarked upon development of the financial markets, *i.e.*, money market, government securities market and foreign exchange markets. The initiative was aimed at fostering smooth and integrated functioning of these markets. Repo (repurchase agreement) was introduced as an operating instrument for liquidity management and put into operation as a money market instrument during the 1990s.

The development of the money market and strengthening of the government securities market were at the core of the Chakravarty Committee recommendations. Thereafter, the Vaghul Committee report

provided a detailed procedural roadmap in the context of strengthening the institutional structure, instruments and operating procedures to widen and deepen the money market while emphasising that transparency of rules was more important than discretion. The major thrust of the recommendations of the Narasimham Committee was on the working of the commercial banking sector and development financial institutions. The committee observed that efforts had been made to broaden money market activities and to create a secondary market, and indicated that induction of more participants and enlarging the variety of instruments would facilitate the development of a well-functioning and sufficiently deep secondary market.

Apart from implementing the recommendations of the three committees, the Reserve Bank put in place a consultative approach to the development of financial markets by setting-up internal working groups and committees with participation from a range of institutions and market players.

#### PUBLIC DEBT MANAGEMENT

The Reserve Bank is enjoined by a statute under section 21 of the Reserve Bank of India (RBI) Act, 1934, with the function of managing the public debt of the Central Government, and by agreement with respective states under section 21A, the Bank assumed a similar function with respect to the states. Under section 17(11) of the RBI Act, the Bank is empowered to act as an agent of the central and the state governments in managing their public debt.

The debt management function was performed rather passively during the period of tightly-regulated interest rates during the 1980s as the demand for government debt came from captive investors and the Reserve Bank participated to absorb the debt not subscribed by others. Also, there was a practice of unlimited and automatic monetisation of Central Government deficit through *ad hoc* Treasury Bills that had been in vogue since the mid-1950s. As a result, there was practically no secondary market in government securities. The Chakravarty Committee had envisaged that to reduce the extent of debt monetisation, the Government's borrowing requirements should be financed from the open market. The DFHI was set up in 1988 as a money market institution in furtherance of the initiatives taken.

The Narasimham Committee envisaged that an active internal debt management policy would enable the integration of the debt management

policy with monetary policy. Thus, the activation of public debt management gained prominence only in the wake of fiscal consolidation undertaken as part of the structural reforms initiated in the early 1990s. The Reserve Bank initiated several reforms in quick succession during 1992–1997, paving the way for full-fledged development of a government securities market that enabled the Bank to actively move away from direct instruments, such as directed credit, the CRR and refinancing, to indirect market-based instruments, such as OMOs and other liquidity management operations such as repos. The manoeuvrability thus provided to the Reserve Bank in managing public debt consistent with the monetary policy stance was enhanced by the agreements signed between 1994 and 1997 for phased reduction in the issuance of *ad hoc* Treasury Bills and their ultimate discontinuation in April 1997. They were replaced with limited ways and means advances (WMA) from the Reserve Bank.

#### ORGANISATIONAL STRUCTURE

The Reserve Bank evolved its organisational structure and capacity building, responding to domestic economic needs and taking cognisance of international practices. The progression of the organisation enlarged the structure of the Bank not only in terms of size but also the functional transformation necessitated by evolving economic and financial conditions. The creation of new departments, the computerisation of various departments, initiatives in mechanisation and improving industrial relations were some of the aspects that engaged the attention of the management through the years. The operations of the Bank emerged out of the diversity of roles entrusted to it. They were also marked by flexibility in operations and practices, which typically characterised the transformation of the Reserve Bank over the decades.

During the period of the 1980s and 1990s, the organisational structure had to be aligned with the spirit of the regime of economic liberalisation and well-modulated regulation of markets and institutions in the financial sector. Thus, the Bank established new departments, such as the Department of Information Technology (DIT) and Internal Debt Management Cell (IDMC, later converted into an independent interdisciplinary department) during the 1990s and changed the nomenclature of the Credit Planning Cell (CPC) to the Monetary Policy Department (MPD). The creation of the office of an Ombudsman in the mid-1990s was a case of providing a platform to cater to the needs of bank customers.

Communication practices in the Reserve Bank, in line with international practices, were strengthened through the years. Though the role played by communication was well recognised, only practices of communication were in place. Such practices were aimed at providing information on monetary policy and the role being played by the Reserve Bank in the economic system, besides disseminating data for public use. Internally, there were attempts at improving inter-department communication and communication from the management to staff. The aim was to strengthen the work ethos and improve productivity. Various establishments of the Reserve Bank, such as the training colleges, performed an important role in bridging skill gaps in various cadres in the commercial banks as also the Reserve Bank staff.

The period of 16 years covered in this volume was very eventful for the Reserve Bank, as it was both an observer and a contributor to policies in transforming an inward-looking economy into a vibrant and forward-looking one. The political and socioeconomic conditions underwent dramatic changes, making the Reserve Bank play a pivotal role in bringing about reforms in the entire financial system in tune with the aspirations of the Government and as per the rapid changes taking place all over the world. The events of the 1980s and 1990s and the proactive and timely responses by the Reserve Bank to fulfil its obligations and responsibilities took the institutional integrity and reputation of the Bank to further heights in the domestic as also in the international sphere.

I

CONSOLIDATION AND EARLY LIBERALISATION: 1981 TO 1989



# 2

## Macroeconomic Context

The decade of the 1980s began with uncertainties on several fronts. Domestically, there was a severe drought in 1979 and on the global front, the oil crises of 1973 and 1979 endangered economic stability. The immediate impact of these developments was rising inflationary pressures. The economic policy debate during the decade was thus dominated by concerns regarding rising prices. The Government and the Reserve Bank responded to these economic challenges through a variety of policy measures directed at relieving the basic causes of the economic difficulties and minimising their impact on vulnerable sections of society.

On the external sector front, the unfavourable foreign trade situation in the aftermath of the spike in oil prices became more pronounced. The foreign exchange reserves declined. Notwithstanding the decline in foreign exchange reserves, the pace of monetary expansion continued unabated. The external payments position remained difficult as a result of a persistent increase in imports combined with only a modest rise in the rate of growth in the value of exports. The widening trade deficit became one of the most pertinent concerns of the policymakers. The current account deficit (CAD) rose sharply to ₹ 2,748 crore (US\$ 3,474.0 million) or 1.6 per cent of the gross domestic product (GDP) in 1980–81. In order to tide over the balance of payment (BoP) difficulties, the Government negotiated a loan of SDR 5 billion under the extended fund facility (EFF) of the International Monetary Fund (IMF) in November 1981.

While the average growth rate in real GDP was satisfactory, having upturned from 2.9 per cent per annum during the 1970s to 5.8 per cent during the 1980s, the fiscal aggregates worsened. Gross fiscal deficit (GFD) as a percentage of GDP (in average terms) rose from 3.8 per cent to 6.8

TABLE 2.1  
Key Macroeconomic Variables: Decadal Trends

Variables	1970–71 to 1979–80	1980–81 to 1989–90
I. Real GDP Growth Rate (% , base 1993–94=100)	2.9	5.8
Agriculture	0.6	4.4
Industry	4.7	7.4
Services sector	4.1	6.4
II. Sectoral Shares		
Agriculture as % of GDP	42.8	36.4
Industry as % of GDP	16.9	19.5
Services as % of GDP	40.3	44.0
III. Index of Industrial Production (IIP)	4.5	7.8
IV. Fiscal Indicators		
Centre's GFD (as % of GDP)	3.8	6.8
State's GFD (as % of GDP)	2.9	2.9
Combined GFD (as % of GDP)	–	8.0
V. Gross Domestic Savings as % of GDP	17.5	19.4
VI. Gross Domestic Capital Formation as % of GDP	17.6	21.2
VII. Inflation (Wholesale Price Index) % (average, base 1993–94=100)	9.0	8.0
VIII. Money, Credit and Banking Indicators (Growth rate)		
Money supply (M <sub>3</sub> )	17.3	17.2
Reserve money	14.5	16.8
Aggregate deposits of SCBs	20.3	18.1
Bank credit of SCBs	18.5	16.8
Non-food credit of SCBs	17.4	17.8
IX. External Sector		
Export/GDP ratio	4.4	4.7
Import/GDP ratio	5.6	7.9
CAD/GDP	–0.1	–1.8

Notes: 1. For decadal growth in GDP and share, ten-year average was worked out, except for the growth variables, namely agriculture, industry and services for the decade 1970–71 to 1979–80, where only the nine-year average was taken due to non-availability of data for the year 1969–70 in the same series.

2. For IIP, nine-year average was taken for 1970–71 to 1979–80 and 1980–81 to 1989–90 at 1970=100 and 1980–81=100, respectively.

3. SCBs: scheduled commercial banks.

4. '–': not available.

Source: Reserve Bank of India, *Database on Indian Economy; Handbook of Statistics on the Indian Economy*, various issues; *Handbook of Monetary Statistics of India*, 2006.

per cent over the decades under consideration. The BoP position also worsened as the CAD to GDP ratio deteriorated from (-) 0.1 per cent during the 1970s to (-) 1.8 per cent during the 1980s.

As the years progressed, despite the improved performance of the economy on the agricultural and industrial fronts, the monetary expansion and price situation called for continued vigil. One major concern was high growth in reserve money. Against this backdrop, broad guidelines were issued to the banks in May 1981 to rein in non-food credit expansion. Subsequently, however, the efficacy of supply and demand management policies resulted in achieving relative stability in the general price level. The Reserve Bank's policy stance nevertheless remained one of caution and restraint. The policy objectives aimed at promoting savings, containing inflationary expectations and ensuring adequate liquidity so that the genuine credit requirements of the productive sectors of the economy were met. Orderly management of the uncomfortable price situation and strains in the external payments were key facets of the economic performance, despite a severe drought and an unfavourable environment for external aid and trade.

The economy posted impressive growth during 1983–84, as the real GDP expanded by 7.7 per cent during the year. The price rise, however, continued to remain the core concern. The impact of the depletion of food stocks as a result of the drought was visible in the disconcerting price situation. Against the backdrop of favourable weather conditions, the agricultural strategy of reduction in the prices of fertilisers, expansion in the distribution network, increase in the irrigated area, availability of credit and distribution of quality seeds and other inputs led to the revival of agricultural output. During 1983–84, agricultural production witnessed a high growth rate of 10.3 per cent.

By the mid-1980s, there was perceptible improvement in the external sector situation. A significant development on the external payments front was that the Government voluntarily terminated the three-year EFF arrangement with the IMF from May 1, 1984, *i.e.*, about six months ahead of the date when this arrangement was to come to an end. India drew only SDR 3,900 million or SDR 1,100 million less than the amount of SDR 5,000 million initially agreed to be drawn over the three-year period ending November 8, 1984.

At the time of initiation of the Seventh Five Year Plan, the economic scenario showed promise. There was a noticeable improvement in the price situation, the food grain stock was at an unprecedented level of 29

million tonnes, the level of foreign exchange reserves was comfortable, the savings rate was high and the capital market was buoyant. The Seventh Five Year Plan envisaged sustaining a growth rate of 5.0 per cent in real national income through 1985–86 to 1989–90.

Priority sector lending had remained an important objective of banking since nationalisation. In the 1980s, the necessity to consolidate and practise sound banking caught the attention of policymakers. As a result, the 1980s saw a significant slowdown in branch expansion, and covering spatial gaps in rural areas gained prominence. Banking policy at this point emphasised providing better customer service, promoting efficiency in housekeeping, recovering dues, enhancing staff productivity and improving profitability. The Reserve Bank underscored the need to improve profitability and the viability of the banking system. The banks were strengthened and modernised, and safety and prudential issues were highlighted. Directing institutional credit flow through regulatory guidelines and directives to specified sectors characterised rural credit. The Chakravarty Committee placed an emphasis on the need for co-ordination between the banks and government agencies for successful implementation of priority sector lending initiatives and promoting a recovery culture. In initiating banking reforms, preliminary attempts were made towards deregulation of interest rates. As a first step in April 1985, the Reserve Bank freed bank deposit rates for maturities between 15 days and less than one year, with a ceiling of 8.0 per cent. The measure, however, did not have the desired effect and prompted a rate war among the banks, forcing the Reserve Bank to quickly reverse the decision.

Reforms were undertaken in many sectors of the economy during the second half of the 1980s. These included a relaxation in industrial licensing and imports. The liberalisation in the industrial policy was aimed at removing the constraints inhibiting the growth potential of the Indian industry. The measures introduced facilitated the import of technology and capital goods, aimed at modernising industry and increasing its competitiveness. The Indian industry at this stage was passing through a stage of transition from a protected to a more competitive environment. While liberalisation in respect of licensing and imports exposed the industry to intense domestic and external competition, it also improved the availability of the inputs for modernisation and technology upgrading.

Fiscal reforms were initiated in 1985–86 with a view to create a conducive environment for growth, productivity and savings, as also to promote an equitable tax system and ensure better tax compliance.

Reduction and rationalisation of the tax structure was brought about in order to impart simplicity, stability and reasonableness in the tax rates. The reforms in the indirect taxes aimed at reducing the costs of investments in the priority sector, encouraging the growth of the small scale sector and removing distortions. On the flip side, the lower-than-planned growth rate in the power sector posed infrastructure constraints. There were challenges posed by the fiscal situation. Rising debt-service obligations and the necessity for essential imports also generated uncertainties for the BoP position.

The long term fiscal policy (LTFP) was announced by the Government in December 1985 with the aim of creating an environment conducive to rapid growth in production and employment, while at the same time achieving reduction in poverty. Major components of the LTFP were steps taken to enhance the share of direct taxes in the total tax revenue over time, to rationalise the tax structure to reduce evasion and to make the fiscal system more progressive. The incidence of the indirect tax system was also sought to be made progressive through lower tax rates on essential commodities and subsidised distribution of food grain, edible oils and sugar through the public distribution system (PDS). Reforms in the tax system under the LTFP were aimed at achieving high growth with social justice, while ensuring that there were no significant revenue losses. An essential component of the LTFP was non-inflationary financing of the Seventh Five Year Plan through increased reliance on surpluses generated by the budget and the public sector undertakings (PSUs) and a corresponding decline in dependence on borrowed funds.

Efforts were made to develop the money market (as per the recommendations of the Vaghul Committee), which led to rationalisation of call money rates and the introduction of money market instruments to improve short-term liquidity in the market, besides creating the necessary institutional infrastructure for providing liquidity to money market instruments. The recommendations of the committee also resulted in the setting-up of the Discount and Finance House of India Ltd (DFHI) in 1988. The measures had a modest immediate impact, as the efficient functioning of the market was hindered by several structural rigidities at that point of time, including a skewed distribution of liquidity and the prevalence of administered deposit and lending rates.

During 1987–88, a drought of severe intensity struck, disrupting the growth process that was intended to be the result of the implementation of the Seventh Five Year Plan. There was substantial drawdown of the

food stocks for maintaining supplies under the PDS. Judicious supply management through the food stock channel and resorting to higher imports of essential commodities helped alleviate the supply constraints that resulted from substantial loss of agricultural production, employment and income. Unlike the drought years in the past, when real income had actually declined, in 1987–88 real income showed positive growth. This reflected a significant structural shift in the economy, with the industrial growth maintained at a reasonable rate and the services sector contributing significantly to the growth of real income. The inflationary pressures during 1988–89 were relatively well-contained considering the earlier experience of the post-drought years being periods of high inflation.

In sum, significant changes took place in various segments of the economy in the form of reform measures, which were undertaken from time to time. The fiscal deficit, inflation rate and the external sector nevertheless remained areas of constant concern for policymakers. By the end of 1988–89, the fiscal deficit was very high, short-term borrowings were on the rise and the signs of an impending crisis began to surface.

# 3

## Monetary-Fiscal Interface

### INTRODUCTION

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

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

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

### OVERVIEW

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

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

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

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

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

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

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

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

#### RESERVE BANK'S VIGILANCE: TWO EPISODES

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### THE FRAMEWORK

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

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

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

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

#### MARKET BORROWING PROGRAMME FOR 1984–85

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

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

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

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

#### *Related Debt Management Matters*

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

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

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

#### MARKET BORROWING PROGRAMME FOR 1985–86

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

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

#### *Related Debt Management Matters*

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

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

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

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

#### LONG TERM FISCAL POLICY

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

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

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

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

#### MARKET BORROWING PROGRAMME FOR 1986-87

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

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

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

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

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

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

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

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

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

#### MARKET BORROWING PROGRAMME FOR 1987–88

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

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

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

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

#### MARKET BORROWING PROGRAMME FOR 1988-89

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

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

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

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

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

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

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

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

#### *Related Debt Management Matters*

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

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

## ASSESSMENT

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

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

TABLE 3.1

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

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

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

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

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

### GROWING MONETISATION OF FISCAL DEFICIT: RESERVE BANK'S CONCERNS

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

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

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

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

#### HISTORY OF *AD HOC* TREASURY BILLS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### INCREASED STRAINS ON GOVERNMENT FINANCES AND EMERGENCE OF FISCAL IMBALANCES

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

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

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

TABLE 3.2  
*Trends in Budgetary Deficit and Net RBI Credit to Government*  
(Centre and States)

(₹ crore)

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

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

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

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

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

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

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

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

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

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

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

TABLE 3.3

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

TABLE 3.4  
*Internal Public Debt of the Government of India*

(Outstanding as at end-March)  
 (₹ crore)

	1980	1981	1982	1983	1984	1985
Public debt	24,319	30,864	35,653	46,939	50,263	58,537
of which :						
(i) Current market loans	12,867	15,549	18,461	22,232	26,270	30,366
(ii) Treasury Bills:						
91 days	10,196	12,851	10,273	17,431	15,756	19,452
182 days						
(iii) Special securities issued to RBI	80	585	4,110	4,210	4,570	4,650
(iv) (ii+iii)	10,276	13,436	14,383	21,641	20,326	24,102
	1986	1987	1988	1989	1990	
Public debt	71,039	86,312	98,646	1,14,499	1,33,193	
of which :						
(i) Current market loans	35,241	40,832	46,695	55,115	62,520	
(ii) Treasury Bills:						
91 days	26,014	19,876	8,028	14,273	25,184	
182 days				567		
(iii) Special securities issued to RBI	5,187	19,867	37,177	36,987	36,881	
(iv) (ii+iii)	31,201	39,743	45,205	51,827	62,065	

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

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

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

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

TABLE 3.5  
*Debt Indicators of the Central and State Governments*

(As percentage of GDP)

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

Notes: \* At historical exchange rate.

Due to rounding-off, totals may not tally.

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

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

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

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

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

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

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

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5. “The Burden of Domestic Public Debt in India”, *Reserve Bank of India Occasional Papers* 8(1), June 1987.
  6. Rangarajan, C., Anupam Basu and Narendra Jadhav (1989). “Dynamics of Interaction between Government Deficit and Domestic Debt in India”, *Reserve Bank of India Occasional Papers* 10(3), September.
  7. Chelliah, Raja J. (1992). “Growth of Indian Public Debt” in Bimal Jalan (ed.), *The Indian Economy: Problems and Prospects*. New Delhi: Viking.
  8. Rangarajan, C. (1990). “Domestic Debt Management and Monetary Control”, *18<sup>th</sup> SEANZA Central Banking Course Lectures*. October–December. Mumbai: Reserve Bank of India.

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

### RESERVE BANK'S CONCERNS AND GOVERNMENT'S PERCEPTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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12. Government of India, *Economic Survey, 1981-82*.

13. Government of India, *Economic Survey, 1984-85*.

14. Government of India, *Economic Survey, 1986-87*.

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

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

### CONCLUDING OBSERVATIONS

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

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

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

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

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

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

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

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

# 4

## Monetary and Credit Policy

### INTRODUCTION

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

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

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

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

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

#### OPERATING FRAMEWORK FOR CREDIT/MONETARY POLICY

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

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

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

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

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

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

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

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

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

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

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

#### INDICATIVE GUIDELINES FOR GROWTH IN CREDIT AND MONEY SUPPLY

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

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

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

#### ECONOMIC RECOVERY AND STABILISATION (NOVEMBER 1981 TO SEPTEMBER 1982)

##### IMF LOAN AND MACROECONOMIC RESPONSIBILITIES OF THE RESERVE BANK

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

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

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

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

## GRADUAL IMPROVEMENT IN ECONOMIC SCENARIO

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

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

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

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

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

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

#### INCREASE IN DEPOSIT AND LENDING RATES

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

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

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

#### REFINANCE/REDISCOUNT FACILITIES

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

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

## CREDIT POLICY TIGHTENED

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

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

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

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

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

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

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

#### BANK RATE INCREASED AFTER SEVEN YEARS

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

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

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

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

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

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

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

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

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

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

#### FURTHER TIGHTENING IN OCTOBER 1981

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### INCREASE IN DEPOSIT RATES AND GOVERNMENT'S CONDITIONAL APPROVAL

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

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

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

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

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

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

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

#### CREDIT POLICY FOR THE FIRST HALF OF 1982-83

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

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

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

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

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

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

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

CRR REDUCTION IN JUNE 1982 AND  
THE ATTENDANT IMBROGLIO

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

As part of a periodic review of credit policy, I had on one occasion reduced the cash-credit ratio for banks by 0.25 per cent to enable banks to meet the legitimate needs of the public and private sectors as we saw them. This released some Rs. 500 crore to the banks for further lending. After all, credit policy was always not to be tightened; it could be relaxed also; and the CRR was not a mechanism for raising money for the Budget. But at a meeting of the Planning Commission where the Prime Minister and the Finance Minister were present, this step was criticised and it was alleged that I have gifted Rs. 500 crore to the private sector at a time when the Government was finding it difficult to raise resources for the Plan.

The Economic Secretary, Ram Malhotra, told me later that the Prime Minister had asked for the Ministry's explanation; but she was not satisfied, and he asked me to see the Prime Minister's Secretary, Shri P.C. Alexander. I saw him and explained the rationale for my action and the point that more than half the additional credit was intended for the public sector, especially oil, so that the charge of favouring the private sector was patently absurd. I could understand the argument that the credit situation was not such as to require reduction. These are matters of judgment. But to say that I helped the private sector was a loaded statement. Eventually, I was asked to explain my action in writing, the only time in my long career that I was asked to do so.<sup>9</sup>

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8. Patel, I.G. (2002). *Glimpses of Indian Economic Policy: An Insider's View*. New Delhi: Oxford University Press.

9. Dr I.G. Patel relinquished the office of the Governor on September 15, 1982.

## ECONOMIC GROWTH OVERSHADOWED BY INFLATIONARY CONCERNS

(OCTOBER 1982–83, 1983–84, AND 1984–85)

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

We need to work within the framework of an increase of  $M_3$  by 15 per cent. Finance Secretary told me that he would be willing to abide by the restrictions on bank credit to Government that would flow as a consequence. This is his response to our fears that the budget implies a very heavy dependence on bank credit, particularly Reserve Bank credit.

However, an increase of 15 per cent in  $M_3$  would imply that non-food credit expansion by scheduled commercial banks in 1984–85 even in absolute amount would be no higher than what it was in the previous year. Partly this is caused by a contemplated increase in SLR by one percentage point. However, the situation in the first half of the year may not be difficult. We may have to watch how demand for credit picks up in the busy season. At that stage some relaxation, if necessary, may have to be thought of.

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

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

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

...it is essential that in the interest of orderly economic management and reasonable price stability, a deceleration of the rate of growth of money supply, overall liquidity and of primary money creation is regarded as an important objective of economic policy during 1984–85.

In formulating credit policy for the coming season, we have to pay balanced attention to all these considerations, often conflicting with one another, which have a bearing both on overall growth of the economy and the climate for economic stability...In the light of the uncertainty associated with weather conditions, the fiscal outlook and the balance of payments outcome, there can be no relaxation of credit discipline. Banks must ensure that bank credit finances only those productive ventures that effectively add to domestic productive capacity and productivity.

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

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

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

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

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

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

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

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

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

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

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

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

## ECONOMY ON A NEW GROWTH PATH

(1985–86 AND 1986–87)

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

## DECISION ON INTEREST RATES

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

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

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

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

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

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

#### MONETARY AND BANKING SCENARIO

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### BACKGROUND

The rationale behind this decision was that interest rates on deposits over the years had been increased, but these increases were largely at the longer end of maturities. Thus, in April 1974, the spread of fixed deposit rates was 3.0-8.0 per cent, while in October 1982 the range was 3.0-11.0 per cent. In fact, the deposit rate for less than one year was only 5.5 per cent and this was raised to 7.0 per cent in March 1982 in a limited effort to correct the distortion in short-term deposit rates. Moreover, with the ceiling on call money rates fixed by the Indian Banks' Association (IBA) at 10.0 per cent, the distortion in the short-term deposit rates came to be attenuated. Another disturbing aspect was that the share of short-term deposits in total fixed deposits was declining sharply as the interest for different maturities widened and these short-term deposits formed an insignificant proportion of the aggregate fixed deposits in May 1985. The deposits in the category of 15 days and above but up to 1 year that accounted for 54.7 per cent of total fixed deposits in 1970, came down to 14.2 per cent in 1975, further to 9.6 per cent in 1978 and finally to 7.5 per cent in 1980. The short-term deposit rate structure had its impact on money market operations too. Entry into the money market was highly regulated. Apart from banks, only

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

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

#### FOLLOW-UP ACTION BY THE IBA

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

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

...Whether the message of the Reserve Bank had been wrongly understood by the banks, because by "innovative move" the Reserve Bank would have meant that the banks could themselves offer interest rates to their depositors, with each bank offering competing rates. With IBA having fixed rates uniformly for all the banks this merely amounts to the Association playing the same role that the RBI had hitherto performed. Was this the "innovation" that the RBI had in mind?

It is felt that the IBA may have decided on uniform interest rates to avoid competition in attracting deposits from each other. Fixing of uniform rates may prevent deposit 'snatching' activities, financial circles aver.

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

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

#### EVENTS LEADING TO WITHDRAWAL

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

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

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

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

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

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

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

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

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

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

Some of the banks are managing their 15-day deposits almost like current accounts. However, resort to maturities above 15 days but below one year has greatly diminished. The consequence was a shift of deposits from current accounts and, to a lesser extent, from savings accounts to 15-day deposits.

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

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

#### PRESS REACTIONS

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### CREDIT POLICY FOR THE FIRST HALF OF 1986–87

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

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

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

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

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

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

#### THE CHAKRAVARTY COMMITTEE

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

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

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

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

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

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

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

#### SLIGHT EASING IN THE SECOND HALF OF 1986–87

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### DIFFICULT TIMES FOR THE INDIAN ECONOMY

(1987–88 AND 1988–89)

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

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

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

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

#### COMFORTABLE LIQUIDITY CONDITIONS IN THE FIRST HALF OF 1987-88

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

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

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

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

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

IMPLEMENTATION OF THE RECOMMENDATIONS OF THE  
WORKING GROUP ON MONEY MARKET

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

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

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

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

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

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

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

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

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

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

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

#### BUY-BACK ARRANGEMENTS IN GOVERNMENT SECURITIES

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

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

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

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

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

### CREDIT POLICY FOR 1988-89 ATTUNED TO PROMOTE GROWTH

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

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

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

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

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

#### PROMOTING EFFICIENCY IN THE FINANCIAL SYSTEM

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

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

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

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

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

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

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

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

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

#### INTEREST RATES

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

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

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

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

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

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

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

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

#### RATIONALISATION OF THE CALL MONEY RATE STRUCTURE

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

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

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

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

CASH RESERVE RATIO: IMPERATIVE NEED  
TO ACTIVATE THE INSTRUMENT

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

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

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

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

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

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

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

#### PUBLIC SECTOR BONDS

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

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

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

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

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

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

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

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

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

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

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

#### PORTFOLIO INVESTMENT MANAGEMENT SCHEME

The portfolio investment management scheme came under the scanner soon after it was launched. A press report<sup>23</sup> read as follows:

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

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22. *Business Standard*. February 5, 1988.

23. "A Mockery of RBI Interest Rate Policy", *The Indian Express*. February 18, 1987.

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

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

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

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

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

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

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

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

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

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

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

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

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

#### INTEREST RATE MANAGEMENT

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

#### RELATIONS BETWEEN THE RESERVE BANK AND THE GOVERNMENT

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

#### PROPOSAL FOR INCREASE IN SLR

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

I have discussed this with F.M. and Deputy Chairman, Planning Commission, as the meeting with the P.M. was cancelled at the last moment.

It was agreed that getting extra resources through an increase in SLR or larger transfer of profits from RBI was not the best (or even a good) way of funding the Plan and that efforts should be made to reduce non-Plan expenditure and divert consequent savings to the Plan. However, the question might be discussed again if such efforts do not succeed.

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

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

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

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

TABLE 4.1  
*Income and Expenditure of the Reserve Bank of India (Select Years)*  
(₹ crore)

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

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

#### MONEY SUPPLY AND INFLATION

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

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

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

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

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

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

#### DECISION TO INCREASE CRR

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

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

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

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

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

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

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

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

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

### CONCLUDING OBSERVATIONS

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

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

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

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

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

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

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

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

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

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

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

## ANNEX 4.1

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

1981–82

*Restoration of Economic Stability*

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

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
The Indian economy in 1981–82 consolidated the gains of the previous year, but remained vulnerable to the adverse impact of international economic developments. In particular, the country's external trade and BoP position was under severe strain due to the steep rise in petroleum/ oil prices and the after-effects of drought.	Restrictive stance with multiple objectives of restraining expansion in $M_3$ and credit, mobilising deposits and directing credit flow to priority and other productive sectors.	<ul style="list-style-type: none"> <li>• Broad guidelines indicated for non-food credit expansion by banks.</li> <li>• Rise in CRR to 7.0 per cent (July 31–August 21, 1981).</li> <li>• Increase in the minimum rate of interest on RBI's discretionary refinance and rediscount from 11.0 to 14.0 per cent.</li> <li>• Hike in Bank Rate to 10.0 per cent (July 12, 1981).</li> <li>• Rise in SLR to 35.0 per cent (September 25–October 30, 1981).</li> <li>• Rise in CRR to 8.0 per cent (November 27, 1981–February 26, 1982) (Proposed).</li> </ul>	

1982–83

*Economy Under Strain*

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

Dr Manmohan Singh (16.9.1982 – 14.1.1985)

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
Severe drought conditions resulted in a serious set-back to agricultural output and a decline in industrial production. Growth in $M_3$ was higher due to a reduction in the negative impact of decline in foreign assets. During the year, the price level was generally stable despite rapid monetary expansion.	To counter sluggishness in deposit growth, the failure of banks to meet their statutory reserves and the demand for credit from productive sectors, the Reserve Bank decided to restore normalcy in credit availability and provide a stimulus for industrial activity by increasing the flow of credit.	<ul style="list-style-type: none"> <li>• Lending rates lowered.</li> <li>• CRR reduced to 7.25 per cent (April 9, 1982) and further to 7.0 per cent (June 11, 1982).</li> </ul>	The committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty) was set up in December 1982.

1983–84

*Economic Growth Overshadowed by Inflationary Concerns*

Governor: Dr Manmohan Singh (16.9.1982 – 14.1.1985)

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
A sharp pick-up in agricultural growth and higher industrial production helped in strong economic growth in 1983–84. While overall, the BoP showed improvement, the growth of liquidity at 17.0 per cent was considered to be uncomfortably high.	To reduce the expansionary impact of rapid growth in reserve money and at the same time support productive activities with increased credit flow.	<ul style="list-style-type: none"> <li>• CRR raised to 8.0 per cent (May 28, 1983–July 30, 1983) and again to 8.5 per cent (August 27, 1983).</li> <li>• Incremental CRR of 10.0 per cent (November 11, 1983).</li> <li>• CRR increased to 9.0 per cent (February 4, 1984).</li> </ul>	Government of India terminated from May 1, 1984, the three-year EFF borrowing arrangement with the IMF, <i>i.e.</i> , about six months before it was to conclude.

1984–85

*Monetary Policy Attuned to Achieving Strong Economic Growth*

Governors: Dr Manmohan Singh (16.9.1982 – 14.1.1985)

Shri A. Ghosh (15.1.1985 – 4.2.1985)

Shri R.N. Malhotra (4.2.1985 – 22.12.1990)

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
Monetary expansion ( $M_3$ ) at 18.2 per cent was higher than in the previous year. The two factors responsible were: (i) the large increase in net foreign exchange assets of the banking sector; and (ii) increases in net bank credit to Government and commercial sector. On the fiscal side, large deficits on revenue account emerged due to a spurt in revenue expenditure for defence, subsidies and interest payments.	The basic stance was to contain overall liquidity and thus curb inflationary expectations. At the same time, the needs of vital public sector investments had to be met.	<ul style="list-style-type: none"> <li>• Main instruments were reserve ratios, changes in refinance limits and selective credit controls.</li> <li>• SLR raised to 36.0 per cent (July 28–September 1, 1984).</li> <li>• Release of a part of impounded cash balances (October 27 and December 1, 1984).</li> </ul>	The Reserve Bank completed 50 years of service to the nation on March 31, 1985. The golden jubilee celebrations were inaugurated on June 1, 1985, by the Prime Minister, Shri Rajiv Gandhi. The function was presided over by the Finance Minister, Shri V.P. Singh.

1985–86

*Emphasis on Fiscal Reforms and its Impact on Monetary Policy*

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

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
<p>The economy exhibited many welcome features: deceleration in inflation rate for the third year in succession, comfortable level of foreign exchange reserves despite a massive trade deficit and sizeable food grain stocks.</p> <p>The Government of India, in the budget for 1985–86, announced the adoption of long term fiscal policy (LTFP) to impart an element of stability to the whole range of fiscal measures.</p>	<p>The cautious stance of credit policy was continued to avoid resurgence of inflation in an environment of large increase in the volume of reserve money and overall liquidity in the economy.</p> <p>The main objective was to contain the overall growth in liquidity in 1985–86 to a rate lower than that in 1984–85.</p>	<p>There was no increase in reserve requirements during the year other than an increase in SLR.</p> <ul style="list-style-type: none"> <li>• SLR raised to 37.0 per cent (June 8, 1985 – July 6, 1985).</li> <li>• One-third of impounded cash balances released (October 26, 1985).</li> <li>• Penalties imposed for defaults in SLR maintenance by banks.</li> </ul>	<p>The Reserve Bank, in consultation with the Government of India (Ministry of Finance), began implementing many important recommendations of the Chakravarty Committee.</p>

1986–87

*The Chakravarty Committee (1985):  
Implementation of Major Recommendations*

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

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
<p>The generally poor performance of the agricultural sector impacted on overall economic growth. Expansion in <math>M_3</math> was on the high side at 18.5 per cent.</p>	<p>In view of the large accretion to reserve money, the Reserve Bank pursued a cautious credit policy to restrain inflationary pressures during the year.</p>	<ul style="list-style-type: none"> <li>• Emphasis on effective maintenance of SLR on a daily basis by commercial banks.</li> <li>• CRR raised to 9.5 per cent (February 28, 1987).</li> <li>• Changes made in the structure of bank lending and deposit rates to reduce the cost of money and to impart flexibility to interest rate policy.</li> </ul>	

1987–88

*Pursuit of a Cautious Monetary Policy*

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

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
India was afflicted by a severe drought followed by floods in parts of the country. These had an all pervasive effect on the economy. The massive expenditure by the Government towards drought relief, among other factors, fuelled inflationary expectations.	The credit policy was cautious, with emphasis on containing the expansion of overall liquidity. The objectives were to prevent excessive monetary expansion and to provide adequate credit to agriculture, industry and exports.	<ul style="list-style-type: none"> <li>• SLR raised to 37.5 per cent (April 25, 1987).</li> <li>• CRR raised to 10.0 per cent (October 24, 1987).</li> <li>• SLR raised to 38.0 per cent (January 2, 1988).</li> </ul>	

1988–89

*Economic Recovery and Inflation Control*

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

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
The excellent monsoon of 1988 helped produce a remarkably good performance by the economy. There was excessive reserve money creation, which had a strong potential for expansion in non-food credit.	The objectives of monetary policy were to provide adequate credit to agriculture and industry, while containing the growth of overall liquidity to a level below the annual average of the past three years ( <i>i.e.</i> , 17%). To moderate the growth in primary liquidity, the broad stance of monetary and credit policy was one of restraint.	<ul style="list-style-type: none"> <li>• The remaining impounded balances under the incremental CRR released (April 23, 1988) to meet the increase in food procurement credit.</li> <li>• CRR raised to 10.5 per cent (July 2, 1988) and to 11.0 per cent (July 30, 1988).</li> </ul>	

1989–90

*Build-up of Serious Macroeconomic Imbalances*

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

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of credit policy</i>	<i>Salient policy measures</i>	<i>Important event/s</i>
Although the Indian economy recorded a reasonably good performance, several serious structural imbalances caused concern. These included, unsustainable level of budget deficits, mounting CAD in the BoP and pressure on prices. In particular, $M_3$ growth was nearly 20.0 per cent, due to reserve money expansion caused by budget deficit.	There was need to contain inflationary pressures without endangering the growth potential of the economy. Therefore, the stance of credit policy was one of restraint on the pace of expansion of non-food credit.	<ul style="list-style-type: none"> <li>• CRR was made applicable at a uniform rate of 15.0 per cent for all deposit liabilities of scheduled commercial banks. This had the effect of simplifying the multiple prescriptions into a single prescription.</li> <li>• The other measures were prescription of an annual incremental non-food credit-deposit ratio for each bank (October 1989); reduction in access to export credit refinance (November 1989); and tightening of selective credit controls.</li> </ul>	

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

STATEMENT 4.1  
*Chronology of Major Credit Policy Measures (1981-1997)*

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

*contd...*

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

*contd...*

*concl.*

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

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

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

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

^ SLR on NDTL as on September 17, 1993.

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

! SLR on NDTL as on September 30, 1994.

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

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

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

STATEMENT 4.2  
*Growth Rates of Selected Monetary and  
 Other Macroeconomic Variables (1981-1990)*

(Percentage variations)

Variable	1980-81	1981-82	1982-83	1983-84	1984-85
(1)	(2)	(3)	(4)	(5)	(6)
Aggregate Monetary Resources (M <sub>3</sub> )	18.1	12.5	16.6	18.2	19.0
Reserve Money (RM)	17.4	7.9	10.1	25.5	21.5
Currency with Public	15.2	7.8	15.1	17.7	15.7
Demand Deposits with Banks	20.5	7.4	13.6	15.5	23.3
Time Deposits with Banks	18.8	16.9	18.1	19.0	18.6
Net RBI Credit to Central Government	30.3	21.0	18.2	18.1	23.5
Other Banks' Credit to Government	21.9	9.9	22.0	11.2	15.6
Other Banks' Credit to Commercial Sector	18.6	18.5	18.9	18.5	16.9
Banks' Investments in Government Securities	23.8	10.2	18.9	11.5	38.8
Net Foreign Exchange Assets of Banking Sector	-11.5	-41.5	-34.0	-10.0	+90.4
<i>Memorandum Items:</i>					
Growth Rates (NNP at factor cost)	7.5	5.8	2.2	8.1	3.4
Wholesale Prices*	18.2	9.3	4.9	7.5	6.5
<i>concl.</i>					
Variable	1985-86	1986-87	1987-88	1988-89	1989-90
(1)	(7)	(8)	(9)	(10)	(11)
Aggregate Monetary Resources (M <sub>3</sub> )	16.0	18.6	16.0	17.8	19.4
Reserve Money (RM)	8.4	17.4	19.4	17.7	23.2
Currency with Public	10.5	13.3	18.2	14.2	20.8
Demand Deposits with Banks	12.6	21.8	7.8	12.9	23.0
Time Deposits with Banks	19.5	19.7	17.3	19.9	18.3
Net RBI Credit to Central Government	19.4	18.6	14.5	12.6	23.7
Other Banks' Credit to Government	22.8	31.0	23.1	16.3	17.9
Other Banks' Credit to Commercial Sector	16.9	14.5	13.5	18.0	18.8
Banks' Investments in Government Securities	1.9	30.5	22.8	17.4	18.1
Net Foreign Exchange Assets of Banking Sector	+23.5	+24.4	+17.8	+19.9	+ 0.3
<i>Memorandum Items:</i>					
Growth Rates (NNP at factor cost)	3.9	3.8	3.8	10.7	7.0
Wholesale Prices*	4.4	5.8	8.1	7.5	7.5

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

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

STATEMENT 4.3  
*Growth in Money Supply, Inflation and National Income*

(Per cent)

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

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

## STATEMENT 4.4

*Estimates/Projections of Growth in Select Macroeconomic Variables and Actuals**(Per cent)*

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

*contd...*

<i>concl.</i>		<i>(Per cent)</i>	
<i>Year</i>	<i>Actuals</i>		
	<i>M<sub>3</sub></i>	<i>National Income (GDP at factor cost)</i>	<i>Inflation</i>
<i>(1)</i>	<i>(5)</i>	<i>(6)</i>	<i>(7)</i>
1980–81	18.1	8.1 (NNP in real terms)	18.2
1981–82	12.5	5.0 (NNP)	9.3
1982–83	16.6	1.7	4.9
1983–84	18.2	8.3	7.5
1984–85	19.0	3.8	6.5
1985–86	16.0	4.1	4.4
1986–87	18.6	4.3	5.8
1987–88	16.0	4.3	8.1
1988–89	17.8	10.0	7.5
1989–90	19.4	6.9	7.5

- Notes:*
1. Since 1985–86, the Reserve Bank started announcing the annual target for expansion in  $M_3$ , with the acceptance of the recommendations of the committee to review the working of the monetary system. In earlier years, the Reserve Bank made known to commercial banks the annual indicative ceiling for expansion in  $M_3$ , which was generally on July-June basis.
  2. The Reserve Bank started the exercise of estimating the growth rate in NNP in real terms from 1982–83 onwards in its Annual Report.
  3. In 'Actuals' National Income relates to GDP at 1980–81 prices, unless indicated otherwise.

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

## STATEMENT 4.5

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

<i>Year</i>	<i>All Commodities (subject to selective credit control)</i>	<i>Food grains</i>	<i>Paddy and Rice</i>
(1)	(2)	(3)	(4)
1981-82		Minimum margins raised (except for advances to roller flour mills against stocks of wheat) (October 30, 1981).	
1982-83	Reduction in minimum lending rates of interest (other than advances to sugar mills) (April 1, 1983).		
1983-84	Direct advances by banks up to ₹ 2,500 per farmer or the amount of crop loan outstanding completely exempt from selective credit control purview (July 4, 1983).		
1984-85	Rationalisation of selective credit controls initiated from April 1985. Minimum margin requirements against stocks were revised downwards from April 8, 1985. The minimum lending rate on advances against commodities (other than sugar) covered by selective credit controls were lowered. Multiplicity of prescriptions for certain commodities were reduced. Controls considered no longer necessary were abolished.		
<i>Year</i>	<i>Roller Flour Mills (against stocks of wheat)</i>	<i>Sugar, Gur and Khandsari</i>	
(1)	(5)	(6)	
1981-82			
1982-83		Minimum margins reduced (September 13, 1982 and November 18, 1982).	
1983-84			
1984-85			

*contd...*

*contd...*

<i>Year</i>	<i>All Commodities (subjective to selective credit control)</i>	<i>Paddy and Rice</i>	<i>Roller Flour Mills (against stocks of wheat)</i>	<i>Cotton and Kapas</i>
(1)	(2)	(3)	(4)	(5)
1984-85	Minimum lending rates lowered (other than sugar) (April 1, 1985).		Advances exempt from all provisions of selective credit control (April 8, 1985).	
1985-86	Advances upto aggregate ₹ 50,000 per borrower in respect of all commodities exempt provided the borrower dealt with only one bank (October 26, 1985). This limit was raised to ₹ 1 lakh from April 4, 1986. The base year was also brought forward.	Minimum margins reduced (October 25, 1985).  Advances exempt from provisions of selective credit control (April 4, 1986).		Advances against raw cotton exempt from all provisions of selective credit control (October 25, 1985).  Advances against cotton/kapas exempt from selective credit control (April 4, 1986).
1986-87			Banks were advised to consider freer flow of credit to wheat millers and traders than hitherto.	
<i>Year</i>	<i>Vegetable Oils, Cottonseed and its Oil</i>	<i>'Other Food grains' and Pulses</i>	<i>Sugar, Gur and Khandsari</i>	
(1)	(6)	(7)	(8)	
1984-85				
1985-86	Minimum margins against vegetable oils further reduced (April 4, 1986).  Bank advances against stocks of cottonseed and its oil were completely exempt from selective credit controls.			
1986-87		Minimum margins reduced across the board (April 1, 1987).	Minimum margins (on unreleased stocks of sugar) reduced.	

*contd...*

*concl.*

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

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

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

# 5

## Balance of Payments and Exchange Control

### INTRODUCTION

By an extraordinary happenstance, India began the 1980s with a severe balance of payments (BoP) problem and ended it with another. On both occasions, there was at least one common factor: a sudden increase in the price of crude oil. India's foreign exchange reserves were low when the decade of 1980s began. Global economic growth was sluggish and India's exports growth was slow. The imports were burgeoning as the oil import bill was large consequent on a rise in the international price of oil. The current account deficit (CAD) as a per cent of gross domestic product (GDP) rose from 0.5 per cent in 1979–80 to 1.8 per cent in 1980–81. External financing was not enough to meet the CAD as loans obtained under external assistance programme were the main source of capital flows. Therefore, the foreign exchange reserves were drawn down and International Monetary Fund (IMF) was approached for a financial assistance of SDR 5 billion in November 1981 to tide over the BoP difficulties. Quite interestingly, a similar chain of events occurred in 1990–91, of course with higher intensity.

In the 1980s, the Indian external sector scenario, to a large extent, mirrored the global situation, which influenced most of the developing countries. In varying degrees, almost all non-oil developing countries (NODCs) ran into BoP problems with India being no exception. In general, there was a substantial increase in trade deficits, as also sustained inflation in industrial countries along with subdued rates of growth in exports due to recessionary conditions coupled with a rise in protectionism in the industrial world. However, invisibles receipts expanded moderately,

which were off-set by an increase in the interest payments on account of borrowings to meet the deficits in BoP. The inflow of larger external assistance was inadequate to meet BoP deficits. In a sense, if one part of the story of the 1980s was financial deregulation in the developed countries, the other part was the external payments crises in the developing world. India's BoP too remained under stress during the 1980s and India put in place several corrective measures, the details of which are given in Appendix 5.1.

The global context for what happened in the early 1980s was that the oil shock induced a slowdown in the overall global economic activity, which deepened into a worldwide recession. Because of the large bank borrowings in the 1970s, the outstanding external debt of the NODCs in the beginning of the 1980s formed 144.0 per cent of their combined exports of goods and services. To make matters worse, the ratio of short-term debt to total debt outstanding increased to 18.2 per cent during 1982. There was a corresponding increase in the indebtedness to private creditors, particularly to banks. The commercial banks had already emerged as the single most important source of non-concessional external financing for the NODCs. The external debt burden of NODCs was also concentrated among a few relatively better developed countries.

The external debt crisis emerged in many developing countries in 1982 fuelled by a host of factors, such as, the higher oil prices in 1973–74 and 1979–80, persistence of high interest rate levels during the period 1980 to 1982, declining export prices and their volumes associated with the global recession in 1981–82, problems of domestic economic management, and risk aversion in the credit markets. Debt had been solidly entrenched in the finances of the developing nations for many years. A sharp spike in international interest rates and plummeting global demand for developing country exports marked the beginning of the debt crisis.

On account of rising debt-servicing, the net external resource flows to the developing countries declined sharply by 12.1 per cent in 1982 due to an absolute decline in both official development assistance (ODA) and non-concessional aid flows. In relative terms, the share of ODA increased marginally from 34.0 per cent in 1981 to 35.0 per cent in 1982, and the share of non-concessional flows showed a corresponding decline during the period. Under the ODA, bilateral assistance declined and the fall was almost entirely accounted for by the reduced flows from the Organisation of the Petroleum Exporting Countries (OPEC). The total external resource

flows to developing countries (in nominal terms) increased by 9.3 per cent during 1983. This increase was partly accounted for by an increase in concessional flow of funds. The share of grants by private voluntary agencies remained unaltered at around 2.0 per cent.

The increase in non-concessional flows in 1983 was predominantly on account of bank lending, as after the 1973–74 oil crisis, banks were flush with *petro* dollars and were keen to put these funds to productive use. As a result, the share of bank lending in total flows increased sharply from 26.9 per cent in 1982 to 39.0 per cent in 1983. Between 1981 and 1985, however, the net resource flows to the developing countries shrank by more than 40.0 per cent. The decline in aid flows was accounted for mainly by contraction in export credits and private flows, with ODA and grants from private voluntary organisations showing some increases. It was at this point that the IMF provided assistance and its structural adjustment programmes were framed to address the BoP problems, especially in the debt-stricken third world nations. Towards the mid-1980s, however, when the situation became grim, international banks abruptly disengaged from lending, since the risks became too grave. Financial resources provided to the developing world fell sharply in real terms in 1986, as higher official aid failed to balance out the continued net decline in export credits and bank lending. The flow of financial resources to the developing countries increased marginally in 1987, due mainly to official aid and international bank lending despite export credits showing a marginal decline. The situation of the indebted nations, however, continued to worsen and this led to a shift in focus from debt rescheduling to debt relief during 1988–89.

#### INDIA'S BALANCE OF PAYMENTS AND EXTERNAL ECONOMIC SITUATION

The 1980s began with a CAD rising sharply to ₹ 2,748 crore (US\$ 3,474.0 million) or 1.6 per cent of GDP and, despite a doubling of net aid disbursements (including a trust fund loan), the overall BoP deteriorated from a surplus position to a deficit of ₹ 407 crore (US\$ 514.0 million). It was well recognised that though the deficit in the BoP was partly because of transitory influences, such as a rise in the international price of oil and the drought, there were other elements, namely, the deterioration in the terms of trade that were likely to persist over time. Therefore, India approached the IMF for financial assistance to tide over immediate BoP difficulties and began considering a comprehensive programme to promote external

adjustment. The medium-term adjustment strategy included, in addition to the traditional focus on demand management, focussed attention on policies to address supply-side concerns. The adjustment strategy, supported by an extended fund facility (EFF) arrangement with the IMF, encompassed the following elements:

- (i) to promote strong and balanced economic growth in order to overcome persistent bottlenecks and provide supplies for exports and reduce imports;
- (ii) to provide resources for investment by raising domestic savings, especially in the public sector;
- (iii) to promote economic efficiency by reducing constraints on private investment and activity and liberalising import restrictions;
- (iv) to adopt domestic financial policies which promoted price stability and external payments adjustment; and
- (v) to encourage openness and, in particular, export promotion.

The EFF arrangement was based on a programme that included a clear enunciation of the performance criteria, a phased ceiling on the total domestic credit and a sub-ceiling on net credit to the Government; a ceiling on the official contracting or guaranteeing of external debt in the 1–12 year maturity range, with a sub-ceiling for maturities between 1 year and 5 years; and liberalisation of the norms relating to exchange and trade practices.

Thus, the key elements of the strategy underlying the extended arrangement with the Fund during the period 1981 to 1984, in short, included measures to increase agricultural and industrial supplies and thereby stimulate exports and compress imports, supplemented by an increase in public sector resource mobilisation. Financial policies provided for cautious demand management to encourage high rates of domestic savings and low rates of inflation. Structural reforms, particularly directed towards the reduction of administrative regulation in the areas of industrial and trade policies, were aimed at enhancing the efficiency of the domestic economy.

The important objectives of the EFF arrangement relating to higher economic growth, reduced inflation and the avoidance of deterioration in the current account balance were largely achieved. However, export performance remained disappointing. This development could be attributed only in part to the weakness in the overseas demand, and it essentially reflected the persistence of structural inefficiencies in the economy.

A number of new measures were introduced during the programme period 1980–81 to 1984–85 to improve the environment for promoting private investment and production. These included recognition of the need to utilise capacity created in excess of the authorised limits; automatic capacity expansion approvals; relaxation of locational restrictions; relaxation of debt equity norms; debt interest ceilings; and tax concessions, including allowances to encourage capital investment. Special measures were designed as incentives for export industries, including cash assistance to exporters to compensate for relatively high rates of indirect taxes, interest rate costs and product and market development costs, exemption of exports from industrial licensing, anti-monopoly and small scale sector reservation regulations, and introduction of tax and other concessions for 100.0 per cent export-oriented units. Duty-free imports of raw materials in select industries were permitted for exporters in 1980–81. Introducing further relaxations, the commodity restrictions on the use of export replenishment licences were eased and exports of items which were in short supply domestically were in many cases banned or made subject to quantitative limits.

In the area of foreign collaboration, policies were generally applied more liberally and pragmatically. Substantial steps were taken to reduce restrictions on investments in the export sector and to provide exporters with more liberal access to imports. Also, industrial pricing policies were made more flexible than in the past.

Overall, the performance under the EFF arrangement in terms of performance criteria was consistently observed and closely monitored. The CAD came down from US\$ 3.4 billion in 1982–83 (1.7% of GDP) to US\$ 2.4 billion (1.2% of GDP) in 1984–85. Imports of petroleum, oil and lubricants (POL) declined during 1981–82, both in quantity and value terms. This gradually led to an improvement in the BoP in 1983–84 and the Government terminated the IMF loan with effect from May 1, 1984, which was about six months before the scheduled final period of the arrangement. Amount drawn under the EFF (₹ 4,654 crore or SDR 3,900 million) was less than initially agreed (₹ 5,966 crore or SDR 5,000 million) to be drawn over the three-year period ending November 8, 1984.

In the aftermath of high political uncertainty following the assassination of the Prime Minister in 1984, general elections were held. The elected Government was keen to achieve an accelerated rate of growth and for this, it was necessary to initiate economic reforms. Efforts were made in this direction but, as the events unfolded over the next five years, growth

did accelerate due to a combination of internal and external developments but BoP began to come under sustained pressure, especially from 1987. An important reason for this outcome was high government expenditure, resulting in a steep increase in the fiscal deficit from 5.9 per cent of GDP in 1983–84 to 7.3 per cent in 1988–89.

The increase in fiscal expenditure affecting the aggregate demand resulted in a decline in the foreign exchange reserves during 1985–86 and a substantial widening of the trade deficit. As a result, India's external payments position, which showed marked improvement in 1984–85, came under strain. During 1986–87, however, the CAD narrowed somewhat and the ratio of the CAD to GDP — which had reached a high of 2.1 per cent during 1985–86 — declined to around 1.9 per cent. This was primarily on account of a reduction in the trade deficit. The CAD in 1987–88 did not show much improvement as compared with 1986–87, both in absolute terms and as a proportion of GDP. The annual average ratio of CAD to GDP of over 2.0 per cent in three years of the Seventh Plan, as against the targeted average of 1.6 per cent for the Plan period, mirrored the severity of the pressure on the BoP (Table 5.1).

TABLE 5.1  
*CAD/GDP and Debt-Service Ratio*

*(Per cent)*

<i>Year</i>	<i>CAD/GDP</i>	<i>Debt-Service Ratio*</i>
1981–82	–1.7	9.3
1982–83	–1.7	11.4
1983–84	–1.5	14.0
1984–85	–1.2	15.3
1985–86	–2.1	22.6
1986–87	–1.9	29.6
1987–88	–1.8	29.8
1988–89	–2.7	29.8
1989–90	–2.3	27.7

*Note:* \*Debt-service ratio reflects debt-service payments as per cent of current receipts.

*Source:* Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2009–10*; IMF, Article IV Staff Reports.

What caused concern was that despite strong export growth and a softening of international commodity prices, the pressure on the BoP did not ease. There was no let-up even during 1988–89, notwithstanding a robust export performance. The strains persisted since there was a sharp rise in the import bill; and the repayments to the IMF were large and, in fact, peaked during the year. The rise in the import bill was mainly due to an escalation in essential imports necessitated by the preceding year's drought, a rise in the international prices of certain commodities and larger import demand emanating from the recovery in the economic activity during the year. The fiscal profligacy of the Government in the 1980s, particularly in the latter half, led to the expansion of the CAD culminating in a BoP crisis in 1991.

The Reserve Bank expressed serious concern about the persistent deterioration in the BoP position in a letter dated December 23, 1988, addressed to the finance ministry, and suggested certain remedial measures. The letter stated:

The balance of payments was under considerable pressure since the beginning of the Seventh Plan. The foreign exchange reserves, excluding valuation changes, declined continuously during the first three years of the Seventh Plan by Rs. 707 crore, Rs. 732 crore, and Rs. 954 crore, respectively, despite a sharp increase in the aid flows and commercial borrowings. The order of current account deficit experienced during the Seventh Plan had crossed the comfort zone. This large order of current account deficit was financed partly by drawing down of reserves, but mainly through a large inflow of capital both on concessional and commercial terms and by way of NRI deposits. As a result, India's medium and long-term debt reached high proportions. The debt, which was around Rs. 13,300 crore at the end of March 1980, multiplied to nearly Rs. 55,000 crore by end-March 1988. In addition, the country had also contracted short-term debt, which was estimated to have gone up from Rs. 750 crore at end-March 1980 to Rs. 3,700 crore by end-March 1988. India's total external debt, as a proportion of exports and current invisible receipts, went up from 135 per cent at the end of 1979–80 to 240 per cent at the end of 1987–88. At the same time, the NRI deposit liabilities swelled from Rs. 855 crore at end-March 1980 to Rs. 11,775 crore by end of September 1988.

Consequent upon the increase in external debt, the debt-service obligations registered a consistent uptrend during the period under review. India's debt-service ratio peaked at 30 per cent in 1988–89. If the instalment payments on defence credits from the USSR, which were financed by way of export of goods but not included under debt-service, were also considered, the ratio would become still higher. Similarly, if the interest payments on the NRI deposits and short-term debt were taken into account for computing the debt-service, India's debt-service ratio in 1988–89 would have been 30.8 per cent. The country's debt-service ratio was fast approaching the level of the countries with debt servicing problems as a group, according to the IMF.<sup>1</sup>

The pressure on balance of payments and the mounting burden of external debt was possible to be contained only through a quick reduction in current account deficit. Looking at the developments and trends, more efforts were needed to attain a higher growth in exports and containment of imports in the areas of defence, POL and edible oils. The possibility of raising duties on products covered by the OGL, as a means of restricting their imports, could also be considered.

The trade deficit during 1988–89 was substantially higher than that in the preceding year. As for invisibles, net receipts were higher during the year due mainly to the receipt of ₹ 642 crore (US\$ 443.0 million) as compensation for Bhopal gas victims. The ratio of CAD to GDP at current market prices was estimated to have gone up to 2.7 per cent from 1.8 per cent in 1987–88. There was also a continuous depletion of reserves. By end-March 1990, foreign currency assets (FCA) declined to ₹ 5,769 crore (US\$ 3,368.0 million), equivalent to 1.7 months of import requirement. India seemed near to a payments crisis which, however, occurred a year later. The main developments under various components of the BoP during the 1980s are given in Table 5.2.

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1. International Monetary Fund, *World Economic Outlook*, 1988.

TABLE 5.2  
Key Components of India's Balance of Payments

(₹ crore)

Year/Item	1982-83	1983-84	1984-85	1985-86	1986-87	1987-88	1988-89
Merchandise							
A) Exports, fob	9,137 (9,490)	10,169 (9,861)	11,959 (10,061)	11,578 (9,461)	13,315 (10,413)	16,396 (12,644)	20,647 (14,257)
B) Imports, cif	15,857 (16,468)	17,093 (16,575)	18,680 (15,715)	21,164 (17,294)	22,669 (17,729)	25,693 (19,812)	34,202 (23,618)
I. Trade balance (A-B)	-6,719 (-6,979)	-6,925 (-6,715)	-6,721 (-5,654)	-9,586 (-7,834)	-9,354 (-7,316)	-9,296 (-7,168)	-13,556 (-9,361)
II. Invisibles, net	3,438 (3,572)	3,610 (3,499)	3,850 (3,238)	3,630 (2,967)	3,524 (2,756)	3,006 (2,316)	1,976 (1,364)
III. Current account (I+II)	-3,280 (-3,407)	-3,316 (-3,216)	-2,873 (-2,417)	-5,956 (-4,867)	-5,830 (-4,560)	-6,293 (-4,852)	-11,580 (-7,997)
IV. Capital account (A to F)	2,010 (2,087)	2,738 (2,655)	3,740 (3,147)	5,514 (4,506)	5,770 (4,512)	6,545 (5,047)	11,678 (8,064)
A) Foreign investment	-	-	-	-	249 (195)	563 (434)	517 (357)
B) External assistance, net	1,125 (1,168)	1,183 (1,148)	1,407 (1,184)	1,676 (1,370)	1,808 (1,414)	2,945 (2,271)	3,210 (2,216)
C) Commercial borrowings, net	732 (761)	785 (761)	1,110 (934)	1,167 (954)	2,513 (1,966)	1,266 (976)	2,743 (1,894)
D) Rupee debt service	-	-	-	-	-	-	-
E) NRI deposits, net	383 (398)	709 (688)	879 (740)	1,767 (1,444)	1,650 (1,290)	1,840 (1,419)	3,636 (2,510)
F) Other capital	-228 (-240)	59 (58)	342 (289)	904 (738)	-450 (-353)	-69 (-53)	1,572 (1,087)
V. Overall balance (III+IV)	-1,270 (-1,319)	-578 (-561)	867 (730)	-442 (-361)	-60 (-47)	253 (195)	98 (68)
VI. Reserves (increase -/decrease +)	-625 (-649)	-773 (-750)	-926 (-779)	707 (577)	732 (573)	956 (737)	1,449 (1,001)

Notes: 1. -: Nil.

2. Figures in parentheses represent US\$ million.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008-09*.

#### EXTERNAL DEBT

The large and recurrent CAD that emerged during this period was financed through inflows of capital from abroad by way of multilateral and bilateral assistance, commercial borrowings and non-resident deposits. As a result, India's external debt rose significantly and the long-

term debt (with original maturity of more than one year), which was relatively small at the end of March 1980 (₹ 13,430 crore), rose in the successive years to around ₹ 36,000 crore by end-March 1985, to nearly ₹ 55,000 crore by end-March 1988 and further to ₹ 69,700 crore by the end-March 1989.

As a proportion of GDP at current market prices, the external debt went up from 12.5 per cent at end-March 1980 to 16.6 per cent at end-March 1988. During the same period, the debt-export (export of goods plus invisibles receipts excluding official transfers) ratio rose sharply from 131.0 per cent to 218.0 per cent. The debt-service ratio as per cent of current receipts (exports plus gross invisibles receipts other than official transfers) also escalated from 8.1 per cent in 1980-81 to 15.3 per cent in 1984-85, but showed sharp spurts in the latter years of the decade to 29.8 per cent in 1987-88 and 1988-89, which was substantially higher than the average of 17.6 per cent, postulated in the Seventh Plan document.

#### DEBT-SERVICING

Total debt-service payments, according to the BoP statistics for the year 1982-83, formed less than 14.0 per cent of the total export earnings during the year and less than 0.8 per cent in relation to the gross national product (GNP). The debt-service payments, including those to the IMF, increased to 16.6 per cent of total export earnings during 1983-84. The CAD was financed increasingly by debt-creating flows. External liabilities as well as debt-service obligations were rising. The debt-service ratio increased sharply from 1985-86 onwards till 1989-90, despite encouraging expansion in exports during the preceding two years. The interest payments on non-resident deposits were treated differently from the usual debt-servicing of external loans because a good part of such interest payments was spent or reinvested in India. Even after allowing for the effect of bunching of debt-servicing relating to the IMF drawings, which peaked in 1988-89, it was necessary to reverse, over the medium-term, the rising trend in the debt-service ratio by a sustained and strong rate of growth in exports. Repayment to the IMF during the fiscal year 1988-89 amounted to ₹ 1,749 crore (which comprised ₹ 1,547 crore under the EFF and ₹ 202 crore in respect of the IMF trust fund loan) as against ₹ 1,389 crore (₹ 1,209 crore under the EEF and ₹ 180 crore on account of the IMF trust fund loan) in the previous year.

## NON-RESIDENT INDIAN (NRI) DEPOSITS

An important factor influencing capital flows was the growth in NRI deposits namely foreign currency non-resident accounts [FCNR(A)] and non-resident (external) rupee accounts [NR(E)RA]. With effect from March 1, 1982, at the instance of the Government, current deposits of one year and above under NRI deposits were allowed at rates of interest that were two percentage points higher than the rates permissible on domestic deposits of comparable maturities. Before the introduction of this measure, the Reserve Bank had opposed this move on technical and prudential grounds, but the Government held to its views. The Reserve Bank was, therefore, directed to offer the differential rate of interest.<sup>2</sup>

With the decline in deposit rates abroad, the interest differential proved effective. For instance, outstanding FCNR deposits increased by ₹ 231 crore during the year 1982–83 as against a decline of ₹ 13 crore in 1981–82. The corresponding movements in the NRE accounts were an increase of ₹ 435 crore in the year 1982–83 as against ₹ 265 crore in the previous year.

Between 1983–84 and 1984–85, there was an inflow of ₹ 680 crore and ₹ 635 crore into the FCNR (A) and NR(E)RA, respectively. It is noteworthy that inflows in 1985–86 rose by ₹ 281 crore and ₹ 1,151 crore under FCNR (A) and NR(E)RA, respectively, despite the lowering of interest rates on FCNR (A) deposits twice during the year. Inflows in NR(E)R accounts were substantially higher during 1986–87 than in the previous year, though they were lower than that under the FCNR (A) scheme. Inflows amounted to ₹ 650 crore and ₹ 3,473 crore under NR(E)R and FCNR (A) schemes, respectively during 1987–88. As at end-March 1989, the quantum of non-resident deposits stood at ₹ 14,154 crore — ₹ 5,899 crore under the NR(E) RA scheme, and ₹ 8,255 crore under the FCNR (A) scheme. The inflows under NRI deposits lent a significant measure of support to India's BoP and supplemented the foreign exchange reserves during the 1980s.

The movements in foreign exchange reserves during the period 1981–82 to 1989–90 are set out in Table 5.3.

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2. Correspondence with the Government in this regard is placed in the documents section.

TABLE 5.3  
*Foreign Exchange Reserves: Components*

(US\$ million)

<i>Year</i>	<i>SDR</i>	<i>Gold</i>	<i>FCA</i>	<i>Total</i>
1981–82	473	335	3,582	4,390
1982–83	291	324	4,281	4,896
1983–84	230	320	5,099	5,649
1984–85	145	325	5,482	5,952
1985–86	131	417	5,972	6,520
1986–87	179	471	5,924	6,574
1987–88	97	508	5,618	6,223
1988–89	103	473	4,226	4,802

*Source:* Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2010–11*.

Foreign exchange reserves recorded a rise from 1981–82 through 1986–87, but declined sharply from 1987–88 to 1989–90, raising an alarm about the situation. During the 1980s, the optimum level of foreign exchange reserves was broadly considered in terms of number of months of imports. Although there was a perception that the foreign exchange reserves should be adequate to meet 6 months of import requirements, the reserves ranged only between 2.5 and 4.5 months of the import cover through the 1980s (Table 5.4).

TABLE 5.4  
*Forex Reserves and Import Cover*

(US\$ million)

<i>Year</i>	<i>Forex Reserves</i>	<i>Imports during the Year</i>	<i>No. of Months' Imports</i>
1981–82	4,390	15,173	3.3
1982–83	4,896	14,786	3.6
1983–84	5,649	15,311	4.1
1984–85	5,952	14,412	4.5
1985–86	6,520	16,067	4.5
1986–87	6,574	15,726	4.4
1987–88	6,223	17,156	3.8
1988–89	4,802	19,497	2.5

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

## FOREIGN CURRENCY ASSETS

The FCA of the Reserve Bank, a major component of India's foreign exchange reserves, were US\$ 5,850.0 million at end-March 1981, which declined steeply to US\$ 3,582.0 million by end-March 1982. During 1982-83 to 1984-85, the FCA progressively rose to US\$ 5,099.0 million by end-March 1984, partly due to the IMF's financial assistance and partly because of external adjustment. They broadly remained range-bound between US\$ 5,482.0 million and US\$ 5,972.0 million from 1984-85 to 1987-88. However, thereafter the FCA declined rather markedly to reach a level of US\$ 2,236.0 million by end-March 1991 when the BoP crisis had got fully entrenched.

## GOLD HOLDINGS

The Gold Control Act, 1962 prohibited the import of gold other than through licensed dealers, and also barred Indian citizens from holding gold bars and coins. As such, there was a negligible amount of official gold import into the country, though large quantities of gold were smuggled into the Indian territory every year. Gold jewellery for use by the general population was made from recycled gold or smuggled gold. The quantum of gold remained largely constant in the country's foreign exchange reserves. The gold holdings of the Reserve Bank during the 1980s remained in the range of US\$ 320.0 million and US\$ 508.0 million or ₹ 226 crore and ₹ 274 crore (valued at the statutory holding price of ₹ 84.39 per 10 grams) [Table 5.3].

At 1987-88 prices, India's gold holdings stood at 324.99 tonnes, which did not earn any income for the country. During a review meeting of the Reserve Bank with the finance ministry on deployment of foreign exchange reserves on July 5, 1988, it was suggested that part of the gold reserves, which was not receiving any returns could be leased out to earn income. As a follow-up measure, the Reserve Bank wrote a letter dated September 10, 1988 to the ministry, proposing that gold could be stored with some central banks such as the Bank of England, the Federal Reserve Bank of New York and the Swiss National Bank, who were also acting as depositories. A proportion of the Reserve Bank's gold reserves could be deployed in international gold markets on a lease basis. Further, approximately 48.7 tonnes of gold could be physically transferred to one such depository, which would conform to the statutory requirement that 85.0 per cent of the gold reserves had to remain within the country. The physical movement of gold from Bombay to London involved a one-time

cost of US\$ 12,900 per metric tonne. Assuming a conservative price of US\$ 400.0 per troy ounce, one tonne of gold could have a deployable value of US\$ 12.86 million, which would yield an income of US\$ 64,300.0 per tonne per annum. The total annual income that could accrue to the Reserve Bank was worked out at ₹ 3.5 crore (US\$ 2.5 million). The Bank asked the finance ministry to examine and accord in-principle approval to the proposal, which materialised at a later date.

#### SPECIAL DRAWING RIGHTS (SDRs)

The SDR holdings had stood at SDR 529 million at end-March 1980, benefiting from the general allocation of SDRs in 1979–80. However, SDR holdings consistently declined thereafter year by year to reach a level of SDR 76 million by end-March 1991.

The SDR balances were generally used for repaying the earlier Fund obligations, payment of charges on various drawals from the Fund and the quota payment to the IMF.

#### EXTERNAL RESERVES MANAGEMENT

During the 1980s, the foreign accounts division (FAD) of the Reserve Bank continued to manage the external reserves. There was no extensive computerisation or connectivity network. In the absence of an extensive communications network, the division took the help of the State Bank of India's (SBI) New York branch to place funds with certain foreign banks as per a decision by the Reserve Bank — a practice that prevailed until the Reserve Bank established its own dealing room in the early 1980s. Selecting dealers from the existing Reserve Bank staff, imparting extensive training within the country and abroad in dealing rooms of large foreign banks, developing expertise in back-office operations, and instilling confidence among the dealers to take quick and judicious decisions were planned meticulously and executed entirely by the FAD. Specific currencies were assigned to the appointed dealers and they were encouraged to undertake extensive studies on those currencies to develop expertise in their trading. The currency limits were fixed for the individual dealers and their performance (profits earned) was reviewed at the end of each month.

The dealers were encouraged to take a view on the potential of a currency, based on which investment/disinvestment decisions could be taken. Under the guidance of the FAD in charge, the dealers decided on the currency portfolios and exposures like cash balance, Treasury Bills, bank deposits, government securities and institutions with whom to

invest. It required continuous alertness and updating with international developments in respect of the currencies and various institutions linked to the dealings. Losses in the individual deals were not important, since the objective was to earn overall profit at the end of the month. On instructions from the Governor, the division began compiling a monthly report containing the currency composition of forex reserves, and changes in the portfolios in terms of currency composition, asset distribution in terms of rupees, dollars, and SDRs as also major receipts and payments. Gradually, the division was fully computerised to facilitate putting in place an effective management information system (MIS).

The division compiled a half-yearly report indicating developments during the period, deployment of reserves, returns thereon, and the overall outlook on each major currency, which was forwarded by the Reserve Bank to the finance ministry. The report was reviewed by a high level committee comprising the Governor, the Deputy Governor, the Executive Director, officials from the concerned department and top officials from the finance ministry. The committee was mandated to regularly take a view on the composition of foreign exchange reserves in terms of currencies for the subsequent half-year.<sup>3</sup>

#### DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET AND REGULATION

The objectives and rationale for exchange market regulation and the Reserve Bank's operations in the exchange market were succinctly brought out by the Deputy Governor, Dr C. Rangarajan in a speech on the occasion of the 20<sup>th</sup> junior international forex seminar on December 13, 1985, New Delhi. The following is an edited summary:

As the economies of developing countries were not sufficiently diversified and developed so as to permit unrestrained imports, a free operation of the exchange markets was to be ruled out and exchange regulations in one form or the other became a necessity. As such the exchange markets were expected to provide more of service to the import and export trade rather than opportunities for pure exchange trading which was common in developed countries. Exchange rate policy and regulation of exchange markets had

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3. Transcript of the interview with Shri P.B. Kulkarni, former Executive Director, Reserve Bank of India.

therefore to be determined in the context of the overall economic objectives as reflected in the industrial and foreign trade policies. The task of central banks was therefore to steer the exchange markets in such a way as to promote the achievement of these objectives. It was viewed that these responsibilities became more difficult with the abandonment of the fixed exchange rate system.

After abandoning of the Bretton Woods system of fixed exchange rates in 1971, the major currencies floated relatively freely in the world currency markets. The developing countries, including India, did not resort to an independent float and instead pegged their currencies either to one of the major currencies or to a basket of currencies.

The exchange rates of major international currencies had started showing extreme volatility since the mid-1970s causing serious fluctuations in the trade flows. The exchange rate volatility was not only substantial but also showed a tendency to increase over a period of time. Barely 5.0 per cent of the foreign exchange transactions reflected international trade and the remaining 95.0 per cent was accounted for by capital transfers, arbitrage trading and speculation.

Faced with the system of floating exchange rates, the developing countries maintained some form of pegging arrangement for their currencies. This meant that uncertainty in the nominal exchange rates had two components — variability in the rate at which they pegged to the numeraire currency and variability in the relationship between the numeraire and other major currencies. The exchange rate fluctuations and volatility had relatively greater adverse consequences for developing countries than for developed countries. Traders faced greater uncertainty, especially because forward facilities were less readily available or, even if available, were more expensive. Variable exchange rates also posed a serious problem to these countries because of the limited responsiveness of their production capacities and trade to such changes. Nevertheless, governments in the developing countries had to make a choice about the most appropriate regime for determining exchange rates. Most developing countries were not in a position to allow their currencies to float independently. They neither had the institutional arrangements to link the local financial markets with international markets nor would their BoP position permit such a possibility. The choice was, therefore, confined to either pegging to a single currency or to a group of currencies. The choice depended on factors such as the degree of trade concentration and the

extent of openness. The choice of currencies and the weights to be assigned to them in the currency basket were again matters on which each country had to decide. Besides the mechanism for exchange rate determination, these countries also needed a specific policy with respect to the exchange rate, which had to be in consonance with their macroeconomic policy objectives.

The role of the central banking authority did not stop with determining the exchange rate regime. The operations in the foreign exchange markets needed to be supervised and monitored. The role of the Reserve Bank in the foreign exchange market in India during the 1980s was in a way typical of the role played by a central bank in most of the developing economies.

The Reserve Bank announced the day's buying and selling rate of the rupee in terms of pound sterling at the beginning of the day, as pound sterling was the intervention currency. The market was free to operate within the prescribed bands of the Reserve Bank Rate, supplemented by exchange margins allowed within the ranges prescribed by the Foreign Exchange Dealers' Association of India (FEDAI) in consultation with the Reserve Bank. The authorised banks were free to deal among themselves in any currency in both spot and forward maturities against the rupee or any other foreign currency. This ensured minimum recourse by market participants to the facilities of sale and purchase provided by the Reserve Bank. The Reserve Bank, on its part, was willing to sell only pound sterling in the spot market against specific demand from an authorised bank. On the purchase side, the Reserve Bank was willing to buy, spot and forward, four major currencies, *viz.*, the pound sterling, the US dollar, deutsche mark (DM) and Japanese yen in order to ensure extending reasonable rates to the exporters.

The guiding principle for the market was that authorised banks could approach the Reserve Bank only after exhausting all avenues for meeting their needs through the market. Also, the specified four currencies that could not be unloaded in the domestic market were required to be necessarily surrendered to the Reserve Bank unless required for cover operations abroad. These regulations, naturally, limited the access of authorised banks to the international markets. The access to international markets was thus confined to covering their currency positions arising out of genuine merchant transactions. While surrendering currencies to the Reserve Bank, the authorised banks were required to declare that the currencies were purchased against genuine trade transactions. The Reserve Bank supervised the market operations through weekly position state-

ments that the authorised banks filed with the Reserve Bank declaring their holdings of open currency positions. The Bank insisted that the currency positions should be either square or near-square at the end of each day.

The regulations relating to foreign exchange trading in India were framed to minimise these risks. Various regulations were logically inter-related to one another. First and the foremost, the Reserve Bank expected the dealers not to resort to outright forward or spot purchases or sales, *i.e.*, transactions that were not related to commercial customer transactions. Dealings in currencies aimed at making profit through the speculation route were to be avoided. Since the resource base of the Indian banks in terms of hard currency was limited, it was imprudent on the part of the Indian banks to maintain overnight open positions in foreign currencies. While prior to 1978 banks were required to maintain square or near-square positions in each foreign currency at all times, subsequently they were required to do so only at the end of the day. Thus, while recognising the need to minimise the open positions at the end of the day, the modifications introduced since 1978 did help to broaden the inter-bank market in India. This also facilitated offering uniform rates to the merchant community.

The Reserve Bank took keen interest in the operation of forward market facilities. The Reserve Bank regulations on forward market operations were extensive and well documented with the objective of making the market a useful tool for covering the exchange risks of importers and exporters in respect of their firm commitments in foreign exchange. The regulations served to ensure that market facilities were need-based and not used for speculative purposes. The Reserve Bank was willing to buy four specific currencies forward in the event that the market was unable to absorb them. The Bank, however, did not sell forward any currency.

The nature and extent of transactions in the foreign exchange market were also determined by exchange controls that were in operation. In relation to exports, the controls ensured that export proceeds were properly accounted for. As regards payments, the same were regulated on the basis of import regulations that were in force. Capital transactions involving borrowings from abroad needed prior approvals and sanction. Thus, the supply and demand in the foreign exchange markets were broadly conditioned by exchange control regulations in force.

With the high degree of volatility witnessed in the 1980s in the foreign exchange markets, the risk attached to carrying open positions in any foreign currency had increased. The second source of risk arose from a mismatch in the maturities of forward transactions. As cover for a forward

transaction, dealers normally undertook an opposite transaction to the nearest possible maturity to cover the transaction at a lower cost, instead of waiting for a counterpart with an identical maturity. Later, at a convenient time, the maturities were matched by undertaking swap operations or by primary trade transactions. In this process, however, banks could suffer losses as a result of changes in swap margins for the currencies concerned. The problem was further complicated when the contracts for the merchandise did not carry fixed date maturities. The contracting party was, therefore, given an option period of one month during which delivery could be taken or made. The third risk related to the credit risk arising from the failure on the part of a party to fulfil his obligations. The credit risk could arise in respect of both trade customers as well as bank customers.

The Reserve Bank regulations also required the banks to maintain balances in foreign currencies with overseas branches and correspondents at the minimum level. The objective of this regulation was to ensure that there was no unwarranted draft on the country's foreign exchange reserves for keeping idle balances abroad. To reduce conversion losses to the extent possible, the Reserve Bank expected the banks to clear all their foreign exchange operations through the inter-bank market in India. However, it was recognised and therefore permitted that, under certain conditions; banks could undertake transactions with banks abroad to cover their position.

Regarding open exchange positions, the reputed international banks carried large overnight positions that they were able to circulate among branches operating in different time zones. The international markets did not have any last resort buyers/sellers and naturally some banks had to carry forward the transactions that the market was unable to clear to the next day. In the free-trading countries in the international markets, central banks intervened only to correct exchange rate disturbances and not to provide last resort facilities to banks stuck with positions. In contrast, the Reserve Bank acted as a buyer/seller of last resort in the inter-bank market in India. This enabled the Indian banks to return to square or near-square position at the end of each day, as required under the regulations.

It was the objective of the Reserve Bank to develop an active exchange market at important trading centres in India with wide participation by the authorised dealers (ADs), exporters and importers so that various currencies that entered the country's external market were actively traded, facilitating customers to obtain fine quotes, with rate variations kept to

the minimum during a day. The foreign exchange market in India till the year 1990 thus remained highly regulated with restrictions on external transactions, barriers to entry, low liquidity and high transaction costs. The exchange rate during this period was managed mainly to facilitate India's imports and to control and monitor the current account balance.

The foreign exchange market in India came into existence in the true sense in 1978 when the banks in India were allowed by the Reserve Bank to undertake intra-day trading in foreign exchange and were required to comply with the stipulation of maintaining square or near-square positions only at the close of business hours each day. The extent of position, which could be left uncovered overnight (the open position), as well as the limits up to which dealers could trade during the day, were left to the management of banks to decide. The exchange rate regime was characterised by a daily announcement by the Reserve Bank of its buying and selling rate.

The beginning of the 1980s saw the Indian rupee appreciating in real terms as inflation was very high during the period. This period was also characterised by a second steep increase in oil prices and an unfavourable international trade and aid climate. The adjustment in the nominal exchange rate was not commensurate with the inflation differential, which led to an appreciation of the real effective exchange rate (REER) in the early 1980s. However, after 1984, a proactive policy of allowing adjustment in the value of the rupee was followed, keeping in view the inflation differential, and this gathered momentum. To add depth to the foreign exchange market and with a view to making it broad-based, the Reserve Bank started buying US dollars, DM and Japanese yen, both spot and forward, from ADs based on the rates and trends prevailing in the international foreign exchange markets with effect from June 1980.<sup>4</sup> The Reserve Bank followed the same procedure for purchases of foreign currencies under the long-term forward cover scheme.

This regime was activated with the intention of making the Reserve Bank's quotations more realistic and to bring them in alignment with the latest market trends. To bring about an overall reduction in the cost of foreign exchange business to exporters and importers, the Bank decided to regulate foreign exchange rates quoted by banks for the customer telegraphic transfer (TT) business in certain specified currencies.

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4. Reserve Bank of India, Exchange Control Department, Central Office, circular no. 20 (AP series), June 4, 1980.

Accordingly, with effect from October 1980, banks were required to quote TT selling and TT buying rates for the US dollar with a spread of one per cent from the mean TT rate and for other currencies, *viz.*, DM, Japanese yen, French franc, Swiss franc, Dutch guilder and Australian dollar, with a spread limit of two-and-a-half per cent. This step was initiated to help not only the exporters and importers but also to further strengthen the inter-bank foreign exchange markets in India.<sup>5</sup> With effect from October 1, 1981, the ADs were allowed to make offers of forward sales to the Reserve Bank without the prior approval of the Exchange Control Department (ECD). Hitherto, all offers for forward sales of pound sterling, US dollar, DM and Japanese yen by ADs to the Reserve Bank, for amounts not less than the specified limits, required prior approval from the ECD.

#### EXCHANGE RATE DEVELOPMENTS

Throughout the 1980s, the authorities did what in other countries is done by the market: they set the exchange rate practically on a daily basis. To illustrate, the exchange rate between the rupee and the pound sterling was changed 87 times between July 1981 and June 1982. It was changed 113 times in 1983 (July–June). Overall, the policy was aimed at a gradual depreciation of the rupee, both in nominal and real terms, in order to maintain the price competitiveness of the exports sector. This, in fact, was viewed as an integral part of the export strategy and a means of reinforcing trade liberalisation measures. This was achieved in a variety of ways, including changing the weight and components of the currency basket to which the rupee was linked, when necessary.

The movements in the international foreign exchange markets from July 1982 to June 1983 were characterised by long swings and a high degree of day-to-day volatility. For example, in 1982, the volatility in the yen/dollar spot rate, measured as the average absolute value of day-to-day percentage changes, was above 0.6 per cent, the highest in any year since the transition to floating rates in 1973. Apart from the volatility, other prominent feature of exchange rate movements was the continued strength of the US dollar despite deterioration in the current account balance of the United States (US). The pound sterling, which depreciated considerably in the latter half of 1982 and early 1983, primarily because of a decline in oil prices, somewhat improved after March 1983.

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5. Reserve Bank of India, Press Release, October 13, 1980.

The exchange value of the rupee continued to be determined in relation to a basket of currencies with the pound sterling as the intervention currency. The value of the rupee appreciated in terms of the pound sterling by 6.8 per cent over the year 1983, following a decline in the middle rate of the rupee per pound sterling from ₹ 16.50 at the end of June 1982 to ₹ 15.45 at the end of June 1983. The maximum appreciation in the exchange rate of the rupee to pound sterling, ever since the rupee was linked to a basket of currencies in September 1975, occurred during the year when the middle rate appreciated to ₹ 14.65 on March 24, 1983. The rupee appreciated against the French franc (5.7%), the Belgian franc (2.6%), and the Italian lira (2.9%). It, however, depreciated against certain other currencies like the US dollar (5.7%), the DM (2.5%) and the Japanese yen (11.5%). The rupee also depreciated against the SDR by 3.9 per cent during the year 1982-83.

The high volatility in the exchange rate movements of the major currencies continued during 1983-84, though on a somewhat lower scale than in the preceding year. As in the previous year, the US dollar remained strong, aided by the hardening of US short-term interest rates, a rebound in the US economy and global political tensions. During 1983-84 (July-June), the annual average rate of appreciation of the US dollar in relation to the SDR was, however, lower than in the preceding year. The Japanese yen, too, emerged stronger, supported by the country's good economic performance; in fact, on an annual average basis, whatever depreciation took place in relation to the US dollar during 1980-1983 was almost neutralised by its appreciation in 1983-84. The pound sterling and the DM weakened further against the US dollar. The pound sterling depreciated by 10.1 per cent during 1983-84, though the pace thereof decelerated. The rate of depreciation of the DM accelerated. Adjustments in the middle rate of the rupee in terms of pound sterling were made on 118 occasions during the year 1983-84 and marginally exceeded the 113 revisions during the previous year, *i.e.*, 1982-83. The middle rate of the rupee moved from ₹ 15.45 per pound on June 30, 1983 to ₹ 15.15 per pound on June 29, 1984 (June 30 being a bank holiday in India and in London), recording an appreciation of 1.98 per cent over the period. The rupee, which also appreciated against the French franc by 0.97 per cent and the Italian lira by 2.45 per cent, depreciated against other currencies, such as the US dollar (9.76%), DM (1.25%) and Japanese yen (10.53%) and also against the SDR (6.62%) during this period.

The volatility of exchange markets increased during the year 1984–85, particularly after February 1985, and continued till the end of the decade. The nominal exchange rate moved by around 51.0 per cent from the financial year average of ₹ 11.89 per US dollar in 1984–85 to ₹ 17.94 per US dollar in 1990–91. The REER with base 1985 declined to 73.33 in 1990–91. Thus the period saw following of the principle of exchange rate management in terms of which the exchange rate moved in line with the movement in the cross-currency exchange rate as well as the inflation differential. Despite gradual depreciation of nominal exchange rate of the rupee and the improved performance on the exports front, the CAD, driven also by internal imbalances, remained high. Thus the adjustment in the exchange rate, though large, was not found adequate to cover the current account gap.<sup>6</sup>

Internationally, the upward trend in the US dollar against most of the major international currencies witnessed since 1980 continued till February 1985, despite a sharp increase in the CAD of the US and a fall in the US interest rates. In fact, the upward movement of the dollar became more pronounced. Strong economic growth in the US, continuing tensions in the Persian Gulf and problems faced by the United Kingdom (UK) in the energy sector encouraged the flow of funds into the US and assisted in the rise in the US dollar value. From late February 1985, the underlying trend in the exchange rate of the US dollar was downwards, but the period was marked by wide fluctuations in exchange rates. Some important factors that contributed to this downturn were the deterioration in the BoP position of the US, greater-than-expected slowdown in the economy and continuation of the fall in interest rates. In 1985, the average rate of the US dollar declined sharply by 7.9 per cent against the pound sterling, by 5.6 per cent against the DM, by 3.8 per cent against the yen and by 3.1 per cent against the SDR. In the same month, the pound sterling rose by 5.1 per cent against the SDR and by 2.4 per cent against the DM.

The rupee value, however, continued to be determined in relation to a weighted basket of currencies of India's major trading partners, with the pound sterling as the intervention currency. The number of rupee–sterling rate adjustments aggregated 164 during 1984–85 (July–June), thus substantially exceeding the 113 changes during 1983–84. The middle rate of the rupee weakened by 5.9 per cent; from ₹ 15.15 per pound on

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6. Rangarajan, C. (1998). "Management of the External Sector", *R.N. Malhotra Memorial Lecture*. New Delhi. December 8.

June 29, 1984 to ₹ 16.10 per pound on June 28, 1985. Likewise, the rupee weakened sharply by as much as 10.0 per cent against the US dollar, by 6.9 per cent against the SDR and by 5.6 per cent against the yen during 1984-85. However, the depreciation of the rupee *vis-à-vis* the French franc, DM and Swiss franc was not pronounced. In contrast, the rupee strengthened marginally against the Italian lira over the same period.

During 1984-85, the rupee-rouble exchange rate was changed three times, *i.e.*, on July 29, 1984, October 25, 1984 and February 15, 1985. The exchange rate of the rupee per rouble as at end-June 1985 was ₹ 11.34 as against ₹ 10.33 per rouble at end-June 1984.

As already indicated, a decline in US dollar rate in relation to several major currencies was noticed during the year 1985-86. The downturn in the US dollar, witnessed since end-February 1985, became pronounced after the September 1985 agreement among G-5<sup>7</sup> ministers to strengthen currencies, particularly the yen and the DM, of the countries with large current account surpluses in relation to the US dollar and to actively use official intervention in foreign exchange markets to meet the objective. The Tokyo Summit in May 1986 emphasised the need for relative stability in exchange rates. However, important differences in the direction of the movement of exchange rates of some currencies emerged at the summit. It was agreed that the finance ministers of G-7<sup>8</sup> would meet more frequently to exercise surveillance over each other's economic objectives and policies so as to secure greater stability in the exchange rates of major currencies. However, between September 1985 and June 1986, the US dollar depreciated in terms of average monthly rates by 29.7 per cent against the yen, 21.3 per cent against the DM, 11.7 per cent in relation to the SDR and 9.5 per cent against the pound sterling.

The exchange markets in India continued to be volatile during 1985-86 with occasional periods of subdued trading. The number of adjustments in the rupee-sterling rates aggregated 149 during 1985-86 (July-June) as against 164 during the preceding year. The rupee remained more or less stable in relation to the US dollar, declining only marginally by 0.7 per cent between end-June 1985 and end-June 1986. However, reflecting the strong appreciation of the yen, Swiss franc, DM, pound sterling and the SDR *vis-à-vis* the US dollar, the rupee declined against these currencies.

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7. G-5 is a group of countries, namely, France, Germany, Japan, the UK and the US.

8. G-7 is a group of countries, namely, Canada, France, West Germany, Italy, Japan, the UK and the US.

During 1985–86 (July–June), the rupee–rouble exchange rate was changed six times, *i.e.*, on July 13, September 9 and November 10, 1985 and January 20, February 6 and April 24, 1986. The rupee–rouble exchange rate weakened over the year by 12.5 per cent to ₹ 12.96 per rouble at end-June 1986. In accordance with the Tokyo declaration of May 1986, the G-5/G-7 finance ministers continued their efforts during the year 1986–87 to bring about relative stability in the exchange rates of major currencies. They attempted a consensus on policy adjustments among the group, with appropriate modifications in relative interest rates and concerted intervention in support of an undisclosed range of exchange rates of key currencies. At times the dialogue became restricted to G-3,<sup>9</sup> with overtones of bilateral bargaining and understandings as reflected in the October 1986 pact between the US and Japan. Subsequently, the Paris meeting of February 1987 and the Washington meeting of April 1987 reaffirmed the intentions of the group to ensure a measure of stability in the exchange markets and this was reinforced in June 1987 by the Venice Summit. The instability in the exchange markets, however, persisted.

During the year 1986–87, reflecting the developments in international currency markets, the number of adjustments in the rupee–sterling rate aggregated to 141. The rupee was broadly stable against the US dollar. In view of the weakening of the US dollar against the yen, DM, pound sterling, Swiss franc and French franc, the rupee softened against these currencies and also *vis-à-vis* the SDR.

The rupee–rouble exchange rate was changed four times, *i.e.*, on July 17, September 21, December 4, 1986 and January 23, 1987 during 1986–87 (July–June). As a result, the rupee–rouble exchange rate, which was ₹ 12.96 per rouble at end-June 1986, became ₹ 14.79 per rouble at end-June 1987.

During 1987, the Louvre Accord of February 1987, and active and concerted intervention in support thereof ensured a measure of exchange rate stability in major currencies until the October 1987 crash in the international stock exchanges. The crash led to renewed pressure for further realignment in exchange rates. By December 1987, the exchange markets had steadied, with the US dollar declining further. The co-ordinated readjustment in the interest rates of major industrial countries and the statement by G-7 ministers issued on December 23, 1987, emphasising renewed co-operation among them to stabilise the US currency had a salutary effect on the exchange markets. The policy directives and

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9. A free trade agreement entered into by Columbia, Venezuela and Mexico.

commitments set forth in the December statement were reaffirmed by the G-7 countries in April 1988 in Washington DC and again in June 1988 in Toronto. In view of the continued large imbalances, the markets, however, remained volatile and prone to sharp day-to-day fluctuations, at times as a sequel to movement in key economic indicators.

During 1987-88 (July-June), the US dollar continued to weaken against all major currencies and the SDR for the third consecutive year. The pound sterling strengthened against the US dollar, DM and the SDR during most of this period.

Consequently, the number of adjustments in the rupee-sterling rate at 150 during 1987-88 (July-June) was marginally higher than those during 1986-87. In relation to the US dollar and the DM, the rupee declined by 8.4 per cent each between June 1987 and June 1988. Reflecting strong appreciation of the pound sterling and the yen *vis-à-vis* the US dollar during the period, the rupee weakened on a point-to-point basis by 14.1 per cent in relation to the pound sterling and by 16.4 per cent against the yen.

Following the statement by the G-7 ministers in December 1987, then in Washington DC in April 1988 and in Toronto in June 1988, there was a greater degree of co-operation among major industrial countries to stabilise the US currency, which had a positive impact on the exchange markets. During the year 1988-89, the US dollar maintained a firm undertone particularly because of the tightening of the US monetary policy in the wake of fears of the emergence of inflationary tendencies. A substantial weakening of the DM caused concerns about imported inflation in West Germany, while strong domestic demand in Japan led to higher economic growth, assuring the competitiveness of the Japanese manufacturing sector even with a further rise in the yen/dollar level. The pound sterling remained easy during most of the year, except during October to December 1988 when some upward pressure was felt.

The G-7 communique in September 1988 endorsed the prevailing pattern of exchange rate management but was not explicit regarding new initiatives for further stabilisation in exchange rates. The value of the rupee underwent adjustments *vis-à-vis* the pound sterling 229 times during 1988-89 (July-June). Between end-June 1988 and end-June 1989, the rupee weakened by 8.7 per cent against the yen, 14.8 per cent against the US dollar, 9.0 per cent against the DM and by 6.4 per cent against the pound sterling. The rupee-rouble rate applicable for settlement of credit

and commercial transactions was changed three times during 1988–89, *i.e.*, on October 10 and 24, and November 20, 1988. Accordingly, the rupee–rouble rate softened by 9.5 per cent; from ₹ 16.39 per rouble at the end-June 1988 to ₹ 18.11 per rouble at the end-June 1989.

The exchange rate of the Indian rupee *vis-à-vis* the SDR, the US dollar, the pound sterling, DM and yen during the period 1981 to 1989 is furnished below (Table 5.5).

TABLE 5.5  
*Exchange Rate of the Rupee*

(Calendar year-annual average)

Year	SDR	Rupee as Per Unit of Foreign Currency			
		Dollar	Pound Sterling	Deutsche Mark	Japanese Yen
1981	10.2418	8.6926	17.5423	3.8512	3.9600
1982	10.4766	9.4924	16.5954	3.9129	3.8200
1983	10.8310	10.1379	15.3653	3.9760	4.2600
1984	11.6482	11.3683	15.1469	3.9979	4.7900
1985	12.5625	12.3640	15.9904	4.2282	5.2200
1986	14.8083	12.6053	18.4924	5.8414	7.5400
1987	16.7617	12.9552	21.2366	7.2207	8.9800
1988	18.6994	13.9147	24.7729	7.9297	10.8700
1989	20.7906	16.2238	26.5515	8.6438	11.7600

Notes: 1. Exchange rate for Japanese yen is in rupees per 100 yen.

2. Data are based on official exchange rates.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09*.

## THE EXCHANGE RATE: A DISCUSSION

One of the persistent misperceptions about the rupee's external value in the 1980s was that it was overvalued and that is why it had to be steeply devalued in 1991. The REER with base 1985 declined to 73.33 in 1990–91, thus resulting in a depreciation of the rupee value in real terms to the extent of around 27.0 per cent.<sup>10</sup> The rationale behind these adjustments was explained by the Deputy Governor, Dr C. Rangarajan in his speech entitled 'Recent Exchange Rate Adjustments: Causes and Consequences' delivered at the Bombay Management Association in August 1991. The

10. Rangarajan, C. (2000). *Perspectives on Indian Economy: A Collection of Essays*. New Delhi: UBS Publishers.

adjustments reflected the growing internal imbalance in macroeconomic terms. Besides, the cost of financing the CAD had gone up. An adjustment to more sustainable levels of capital flows was imperative. A downward adjustment of the exchange rate of the rupee was one of the instruments, among others, for resolving these problems. A situation of continuing depletion of foreign exchange reserves generated destabilising market expectations. In the immediate short run, exchange rate adjustments helped to reverse market expectations and thereby stem the outflow of capital in the first instance and later encouraged its inflow. In fact, with respect to 20 of India's trade competitors, the REER of the rupee appreciated for a long time — by over 20.0 per cent between 1979 and 1986. It was only from 1987 that the rupee began depreciating in real terms as compared with these countries, and by 1989 was back to roughly the same level of exchange rate that prevailed in 1979.

A question often raised in the above context was whether the Reserve Bank targeted the REER during the period. In a technical sense, REER targeting would mean that the exchange rate is adjusted to an accepted measure of the REER. The rupee value underwent several adjustments over the period from 1985, resulting cumulatively in a one-way movement amounting to real depreciation by about 27.0 per cent. This downward adjustment in the effective exchange rate was on account of real depreciation of the currencies of competitor countries. Thus, it was a creeping depreciation or devaluation in real terms within the framework of the rupee's peg to a secret basket of currencies.

The debate on the issue of India's external sector policies and developments, particularly on managing the exchange rate, brought out the fact that despite the official announcement that the rupee was linked to a currency basket, the IMF, in its classification of the exchange rate arrangement of member countries, included India among the group of 'other managed floating currencies' rather than 'basket-linked currencies'. It was also noted that while most of the basket-linked currencies published their currency components and the method of the basket-related exchange rate adjustment, India did not disclose either the basket or the mode of calculation and adjustment during the period. India, while in principle accepting a basket-related peg, chose to adopt in practice an arrangement that would permit discretionary management of the external value of its currency.

From the early 1980s, the exchange rate was thus actively used as a policy instrument to achieve a sustainable CAD by ensuring improvement

in the price competitiveness of exports. At the same time, the gradual withdrawal and rationalisation of quantitative restrictions on imports enabled the import decisions to be increasingly responsive to price signals from exchange rate movements.<sup>11</sup> During the fixed exchange rate regime, the foreign exchange market for all practical purposes was at a nascent stage. The banks were required to undertake only cover operations and maintain a square or near-square position at all times. The objective of exchange control was primarily to regulate the demand for foreign exchange for various purposes within the limit set by the available supply. To overcome the weaknesses associated with a single currency peg and to ensure stability of the exchange rate, the rupee was pegged to a basket of currencies with effect from September 1975. The Reserve Bank of India was required to maintain the exchange rate within a band of  $\pm 2.25$  per cent which was widened to  $\pm 5.0$  per cent in January 1979 on either side of the base basket value. This exchange rate regime can be best described as an adjustable nominal effective exchange rate (NEER) peg with a band and this allowed for the achievement of a medium-term REER objective through changes in the NEER.<sup>12</sup>

## REFORMS AND POLICY CHANGES

### FOREIGN INVESTMENT POLICY AND DEVELOPMENTS

Foreign investment was considered as a vehicle for transfer of technology, not available indigenously, aiding either export promotion or import substitution. The ceiling for foreign equity participation, even when accompanied by import of technology, stood at 40.0 per cent. There were exceptions, however, and the Government could permit higher levels of foreign equity participation in industries with highly sophisticated technology or for export-oriented units. In fact, the Government could approve cent per cent foreign equity in the case of 100.0 per cent export-oriented units. In the field of technology, the Government was committed to allowing import in sophisticated and high priority areas, for export-oriented and import substitution industries and/or for updating the existing technology. As an exception to the general policy on foreign investment, investment proposals from the oil exporting developing countries (OEDC) were not linked to the transfer of technology clause.

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11. Rangarajan (1998) *op. cit.*

12. *Ibid.*

Such investments could be in the form of equity participation in certain specified industries.

As the BoP came under stress, particularly in the latter half of the 1980s, various possibilities of tapping the savings of NRIs were explored, partly with the belief that they would be irreversible. With a view to attracting remittances from Indian residents abroad, facilities with regard to bank deposits and investment in equity shares of the corporate sector were liberalised. Subsequently, in July and August 1982, these facilities were further enhanced and extended to cover preference shares and debentures issued by Indian companies. The Reserve Bank simplified the exchange control procedural formalities to facilitate such investments. The Government, on its part, decided to encourage borrowing low-cost funds from the international capital markets. In line with this policy, the Indian enterprises, both public and private, were selectively permitted to raise funds abroad. Hitherto, the facilities available for deposits in non-resident accounts and investment in shares of Indian companies were confined to non-resident individuals of Indian nationality or origin. During 1981-82, however, the entire gamut of liberalised facilities was extended to overseas companies, partnership firms, trusts, societies and other corporate bodies, in which at least 60.0 per cent of the ownership or beneficial interest was vested in non-resident individuals of Indian nationality or origin. The overseas bodies owned even indirectly to the extent of at least 60.0 per cent by such non-residents were also brought under the purview of this arrangement during 1983-84.

#### FACILITIES FOR INVESTMENTS WITHOUT BENEFITS OF REPATRIATION OF CAPITAL AND INCOME

NRIs and overseas corporate bodies were allowed to make portfolio investments through stock exchanges in India in equity, preference shares and convertible/non-convertible debentures without any limit on the quantum or value. They were also allowed to invest in the new issues of public or private limited companies in any business activity (except real estate) up to 100.0 per cent of the issued capital. Payment for purchases either through stock exchanges or for direct investment in new issues could be made by the eligible investors either through fresh remittances from abroad or out of the funds held in NR(E)RA/foreign currencies and non-resident ordinary (NRO) accounts.

In order to facilitate sale and transfer of shares through stock exchanges in India, where the original investment was on a non-repatriation basis by

non-residents of Indian origin, and where the other party was a citizen of India or a person of Indian origin, the Government waived the confirmation stipulation by the Reserve Bank, subject to certain conditions.<sup>13</sup>

FACILITIES FOR INVESTMENT WITH BENEFITS OF REPATRIATION  
OF CAPITAL AND INCOME

Non-residents of Indian nationality or origin and overseas corporate bodies predominantly owned by NRIs were permitted to make portfolio investments in equity preference shares and convertible/non-convertible debentures through stock exchanges in India, provided such investments in shares and convertible debentures in any one company by each investor did not exceed one per cent of paid-up value of the equity/preference shares and convertible debentures issued by the concerned company. The portfolio investment in convertible debentures could be made up to one per cent of the total value of each debenture series. Further, equity shares allotted on conversion were in addition to the shares of the concerned company purchased through the stock exchanges up to the limit of one per cent of paid-up equity capital. No limit, either on quantum or value, was stipulated with regard to purchases of non-convertible debentures. Payment for the portfolio investment was to be made either by fresh remittances from abroad or out of the funds held in NR(E)R/FCNR accounts with a bank in India.

Apart from the purchases of shares and debentures through stock exchanges, NRIs including corporate bodies owned by them were permitted to invest, with repatriation benefits, in the capital raised by a new or existing company (other than a Foreign Exchange Regulation Act [FERA] company) through new issues of equity/preference shares and convertible/non-convertible debentures. Investment in the new issues of non-convertible debentures was permissible without any monetary limit. However, in the case of new issues of shares and convertible debentures through the issue of prospectus, NRIs and corporate entities were allowed to invest up to 40.0 per cent of the new capital raised. The facility of non-resident investment of up to 74.0 per cent in equity capital raised by companies/partnership firms engaged in priority industries was extended

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13. Subject to the condition that shares were purchased through a member of a recognised stock exchange in India and proceeds were credited to the transferor's ordinary non-resident account with a bank authorised to deal in foreign exchange in India with no rights of repatriation outside India.

to direct investment in new issues of convertible debentures/preference shares and henceforth covered investment in hotels. The hotels segment was included in addition to abolition of list of industries, which were hitherto not open for direct investment by non-residents. Widening the scope further, in 1982-83, investment in hospitals was approved with full repatriation benefits under 40.0 per cent and 74.0 per cent schemes. Modifications in the list were made with the objective of stimulating growth in industries in the core sector, apart from promoting those with export potential or import substitution. Encouraging the adoption of advanced technologies and reaping economies of scale were some additional benefits assumed to flow from such policies. In 1985, the non-residents were accorded the facility to invest up to 100.0 per cent of equity capital in sick companies in India on a repatriation basis. The lock-in period in such cases was, however, placed at five years. New issues of Indian shipping companies under the 40.0 per cent scheme were next opened up for non-residents. Also relaxations were granted for diagnostic centres under the 40.0 per cent and 74.0 per cent schemes. In addition to the facilities for investment outlined above, NRIs and corporate bodies were permitted to invest freely in 12.0 per cent six-year national saving certificates (NSCs). A significant change made in respect of FERA companies was the enlargement of the list of industries open to them.

The Government, in the first half of the 1980s, permitted the shareholding of foreign investors to be maintained at 51.0 per cent or below, subject to the foreign shareholders bringing in the required foreign exchange in cash to acquire shares at about the market price to maintain the stipulated level of foreign equity holding and further, subject to the passing of the required special resolution under section 81 of the Companies Act, 1956. The quantitative ceiling of ₹ 40 lakh for investments by non-residents in private limited companies under the 40.0 per cent scheme was also removed.

Designated banks were allowed to promptly repatriate sale proceeds of investments of NRIs with the permission of the Reserve Bank, even without producing a no-objection certificate (NOC) or the tax clearance certificate. The amount due for repatriation was, however, limited to the cost of acquisition of investments sold or actual sale proceeds realised, whichever was lower. In respect of the portfolio investments in equity shares, such investments were to be held for a minimum period of one year.

The budget for 1985–86 abolished estate duty, which was a major hurdle for remittances to India by non-residents. Further, the abolition of surcharge on income tax was expected to attract investments in shares and debentures of Indian companies and company deposits by NRIs. The data on approvals granted for such investment registered an increase during the year. Thus, the number of approvals granted by the Reserve Bank for direct investment with full repatriation rights to NRIs rose from 162 in 1983–84 to 211 in 1984–85. The amount of investment involved also went up by 24.6 per cent during the same period; the approvals under the 74.0 per cent scheme, however, declined. The approvals for direct investment on non-repatriation basis showed an increase of 52.9 per cent in 1984–85. The rise in respect of consents for initial issues to non-residents from ₹ 8.3 crore in 1983–84 to ₹ 95.4 crore in 1984–85 was highly impressive and reflected, *inter alia*, the effect of liberalised investment schemes, which were introduced in 1982–83, for attracting investments from NRIs.

With effect from July 31, 1986, to facilitate prompt remittance of dividends, the ADs were granted permission to remit dividends to non-resident shareholders, irrespective of the face value of the equity shares or percentage of issued equity capital held by such non-residents, without the prior approval of the Reserve Bank in respect of non-FERA companies. Only applications of FERA companies were required to be submitted to the Reserve Bank.

The number of proposals approved by the Reserve Bank under facilities available for direct investment with full repatriation rights to NRIs went up by 65.2 per cent, from 264 in 1985–86 to 436 in 1986–87. The amount involved also went up sharply by 65.9 per cent over the previous year. As in the past, approvals for investment under the 40.0 per cent scheme accounted for the bulk of the investment (97.0%) approved during 1986–87. During 1986–87, while consents issued to non-residents for further issues and bonus issues increased over the previous year, this was more than off-set by a drop in approvals for loans, initial issues and debenture issues.

Approvals granted for investment under the 40.0 per cent scheme during 1988 accounted for the bulk (91.0%) of the investments approved; the approvals under the 74.0 per cent scheme also increased during 1988–89. The amount invested by banks on behalf of their non-resident constituents through stock exchanges in respect of approvals granted for portfolio investments was marginally higher. During the year 1988–89, further efforts were made to attract the savings of NRIs. The India Growth

Fund (Country Fund), the second in the series, was launched in the US jointly by the Unit Trust of India (UTI) and Merrill Lynch, which helped mobilise a sum of ₹ 88 crore (US\$ 60.0 million). Another investment scheme was launched by the SBI in November 1988 through floatation of seven-year cumulative non-repatriable NRI bonds denominated in US dollars. The inflow under this scheme during 1988–89 amounted to ₹ 138 crore (US\$ 92.0 million).

Final orders under section 29(2), FERA 1973, requiring Indianisation/dilution of non-resident equity holdings to a specified level were issued to 389 companies. Of these, 369 companies complied with FERA directives as on March 3, 1989. The remaining 20 companies were at various stages of compliance, such as winding up, and were granted an extension at their request.

The liberal policy of encouraging direct and portfolio investment by the non-residents was continued during 1988–89. In fact, investment by non-residents, particularly in the form of deposits under the NR(E)R and FCNR accounts schemes provided significant support to India's external payments during 1989–90.

#### EXTERNAL ASSISTANCE AND FUND DRAWINGS

Before liberalisation of external commercial borrowings (ECBs) and foreign investment, external assistance was an important source of financing the CAD. In the 1980s, though ECBs were encouraged during the later part of the decade, foreign direct investment (FDI) was broadly restricted to transfer of technology, while portfolio investment was confined to investment by NRIs only. Therefore, external assistance became an important segment of capital flows. Net loans received under the external assistance programme accounted for roughly 37.0 per cent of capital flows and financed as much as 35.0 per cent of the CAD in the 1980s. The external assistance received by India comprised loans and grants. Loans had the concessional and non-concessional components. Interestingly, concessional loans comprised a significant part. Similarly grants consisted of both cash and commodity grants, the latter being dominated by food grants.

India received external assistance from multilateral as well as bilateral sources. The major part of multilateral loans was received from the World Bank Group (International Bank for Reconstruction & Development [IBRD] and International Development Agency [IDA]). While the loans from the IBRD were at near market terms, the IDA credits were highly

concessional, where only a service charge of less than one per cent was applicable. The bilateral donors, who actively lent to India in the 1980s, were West Germany, France, Japan and the erstwhile USSR. The fresh commitments by the World Bank showed an uneven trend during the 1980s. They remained in the range of US\$ 1.8 and US\$ 2.1 billion during 1980–81 to 1984–85, except in 1983–84 when they declined rather sharply to US\$ 1.1 billion due to the combined effect of the lower overall commitment by the IDA in that year and higher IBRD support to Latin American countries. In the second half of the 1980s, the World Bank stepped up aid commitments to India to an annual average of around US\$ 2.2 billion. The major portion, however, came from the IBRD.

As far as bilateral aid was concerned, the Aid India Consortium used to meet in June every year to deliberate on India's requirement of concessional flows and effective use of aid already received. The amount of aid pledged remained broadly the same for 1982–83 and 1983–84 at around US\$ 3.4 billion. The member countries in the meeting held on June 14–15, 1983, acknowledged the soundness of India's development policies and the prudence with which it had managed the BoP position. For the year 1984–85, the consortium members met on June 19–20, 1984, and pledged an amount of US \$4.0 billion. The members appreciated the strong performance of the Indian economy and underlined the need for concessional aid flows to enable India to achieve its development objectives. The Paris Club members met in Paris on June 18–19, 1985 to consider India's aid requirements for the year 1985–86 and pledged a total amount of SDR 4 billion, which was the same as in the previous year. For the years 1987–88 and 1988–89, the consortium pledged an amount of US \$5.4 billion and US \$6.3 billion, respectively. The amounts pledged in the consortium meetings represented only broad indications of the likely level of assistance in the year and the amounts made available depended upon bilateral agreements concluded during the course of the year.

India's external sovereign borrowing during the 1980s was restricted to loans obtained from multilateral and bilateral sources under external assistance programmes. Neither the central nor the state governments borrowed from the international capital market.

The pick-up in the receipt of gross external assistance evidenced in 1979–80 continued during 1980–81. However, the net loans received during 1981–82 were placed lower at ₹ 746 crore, which was made up of gross loan receipts of ₹ 1,367 crore and repayment of ₹ 621 crore. This,

along with the official transfers (grants), financed only 18.0 per cent of trade deficit as against over 27.0 per cent in 1980-81.

During 1982 to 1985, the net loan receipts rose gradually from ₹ 1,124 crore in 1982-83 to ₹ 1,183 crore in 1983-84 and further to ₹ 1,407 crore in 1984-85 mainly due to corresponding increase in gross loan receipts. Official transfers during these years were ₹ 380 crore, ₹ 392 crore and ₹ 574 crore, respectively. Net loan receipts combined with the official transfers financed the trade deficit at an annual average rate of around 20.0 per cent during this period.

The net inflow of external assistance during the second half of the 1980s grew progressively from ₹ 1,676 crore in 1985-86 to ₹ 3,090 crore in 1989-90, owing to larger gross receipts partly due to better utilisation of external loans. In tandem, official transfers too as per BoP statistics rose from ₹ 427 crore in 1985-86 to ₹ 897 crore in 1989-90. As a result, net external aid financed higher proportion of trade deficits in the second half of the decade, which rose gradually from 22.0 per cent in 1985-1986 to 32.0 per cent in 1989-90.

In November 1981, the Government negotiated a loan of ₹ 5,966 crore (SDR 5 billion) from the IMF under the EFF. Under this arrangement, a sum of ₹ 948 crore was drawn up to June 30, 1982. According to the BoP data, purchases (drawals) from the IMF during the fiscal year 1982-83 stood at ₹ 1,896 crore under the EFF. Such drawls had amounted to only ₹ 637 crore during 1981-82. In 1984-85, the drawals from the IMF at ₹ 1,425 crore lent significant support to India's BoP. However, purchases from the IMF were only ₹ 217 crore during 1984-85, and the IMF loan was terminated in May 1984. From 1985-86, outflows began on account of the IMF repayments, which went up from ₹ 264 crore in 1985-86 to ₹ 673 crore in 1986-87. During 1986 to 1990, the repayments to the IMF ranged between ₹ 1,209 crore and ₹ 1,547 crore adding to the pressure on the BoP particularly during 1988-89 and 1989-90 when the CAD expanded respectively to 2.6 per cent and 2.2 per cent of GDP in the respective years.

### CONCLUDING OBSERVATIONS

In the early 1980s when a severe BoP problem struck the country following the second oil price shock, the Indian external sector scenario largely mirrored the global situation. In varying degrees, almost all NODCs ran into BoP problems.

The widening CAD in the BoP was, however, only partly because of the rise in the international price of oil. A drought and the deterioration in

terms of trade also contributed to the worsening of the CAD. Therefore, India entered into an EFF arrangement with the IMF for financial assistance to tide over the immediate BoP difficulties. The EFF arrangement included a clear enunciation of certain performance criteria and structural economic reform measures. Though the reforms met with political resistance and remained an unfinished agenda, some important objectives of the EFF arrangements relating to higher economic growth, reduced inflation and improvement in the current account balance were largely achieved. This gradually led to an improvement in the BoP position in 1983–84 and the Government took the opportunity to terminate the IMF loan in May, 1984, about six months before the original schedule.

During the period 1984–85 through 1989–90, growth accelerated due to a combination of external and internal developments but BoP came again under pressure, especially after 1987. An important reason for this situation was uncontrolled expansion in government expenditure resulting in a steep increase in fiscal deficit from 5.9 per cent of GDP in 1983–84 to 7.3 per cent in 1988–89, a substantial part of which was monetised through unlimited issue of *ad hoc* Treasury Bills. What caused concern was that despite strong exports growth and softening of international commodity prices, the pressure on the BoP did not ease. The fiscal excesses of the Government in the latter half the 1980s evidently spilled over into widening of the CAD that led to a gradual build-up of a crisis situation by 1989–90.

During the 1980s, the newly created FAD of the Reserve Bank continued to manage the external reserves. The division earlier took the help of the New York branch of the SBI to place funds with certain foreign banks as per the decision of the Reserve Bank. In the early 1980s, however, the Reserve Bank established its own dealing room and evolved its own policy for managing the external reserves through dealers selected from the staff.

After the Bretton Woods system of fixed exchange rates was abandoned in 1971, major currencies floated relatively free in the world currency market. Most developing countries including India, however, could not afford to allow their currencies to float independently for fear of volatility and exchange rate misalignment. The choice was thus confined to either pegging to a single currency or to a group of currencies. The option depended on factors such as the degree of trade concentration and the extent of openness. The choice of currencies and the weights assigned to them in the currency basket were matters on which each country took its own decision. In India, the exchange value of the rupee was determined

initially in relation to a secret basket of currencies with the pound sterling as the intervention currency.

The Reserve Bank thus announced the day's buying and selling rate of the rupee in terms of pound sterling. The market was free to operate within the prescribed bands of the Reserve Bank Rate supplemented by exchange margins allowed within the range prescribed by the FEDAI. The authorised banks were also free to deal among themselves in any currency. This facilitated development of an active inter-bank market in foreign exchange. The Reserve Bank also evolved extensive and well documented regulations on forward market operations with the objective of making the market a useful tool for covering the exchange risk of importers and exporters.

Throughout the 1980s, given the need for sustaining external competitiveness, the exchange rate policy was implicitly aimed at a gradual depreciation of the rupee, in real terms, in order to maintain the price competitiveness of the exports sector. The rupee value consequently underwent a series of small adjustments over the period from 1985, resulting cumulatively in a real depreciation of about 27.0 per cent by 1989–90. As a result, despite the official announcement that the rupee was pegged to a currency basket, the IMF, in its classification of exchange rate arrangement of member countries included India among the group of 'other managed floating currencies'.

By 1988–89, there were clear signs of an oncoming external payments crisis. During the second half of the 1980s, non-concessional and short-term external borrowings increased. Between 1984–85 and 1989–90, the total debt to GNP ratio increased from 17.7 per cent to 24.5 per cent and the debt-service ratio increased from 15.3 per cent to a rather unsustainable level of 27.7 per cent during the same period. The difficulty of financing of the widening CAD through external short-term commercial borrowings triggered by loss of confidence remained at the heart of the problem. The foreign exchange reserves shrank dramatically by December 1990. India thus ended the decade as it had started — with a full-blown BoP crisis lurking around the corner.

## ANNEX 5.1

*Joint Ventures (JVs) Abroad*

India continued to pursue its overall strategy of participating in the development efforts of other countries by way of encouraging and promoting JVs abroad. The efforts made by the Indian private enterprise in encouraging and promoting JVs abroad were rather new during the early 1980s. Such ventures, however, were crucial to the development strategies of Indian enterprises. Apart from the private companies, a number of public sector enterprises also showed a keen interest in setting-up JVs in diverse areas such as machine tools, engineering contracts and fertilisers. During 1981–82, there were 228 JVs located in 37 countries, of which 134 were in operation and 94 under various stages of implementation. Prominent among these countries were Malaysia, Singapore, Indonesia, Kenya, Nigeria, Thailand, the UK and the US. During 1982–83, 140 JVs were in operation and 88 proposals were being implemented. By the end of December 1983 the number of JVs in operations reached 154, while 81 proposals were at various stages of implementation. During 1984–85, a number of Indian companies established JVs abroad, particularly in Asia and Africa. Remittances received in India from JVs abroad as at end-December 1984 amounted to ₹ 7.7 crore by way of dividends and ₹ 25.4 crore by way of fees for technical know-how, engineering services and consultancy management. With regard to foreign collaboration in Indian industry, the number of approvals during 1985–86 declined marginally by 5.0 per cent from 979 to 930. Of the approvals granted during 1986–87, 674 or 72.0 per cent were for pure technical collaboration, drawings and designs, and 256 for technical-cum-financial collaboration. However, the number of Indian JVs in operation abroad declined from 156 at end-December 1985 to 150 at end-December 1986. Equity participation by Indian companies in JVs in operation abroad also declined at end-December 1986.

As at end-December 1988, there were 179 JVs abroad, of which 152 were in operation while 27 JVs were at different stages of implementation. Equity participation by Indian companies in JVs which were in operation abroad stood at ₹ 96.78 crore (including bonus shares) as at end-December 1988 compared with ₹ 93.12 crore at end-December 1987. The approved Indian participation in the equity of the JVs under implementation stood at ₹ 16.79 crore as at end-December 1988. Of the 152 JVs in operation, 94 (62.0%) were in the manufacturing sector and 58 (38.0%) in the non-manufacturing sector.

*Foreign Collaborations in India*

As regards foreign collaboration approvals in Indian industry, the number of approvals granted for foreign collaboration, both technical as well as financial, stood at 389 in 1981, gradually increased to 752 in 1984, posted a jump to 1,024 in 1985 but declined thereafter gradually to 605 during 1989. The financial

approvals, which were 57 in 1981, increased gradually to 238 in 1985 but declined to 194 during 1989. A significant shift was noticed in the percentage of technical approvals *vis-à-vis* the financial approvals. The technical collaborations remained close to or above 80.0 per cent of the total approvals granted in the early 1980s, but the mid-1980s witnessed a gradual slowdown to about 70.0 per cent in such collaborations, meaning that the financial approvals were gaining prominence with time. The continued emphasis on technical collaboration was expected to help improve the productivity and efficiency of Indian industries. In the long run, it was expected to impart a competitive edge to the Indian export industries as also to reduce dependence on foreign imports.

# 6

## Banking and Finance

### INTRODUCTION

The 1970s was a tumultuous decade for the world as well as for India. The Organisation of the Petroleum Exporting Countries (OPEC) had virtually quadrupled the price of crude oil during the decade and the Western economies had sunk into what Paul Samuelson labelled as stagflation — inflation and stagnant growth. For India the 1980s began with two major setbacks to the economy, namely, the second oil price shock of 1979 and the drought of 1979. Both shocks led to very high inflation, which touched 22.0 per cent at its highest. The five-year period preceding 1979, which had gone off smoothly with low and even negative inflation, comfortable foreign exchange reserves and steady economic growth, thus, came to an abrupt end. When the new Government took over in January 1980, it found itself with a host of problems, not the least of which was the low banking penetration and poor credit facilities. Also, the deficient financial resources of the Government prompted it to shift the burden of poverty-targeted direct interventions to the banking system. In that sense, banking took on the role of a social institution and lost a great deal of its commercial sharpness. It also became overextended, undermanned and undercapitalised. It turned, for all practical purposes, into an adjunct of the finance ministry, with the role of the Reserve Bank virtually relegated to the background.

By the beginning of the 1980s, it was clear that the banking system needed to consolidate and get back to sound banking practices. It was to this task that the Governor of the Reserve Bank, who took over in late 1982, devoted himself. The immediate agenda, as the 1980s set in, thus,

was to consolidate and build on the gains of the 1970s. The key elements adopted by the banking sector during this phase were, *inter alia*, a significant slowdown in branch expansion while shifting the focus to covering spatial gaps in rural areas, drawing up of comprehensive action plans by individual banks (covering organisation and structure, training, housekeeping, customer service, credit management, recovery of dues, staff productivity and profitability), introducing modern technology in banking operations in a phased manner, relieving policy-related constraints on bank profitability by raising coupon rates on government bonds and return on cash balances held with the Reserve Bank, allowing greater flexibility in bank service charges, and strengthening the capital base of banks.<sup>1</sup> The media reaction to such policies reflected that the ambitious branch banking of the earlier years, without adequate preparatory work, had also meant heavy expenditure on new branches and the consequent losses in running these in many semi-urban and rural centres. It was thus realised that there was a need for consolidation. Attention also needed to be focused on the quality of lending and the safety of funds.<sup>2</sup>

The approach to banking consolidation was expressed by the Governor, Dr Manmohan Singh in his speech<sup>3</sup> at the founders' day of Bank of Maharashtra. He emphasised that the banking system had a major contribution to make to the Seventh Plan, which aimed to achieve a 5.0 per cent rate of gross domestic product (GDP) growth. The banks, he said, had a strategic role to play in increasing the national savings rate and in channelising the available savings to finance high-priority investments. Better utilisation of available capacities was required both in agriculture and industry through adequate supply of credit as working capital. The cause of social justice had to be promoted by increased emphasis on meeting the credit needs of hitherto neglected sectors and sections of the population, as also by providing finance for anti-poverty programmes, such as the integrated rural development programme (IRDP). He further pointed out that banking had a major impact on maintaining price stability and managing the balance of payments which, in turn, exerted a powerful

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1. Malhotra, R.N. (1990). "The Evolving Financial System", *50 Years of Central Banking: Governors Speak*. Reserve Bank of India.
  2. "Rigidity of Interest Rate Structure", Editorial, *The Hindu*. October 16, 1985.
  3. Singh, Manmohan (1984). *Indian Banking System in the Seventh Five Year Plan*, Speech delivered at founders' day of the Bank of Maharashtra. Pune. September 16.

influence on the orderly implementation of development plans. To achieve all this, the banking system needed to promote greater efficiency and better customer service through new work technology, manpower planning and training arrangements. The international operations needed to be improved by streamlining the functioning of the overseas bank offices. At the same time, profitability of banking operations had to be taken care of. At the end, however, the task of getting all this done was the responsibility of the Reserve Bank. Further, the Reserve Bank, as banker to the Government and as the regulator of the banking system, was required to ensure that the expectations of the Government were met.

By 1985, there was a massive increase in the number of bank branches and a strong effort at mobilising savings and extending credit, as dictated by targets and sub-targets for the preferred sectors. That some of these endeavours were contrary to normal banking practices mattered little. These efforts did help in fact in creating the extensive financial infrastructure.

It must be noted, however, that while the Reserve Bank and the Government agreed on the ultimate objectives, some differences in perceptions and policies surfaced between the Reserve Bank and the Government.

#### APPROACH TO BRANCH LICENSING POLICY

The Indian banking system comprised commercial banks, co-operative banks and regional rural banks (RRBs). Commercial banks fell into three categories, *viz.*, public sector banks (PSBs) whose ownership was with the Government, private sector banks and foreign banks. In the case of PSBs and RRBs, whose share of business was more than 80.0 per cent in the 1980s, Government dominance and command was the unique feature, where the role of the Reserve Bank as regulator of the banking system was rather limited.

Indian banking, until nationalisation in 1969, was mostly urban. There were very few rural branches. The Government tried hard to persuade banks to open branches in the rural areas, but to little avail. So when the regime nationalised 14 banks, the aim of the branch licensing policy turned to spreading the branch network. The emphasis was on branch expansion in rural, semi-urban and urban centres. With time, however, it became apparent that there was a limit to which this policy could be pursued. The Reserve Bank, in consultation with the Government, therefore, reformulated the policy for the next triennium covering the fiscal years

1982–83 to 1984–85 to coterminate with the Sixth Five Year Plan. The basic message was to place requisite emphasis on relevant social factors.

While the policy of reducing interstate and inter-district disparities continued to be reiterated, the new policy<sup>4</sup> aimed at providing one bank office in the rural and semi-urban areas for a population of 17,000 on the basis of the 1981 census by March 1985. Provisions were also made for expansion in other areas keeping in view the growth in economic activities, the need for banking facilities, the potential for deposit mobilisation, the spatial gap in the availability of banking services in an area and other features. Sparsely populated areas, hilly regions and tribal areas were to be given special consideration.

#### SPREAD OF BANKING

The emphasis on branch expansion efforts yielded results. Consequently, between June 1981 and June 1989, the share of rural branches increased by about 8.0 per cent and that of metropolitan branches came down by about 2.0 per cent, indicating the special attention paid to create a network of branches in the rural and semi-urban centres (Table 6.1). The three-year branch expansion plan for the period April 1982 to March 1985 was implemented successfully. The main objectives of the branch licensing policy, namely, improving banking facilities in rural and semi-urban areas with greater emphasis on proper spatial distribution of bank offices and reduction in interregional disparities in banking development, were largely achieved. The coverage would have improved further if banks had also opened offices at about 5,000 rural and semi-urban centres for which they held licences. The expansion of branches in urban/metropolitan/port-towns, where the spread of banking services was already quite intensive, continued to be restricted and new branches in these areas were allowed to be set up on a selective basis, taking into account their necessity and financial viability. The expansion programme in these areas was implemented in two phases: phase 1 from April 1985 to March 1988 and phase 2 from April 1988 to March 1990.

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4. A rural banking centre was to cover an average of about 200 sq km and a rural branch was to be normally available within 10 km. In urban and metropolitan centres, the policy was relatively restrictive but recognised the needs and potential of specific areas. Branch expansion programmes for rural areas of 18 states and 5 union territories (UTs) were finalised during the triennium period.

TABLE 6.1  
Bank Branches

*(Per cent of total)*

<i>Year (as at end-June)</i>	<i>Rural</i>	<i>Semi-urban</i>	<i>Urban</i>	<i>Metro</i>
1981	49.4	23.6	14.4	12.6
1985	55.4	20.1	14.5	10.0
1989	57.2	19.4	13.0	10.4

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

Interstate disparities in providing banking facilities were substantially reduced during the three-year period. Illustratively, in Assam, the population per bank office, which was as high as 35,000 in June 1982, came down to 25,000 by the end of February 1985. Similarly, in Bihar and Uttar Pradesh, the population coverage per bank office came down from 25,000 and 23,000 to 19,000 and 17,000, respectively during the same period. However, the trend of opening branches in the urban centres gradually declined, particularly after 1985.

Not every bank was able to deliver on the policy requirements. Three banks which had unsatisfactory financial position and unacceptable methods of operation were issued moratorium orders in 1985. Miraj State Bank Ltd with 26 branches was amalgamated with the Union Bank of India on July 30, 1985; Lakshmi Commercial Bank Ltd with 231 branches was merged with Canara Bank on August 24, 1985; and the Bank of Cochin Ltd with 108 branches was merged with the State Bank of India (SBI) on August 26, 1985. Consequent to these amalgamations, the total number of scheduled commercial banks (SCBs) reduced to 80, but increased subsequently to 81 with the inclusion of Oman International Bank S.A.O.G.,<sup>5</sup> which opened a branch in Bombay (now Mumbai) under the terms of the second schedule to the Reserve Bank of India (RBI) Act, 1934.

As noted earlier, relations between the Government and the Reserve Bank were not always mutually reinforcing. At times something as small as a request from the Government<sup>6</sup> to publicise the allotment of the identified centres for new bank offices led to a stiff response from the Reserve Bank.<sup>7</sup> Thus, in an internal note, the Bank told the Government that "it is not

5. S.A.O.G.: Societ  Andrea Omani Generale.

6. D.O. letter no 1 (14)-87 dated October 26, 1987.

7. Reserve Bank of India, DBOD (BL section). Follow-up action based on the Finance Minister's meeting with the Governor on November 3, 1986.

the practice of the Bank to give any publicity on completion of allotment of identified centres to banks for opening branches. If the Government so desire they may consider issuing a press note to that effect.” Further, “such publicity will not confer any benefits. On the contrary, the phased expansion programme will get upset by the owners of premises, who would seek to pressurise the banks to rush through the entire branch expansion plan in the very first year and also to change the need-based location to places where their premises are situated.”

A review of branch expansion in 1989 revealed that allotment of centres to commercial banks, including RRBs, based on lists of centres received from the state governments, was almost complete. In all, 5,360 centres were allotted in rural and semi-urban areas up to June 30, 1989; 2,024 to RRBs and 3,336 to commercial banks. This left 775 deficit blocks that required additional offices. With the adoption of the service area approach (SAA), it became necessary to allow additional branches so that the number of villages allocated to a rural branch was within a manageable limit of 15 to 25. Considering both these aspects, 1,236 additional centres were allotted up to June 30, 1989. By any standards, it was a remarkable bureaucratic achievement, even if the banking benefits were not immediately visible.

### INTERNATIONAL BANKING

From the time of bank nationalisation in 1969, foreign operations were not a high priority for the Government and policy in this respect was essentially need-based. On account of the relatively low level of openness, Indian banks did not have a very significant presence abroad. Thus, in 1980, there were only 12 Indian banks with 133 branches operating abroad. The decade of the 1980s saw no change in the restrictive policies in this regard. From 1985 to 1989, no new branches were opened and, on the contrary, as many as 27 branches were closed. The number of overseas branches of 9 Indian banks stood at 116 as on June 30, 1989.<sup>8</sup> It was the same case with the representative offices, although a few representative offices were opened by Bank of Baroda (BoB) and Indian Bank at Harare (Zimbabwe) and Jakarta (Indonesia) in 1985. The SBI merged the functions of its representative office and its branch at Frankfurt (West Germany). The number of representative offices of four Indian commercial banks stood at 12 in 10 countries at the end of June 1985, and this number came down to 10 as at the end of June 1989. There were three deposit-taking entities,

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8. Nine banks had 123 branches abroad as on June 30, 1987.

three wholly-owned subsidiaries and six affiliates functioning abroad as at end-June 1989.

#### FOREIGN BRANCHES IN INDIA

The policy towards foreign banks and their branches was dictated by the strategy of reciprocity. Some minor policy changes were, however, made as follows:

- (i) A start-up capital of ₹ 15 crore was prescribed for new entrants;
- (ii) Lending to priority sectors was made obligatory and the banks were required to achieve a level of 10.0 per cent of total lending by end-March 1989, 12.0 per cent by March 1990, and 15.0 per cent by March 1992; and
- (iii) Banks had to retain 20.0 per cent of the disclosed net profits in the Indian books.

In June 1985, 32 foreign banks had 134 branches and 13 representative offices in India. As on June 30, 1989; the number of branches and representative offices of foreign banks operating in India stood at 137 and 21 (of 21 banks), respectively.

#### FIRST INDO INTERNATIONAL BANK LTD<sup>9</sup>

The FIIB was floated by non-resident Indians (NRIs) and incorporated in Nassau, Bahamas, a tax haven where supervision by the central banking authority was practically non-existent. The FIIB approached the Reserve Bank for permission to open an office in India but the request was rejected at a meeting of the inter-departmental committee held on November 17, 1988. The FIIB approached the Reserve Bank again through the Indo-NRI Chamber of Commerce and Culture and also through the Ministry of Finance, Government of India (GoI),<sup>10</sup> emphasising that the proposed branch would help attract NRI investments to India. A note of commendation<sup>11</sup> was also forwarded, highlighting some points for reconsideration of the proposal. The points were:

- (i) The FIIB was the largest NRI-owned bank in San Francisco.
- (ii) The FIIB, which was promoted by the promoters of Foreign Intelligence Advisory Board (FIAB), was incorporated in Nassau, Bahamas, a leading off-shore financial centre.

9. FIIB, Bahamas.

10. Letter dated F. No. 16 (108)/89-B.O. 111 dated March 1, 1990.

11. From Shri Yashwant Sinha, Member Parliament.

- (iii) The new capital adequacy rules in international banking might force closure of more branches of Indian banks abroad. This had happened — the number of branches of Indian banks had declined from 136 to 114 with the possibility of a further reduction in the process of rationalisation.
- (iv) About 75.0 per cent of the business of people of Indian origin abroad was with foreign banks and 25.0 per cent of such business was with the overseas branches of Indian banks.
- (v) The FIIB would open banks, buy banks and take over other banks in as many foreign centres as possible by involving local NRIs and their resources at each centre to serve the Indian community.
- (vi) With the involvement of a large number of NRIs, the FIIB would be able to compete with foreign banks and take over a large share of Indian business from them.

The proposal<sup>12</sup> was turned down by the Reserve Bank, which felt that the proposal was not in conformity with the prevalent policy of not allowing banks incorporated in tax havens to enter the Indian financial system. Besides, the failure of the Bank of Credit and Commerce International (Overseas) [BCCI (O)] Ltd was still fresh in the memory. The Reserve Bank also took the view that the arguments of national pride and patriotic instincts put forward by the bank were not important and the proposal had emanated from the NRIs' desire to legalise their unauthorised/illegal incomes held outside India over the years. It had earlier rejected another proposal by an NRI-owned bank based in Britain, namely, Equatorial Bank, London, to open a branch in India. The other reasons were that the bank was incorporated in Nassau, Bahamas, a tax haven with little control by the host country and also that the bank existed merely on paper, having acquired the certificate of incorporation. It had not commenced banking operations even in the country of its incorporation and had not presented or maintained a balance sheet, said the Reserve Bank. Also, it had not constituted a Board, though, it proposed to do so after securing a licence to open a branch in Bombay.

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12. Shri Kalpanath Rai, Union Minister, Ministry of Power, had recommended the bank's request for consideration on 'sympathetic' grounds and, as a consequence, had invited a comment in the records that business decisions involving money and banking had to be taken on the basis of sound banking principles and not on sympathetic grounds. A note communicating the decision was approved by the Governor on March 25, 1992, and the Government was suitably informed.

The story of the BCCI (O) Ltd (incorporated in Grand Cayman), a wholly-owned subsidiary of the BCCI Holdings (Luxembourg), was different and controversial. The BCCI submitted an application to the Reserve Bank in April 1977 to open two branches in India. After initial hesitation, the Reserve Bank permitted the BCCI to open a representative office in June 1977. There were talks that the BCCI was linked to ‘funny money’, but nevertheless had some influential support from within the Indian financial system.

The BCCI again applied for a licence to open a branch office in Bombay towards the end of 1982. The request was not initially considered favourably by the Reserve Bank. The BCCI, however, finally got a licence, which was issued by the Reserve Bank in 1983. Nevertheless, the bank collapsed some years later, after being linked to suspicious transactions all over the world.

The policy of consolidation did not mean a mere slowdown in expansion of branches. It also led to amalgamations, liquidations and mergers. Banks found to be financially and operationally weak were sought to be strengthened and the number of banks was thus brought down by either mergers or amalgamations. During 1980–1985, 18 banks were dissolved after liquidation proceedings were completed and during 1985–1989, 4 banks were wound up. At the end of June 1989, 128 more banks were put under liquidation.<sup>13</sup>

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13. Based on the recommendations of the Reserve Bank, the Government issued moratorium orders on April 27, 1985, in respect of Miraj State Bank and Lakshmi Commercial Bank. Miraj State Bank (with 26 branches) was amalgamated with the Union Bank of India effective July 30, 1985; Bank of Cochin (with 108 branches) was merged with the SBI on August 26 of the same year; and Lakshmi Commercial Bank (with 231 branches) was amalgamated with Canara Bank on August 24, 1985. Hindustan Commercial Bank Ltd was placed under moratorium from the close of business on May 24, 1986; the bank was subsequently amalgamated with Punjab National Bank (PNB). Further, a moratorium order was issued in respect of United Industrial Bank Ltd, Calcutta (now Kolkata) — a private sector bank — by invoking the provisions of section 45 of the Banking Regulation Act, 1949. The bank was thereafter merged with Allahabad Bank, with full protection to depositors. Moratorium orders were issued on August 22, 1989, in respect of four more private sector banks, *viz.*, Bank of Tamil Nadu Ltd, Bank of Thanjavur Ltd, Parur Central Bank Ltd, and Purbanchal Bank Ltd. The Government sanctioned schemes of amalgamation in respect of five banks during the period 1985 to 1988. Traders Bank Ltd, New Delhi, a private sector bank, was amalgamated with BoB in May 1988. Of the four private sector scheduled commercial banks — Bank of Tamil Nadu Ltd, Bank of Thanjavur Ltd, Parur Central Bank Ltd, and Purbanchal Bank Ltd — placed under moratorium on August 19, 1989, the first three were amalgamated with Indian Overseas Bank (IOB), Indian Bank, and Bank of India (BoI), respectively, with effect from February 20, 1990. Purbanchal Bank Ltd was amalgamated with Central Bank of India on August 29, 1990.

## BANKING LAWS

### BANKING LAWS (AMENDMENT) BILL

All through the 1970s, various practical difficulties were encountered by the banks. It became clear by the mid-1970s that unless different parts of the banking laws were amended, forward movement on a number of intricate issues was not possible. Accordingly, a number of amendments were sought, and though proposed, they were not legislated. For example, the banking laws (amendment) bill, 1978, could not be considered as the Lok Sabha was suddenly dissolved in July 1979.

In 1981, the Reserve Bank established a special cell to process the recommendations of the banking laws committee which examined two reports, *viz.*, the documents of title to goods, 1978, and the indigenous negotiable instruments (*hundis*), 1978. On the first report, the recommendations of the banking laws committee were considered by a study group comprising a representative each from the Reserve Bank and the Indian Banks' Association (IBA). The group examined the report on *hundis* but did not find it acceptable, mainly because of the policy of not encouraging the *hundi* system. The group instead recommended that modern banking practices be adopted.

In 1981, additional amendments to the Banking Regulation (BR) Act, 1949, and the RBI Act, 1934, were suggested by the Reserve Bank to the Government at the latter's instance. The bill was reintroduced in Parliament in May 1983. It contained important amendment provisions, such as, providing nomination facilities for bank accounts; prohibiting deposits by individuals and firms from more than the prescribed number of depositors, enabling banks to undertake innovative measures like leasing activities; restricting the tenure of directors of private sector banks to eight consecutive years and protecting directors nominated by PSBs on the boards of assisted units; empowering the Reserve Bank to vary statutory liquidity ratio (SLR) from 25.0 per cent to 40.0 per cent by issuing a notification; widening the scope of consideration by the Reserve Bank before issuing a licence to a bank to commence banking business; and placing the rules and regulations framed under the Act/Acts before each House of Parliament.

## BANKING LAWS (AMENDMENT) ACT, 1983

The banking laws (amendment) bill, 1983, containing important provisions and proposing amendments to the laws affecting banking, mainly the RBI Act, 1934, and the BR Act, 1949, was passed by both Houses of Parliament in December 1983 and, after the President of India gave his assent, it was renamed as the Banking Laws (Amendment) Act, 1983. The Government issued a notification bringing into force the provisions of this Act. The amendments are reflected in Table 6.2.

TABLE 6.2  
*Amendments to Banking Laws*

<i>Name of Act</i>	<i>Amendment/ Incorporation</i>	<i>Section</i>	
RBI Act	Amendment	42	Maintenance of cash reserve ratio (CRR) by scheduled banks.
RBI Act	Amendment	43	Weekly statement.
BR Act	Amendment	18	Maintenance of CRR by non-scheduled banks.
BR Act	Amendment	24	Maintenance of SLR by all banks.
BR Act	Incorporation	45Y to 45ZF	Nomination facilities to depositors, hirers of lockers and safe custody.
BR Act	Amendment	56(j) and (q)	Maintenance of CRR and SLR by co-operative banks.

*Source:* Reserve Bank of India, internal records.

Various provisions of the Banking Laws (Amendment) Act, 1983, came into force from February 15, 1984, except for sections 6, 7, 21, 26 and 37, and clauses (v) and (ix) of the section 42. The Government brought the provisions of these sections into force effective March 29, 1985, after finalising the necessary rules and regulations. The provisions of amendments in brief are captured in Table 6.3.

The Banking Laws (Amendment) Act, 1983, widened the activities that the banks could undertake, strengthened the powers of the Reserve Bank, streamlined returns, and prohibited unincorporated bodies from accepting deposits from the public, except to a specified extent. It led the Reserve Bank to issue a series of notifications.

The periodicity for the maintenance of average daily balances for CRR purposes was changed from one week to a fortnight. Changes were also made in the basis of calculating demand and time liabilities for the maintenance of SLR. The Reserve Bank was empowered to levy a penalty

TABLE 6.3  
*Details of Amendments*

<i>Section of the Amendment Act, 1983</i>	<i>Amendment of the Existing Act/Section</i>	<i>Subject</i>
6	RBI Act section 42	Cash reserve of scheduled banks: change of periodicity of maintenance of CRR and submission of relative returns from weekly to fortnightly.
7	RBI Act section 43	Issue of press communique.
21	BR Act section 43	Cash reserve of non-scheduled banks.
26	BR Act section 24	Liquid assets of banks (scheduled as well as non-scheduled) providing for netting concept and conferment of power on the Reserve Bank to specify the increase in SLR up to 40.0 per cent, the mode of valuation of unencumbered approved securities and penalty provision.
37	BR Act—Incorporation of new sections 45Y to 45 ZF	To provide: (1) Period of preservation of bank records. (2) Nomination facilities to depositors, hirers of lockers and safe custody of articles
42 (v)	BR Act section 18 as applicable to co-operative banks	Cash reserve of non-scheduled co-operative banks.
42 (ix)	BR Act section 24 as applicable to co-operative banks	Liquid assets of all co-operative banks (scheduled and non-scheduled).

*Source:* Reserve Bank of India, internal records.

for non-compliance with SLR requirements. Section 37 of the Banking Laws (Amendment) Act, 1983, was also brought into operation; this related to the rules for preservation of banks' records and nomination facilities for bank customers. The nomination facility was a landmark provision, as it helped the general public in inheritance cases.

In a definitive step towards liberalisation, the BR Act was amended in 1984 to address the perceived decline in the role of banks due to financial disintermediation. Many banks, accordingly, set up subsidiaries to undertake merchant banking, securities market-related activities, equipment-leasing, hire-purchase, mutual funds, housing finance, and venture capital functions. Diversification of banking activities facilitated the banks to broaden their business portfolio and raise their profitability through the opportunity to gain non-interest income. This was a symbiotic process, as the industrial sector was also more comfortable with their

banks handling these activities. As a result of the deregulation, distinct risks emerged that had to be countered. The Reserve Bank addressed these by encouraging banks to engage in the securities business through subsidiaries, thereby segregating traditional banking from non-traditional activities. The Reserve Bank also prohibited cross-holdings with industrial groups to minimise connected lending.

BANKING LAWS (AMENDMENT) ACT, 1985

The 1985 Act, amending mainly the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 and 1980, and the RBI Act, 1934, was enacted in December 1985. Some provisions of the Act were brought into force from December 30, 1985, and the others from May 1, 1986.

The Amendment Act also provided for the termination of the services of the chairman of the National Bank for Agriculture and Rural Development

TABLE 6.4  
*Amendments to Banking Companies Act*

<i>Section and Act Amended</i>	<i>Subject</i>
Section 17(4A) of RBI Act, 1934, with effect from May 1, 1986.	Borrowing powers of the state financial corporations (SFCs): limit was raised to twice the paid-up share capital of the SFCs instead of the earlier 90.0 per cent.
Section 17 (11A) (a) of RBI Act, 1934, with effect from May 1, 1986.	The amendment was consequent to deletion of chapter IV of the Deposit Insurance Corporation (DIC) (Amendment and Miscellaneous Provisions) Act, 1978. By this, section 17 (11A) (a) in the RBI Act, 1934, was restored.
Sections 3 and 9 of Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, with effect from December 30, 1985.	The ceiling on the paid-up capital and reserves of nationalised banks was raised from ₹ 15 crore to ₹ 100 crore.
First Schedule of Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970, with effect from December 30, 1985.	Changed the name of United Commercial Bank to UCO Bank.
SBI Act, 1955, SBI (Subsidiary Banks) Act, 1959, RRBs Act, 1976, Deposit Insurance and Credit Guarantee Corporation (DICGC) Act, 1961, Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970/1980, with effect from May 1, 1986.	Provisions in these statutes required that the auditors' report and the report on the working and activities of the banks/corporations be laid for a total period of 30 days before each House of Parliament (while it was in session). The period of 30 days was deleted by the amendments. The above provision was incorporated in the RRBs Act, 1976.

Source: Reserve Bank of India, internal records.

(NABARD) by the Government by giving three months notice or three months' salary and allowances in lieu of such notice. Further, the Act provided for increasing the term of the chairman and managing director (CMD) of the Export-Import Bank of India (Exim Bank) from three to five years, on par with the chief executives of other banks and financial institutions (FIs). Some of the important amendments are given in Table 6.4.

#### SPECIAL LEGISLATION FOR RECOVERY OF BANK DUES

The Government accepted the recommendation of the Tiwari Committee to set up special tribunals that were devoted to adjudicating on issues related to recovery of bank dues. A committee of legal experts was constituted to prepare draft legislation for the purpose and it was decided to confer special powers on banks and FIs, similar to those vested in the Industrial Finance Corporation of India (IFCI) and SFCs under their respective statutes.

#### OTHER LEGISLATIVE MEASURES

The banking, public financial institutions and negotiable instruments laws (amendment) bill was passed by Parliament in December 1988. The provisions of the Act, except for three specific sections, were brought into force with effect from December 30, 1988. On the same day, the Government issued a notification that banks were required to close their accounts on the expiry of a period of 12 months ending March 31, instead of at the end of the calendar year, as was the practice earlier. Accordingly, banks closed their accounts on March 31, 1989, covering a 15-month period from January 1, 1988 to March 31, 1989. The other important provisions, which came into force on December 30, 1988, related to: (i) uniform tenure for directors of nationalised banks, associate banks and other FIs like the Industrial Development Bank of India (IDBI), NABARD, Exim Bank, DICGC and Industrial Reconstruction Bank of India (IRBI); (ii) increase in the limit of paid-up capital of nationalised banks from ₹ 100 crore to ₹ 500 crore; (iii) vesting authority in the Reserve Bank to direct special audits of banks; (iv) increase in the rate of interest specified in sections 80 and 117 (C) of the Negotiable Instruments Act (NIA), 1881, from 6.0 per cent to 18.0 per cent; and (v) removal of legal lacunae in the existing Nationalisation Act to provide for amalgamation of two nationalised banks and to enable transfer of part business in this regard.

Subsequently, the Government issued a notification that gave effect to the provisions of section 4 of the Amendment Act. This section provided for

penalties in the case of cheques that were not honoured due to insufficient funds in the drawer's accounts. With effect from April 1, 1989, in the event of any cheque drawn by a person on any account maintained by him with a banker for payment to another person for discharge, in whole or in part, of any debt or liability was returned unpaid by the bank on account of insufficient funds in the account or because it exceeded the arrangements with the bank, such personnel were deemed to have committed an offence and were liable for imprisonment for a term extending up to one year or for a fine extending to twice the amount of the cheque, or both. The section also provided for safeguards to save harassment to unwary drawers of cheques. It was, *inter alia*, provided that the drawer could make payment within 15 days on receipt of the notice of return and, only if he failed to do so could prosecution be launched. It was also envisaged that the complaint could be made only by the payee or holder in due course.

The NIA, 1881, which governed laws related to cheques, was amended by the Banking, Public Financial Institutions and Negotiable Instruments Laws (Amendment) Act, 1988, to incorporate these provisions. The amendments resulted in inserting chapter XVII, with effect from April 1, 1989, comprising sections 138 to 142 relating to the penalties.

Before 1988, dishonour of a cheque entailed recourse to a civil suit and there were no effective legal provisions to restrain people from issuing cheques without having sufficient funds in their accounts. The purpose of introducing the penalties was to encourage the culture of using cheques and to enhance the credibility of the instrument.

### DEPOSIT MOBILISATION

Throughout the 1970s, the Government and the banking system tried hard to get people to adopt banking habits. The drive was successful and was continued through the 1980s with fairly gratifying results (Table 6.5). The massive branch expansion during the 1970s and in the early part of the 1980s contributed considerably to improving deposit mobilisation by banks. The deposits of SCBs grew more than two-and-a-half times (264.6%) during the period 1981–1989. The growth in deposits was primarily due to strong growth in gross domestic product (GDP), special attention paid to improve customer service by banks, mechanisation of branches and improved banking habits due to greater awareness. Rationalisation of deposit rates in alignment with the rate of inflation, changes in the maturity pattern of deposits and the introduction of nomination facilities also helped to enhance deposit growth. The growth pattern during the period was,

however, not uniform and there were downward fluctuations in the rate of growth in some years due to factors, such as drought conditions in the country, inflationary pressures, the competitive environment in deposit mobilisation, and the emergence of new institutions and instruments on account of the disintermediation process in banks.

TABLE 6.5  
*Aggregate Deposits of Scheduled Commercial Banks*

(₹ crore)

<i>Year</i>	<i>Aggregate Deposits</i>	<i>Per cent Growth</i>
1981	40,549	21.5
1982	46,128	13.7
1983	54,039	17.2
1984	64,620	19.6
1985	77,075	19.3
1986	91,828	19.1
1987	1,07,899	17.5
1988	1,26,323	17.1
1989	1,47,854	17.0

*Source:* Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

Following media reports in February 1982 that some banks were accepting funds from institutions like Life Insurance Corporation (LIC) and the Unit Trust of India (UTI) as deposits on a roll-over basis and paying interest at 11.5 per cent or higher, a series of measures related to commercial banking were announced. The Reserve Bank instructed the banks to treat deposits from these institutions as deposits from the public and, as such, apply the appropriate rates of interest. Banks that accepted such institutional deposits at rates in excess of the prescribed rates were asked to discontinue the practice and take steps to recover the excess interest, if paid, from the concerned institutions. Banks were also advised to stop rediscounting non-trade bills because technically these had all the characteristics of participation certificates; it was felt that resorting to such a practice for the purpose of resource mobilisation would defeat the Reserve Bank's credit restraint measures, as also its policy on recourse to participation certificates.

With a view to aligning short-term deposit rates with the rates on longer-term maturities, the Reserve Bank raised interest rates on term

deposits for a period of less than three years. The new rates came into effect from March 1, 1982, and were applicable only on fresh deposits or on renewals of maturing deposits. SCBs that had aggregate demand and time liabilities of less than ₹ 25 crore were allowed to pay an additional interest rate of 0.25 per cent per annum at their discretion on all term deposits of less than three years. Similarly, RRBs were given the discretion to pay additional interest of 0.5 per cent per annum.

Up to March 1982, the rate of interest on bank deposits, along with the interest rate on investments in other specific categories of up to ₹ 3,000 was tax-free. In terms of the Finance Act, 1982, this exemption limit was raised to ₹ 4,000. The Act also provided for additional exemption of up to ₹ 2,000 on income from bank deposits with a maturity of one year or more along with the interest on government securities.

In July 1981, the Government promulgated an ordinance that no company (including a banking company), co-operative society, or firm shall repay to any person any deposit other than by an account payee cheque or account payee bank draft, when the amount of such deposit repayable with interest, if any, was ₹ 10,000 or more. If the repayment was by a banking company or a co-operative society, it was required to be made by crediting the amount to the account of the person to whom the deposit had to be repaid. The Reserve Bank directed all commercial banks to comply with the provisions of the ordinance. The Reserve Bank also reiterated its earlier stance that banks must satisfy themselves about the identity of their depositors through a proper introduction.

Deposit growth showed perceptible improvement during 1982–83 (July–June) as compared with the previous year, as the accretion to aggregate deposits of SCBs at ₹ 7,911 crore was significantly larger than that of ₹ 5,579 crore in 1981–82. The growth rate during the year worked out to 17.2 per cent compared with 13.7 per cent during the previous year. The improvement in absolute terms was noticed in three quarters of the year as compared with the corresponding quarters of the previous year. The growth in deposits in 1982–83 in the face of a deceleration in the rate of growth of national income could be attributed principally to an expansion in reserve money, revival of the category of term deposits of five years and above carrying a higher rate of interest in October 1982, and the response from non-residents to the offer of an interest rate at two percentage points premium over the rates permissible on domestic deposits of comparable maturities on non-resident deposits effective March 1, 1982.

Following the recommendations of the working group on bank deposits in October 1982, the category of term deposits of five years and above was revived with a directed interest rate of 11.0 per cent. The deposit category of five years and above was abolished in March 1981, and the maximum interest allowed on term deposits was 10.0 per cent for deposits of three years and above. The reversion to the long-term maturity category at a higher interest rate was intended to offer a better return on savings in the form of longer-term bank deposits and to assist banks in their deposit mobilisation efforts.

There was a sharp increase in deposits in 1983-84, which was attributable to a sizeable increase in national income, substantial growth of reserve money, large inflows of non-resident deposits and expansion in bank credit. The trend was maintained in 1984-85. The growth rate during the year 1983-84 worked out to 19.6 per cent, which was higher than the 17.2 per cent recorded during the previous year. A discernible feature of the deposit expansion in 1983-84 was that there was deposit accretion in all the four quarters, including the January-March quarter when deposits usually showed a sizeable decline after a large jump in the preceding quarter (October-December).

An analysis of the growth in aggregate deposits by type of deposit revealed that the rate of growth in demand deposits at 17.0 per cent was markedly higher than that of 12.7 per cent in 1982-83. With regard to time deposits, however, there was a marginal increase in the rate of growth at 18.4 per cent as compared with 18.2 per cent in 1982-83. The absolute increase in demand deposits was ₹ 1,737 crore in 1983-84 as against ₹ 1,146 crore in 1982-83, and in time deposits, it was ₹ 8,076 crore as against ₹ 6,765 crore the year before.

The increase in deposits during 1984-85, despite a lower growth in national income, a deceleration in price rise, competition from other savings instruments such as the national savings certificates (NSCs), national deposit schemes, and special schemes of the UTI, was a notable feature of banking during this period.

With effect from April 1985, the number of prescribed maturity slabs for fixed deposits was reduced from nine to five. Individual banks were allowed the freedom to fix interest rates, within the prescribed limit of 8.0 per cent, for maturities of less than one year and various maturities from 15 days and above, provided that uniform rates were adopted by all branches of the bank and applied to all its customers. The deposit rate for one year and over one year was raised from 8.0 per cent to 8.5 per cent.

The deposit rates for other maturities remained unchanged. The premium interest of 2.0 per cent on non-resident deposits of one year and above was kept unchanged. It was expected that these measures would enable banks to mobilise untapped sources of funds and thereby widen their deposit base.

#### THE 1985 EXPERIMENT

With the objective of providing credit to the productive sectors of the economy, bank lending rates as well as the allocation of bank credit were closely regulated by the Reserve Bank till the late 1980s.<sup>14</sup> Further, there was a multiplicity of deposit rates, which made little commercial or economic sense and commercial banks were demanding that they needed greater flexibility in setting the deposit rates. In April 1985, the Reserve Bank announced that within a ceiling of 8.0 per cent, banks could fix their own deposit rates for maturities between 15 days and less than one year. The move had unwelcome consequences as a rate war broke out among the banks. In the words of Shri S.S. Tarapore, Deputy Governor, “all banks, like sheep jumping off a cliff, offered 8 per cent for 15 days without giving attention to their profits. The RBI’s expectation that banks would use their discretion with some finesse to maximise their profits was totally belied.”<sup>15</sup> The short-lived freedom was withdrawn at the end of May 1985.

TABLE 6.6  
*Share of Demand and Time Deposits in Total Deposits*

	1981–82	1982–83	1983–84	1984–85	1985–86	1986–87	1987–88	1988–89
Demand	19.2	19.4	18.7	19.6	18.3	18.7	17.2	16.7
Time	80.8	80.6	81.3	80.4	81.7	81.3	82.8	83.3

*Source:* Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

The break-up of the aggregate deposits (Table 6.6) for eight years revealed that the share of demand deposits, which had stabilised at a lower level of 18.0–19.0 per cent during 1981–82 to 1984–85, declined steadily,

14. Mohanty, Deepak (2010). *Perspectives on Lending Rates in India*. Speech delivered at the Bankers’ Club. Kolkata. July.
15. Tarapore, S.S. (2011). “Episodes from Monetary and Other Financial Policies (1982–1997): An Anecdotal Presentation”, in Sameer Kochhar (ed.), *Growth and Finance: Essays in Honour of C. Rangarajan*. New Delhi: Academic Foundation.

reaching 16.7 per cent during 1988–89. To provide a better rate of return on short-term surplus funds, effective March 28, 1989, the rate on the deposits of 46 days to 90 days maturity was raised from 4.0 per cent to 6.0 per cent; simultaneously, the category of fixed deposits of 15 days to 45 days, which had so far invited a rate of 3.0 per cent, was abolished. Thus, the period for fixed deposits became a minimum of 46 days as against 15 days hitherto.

### WOOING NON-RESIDENT INDIANS

As was noted, when the 1980s began, India was short of foreign exchange and domestic savings. Indians settled abroad were remitting large sums of money to India and a significant part of it was routed through informal channels. It was decided to tap such resources and attract them into the banking system. The only instrument available to facilitate this was the interest rate and, thus, various schemes to attract NRI deposits were born. The Reserve Bank provided special incentives and banks were allowed to pay, effective March 1, 1982, additional interest on such deposits at 2.0 per cent premium over and above the rates applicable on domestic deposits of comparable maturities.

The deposits under non-resident external rupee account (NR(E)RA) and foreign currency non-resident account (FCNR(A)) schemes registered a sharp increase during the period 1981 to 1989 in response to the liberal incentives offered by both the Reserve Bank and the Government. The deposits under the NRE(R)A and FCNR(A) schemes increased by US\$ 2,329.0 million and US\$ 6,523.0 million, respectively, during the period 1981–1989. The net inflows of NRI deposits increased from US\$ 226.0 million in 1981 to US\$ 2,403.0 million in 1989, registering a staggering increase of 963.2 per cent. These flows helped, to a great extent, in minimising the adverse impact of the widening current account deficit (CAD) experienced by the economy during this period.

In this context, it was noted, “As the nation’s economists look for India’s balance of payments difficulties, there is only one point on which both Government and the opposition seem to agree — that a vital element in any equation will be the well-heeled, and still patriotic NRI.”<sup>16</sup> Further, throughout the second half of the 1980s, remittances from NRIs —

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16. Extracts from Tharoor, Shashi (2006). *India from the Midnight to the Millennium and Beyond*. New York: Arcade Publishing.

primarily the diligent Indian workers in the countries of the Arab/Persian Gulf—averaged ₹5,000 crore (US\$ 1.5 billion) a year. As a source of foreign exchange, this amounted to 40.0 per cent of India's annual merchandise exports, or about 3.0 to 4.0 per cent of GDP. NRI depositors placed annually over ₹9,000 crore (nearly US\$ 3.0 billion) in external accounts of Indian banks during the period 1976–1988. The incentives offered to NRIs included, *inter alia*, offers of government securities and facilities for direct investments in Indian industry. NRIs were granted an extraordinary range of special concessions by the Government, ranging from privileged rates of interest on their hard currency deposits in Indian banks to exclusive housing colonies and the opportunity to import Hollywood films onto Indian screens. The privileges also included coverage of forex risk, allowing opening of accounts in different currencies and priority for NRIs in the allotment of telephone connections and purchase of scooters and cars.

By the mid-1980s, there was a noticeable decline in interest rates abroad, particularly in the United States (US). The interest rates on the term deposits of one year and above under the FCNR (A) scheme were, therefore, reduced with effect from April 22, 1985, and again in February 1986 and May 1986. It was also specified that effective May 5, 1986, deposits under the FCNR (A) scheme were not to be accepted for maturity of above three years. The interest rates on NRE accounts were, however, kept unchanged at 2.0 per cent above the rates for domestic deposits. With effect from April 1987, the link between NRE deposit rates and domestic rates was severed and an independent structure of interest rates and maturities was specified.<sup>17</sup>

The FCNR deposit scheme, which was applicable to the pound sterling and the US dollar, was extended to deutsche mark (DM) and Japanese yen. Separate interest rates were prescribed for deposits in each of these currencies with effect from August 1, 1988.

The interest rates on deposits under FCNR (A) were revised on several occasions. With a view to providing a remunerative rate of return on short-term surplus funds, the term deposit rates for maturities of 91 days and above but less than six months were revised effective April 4, 1988, from 6.5 per cent to 8.0 per cent. As a result of this change, the deposit rate for 91 days and above but for less than one year stood at 8.0 per cent.

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17. For details, refer to chapter 4: Monetary and Credit Policy.

### CERTIFICATES OF DEPOSIT

To further widen the range of money market instruments and to give investors greater flexibility in the deployment of their short-term surplus funds, a new instrument, *viz.*, certificates of deposit (CDs) were introduced in 1989. CDs could be issued in multiples of ₹ 25 lakh, subject to a minimum size of an issue at ₹ 1 crore; the maturity could be between three months and one year; and these could be issued at a discount to face value and the discount rate could be freely determined. The CDs could be transferred 45 days after the date of issue. The total outstanding of all CDs issued by a bank at any point of time was not to exceed one per cent of its fortnightly average deposits. The CDs were subject to reserve requirements and banks were neither allowed to grant loans against CDs nor buy back their own CDs.

The Indian banking sector in the early 1980s faced competition from the stock and bond markets, non-banking financial companies (NBFCs) and mutual fund schemes. Many companies made successful foray into the equity market and floated bonds with remunerative yields, with and without tax incentives. Small savings instruments (such as the NSCs VI issue) also became popular as these offered tax benefits. This turned savers away from bank deposits that offered no such features and carried very low or negative real interest rates. The banking sector was largely constrained as the BR Act did not permit it to undertake non-banking activities. As a result, the share of bank deposits in the household sector's savings declined, while that of deposits with non-banking companies and in small savings instruments floated by the Government increased. The variety of investment opportunities available to individuals as well as corporate depositors was the main reason for beginning of the process of disintermediation in the banking industry.

### DEPOSIT INSURANCE AND CREDIT GUARANTEE CORPORATION (DICGC)

As no comprehensive review of the deposit insurance and credit guarantee scheme was conducted since its inception 25 years ago, the Deposit Insurance and Credit Guarantee Corporation (DICGC) Board decided to appoint an expert committee to undertake an in-depth reexamination of the scheme. Accordingly, the expert committee was appointed on July 14, 1986, under the chairmanship of Shri M.N. Goiporia. The major terms of reference were:

- (i) To examine the terms and conditions on which deposit insurance/ credit guarantee cover was provided by the corporation under its various schemes and to make suggestions for rationalising the same.
- (ii) To examine the existing procedures and to suggest simplifications, if necessary, to ensure prompt payment of insurance premium/ guarantee fees by credit institutions and expeditious disposal of claims by the corporation.
- (iii) To examine, in the light of growing claim liabilities, the adequacy of the corporation's funds and to make suggestions, if necessary, to rationalise the level and structures of guarantee cover so as to make the scheme viable.
- (iv) To examine the operational problems, if any, experienced by the participating credit institutions and make suggestions for improvement.

The committee submitted its report in January 1987. The deposit insurance scheme had contributed to the growth of the banking system over the years. Availability of an insurance cover did provide an inducement to the public to retain their savings with the banking system. The committee felt that there was a need to continue with the incentives, given the highly competitive environment and availability of lucrative alternate avenues of investment, such as post office savings, NSCs and public sector bonds to the masses. The deposit insurance scheme was designed to provide protection primarily to relatively small depositors whose number was very large and to whom bank failure meant a severe blow. Coverage of 100.0 per cent of the deposits was seen to be impractical and costly. However, taking into account the inflation rate and the fact that the last revision was made in the year 1980, the committee felt that the insurance cover could be raised from ₹ 30,000 to ₹ 1 lakh.

#### DEPLOYMENT OF CREDIT

Throughout the decades of the 1950s and the 1960s, one constant refrain was that the banks were not lending to the poor. Consequently, after nationalisation in 1969, they were directed by the Government to start lending to the 'weaker sections of society'. While this in itself was not undesirable, it did mean that over a period of time the freedom available to banks in this realm would be lost. And this, in fact, was what happened. By the end of the 1970s, banks had virtually no freedom to deploy their resources as they desired. There was also the compulsion that the

Government's fiscal position was not strong and it had to draw heavily from banks for its socioeconomic programmes.

In addition, there was a multiplicity of interest rates, which were set by the Reserve Bank. The monetary and credit policies of the Reserve Bank were supportive to the Government's economic policies. The cost of funds and profitability of banks were not subjects of internal policy debate until the mid-1980s, when the issue of the viability of the banking system came into focus and the thinking began to change.

As the 1980s began, it became clear that although the economy had grown, it had not done so in a regionally balanced way. This led to a renewed emphasis on balanced regional growth, which for socioeconomic reasons was the top national priority. The Reserve Bank was assigned the task of reducing regional disparities in credit distribution, which, in turn, asked banks to increase their credit-deposit ratio in rural and semi-urban centres (Table 6.7).

TABLE 6.7  
*Credit-Deposit Ratio of Public and Private Sector Commercial Banks  
by Population Group*

	<i>(Per cent)</i>		
	<i>June 1982</i>	<i>June 1985</i>	<i>December 1989</i>
Rural branches	58.7	65.6	63.8
Semi-urban branches	50.0	52.8	50.0
Urban/Metropolitan branches	75.1	74.6	69.8
Total	67.0	68.7	64.7

*Source:* Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

Credit distribution was envisaged in a manner that enabled hitherto neglected regions like eastern and central to get an improved share, although the western and southern regions continued to enjoy sizeable credit disbursements (Table 6.8). Historically, these regions had a concentration of banking that reflected their advanced economic and social status.

The banking sector had to operate within the constraints of restrictions on the credit-deposit ratio imposed by the Reserve Bank in order to maintain orderly usage of banks' resources. This was supplemented by the instrument of moral suasion. The requirements of various schemes and detailed provisions complicated the banks' job. For instance, differential rates of interest (DRIs) were set by the central bank for various purposes in accordance with the needs of borrowers in an effort to align the Reserve

Bank's policies with the Government's development goals. Micro allocation of credit and credit subsidies to preferred sectors were undertaken to support the Government's growth initiatives. The result was that the banks had to operate within multiple restraints. Moreover, these quasi-fiscal policies gradually affected commercial banks' balance sheets by impinging upon their profitability. At the same time, the non-performing assets (NPAs) of banks increased sharply. The decline in profitability and increase in non-performing loans (NPLs) impacted the soundness of the banking sector as banks were unable to plough back their profits.<sup>18</sup>

TABLE 6.8  
*Credit-Deposit Ratio of Public and Private Sector  
Commercial Banks: Region-wise*

(Per cent)

Regions	Rural			Semi-urban			Urban/Metropolitan			Total		
	June 1982	June 1985	Dec. 1989	June 1982	June 1985	Dec. 1989	June 1982	June 1985	Dec. 1989	June 1982	June 1985	Dec. 1989
Northern	50.1	48.9	45.6	52.1	52.3	45.7	84.7	69.6	59.3	73.3	63.7	55.0
North-East	45.8	62.5	66.7	37.6	39.7	41.3	55.5	51.7	49.8	43.9	48.9	50.9
East	49.6	57.6	56.9	33.5	35.1	33.7	64.0	55.7	58.2	55.5	52.0	52.9
Central	56.1	64.5	53.2	51.6	50.3	44.4	49.8	49.3	52.4	51.6	52.7	50.5
Western	52.5	57.1	66.0	47.8	52.2	49.9	75.5	87.7	75.6	68.5	79.9	71.3
South	80.7	94.9	103.4	60.4	64.5	64.9	89.4	93.1	95.4	79.1	84.4	87.0

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

Some help was provided in the form of discretionary support by the Reserve Bank, as in most developing countries, through the use of instruments such as refinance on preferred activities, including credit to agriculture, co-operative banks and export credit. Such refinancing had two effects — direct credit effect and an announcement effect — and helped banks to cover their cost of lending to the preferred activities. However, like all subsidy-based quasi-fiscal regulations, such measures distorted the markets further as they enlarged the monetary base, altered the credit multiplier and complicated monetary management.

The gross bank credit expanded three times within a span of seven years *i.e.*, 1982–1989, indicating involvement of the banking system in

18. For details, refer to chapter 7: Developments in Banking Supervision.

the economic development of the country (Table 6.9). In response to the Government's economic policies and the Reserve Bank's directives/close monitoring and follow-up, the credit deployment pattern had become largely equitable among various sectors. The rate of increase in the case of priority sector was, however, significantly higher as compared with the other segments on account of the special thrust on priority sector advances in the successive Five Year Plans.

TABLE 6.9  
*Sector-wise Deployment of Credit*

	(₹ crore)		
	June 1982	June 1985	June 1989
Gross Bank Credit	29,775	50,369	89,609
Food Credit	2,825	6,754	1,659
Non-food Credit	26,950	43,615	87,950
Total Priority Sector Advances	10,673	19,208	35,242
Agricultural Advances	4,594	7,978	14,133
Small Scale Industry (SSI)	3,909	6,956	13,677
Other Priority Sector Advances	2,170	4,274	7,432
Industry—Medium and Large	11,213	16,374	33,735
Wholesale Trade	2,122	2,771	4,919

*Source:* Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

### CREDIT AUTHORISATION SCHEME

In the early 1960s, when the Third Five Year Plan was being finalised, the Government became aware of the imbalances in bank credit. In 1965, the credit authorisation scheme (CAS) was introduced as a credit rationing tool. Basically, the scheme allowed the Reserve Bank and the Government to decide who would get how much credit. As such, the scheme was never very satisfactory. Attempts were made to fine-tune the CAS during 1982–1989 but without much success. Eventually, the scheme was abolished in 1989. The banks regained their freedom, which was intrinsic to their operations, after 25 years. The effects were quite encouraging in the ensuing years.

In the late 1980s, the industrial sector grew at a healthy annual rate of 5.5 per cent, with the manufacturing sector doing even better and growing at 8.9 per cent per annum. Market capitalisation galloped more than eight-fold over the decade. Consequently, some companies grew

faster than the others and had better access to credit from the banking system because of their strong financial position. The Reserve Bank had to face an unusual situation during this period as banks took advantage of the process of liberalisation and accommodated industries generously by granting loans, occasionally ignoring the regulatory guidelines in force. One of the large corporate houses of the times turned out to be one of the major beneficiaries.

The Reserve Bank, during the course of inspection of BoI carried out in the first quarter of 1986, came across instances of large advances being granted against the security of shares of one of the large corporate and to certain companies reportedly connected with the corporate. At about that time, there were also press reports to the effect that substantial advances were granted by several banks to certain allied concerns of the said large corporate for the purpose of subscription to its 'F' series debentures. The Reserve Bank carried out a quick scrutiny of the corporate accounts at different banks and a preliminary report was submitted to the Government. This report was also placed on the table of the House by the Government in July 1986. In the context of the findings of the preliminary scrutiny and widespread discussions on the subject including in Houses of Parliament, the Reserve Bank considered it necessary in the public interest to enquire in detail into the circumstances leading to and connected with the advances made by some commercial banks to borrowers against the security of shares/debentures of the corporate. Accordingly, a committee was constituted by the Reserve Bank on July 14, 1986, under the chairmanship of Dr C. Rangarajan, Deputy Governor, to look into the issue. The committee came to the conclusion that banks had followed the letter of Reserve Bank guidelines but had violated the spirit. As a follow-up, necessary action was initiated by the Government.

In March 1987, the Reserve Bank asked the banks to review the position with respect to compliance with the requirements prescribed by the Tandon, Chore and Marathe Committees in respect of those borrowers whose aggregate working capital limits exceeded the cut-off points for the Reserve Bank's prior authorisation, *i.e.*, ₹ 7 crore for export-oriented units and ₹ 6 crore for borrowers other than those who could be classified as sick or weak industrial units. An exhaustive review in 1987 by the Reserve Bank showed that while the scheme had brought about a large measure of financial discipline, compliance by many parties was below expectations. It was decided that the entities which had broadly complied with the prescribed discipline should be treated differently from those who did not

observe the same. Accordingly, in respect of borrowers who: (i) complied with the second method of lending, requiring a minimum current ratio of 1.33:1; (ii) regularly submitted the prescribed quarterly statements to their banks on their level of operations; and (iii) maintained levels of inventory/receivables within or at the prescribed norms/past levels, banks could release the entire amount of additional limits sanctioned by their boards of directors without the Reserve Bank's prior authorisation to such clients. Second, in the case of borrowers who complied with the disciplines at (i) and (ii) referred to above but were not fully compliant in respect of the inventory and receivables norms, the banks would have the discretion of relaxing the norms up to 20.0 per cent, if they considered it appropriate. Such cases were not required to be referred to the Reserve Bank for prior approval for sanctioning the enhanced credit limits. Third, where cases had still to be referred to the Reserve Bank, the existing limits for temporary accommodation by banks were raised substantially and discretionary powers were enhanced liberally to enable the banks to release funds without referring the cases to the Reserve Bank. This decision was expected to reduce the number of CAS cases to be referred to the Reserve Bank by about 35.0 per cent.

The Reserve Bank decided that it would give its decision on all proposals received for its prior authorisation within one month of the date of receipt of the proposals. Concurrently, banks were also advised to gear up their machinery to handle proposals for larger credit limits so that decisions were taken without undue delay, irrespective of whether or not the Reserve Bank's prior authorisation was to be sought. The liberalisation in the CAS was open-ended in that the CAS parties who started complying with the prescribed discipline subsequently were also exempted by the Reserve Bank from the condition of prior authorisation. Follow-up scrutiny by the Reserve Bank of the CAS cases decided by the banks continued as hitherto.

Revised instructions were issued to ensure closer co-ordination between banks and FIs in dealing with sick industrial units so that decisions on measures for their rehabilitation and implementation were expedited. Similarly, instructions were issued to the banks for promptly dealing with proposals of borrowers who were extended working capital credit by more than one bank under consortium arrangements. In both the cases, the role of the lead bank in a consortium was considerably strengthened.

In a review in 1988, it was found that the majority of the CAS parties complied with the prescribed level of the current ratio and that there had been substantial improvements in compliance with inventory

norms as well as in the submission of quarterly information system (QIS) statements. Over a period, the inventory-sales ratio of the corporate sector had declined appreciably. Also the share of priority sectors in the outstanding bank credit, which was rising progressively, stood at well above the target of 40.0 per cent. It, thus, appeared that the objectives of CAS were being broadly achieved due mainly to the enforcement of basic financial discipline. In light of this review, it was decided to withdraw the system of prior authorisation by the Reserve Bank and an announcement to this effect was made on October 8, 1988, in the credit policy. CAS was replaced by the credit monitoring arrangement (CMA). However, as per the new approach, all proposals involving the sanction of aggregate working capital limits beyond ₹ 5 crore (instead of the prevailing limit of ₹ 2 crore) were to be subjected to post-sanction scrutiny by the Reserve Bank to ensure that the basic discipline was being observed. As far as term loans were concerned, all proposals which were required to be referred to the Reserve Bank for prior authorisation were henceforth to be subjected to post-sanction scrutiny.

The banks were advised that there was no change in the criteria for lending to borrowers and the assessment of the working capital requirements by banks needed to be in conformity with the following basic financial disciplines: (i) reasonableness of estimates/projections with regard to sales, chargeable current assets, current liabilities (other than bank borrowings) and net working capital; (ii) classification of current assets and current liabilities in conformity with the guidelines issued by the Reserve Bank; (iii) maintenance of the minimum current ratio of 1.33:1 (except in certain exempted categories); (iv) prompt submission of quarterly operations statements; (v) an undertaking by the borrower to submit annual accounts on time; and (vi) regular annual review of the limits by the bank, even where no enhancement in credit limits was involved. In case, as a result of the scrutiny instituted through the CMA, it was found that a particular bank was not enforcing the basic disciplines, the Reserve Bank could instruct such a bank to refer cases of larger accounts for prior authorisation.

The banks were apprised that term loans granted to industrial units needed to be in consonance with the priorities laid down by the Government and that term credit, either as loan or as guarantee/acceptances, was not to be provided for infrastructure activities financed from budgetary sources.

The banks made representations that the penalty for default in submitting statements under the QIS might be waived in the case of

exporter-borrowers and sick/weak units. It was agreed that based on the merits of the each case, banks could exempt sick units which remained closed and borrowers affected by political disturbances, riots and natural calamities from paying penal interest. This was a great relief, both for borrowers and the banks. Freedom over micro-level control, which was exercised by the Reserve Bank, was henceforth gradually passed on to the banks after ensuring that both banks and borrowers adhered to the credit and financial discipline as per the Reserve Bank's regulatory requirements. This was a major shift and perhaps a pointer to the impending reforms.

The number of entities with credit limits stipulated under CAS/CMA increased to 931 by the end of March 1989 from 712 at the end of March 1988. The total limits in force relating to 931 parties amounted to ₹ 22,897 crore at the end of March 1989 as compared with ₹ 20,936 crore as at the end of March 1988. The share of public sector undertakings (PSUs) in the total limits at the end of March 1989 was ₹ 11,106 crore, *i.e.*, 48.5 per cent of the total. Of the total limits in force at the end of March 1989, 92.7 per cent was for working capital purposes (including packing credit, inland and foreign bills), 6.3 per cent for term finance and 1.0 per cent for sale of machinery on deferred payment basis.

Activity-wise, of the total working capital limit of ₹ 21,223 crore as end-March 1989, the share of the engineering industry was 16.9 per cent, followed by manufacture of chemical and chemical products (14.0%), cotton textiles (6.9%), and basic metal and metal products (5.7%). The aggregate working capital limits sanctioned to the industry as a whole amounted to ₹ 15,705 crore, *i.e.*, 74.0 per cent of the total. A working capital limit of ₹ 10,476 crore was in force for the public sector, of which trade accounted for 41.6 per cent (the share of food procurement being 21.4% and that of fertiliser distribution at 8.5% of the total), 11.2 per cent for fertiliser production, 11.7 per cent for the engineering industry, 6.0 per cent for the petroleum industry, 6.2 per cent for basic metal and metal products, and 3.2 per cent for generation and distribution of electricity.

#### TRANSFER OF BORROWAL ACCOUNTS

All parties, including those availing credit limits in excess of ₹ 5 crore, were allowed to transfer their accounts from one bank to another without requiring a no objection letter from the existing bank, provided the transferee bank agreed to take over the entire liabilities of the party. If any industrial group sought to transfer only a good account leaving an unsatisfactory account with the existing bank, the latter could refuse to

allow such a transfer, unless arrangements were made by the concerned party to the bank's satisfaction.

#### CONSORTIUM ADVANCES

With a view to easing operational problems, the restriction on the number of banks (*i.e.*, 5) in respect of consortium advances with credit limits of up to ₹ 50 crore was removed. Banks were, however, advised to limit the number of banks in the formal consortia arrangements at around 10.

#### MECHANISATION OF BANKING

The Reserve Bank gave special emphasis in the 1980s to bring about mechanisation in banking, despite heavy opposition from trade unions and some political parties that feared massive unemployment from large-scale mechanisation. In 1983, the Reserve Bank constituted a committee under the chairmanship of the Deputy Governor, Dr C. Rangarajan<sup>19</sup> to identify areas/functions where mechanisation was essential, recommend appropriate hardware for various types of processing, recommend infrastructure needed to ensure smooth data flow, suggest a phased programme of implementation, suggest appropriate steps for the exchange of information through suitable computer media between different banks and the Reserve Bank, propose standardised procedures in different areas of work and examine the feasibility of common processing arrangements for all banks at selected focal points.

The committee submitted its report in 1984 in which it analysed the prevailing banking scenario. The committee observed that though the banking industry with 45,000 branches at that time was spread across 25,000 centres, 60.0–70.0 per cent of the business was concentrated in around 10,000 branches located in about 100 centres. It also observed that with the phenomenal increase in the activities of banks and the wide geographical coverage, a certain degree of mechanisation was essential to perform routine functions efficiently, especially in the areas of customer service, housekeeping, and data generation for control and monitoring. While making the recommendations, the committee took into account the extent and level of technology available in the country in the early 1980s and the agreement entered into by the IBA with the employees' union in 1983,

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19. The Committee on Mechanisation in the Banking Industry (Rangarajan Committee), 1983.

which imposed limitations on the extent and degree of computerisation in terms of types of machines to be used, application areas, number of machines to be used and capacity of computers.

The major recommendations of the committee, *inter alia*, were that the mechanisation should encompass various levels — branch, regional/zonal office, and head office — with the emphasis varying from one level to another. At the branch level, mechanisation was to be implemented as either model I or model II of mechanisation. In model I, a stand-alone electronic ledger posting machine with an attached memory module was to be installed to perform dedicated functions at different counters; the machine was also expected to generate account statements and periodically work out products and interest accruing on accounts. In model II, a single microprocessor-based system was to be installed in a branch; vouchers were to be posted manually in primary ledgers and then information entered into the microprocessor system to generate supplementaries, day book, general ledger and other statistical returns. The approach was outlined as under:

- (i) Data from branches were to be received by the regional/zonal offices and processed through microprocessor-based computer systems to generate appropriate outputs to facilitate their control functions. The data were then to be transmitted to the head office where they were to be stored in the mainframe system to generate macro-level information for the bank as a whole.
- (ii) Input/output formats were to be standardised.
- (iii) The mechanisation programme was to be implemented in two stages. During the three-year period from 1985 to 1987, regional/zonal offices and head offices were to be equipped with suitable systems. About 2,500 branches were to be equipped with 10,000 model I or model II machines. In stage II (1988–89), additional 6,000 branches were to be mechanised with 20,000 machines.
- (iv) Telecommunication needed to be made more effective, and
- (v) Clearing house operations needed to be computerised on a priority basis.

The IBA had entered into an agreement on mechanisation/computerisation with the All-India Bank Employees' Association (AIBEA) in September 1983 under which electronic ledger posting/accounting machines, microprocessors/minicomputers and mainframe computer systems were to be installed to support specified functional areas in branches, regional/zonal and head offices of the banks. The settlement

specified that accounting machines, electric/electronic with memory, other than computers were to be utilised in the banks for all deposit accounts, general ledger accounts, cash credit, loan accounts, salary and payrolls.

There were other conditions in the agreement, which mainly included no staff retrenchment as a result of the introduction of machines/computers, non-utilisation of accounting machines in rural branches and non-installation of electronic machines with memory. The capacities and configuration of machines were also expected to match the specifications. The number of machines to be installed by the banks, including 28 PSBs, was fixed at up to 3,500 for the period ending September 7, 1987, and up to 5,700 during the next two years, that were to be shared among the banks on a pro rata basis of the aggregate deposits as on December 31, 1985. It was also agreed that a special allowance of ₹ 350 per month would be paid to the machine operators.

Most of the banks did not have either a suitable organisational set up or technically qualified staff to effectively implement the computerisation plan. Therefore, the first task was to create a distinct and fully accountable organisational structure. For effective monitoring and to oversee the implementation of recommendations at the macro level, a high level standing monitoring committee was constituted by the Reserve Bank comprising representatives from the Government, the IBA, major banks and the Reserve Bank. The Reserve Bank conducted several meetings of liaison officers of banks to speed up and co-ordinate action at the operational level by banks. The steps taken included setting-up of a separate computer policy and planning department in each major bank, empanelling manufacturers of ledger posting machines (LPMs), standardising hardware and software, defining specifications for systems to be installed, determining the hardware configuration for the mainframe system to be installed at head offices and making arrangements to train about 300 systems analysts/programmers by 1985. As per the action programme announced by the Government in July 1985, LPMs were expected to be installed in about 1,000 branches and minicomputer systems in about 100 regional/zonal offices of PSBs by the end-March 1986.

In conformity with the policy to bilingualise enunciated by the Department of Official Languages, the hardware specifications were revised in the late 1987 to provide hardware capability for bilingual operations on advanced ledger posting machines (ALPMs). A separate group consisting of members from the Reserve Bank, Department of Electronics, a few commercial banks and experts from Computer Maintenance Corporation

Ltd (CMC) was set up in December 1986 to take a comprehensive look at all related issues. The group in its report submitted in 1987 outlined various applications at the head office level, and the required hardware and software specifications. The report covered the details pertaining to site preparation, selection and training of personnel and organisational set up as well as the need to develop standardised applications software. The group considered it desirable for banks to install such a set up in place of several minicomputers as the mainframe provided better security features, faster data transmission and message-switching facilities. While one bank installed an imported mainframe, another bank installed a mainframe from an empanelled vendor in June 1989. Efforts were on to pool in the resources of the banks and develop in house application software. A group was appointed to develop software specifications for two applications, *viz.*, location based service monitoring and co-ordination of government accounts among volunteering banks.

In addition to various systems installed for identified purposes within the guidelines of the Rangarajan Committee report (1984), banks also installed several other computers for activities, such as foreign exchange dealings, inter-branch reconciliation, word processing, training, generation of management information system (MIS) reports, software development and consolidation of annual accounts. The number of such systems, which included personal computers (PCs), minicomputers and other machines as on September 30, 1988, was about 600.

An agreement between the IBA and employees' unions was signed in March 1987 in terms of which banks were allowed to install 5,700 ALPMs by September 1989 in proportion to their share in aggregate deposits as on December 31, 1985. The share of PSBs worked out to 5,480 ALPMs. The banks were advised to initiate steps for site preparation and training of personnel and commence exercises for software development so as to ensure optimal utilisation of systems on delivery.

As at the end of June 1989, banks had installed 4,264 ALPMs at their branches, of which 3,997 ALPMs were operational and 2,962 ALPMs had a live run. The banks also installed 218 minicomputer systems at their regional/zonal offices at end-June 1989. As regards the mainframe systems at the head offices of banks, the benchmarking for the selection of three indigenously manufactured systems was completed and the results were communicated to the banks.

## COMPUTERISATION IN THE RESERVE BANK

### COMPUTERISATION OF CLEARING HOUSES

The work involved in cheque clearing operations was voluminous, repetitive and of a routine nature. To speed up the process, it was felt that clearing house operations needed to be computerised.<sup>20</sup> In the first phase, operations of the clearing houses managed by the Reserve Bank were computerised at the major centres, *viz.*, Ahmedabad, Bangalore (now Bengaluru), Bombay, Calcutta, Hyderabad, Kanpur, Madras (now Chennai), New Delhi and Nagpur. To facilitate cheque sorting and to cut delays, high-speed reader/sorter systems driven by IBM 4381 were installed at Bombay, New Delhi, Madras and Calcutta. The four systems processed about 10 lakh instruments per day, with the Bombay clearing house touching a peak of over 6 to 7 lakh on some days. Special clearing for high-value cheques of more than ₹ 1 lakh was introduced in Bombay, Calcutta and Madras; credit was made available to parties within a day and withdrawal allowed the next day. Inter-city cheque clearance was operationalised in four metros, *viz.*, Bombay, New Delhi, Calcutta and Madras; outstation cheques drawn on these centres could be cleared within a week, as against four weeks taken earlier.

As part of the efforts to mechanise cheque clearing, magnetic ink character recognition (MICR) technology was introduced. The MICR technology required standardisation of cheques in terms of paper quality and printing of particulars of cheques, such as, the serial number, city/bank/branch on which drawn, and account number, nature of transaction and amount at the bottom of the cheque in magnetic ink. Seven manufacturers of MICR grade paper and 51 security printers were empanelled and the size of the instruments was standardised. The first phase of mechanised cheque clearing using MICR technology, initiated by introducing a high-speed reader-sorter system for processing local as well as inter-city MICR cheques, commenced operations.

As part of the project to introduce national clearing of cheques and adoption of MICR technology for mechanised cheque processing, the majority of banks in Bombay, Madras and New Delhi began issuing

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20. Computerisation in the Reserve Bank is dealt with in detail in chapter 21: Institutional Changes.

MICR cheques to their customers. Mechanised cheque processing at the centres of operation stabilised over time. Work was initiated to introduce mechanised cheque processing using MICR technology at Calcutta and for computerised clearing house settlement operations at Bhubaneswar, Jaipur, Nagpur, Patna and Trivandrum. Arrangements were made to computerise clearing house settlement operations at Guwahati. Mechanisation of clearing house settlement operations was also extended to select large clearing houses managed by the SBI.

Taking into account the progress achieved, the future requirements of banks to improve customer service and productivity and to consider allied issues, the Reserve Bank constituted a committee in September 1988 under the chairmanship of Dr C. Rangarajan, Deputy Governor, with members drawn from the major PSBs, FIs, training institutions, government departments and the Reserve Bank to prepare a perspective plan to computerise banks over the next five years, covering the period 1990 to 1994.

Further, an expert group was constituted by the IBA at the instance of the Reserve Bank to examine all aspects relating to the establishment of back-up cheque processing facilities to handle prolonged system breakdowns and other contingencies to ensure that clearing operations were not disrupted. Based on the recommendations of the group, the Bank finalised the uniform regulations and rules (URRs) for clearing houses, and these were adopted by all clearing houses in the country. Steps were also taken to frame regulations for clearing houses under section 58(2)(P) of the RBI Act, 1934. In centres where more than five banks were functioning and where there were no clearing houses to cater to their needs, banks were advised to take necessary steps to open clearing houses. During the year 1987–88, 30 new clearing houses were opened.

After the adoption of finalised URRs by all clearing houses, section 58(2)(P) of the RBI Act, 1934, which empowered the Reserve Bank to frame regulations for clearing houses only for scheduled banks, was amended by Parliament in December 1988 to provide for framing of regulations of clearing houses to govern all member banks, including non-scheduled, co-operative and post office savings banks. An expert group comprising senior officers drawn from the concerned departments of the Bank, the IBA and the SBI was constituted in May 1989 to review the existing URRs for clearing houses in order to place them on a statutory basis under the said Act. During 1988–89, 23 clearing houses were set up.

## TELECOMMUNICATIONS NETWORK

Pursuant to the recommendations of the committee for a communication network for banks (1987), steps were taken to set up an exclusive data communication network for banks called BANKNET, which was a general-purpose network that provided basic connectivity from/to geographically dispersed locations across the country. Through its implementation, 37 banks in India (including the Reserve Bank) became members of the Society for Worldwide Interbank Financial Telecommunications (SWIFT), a co-operative society based in Belgium. Action was taken to install the SWIFT regional processor at Bombay, which was entrusted with acting as the international gateway.

Message formats conforming to SWIFT specifications were standardised by the Reserve Bank and the IBA. Through this network, any bank on the network could establish a connection with its own offices and with any other banks/offices/computers in the network. The connections in the network called ports were terminals of mini/micro systems and mainframe computers. The IBM computers installed at the National Clearing Cells (NCCs) of the Reserve Bank at the four metropolitan centres, *viz.*, Bombay, Madras, Delhi and Calcutta, formed the hub of the BANKNET network. Basic connectivity between the systems on the network was through the dedicated data transmission lines leased from the Department of Telecommunications (DOT). The activities to make BANKNET operational, *viz.*, commissioning the DOT circuits, importing essential communications equipment, defining application areas and preparing message formats and sites, were put in place in a phased manner.

## STUDY GROUP ON FACTORING SERVICES

The Reserve Bank perceived extending factoring services as a measure to expedite collection of dues by suppliers and in this context constituted a study group in January 1988 under the chairmanship of Shri C.S. Kalyanasundaram, to examine the feasibility and mechanics of setting-up factoring organisations in India.

The terms of reference for the study group included considering the need and scope for one or more factoring organisations in the country, the nature of their constitution, whether they were to be in the public, private or joint sector, the changes required in the legal framework to promote factoring business, the feasibility of extending factoring services to exporters and other matters relating to factoring. The group submitted

its report in January 1989 and its recommendations were accepted in principle by the Reserve Bank. The important findings of the study group were as follows:

- (i) There was sufficient scope to introduce factoring services in India, which would be complementary to the services provided by banks.
- (ii) Export of factoring services from India would provide an additional facility to exporters.
- (iii) While quantification of the demand for factoring services was not possible, it was assessed that it would grow sufficiently so as to make factoring business a commercially viable proposition within a period of two/three years.
- (iv) On the export front, there would be a fairly good availment of the services offered by export factors.
- (v) To attain a balanced dispersal of risks, factors should offer their services to all industries and all sectors in the economy.
- (vi) The pricing of various services by factors depended on the cost of funds. Factors should attempt a mix from among the various sources of funds to keep the cost of funds as low as possible, in any case not exceeding 13.5 per cent per annum so that a reasonable spread was available.
- (vii) The Bank could consider allowing factoring organisations to raise funds from the Discount and Finance House of India Ltd (DFHI) as also other approved FIs, against their usance promissory notes covering receivables factored by them, along the lines of the revised procedure under the bill rediscounting scheme.
- (viii) The price for financing services would be around 16.0 per cent per annum and the aggregate price for all other services might not exceed 2.5 per cent to 3.0 per cent of the debts serviced.
- (ix) Only select promoter institutions/groups/individuals with a good track record in financial services and competent management were to be permitted to enter this new field.
- (x) Initially the organisations could be promoted on a zonal basis.
- (xi) There were distinct advantages in banks being associated with handling the factoring business. Subsidiaries or associates of banks were ideally suited to undertake this business.

- (xii) Factoring activities could be taken up by the proposed Small Industries Development Bank of India (SIDBI), preferably in association with one or more commercial banks.
- (xiii) The business community needed first to be educated through bank branches about the nature and scope of these services and the benefits accruing from them.
- (xiv) Factors could not extend their services efficiently, effectively and economically without the support of computers, as also quick and dependable means of communication, and hence the adoption of the latest technology in this field needed to be encouraged. In this context, the promoters needed to initiate measures for organising a network of computers/dedicated lines linking branches/agents in different parts of the country for accounting, follow-up, remittances, and other activities involved in the factoring business.
- (xv) The Central Government and the Reserve Bank needed to immediately initiate measures to set up specialised agencies for credit investigation and, until such agencies became fully operative, factors could rely on the information on clients/customers collected through banks or other sources.
- (xvi) Since it was envisaged that suppliers would be able to obtain financial services from both banks and factoring organisations, it was necessary to provide for proper linkages between banks and factors.
- (xvii) The factoring of small scale industry (SSI) units could prove to be mutually beneficial to both factors, and SSI units and factors needed to make every effort to orient their strategy to crystallise the potential demands from this sector.
- (xviii) An efficient financial system could sustain itself on a viable basis only if a favourable environment was created and fostered; the Government needed to take expeditious steps to promote legislation, grant appropriate exemptions and amend existing laws in order to subserve the objectives of promoting factoring.

#### URBAN CO-OPERATIVE BANKS

The urban co-operative banks (UCBs) were essentially the common man's bank, operating in metropolitan, urban and semi-urban centres to cater to the needs of the weaker sections and small borrowers, such as SSI units, retail traders, professionals and the salaried class. The difference between

UCBs and commercial banks was in the scale of their operations. Their record of performance, however, depended on the quality and intentions of their boards. Though the share of UCBs in total deposits of urban and metropolitan areas was not significant, they were able to promote thrift and savings among small and medium-income groups in these centres. They provided loans to the small and medium categories of borrowers, and in this sense they had a definite role to play in meeting the financing needs of these categories.

TABLE 6.10  
*Performance of UCBs at End-June*

(₹ crore)

	<i>Number</i>	<i>Owned Funds</i>	<i>Deposits</i>	<i>Borrowings</i>	<i>Loans Issued</i>
1982	1258	2,825	1,650	146	1,425
1983	1281	393	2,278	313	1,802
1984	1310	429	2,659	185	2,103
1985	1331	511	3,255	210	2,524
1986	1346*	612	3,939	214	3,046
1987	1354*	734	4,838	238	3,693
1988	1378*	886	5,789	317	4,636
1989	1378	1,082	7,232	376	5,820

Note: \* Revised.

Source: Reserve Bank of India, *Report on Trend and Progress of Banking in India*, various issues.

Of the 1331 UCBs in the country in June 1985 (Table 6.10), 1015 constituting 76.3 per cent were located in Maharashtra, Karnataka and Tamil Nadu. These were also the states which had a concentration of commercial bank offices in urban and metropolitan areas. There were regional imbalances in the growth of UCBs in the country. Five states put together had 17 UCBs; these were: Assam (3), Haryana (6), Punjab (5), West Bengal (1) and Bihar (2). Of the 330 UCBs in Maharashtra (excluding salary earner-type banks), as many as 286 were either located in the Konkan region (including Bombay) or in western Maharashtra.<sup>21</sup>

21. Ojha, P.D. (1985). *Role of the Urban Banks in the Multi-Dimensional Economic Growth of the Country*, keynote address delivered at the Seminar of Chairmen of UCBs in Maharashtra State. Bombay: Maharashtra Urban Co-operative Bank Federation. August 24.

The UCBs came under the Reserve Bank supervision on March 1, 1966, but control over the organisation, management and staffing was exercised by the Registrar of Co-operative Societies, a functionary of the state governments. Over the years, the Reserve Bank evolved a mechanism, assisted by the standing advisory committee (SAC) constituted specifically for the purpose, to deal with the issue of dual control.

The agricultural credit board (ACB), set up under the aegis of the erstwhile Agricultural Credit Department (ACD) of the Reserve Bank, was entrusted with examining policy matters relating to rural credit. It was also a forum to discuss issues relating to non-agricultural credit such as those concerning primary (urban) co-operative banks. The board ceased to exist after the establishment of NABARD. The Reserve Bank, however, continued to shoulder the responsibility of discharging various functions towards primary (urban) co-operative banks. With the dissolution of the ACB, there was, however, no exclusive forum/body within the Reserve Bank to tender expert advice on matters relating to primary (urban) co-operative banks. The Reserve Bank, therefore, constituted an SAC in February 1983 to advise on policies relating to licensing of new primary (urban) co-operative banks, opening of branches, capital, membership, priority sector advances, refinance facilities, rehabilitation or merger/liquidation of weak and non-viable primary co-operative banks, advice on the training needs of their staff, professionalisation of management and other important issues. The chairman of the advisory committee was a Deputy Governor of the Reserve Bank, and the chief general manager of the Urban Banks Department (UBD) acted as the member secretary of the committee. The SAC consisted of representatives from the Central Government, select state governments, national/state federation of primary (urban) co-operative banks, the IBA and NABARD. The diverse membership of the committee ensured that the Reserve Bank had the benefit of the expertise of various authorities on different aspects referred to the committee. The committee usually met once a year.

Recognising the importance of UCBs, the Reserve Bank extended certain concessions to them. They were permitted to pay 1.0 per cent higher rate of interest on their savings and term deposits, at their discretion, as compared with the rates payable by commercial banks. The prescribed rates for CRR and SLR for UCBs were lower than those for commercial banks. As an illustration, in August 1985, for UCBs these requirements were only

3.0 per cent and 25.0 per cent as against 9.0 per cent and 37.0 per cent, respectively in the case of commercial banks. Further, while commercial banks had to invest a major portion of their resources in government and trustee securities, UCBs could keep almost the entire statutory liquid assets with state/central co-operative banks, and such provisions enabled them to earn higher interest. The rationale behind such concessions was to induce UCBs to mobilise resources of the low and middle income groups, inculcate a sense of thrift among them and use these resources for the maximum economic benefit of the people in their area of operation.

Maharashtra continued to be at the forefront in the field of the co-operative movement, including the development of urban banks. The state took the lead in promoting urban banking and nearly 30.0 per cent of the UCBs in the country were located in Maharashtra by the latter half of the 1980s. Further, more than 40.0 per cent of the UCBs with a working capital of ₹ 5 crore and above, were located in Maharashtra. The UCBs in the state accounted for 45.0 per cent of the deposits of UCBs in the country. As many as 176 co-operative banks in the state had deposits of ₹ 1 crore and above.

The Reserve Bank as the central banking authority of the country assumed responsibility for ensuring harmonious and balanced growth of all banking constituents of the industry, while at the same time avoiding unhealthy and wasteful competition among them. It was recognised that sound banking development would also help reduce regional imbalances and promote growth. Towards this end, the Reserve Bank adopted a cautious and selective approach in forming new banks or opening branches to prevent overbanking of the areas and to facilitate an even geographical spread. However, in unbanked and underbanked areas, the Reserve Bank was willing to consider requests to set up new UCBs or branches of the existing banks, keeping in view, among others, if such banks/branches could function as viable business entities in the long run. Further, as there was a parallel rural banking infrastructure in the country, UCBs were not intended to function in rural areas, but were expected to cater to the needs of all residents in their area of operation regardless of caste, community, creed, or vocation. Since UCBs were required to have an open membership, the Reserve Bank did not accept demands to set up new banks on the grounds that the existing banks were catering to the needs of only particular groups and were unwilling to admit others into their fold. Further, the Reserve Bank did not want depositors' interests

to be put at stake and wanted the management of UCBs to be cautious and avoid doing anything, advertently or inadvertently, that violated the Reserve Bank's guidelines or affected the health of the institutions.<sup>22</sup>

Inclusion in the second schedule to the RBI Act had been a persistent demand of UCBs. This was also one of the recommendations at the conference of the national federation of UCBs held at New Delhi in November 1986. The Governor appointed a committee under the chairmanship of an Executive Director of the Reserve Bank to look into these recommendations. The committee proposed that larger urban banks that had a working capital of above ₹ 10 crore could be considered for inclusion in the second schedule to the RBI Act and that the concessions given to state co-operative banks with regard to maintenance of cash reserve and liquid assets could be extended to such UCBs as well. The recommendations of the committee were discussed by the Reserve Bank management on June 24, 1987, and the proposal to accord scheduled status to bigger urban banks was accepted.

One factor that weighed in favour of according scheduled status to UCBs was that such banks, especially the larger ones, functioned like commercial banks and extended a variety of services to their members. Further, some scheduled banks were much smaller in terms of size and range of operations than the large urban banks. It was felt that urban banks had an important role to play in the Indian banking system, since they catered to the needs of people with small means and their exclusion from the second schedule came in the way of discharging their role efficiently and effectively. There was, therefore, little justification for keeping urban banks out of the second schedule to the RBI Act. However, as this meant a major policy change, it was decided to have a restricted criterion for scheduling urban banks and a cut-off point of ₹ 50 crore of deposits was laid down.

The proposal for inclusion of UCBs was submitted to the Government, which asked for certain clarifications. After detailed consultations between the UBD and the Department of Banking Operations and Development (DBOD), the following clarifications were submitted in September 1987:

- (i) Preferential treatment to co-operative banks was envisaged in the provisions of the BR Act, 1949. In terms of section 42 of the RBI Act, and section 24 of the BR Act, commercial banks (excluding

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22. Ojha (1985) *op. cit.*

RRBs) were at this point required to maintain 9.5 per cent and 37.5 per cent of their demand and time liabilities as CRR and SLR, respectively. However, scheduled co-operative banks were required to maintain a minimum statutory ratio of only 3.0 per cent (CRR) and 25.0 per cent (SLR), respectively. Such clauses were incorporated in the Acts by reason of the specific role that the co-operative movement was assigned to play in the development process of the economy. Such preference would not adversely affect commercial banks because the deposits of urban banks were at around ₹ 4,000 crore, which constituted only 4.0 per cent of the total deposits of commercial banks of over ₹ 1,00,000 crore. Further, while it was true that all sections of the BR Act were not applicable to co-operative banks, such banks had a distinct, useful role to play in the banking system and their inclusion in the second schedule would enable them to perform this role more effectively. This move was, however, not likely to adversely affect commercial banks because urban banks had a limited area of operation, generally confined to the limits of the city in which they were established. There were no such restrictions in the case of commercial banks, however.

- (ii) In addition to direct access to the Reserve Bank refinance and improvement in image, which had been referred to by the Government, scheduling would enable urban banks to get direct finance from the Bank as also refinance assistance directly from the IDBI. Scheduling would also facilitate acceptance of their guarantees and letters of credit (LCs) by government departments and PSUs. It was stated that the UBD had frequently received representations from urban banks and their federations to the effect that their guarantees and LCs could be accepted by the government departments and the PSUs, but this request did not find favour with the Government because these banks were not included in the second schedule.
- (iii) The functioning of central co-operative banks, which catered to the rural credit requirements of the society, was quite different and distinct from urban banks. The functioning of UCBs was akin to that of commercial banks. So far, central co-operative banks had not requested the Reserve Bank for inclusion in the second schedule. Perhaps these institutions did not face any handicap

on this account. Conferring scheduled status on urban banks did not, therefore, amount to any discrimination against central co-operative banks.

- (iv) The obligation for social banking cast on UCBs was much higher than that for commercial banks. Urban banks were required to channelise not less than 60.0 per cent of their total advances to the priority sector as against the level of 40.0 per cent prescribed for commercial banks, although the total deposits of UCBs constituted only about 4.0 per cent of the deposits of SCBs. Also, as per the criteria proposed by the Reserve Bank, only nine urban banks with deposits aggregating ₹ 1,108 crore were eligible for scheduling. With such a limited deposit base, urban banks in no way offered any competition to commercial banks.
- (v) The Government examined the matter and in January 1988, it assured a decision to notify the primary co-operative banks<sup>23</sup> through a notification to this effect which was issued on April 5, 1988. Accordingly, the following 11 UCBs were included in the second schedule of the RBI Act with effect from September 1, 1988, after an inspection of these banks and satisfying other criteria:
  - (1) Abhyudaya Co-operative Bank Ltd, Bombay.
  - (2) Bombay Mercantile Co-operative Bank Ltd, Bombay.
  - (3) Development Co-operative Bank Ltd, Bombay.
  - (4) Janata Sahakari Bank Ltd, Pune.
  - (5) Kalupur Commercial Co-operative Bank Ltd, Ahmedabad.
  - (6) Rajkot Nagrik Sahakari Bank Ltd, Rajkot.
  - (7) Rupee Co-operative Bank Ltd, Pune.
  - (8) Sangli Urban Co-operative Bank Ltd, Sangli.
  - (9) Saraswat Co-operative Bank Ltd, Bombay.
  - (10) Shamrao Vithal Co-operative Bank Ltd, Bombay.
  - (11) Surat People's Co-operative Bank Ltd, Surat.

The UBD requested the Government in June 1988 to consider exempting scheduled UCBs from the provisions of section 18 of the BR Act, 1949 as they were required to hold cash reserves under section 42 of the RBI Act, 1934. The Government, in response, issued a notification on

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23. As defined under clause (ccv) and section 5 read with section 56 of the BR Act, 1949, which were licensed and whose demand and time liabilities were not less than ₹ 50 crore as FIs for the purpose of sub-clause (iii) of clause (a) of sub-section (6) of section 42 of the RBI Act, 1934.

August 5, 1988, declaring that the provisions of section 18 of the BR Act, 1949 would not apply to UCBs included in the second schedule of the RBI Act, 1934.

#### SUPERVISORY ROLE

The bond between the Reserve Bank and the urban banks was not as close as was perceived. There were no statutory provisions for nominating a director from the Reserve Bank to the board of management of UCBs, unlike in the case of commercial banks. Continuous association with banks' executives, dialogues and consultations enabling the Reserve Bank and commercial banks to have the mutual benefit of exchange of information and feedback about operational problems related to policies and guidelines was not feasible with the urban bank set up in view of their large numbers and comparatively insignificant level of operations. The Reserve Bank was empowered, at best, to send an observer to attend the meetings of the board. Statutory inspections were conducted once in two years. There was no mechanism in place to get regular feedback about the policies and operating procedures being followed.

The Deputy Governor, Dr P.D. Ojha, cautioned that UCBs should not expect to depend continuously on concessions.<sup>24</sup> He emphasised that the banks functioned in a highly competitive environment and as such should develop their own strengths. He went on to say that it was essential for the urban banks to continue to be distinctive in the matter of quality of service rendered, as it was not only by performance that they would be recognised by the community. He exhorted them to continue their efforts to extend efficient customer service and ensure the most efficient management of available resources, besides earning and retaining confidence of the depositors. As in the case of other banks, deposits with UCBs were insured within limits by the DICGC, the subsidiary of the Reserve Bank. However, mere insurance of deposits did not satisfy the depositors who wanted to be assured that the institutions to which they entrusted their savings had the required financial strength and operational efficiency to ensure continued safety of their funds.

In September 1983, the Reserve Bank exhorted UCBs to lend not less than 60.0 per cent of their total loans to the priority sectors by June 1985, of which 25.0 per cent were to go to the weaker sections of society.

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24. Ojha (1985) *op. cit.*

The underlying objective behind fixing priority sector lending targets was to ensure that loans went to the common man and got increasingly directed towards productive purposes. Granting of consumption loans was discouraged. Any weakness, for any reasons, in this respect was seen to adversely affect the image of banks and the same was conveyed to them.

A disturbing development in the case of UCBs was an increase in the number of weak banks. As at the end of June 1984, the number of such banks was as high as 310, of which 78 were located in Maharashtra. Their working was characterised by serious shortcomings including irregularities, gross mismanagement, deteriorating quality of their loan portfolios, heavy overdues and erosion of assets. Some banks did not comply with the statutory requirements of minimum share capital and were non-viable. The small and uneconomic size of the banks made their functioning inflexible, leading to failures. The existence of a large number of such units, which had attained the status of UCBs by virtue of crossing the owned funds limit of ₹ 1 lakh, proved to be a severe drag on the urban banking movement. This was a matter of concern for the Reserve Bank and the bank managements. Banks were advised to implement time-bound rehabilitation or reorganisation programmes to help themselves out of the mess.

The viability issue was engaging the attention of the Reserve Bank and the Bank conducted a comprehensive study to revise the norms of viability of UCBs. It emphasised that a sound UCB was not only meant to meet the administrative and operational costs, declare a reasonable dividend to shareholders and strengthen its reserves, but also had to ensure sustained growth in the years to come even after attaining the norms of viability. The Deputy Governor, Dr Ojha, highlighted in his address to the chairmen of UCBs that the boards of management should be well informed, fully conversant with all matters dealt with by UCBs, be progressive and forward-looking, objective in their outlook, dynamic and, above all, visibly honest in their dealings. They should know the broad national goals and priorities indicated in successive Five Year Plans. They should also be familiar with various provisions of the Acts, the rules, by-laws and instructions issued by the Registrar of Co-operative Societies and the Reserve Bank on various aspects of the working of UCBs. In short, they needed to be professional in their outlook and management.<sup>25</sup>

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25. Ojha (1985) *op. cit.*

The regulation and supervision norms in respect of UCBs were broadly in conformity with those in vogue for commercial banks. The regional offices of UCBs were required to keep their central office informed of developments in the field of their operations through monthly demi-official letters that covered various aspects such as the progress in the inspection of banks, status of the proposals for setting-up new banks/branches, deployment of staff, position of urban banks in the region and conferences/meetings convened.

### THE BANK, FIs AND NBFCs

Since the initiation of the Second Five Year Plan, the focus of Indian planning turned in favour of the development of highly capital-intensive, large scale basic and heavy industries. The strategy for industrialisation demanded more long-term credit from the banking sector and such needs were being met by commercial banks. The banks, however, had to provide finance to the priority sector of not less than 40.0 per cent of their net bank credit. This exerted tremendous pressure on them to strike a balance between the two areas of credit disbursal. It was in this context that the FIs stepped in to play a vital role in meeting the exclusive long-term credit requirements of the industrial sector, as per the Plan priorities.

It was, however, necessary to ensure that these institutions were subjected to prudential practices and standard procedures, and the Reserve Bank laid down broad guidelines keeping in view the day-to-day operations of the FIs. The MIS envisaged for the purpose had two facets: one, to aggregate information for facilitating monetary control and two, to examine the quality of assets from the supervisory standpoint. For this purpose, the Reserve Bank set out to collect all relevant information on the activities of non-banking financial institutions (NBFIs).

There was, however, only a limited attempt to evaluate developments in this field and practically no attempt to analyse the overall impact of the FI operations. This was clearly a deficiency from the viewpoint of macro monitoring of the financial system. Towards the late 1980s, a need was felt to devise adequate safeguards for effective monitoring and control of the FIs. With this in view, the Reserve Bank constituted an in house group on FIs headed by Shri S.S. Tarapore. The group submitted its report on June 2, 1990. In their report, the group recommended introducing an information system for the FIs, so as to obtain an insight into the financial health of these entities and to monitor their operations, particularly the

total debt and investment instruments. From the viewpoint of effective supervision, introducing a system of annual financial review akin to that adopted for commercial banks was recommended; it also detailed a quarterly action plan to be put in place after the initial assessment of the health of these institutions by the Reserve Bank. Further, the group recommended that a system of formal dialogue be initiated for structured supervision of the FIs. The structure of the interest rates charged by the FIs was to be approved by the Reserve Bank in consultation with the Government. The group also suggested that a financial institutions cell (FIC) be set up in the Reserve Bank as an independent unit of the central office with an interdisciplinary officer orientation. Most of the recommendations were implemented during the early 1990s by the Reserve Bank.

#### INDUSTRIAL DEVELOPMENT BANK OF INDIA

The IDBI<sup>26</sup> was designed to cater to the long-term financial requirements of the corporate sector. It was instituted to provide two types of advances, *viz.*, direct assistance and indirect assistance, besides providing guarantees for loans and deferred payments. While direct finance comprised project finance of an industrial nature, indirect finance included refinance of industrial loans provided by other term-lending institutions, bill financing, loans to other financial institutions (OFIs), investments in shares and bonds of the OFIs and seed capital financing.

The aggregate financial assistance sanctioned and disbursed (excluding guarantees) by the IDBI increased by 26.6 per cent and 18.9 per cent, respectively, during 1983–84 over that of 1982–83. There was a rise of 13.1 per cent and 26.1 per cent in sanctions and disbursements of aggregate financial assistance, respectively, during the year 1984–85 over that in 1983–84. The aggregate sanctions and disbursements continued to rise through the 1980s and increased by 44.3 per cent and 28.4 per cent, respectively during 1988–89 over that in 1987–88.

Direct assistance disbursed by way of project loans, underwriting and direct subscriptions along with assistance for technical development recorded a rise of 43.7 per cent during 1985–86, 38.8 per cent during 1987–88 and 39.4 per cent during 1988–89, respectively, over those of the respective previous years. However, the rise in disbursements during 1983–84 stood at a dismal 2.8 per cent over the previous year, while total

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26. Set up in 1964.

sanctions recorded a significant rise of 44.9 per cent during the same period. Disbursement of indirect assistance by way of refinance of industrial loans, rediscounting of bills, subscription to shares and bonds, and seed capital also increased by 25.1 per cent during 1983-84, by 19.7 per cent during 1985-86 and by 22.3 per cent during 1988-89, over the respective previous years.

As a part of introducing innovative finance, the IDBI set up a textiles modernisation fund (TMF) during 1986-87. It initiated a new scheme of assistance for export-oriented units and floated a 9.0 per cent capital gains bond scheme with a maturity of three years. A new feature of the bonds was that investors had the option to receive the entire interest in advance on a discounted basis or half-yearly interest of 9.0 per cent per annum. Under the leadership of the IDBI, the FIs made the single-window concept more effective. The IDBI (amendment) Act, 1986 enlarged the scope of its activities, which included health care, storage, distribution of energy, consultancy, merchant banking and trusteeship activities.

In 1987-88, the IDBI set up a voluntary executive corps cell (VECC) to offer counselling to small scale units with investments above ₹ 5 lakh. To simplify the procedures, the IDBI along with the IFCI and Industrial Credit and Investment Corporation of India Ltd (ICICI) extended the single-window clearance concept to foreign currency loans. A scheme was devised to assist projects engaged in energy conservation during March 1988.

During 1988-89, the IDBI introduced the exchange risk administration scheme (ERAS) in collaboration with other FIs, *viz.*, the IFCI and ICICI, to offer protection against exchange risk to foreign currency borrowers. During the year, a decision was taken to extend financial assistance to tourism-related facilities, such as, amusement parks, cultural centres and restaurants. To meet the foreign currency requirements of industrial units, the IDBI entered into foreign currency lines of credit from commercial banks of foreign countries, *viz.*, West Germany, Japan, and the erstwhile USSR, among others. The Reserve Bank sanctioned credit limits to the IDBI ranging from ₹ 260 crore during 1982-83 to ₹ 375 crore during 1988-89 out of the NIC (LTO) fund for a period of 15 years at an interest rate of 8.0 per cent. The IDBI fully utilised the above credit. The Reserve Bank also sanctioned short-term credits from time to time against security of eligible usance bills rediscounted by it.

The total financial assets of all FIs stood at over ₹ 89,000 crore at the

end of March 1989. The outstanding position revealed certain interesting facts. Illustratively, the total liability of the IDBI as at the end of March, 1989 amounted to ₹ 17,139 crore. Borrowings from the Reserve Bank were equivalent to 22.0 per cent of the total liabilities and 33.0 per cent of loans and advances. The capital and reserves together amounted to 8.3 per cent of the total liabilities of the IDBI. A number of FIs received assistance from the Reserve Bank either under the long-term operation (LTO) fund or through short-term credit; the total sum outstanding under the national industrial credit (NIC) (LTO) fund and national housing credit (NHC) (LTO) fund at the end of March 1990 amounted to ₹ 4,616 crore. Further, under the national rural credit (NRC) (LTO) fund and NRC [stabilisation (S)] fund, the outstanding as at the end of March 1990 amounted to ₹ 3,975 crore. Thus, credit outstanding under all the LTO funds together amounted to ₹ 8,591 crore or about 12.0 per cent of the reserve money. Further, a number of FIs were provided accommodation at the Bank Rate; these limits amounted to ₹ 530 crore at the end of March 1990, though there were no dues outstanding against these limits.

INDUSTRIAL CREDIT AND INVESTMENT CORPORATION OF  
INDIA LTD

Assistance from the ICICI<sup>27</sup> included rupee and foreign currency loans, underwriting, and direct subscriptions to shares, debentures and guarantees. Rupee loans continued to form the main component of assistance over a period of time; their share in total sanctions stood at 57.2 per cent during 1982–83, 45.9 per cent during 1983–84 and 41.6 per cent during 1988–89. As part of its merchant banking activities, the ICICI offered advisory services on foreign currency management, overseas company floatation and organisational restructuring. In collaboration with other institutions, it played an important role in setting-up the over-the-counter (OTC) market. The ICICI also introduced buyers' credit in December 1988 to enable companies to acquire equipment not covered under the suppliers' credit scheme. During 1988–89, the ICICI initiated negotiations with the World Bank for a programme to strengthen the capabilities of research institutions to provide technology services to industry. The Technology Development and Information Company of India Ltd (TDICI) established by the ICICI commenced operations to provide technological information and commercial R&D schemes. The ICICI extended assistance to various

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27. Set up in 1955.

industrial sectors such as the chemical, fertiliser, cement, textiles and basic industries. It laid emphasis on providing assistance to industrially backward areas of the country. Assistance sanctioned by the ICICI during 1983-84 increased by 25.8 per cent and disbursements by 8.8 per cent over the previous year. The aggregate sanctions increased by 17.1 per cent, 14.1 per cent and 57.9 per cent during the years 1984-85, 1986-87 and 1988-89, respectively, over the corresponding previous years. Similarly, disbursement of assistance by the ICICI recorded a growth of 16.6 per cent, 44.2 per cent and 40.8 per cent during the years 1984-85, 1986-87 and 1988-89, respectively, over the respective earlier years.

The ICICI was sanctioned a credit limit of ₹ 10 crore during 1982-83 by the Reserve Bank and the corporation availed of the limit on several occasions for short periods. The amount was enhanced to ₹ 15 crore during 1984-85, which continued during 1985-86. However, during 1987-88, an *ad hoc* credit limit of ₹ 20 crore was sanctioned to the ICICI, which was fully utilised and a fresh limit of ₹ 25 crore was sanctioned for the financial year 1988-89. The facility was availed of on several occasions.

#### INDUSTRIAL FINANCE CORPORATION OF INDIA

The IFCI<sup>28</sup> was established by an Act of Parliament to provide medium and long-term loans to industrial concerns in the corporate and co-operative sectors. In the initial years, the assistance portfolio of the IFCI was concentrated in traditional industries like sugar and textiles, but over time it diversified its assistance portfolios to cover various promotional activities to help catalyse the growth of industrialisation in the country.

The assistance sanctioned by the IFCI during 1983-84 increased sharply by 43.3 per cent as against 5.6 per cent in 1982-83. Total disbursements showed an increase of 15.8 per cent during 1982-83, 14.8 per cent during 1983-84 and 21.6 per cent during 1984-85, over the respective previous years. The disbursement of assistance increased at a comparatively lower pace of 11.8 per cent and 48.0 per cent during the years 1985-86 and 1986-87, respectively. Further, aggregate assistance sanctioned by the IFCI during 1988-89 registered a growth of 85.9 per cent, while disbursements increased by 52.3 per cent over the previous year. During the 1980s, a volatile trend was discernible in the relative shares of rupee loans and foreign currency loans in total assistance sanctioned. The

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28. Set up in 1948.

share of rupee loans in total sanctions declined gradually from 88.5 per cent in 1982–83 to 63.2 per cent during 1985–86 and increased to 72.6 per cent during 1988–89. The share of foreign currency loans increased over the years, from 2.5 per cent during 1982–83 to 19.0 per cent during 1988–89. The remaining portion of sanctions comprised underwriting, direct subscriptions and guarantees. The IFCI sanctioned loans to textiles, basic chemicals, transport equipment, metals, fertilisers and electricity generation industries. An amendment to the IFCI Act in 1982 enabled it to extend project financing to other sectors, such as passenger and goods transport, road repairs, and industrial estate.

An important development that impacted IFCI's operations was the enactment of the Sick Industrial Companies (Special Provisions) Act (SICA), 1985. The Government established a quasi-judicial authority known as the Board for Industrial and Financial Reconstructions (BIFR) in January 1987, which became functional from May 15, 1987. The Appellate Authority for Industrial and Financial Reconstruction (AAIFR) was constituted in April 1987; this was an appellate authority to review the BIFR decisions and to formulate rehabilitation proposals for sick industries, since the number of sick units was on the rise during the 1980s.

A state-wise analysis of assistance disbursed revealed that the industrially backward states steadily improved their share in assistance received from the IFCI from 41.7 per cent in 1982–83 to 43.6 per cent in 1983–84 and further to 60.2 per cent, cumulatively up to the end of March 1985. Disbursements to backward areas during the year amounted to 57.5 per cent of the total disbursements. Of the total sanctions up to end-March 1989, over 50.0 per cent were meant for backward areas.

#### EXPORT-IMPORT BANK OF INDIA

Exim Bank<sup>29</sup> was established as a statutory corporation under the Export-Import Bank of India Act, 1981. Its objectives were to provide financial assistance to importers and exporters, to act as the principal FI in co-ordinating the work of other institutions financing international trade, and to undertake certain development and merchant banking activities.

Exim Bank was formed by transferring the export finance operations of the IDBI to the newly constituted bank. Established on January 1, 1982, the bank commenced operations from March 1, 1982. The export loans

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29. Set up in 1982.

and guarantee portfolios of the IDBI were transferred to Exim Bank, which assumed a funded liability of ₹ 169 crore and non-funded liability in the form of export guarantees of ₹ 336 crore under the general fund and ₹ 3 crore under the development assistance fund, now termed the export development fund. The bank took over from the IDBI various programmes of funded assistance, *viz.*, direct financial assistance to exporters, overseas investment financing, pre-shipment credit, overseas buyers' credit, lines of credit and refinance of export credit.

Exim Bank operates various lending programmes to promote exports of engineering and capital goods and related services from India. Funded financial assistance on competitive credit terms is extended to enable Indian exporters to operate in the international markets. The bank, along with commercial banks in India, participates in the issuance of guarantees in foreign currencies on behalf of Indian exporters/contractors in favour of overseas importers.

During March–December 1982, Exim Bank's approvals in terms of funded assistance aggregated to ₹ 293 crore, of which sanctions and utilisation amounted to ₹ 236 crore and ₹ 179 crore, respectively. Approvals on account of non-funded facilities aggregated to ₹ 774 crore. Export guarantees of ₹ 102 crore were executed during March–December 1982. Outstanding sums at the end of December 1982 in terms of funded and non-funded assistance amounted to ₹ 220 crore and ₹ 399 crore, respectively. More than three-fourth of the funded approvals were to finance the export of transport equipment (43.0%), power generation and distribution equipment (33.0%), while the construction industry claimed the bulk of the non-funded approvals (78.0%).

Nearly two-third of the approvals for funded lending programmes was for exports to South-East Asia. Two regions, namely, South-East Asia and Africa, accounted for 93.0 per cent of funded approvals. Of the non-funded approvals, projects in West Asia received the largest share (66.0%) followed by those in Africa (22.0%) and South-East Asia (12.0%).

Exim Bank's resources as on December 31, 1982, amounted to ₹ 359 crore, comprising paid-up capital of ₹ 75 crore, long-term loans of ₹ 20 crore from the Government, ₹ 70 crore from the Reserve Bank, ₹ 172 crore due to the IDBI on transfer of export loans from the IDBI and the balance made up of reserves. The bank raised its first euro-dollar loan of US\$ 25 million during the year.

## NATIONAL HOUSING BANK

The Governor, Shri R.N. Malhotra in his address on November 28, 1990 expressed:<sup>30</sup>

Housing activities were being financed by both institutional and non-institutional sources. Institutional sources included central and state governments, insurance companies, commercial banks, specialised housing finance institutions, such as, the Housing and Urban Development Corporation (HUDCO), Housing Development Finance Corporation Ltd (HDFC), Provident Fund, and the Unit Trust of India. However, investment in the housing sector declined from 34 per cent in the First Five Year Plan to less than 10 per cent in the Seventh Five Year Plan. The share of housing in Gross Domestic Product at 1980–81 prices slipped from 5.9 per cent in 1980–81 to 5.3 per cent in 1987–88. However, in absolute terms, the investment in housing had multiplied almost 28 times from Rs. 1,150 crore during the First Five Year Plan to Rs. 31,458 crore in the Seventh Five Year Plan. This investment in the housing sector was inadequate as the shortage of usable housing increased from 152 lakh units in 1961 to 233 lakh units in 1981 and was projected to widen further to 410 lakh units by 2001. Assuming a conservative cost of Rs. 50,000 per dwelling unit, the all-India shortage of 410 lakh units required an investment of over Rs. 2,05,000 crore. This figure indicated vast growth potential in this sector. The National Housing Policy formulated by the Central Government during 1988 set out the priorities and framed a strategy to eradicate the shortage of usable dwelling units by the turn of the century. The policy also advocated the creation of an institutional framework to mobilise savings for housing, meet the credit needs of the household sector and respond to the specific shelter needs, income patterns and living conditions of people in different parts of the country.

To achieve the above objective, the National Housing Bank<sup>31</sup> (NHB) was set up on July 9, 1988, with an initial share capital of ₹ 100 crore entirely subscribed to by the Reserve Bank. During 1988–89, the NHB

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30. Malhotra, R.N. (1990). Inaugural Address at the inaugural ceremony of the Vysya Bank Housing Finance Ltd. Bangalore. November 28.

31. Set up in 1988.

floated bonds for ₹ 20 crore, carrying an interest rate of 11.5 per cent per annum. The NHB was sanctioned a long-term loan of ₹ 50 crore out of the NHC (LTO) fund constituted by the Reserve Bank.

To promote savings for acquisition of a house, a new scheme called home loan account scheme (HLAS) was introduced by the NHB in co-operation with scheduled banks. The scheme was announced by the Union Finance Minister while presenting the Union Budget for 1989–90. The minimum contribution to the savings scheme was fixed at ₹ 30 per month or ₹ 360 per annum. These savings earned the interest at the rate of 10.0 per cent per annum. Any individual not owning a house anywhere in India was eligible to join the scheme. After saving for a minimum period of five years, a member was eligible for a loan equal in amount to a multiple of the accumulated savings including interest. To make the scheme attractive, some fiscal concessions were extended. Savings in the HLAS of the NHB qualified for deduction from gross income under section 80C of the Income Tax Act, and repayment of the same housing loan up to a maximum of ₹ 10,000 per annum qualified for deduction under section 80C. Further, investments under the HLAS were exempted from wealth tax, subject to the overall ceiling of ₹ 5 lakh under section 5 of the Wealth Tax Act.

Another major initiative of the NHB was preparation of guidelines on formation of housing finance companies (HFCs) in the private and joint sectors. The guidelines stipulated that an HFC needed to have a minimum paid-up capital of ₹ 1 crore and that at least 20.0 per cent of the equity was required to be from a scheduled bank, a public FI, a state government or an HFC approved by the NHB. Further, at least two directors from banking/FIs were required to be on the board. Limitations were prescribed on the total borrowings of an HFC as a multiple of its net owned funds, on the maturity period of deposits, on the interest rate payable on deposits, on lending rates and margins, on front-end charges and administrative costs, and on the proportion of total lending that an HFC could undertake for purposes other than housing. The guidelines struck a balance between the regulatory and promotional roles of the NHB, as the objective was to create an enabling environment for the growth of housing finance institutions along sound lines.

The NHB had already commenced refinance schemes for SCBs, scheduled state co-operative banks, scheduled UCBS, HFCs and the apex co-operative housing finance societies. It had also formulated a scheme to extend financial support to the state-level land development banks (LDBs)

in respect of housing loans granted by them, through subscription to special rural housing debentures to be floated by them. The terms and conditions of all the refinance schemes were more or less similar. The refinance was to be provided only in respect of direct lending to individuals/groups of borrowers (formal or informal, including co-operative societies).

The housing finance routed through RRBs by the sponsor banks was treated as direct lending of the latter. Refinance was provided up to 100.0 per cent of direct loans of up to ₹ 50,000 for construction of new housing units with built-up accommodation of 40 square metres. This facility was additional to, and separate from, housing loans granted under the annual credit allocation for housing made by the Reserve Bank and housing loans of up to ₹ 5,000 at a concessional interest rate of 4.0 per cent per annum extended to persons belonging to scheduled castes (SCs)/scheduled tribes (STs). Individual housing loans of up to ₹ 1 lakh granted in the urban areas were eligible for refinance, provided the built-up accommodation did not exceed 40 square metres. The refinance amount was, however, restricted to ₹ 50,000. In rural areas, the area limit of 40 square metres could be relaxed at the discretion of the lending agency, provided the cost of the housing unit did not exceed ₹ 65,000. The aggregate amount of refinance in no case exceeded the aggregate amount of outstanding loans to the eligible categories excluding overdues. Refinance was available to banks for 15 years, irrespective of the actual repayment period or moratorium allowed by them in individual cases. Banks were expected to stipulate a repayment schedule of 15 years, as provided under the Reserve Bank guidelines. In the case of HFCs and apex co-operative housing finance societies, the repayment period for refinance was fixed at 20 years.

The refinance schemes came into operation from January 1, 1989, and specified housing loans sanctioned after that became eligible for the scheme. As of end-June 1989, the NHB released refinance aggregating ₹ 96 lakh to two HFCs and an SCB.

During the year, United States Agency for International Development (USAID) provided a loan guarantee for US\$ 50.0 million to the NHB under the USAID government housing guarantee programme, under which developing countries could borrow in the US capital market with the guarantee of the US government for periods up to 30 years.

Apart from organising financial resources for housing, the NHB initiated steps to augment real resources for housing. Towards this objective, it evolved guidelines to finance land development projects. The

NHB drew up a land development project keeping in view local conditions, technical feasibility and affordability for different income groups. This was intended to be an integrated project, including acquisition of land and on-site infrastructure. Funds were made available in the form of term loans at market rate of interest. To ensure timely execution, the NHB charged higher rate for time overruns. A period not exceeding two years was envisaged for developing land and making the site available for construction of a shelter.

The NHB also proposed to extend full support to industries that augmented supplies of building materials and/or led to construction at a lower cost. Some of the related activities that got the support of the NHB were production and use of: (i) locally produced, low-cost building materials and construction components; (ii) standardised building materials and components; (iii) building materials and components produced by use of agricultural and industrial wastes; (iv) building materials and components which replaced or reduced substantially the use of scarce resources like wood; and (v) low-energy consumption building materials and components.

#### NATIONAL BANK FOR AGRICULTURE AND RURAL DEVELOPMENT

With a view to providing all types of production and investment credit for agriculture and rural development and to act as an agency for promoting integrated rural development, the committee to review arrangements for institutional credit for agriculture and rural development (CRAFICARD), in its report submitted in March 1981 to the Bank, recommended the establishment of NABARD.<sup>32</sup> The bill for the establishment of NABARD<sup>33</sup> was passed by Parliament and received the assent of the President on December 30, 1981. NABARD came into existence on July 12, 1982. Established on the basis of the National Bank for Agriculture and Rural Development Act, 1981, NABARD was set up as the apex FI to provide and regulate rural credit and promote integrated rural development in the country. After its establishment, there was internal reorganisation of the departments within the Reserve Bank; the Agricultural Credit Department (ACD) ceased to function and a new Rural Planning and Credit Department (RPCD) was set up.

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32. Set up in 1982.

33. A detailed account of NABARD is given in chapter 8: Rural Credit Policy.

The obligations cast on the Reserve Bank under section 54 of the RBI Act in the sphere of agricultural credit were modified. The amended section envisaged that the Reserve Bank would maintain expert staff to study various aspects of rural credit and development, tender expert guidance and assistance to NABARD, and conduct special studies in areas that it may consider necessary for the promotion of integrated rural development.

The board of directors of NABARD consisted of, besides the CMD, two directors from experts in rural economics and rural development, three directors from the Central Board of the Reserve Bank, three directors from among officials of the Government and two directors from among officials of the state governments. A Deputy Governor<sup>34</sup> from the Reserve Bank and chairman of the erstwhile Agricultural Refinance and Development Corporation (ARDC) was appointed as the chairman of NABARD.

The paid-up capital of NABARD was ₹ 100 crore and was held by the Reserve Bank and the Government in equal proportions. In terms of the provisions of the NABARD Act, the assets and liabilities of the erstwhile ARDC were taken over by NABARD. For its short-term operations, NABARD could draw funds mainly from the Reserve Bank. For its term loan operations, it could draw funds from the Government, float bonds in the open market and also draw, to the extent needed, from its NRC (LTO) fund and NRC (S) fund. The assets and liabilities of the two funds maintained by the Reserve Bank, *viz.*, the national agricultural credit (NAC) (LTO) fund and NAC (S) fund were transferred to the above funds of the NABARD. NABARD was also authorised to accept deposits with a maturity of not less than 12 months from the central and state governments, local authorities and scheduled banks, and to borrow, with the approval of the Central Government, foreign currency from any bank or FI in India or elsewhere. The short-term loans outstanding granted by the Reserve Bank to SCBs and RRBs under section 17 of the RBI Act [except those under section 17(4) (a)] were transferred to NABARD which, in turn, was required to repay these to the Reserve Bank.

NABARD was required to provide assistance by way of refinance credit, for the promotion of agriculture, SSI units in rural areas, cottage and village industries, handicrafts, other rural crafts and other allied economic activities in rural areas, with a view to promoting integrated rural development and securing rural prosperity. Short-term credit by

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34. Shri M. Ramakrishnayya.

way of refinance (repayable within 18 months) was to be provided to SCBs, RRBs and OFIs (approved by the Reserve Bank) for agricultural operations or marketing of crops; marketing and distribution of inputs necessary for agriculture or rural development; bona fide commercial or trade transactions; production or marketing activities of artisans or SSI units in rural areas; industries in tiny and decentralised sectors, village and cottage industries or those engaged in handicrafts and other rural crafts; and other allied economic activities in rural areas. The short-term loans granted to SCBs and RRBs could be converted into medium-term loans for periods not exceeding seven years under conditions of drought, famine or other natural calamities. Medium-term loans (*i.e.*, 18 months to 7 years) were to be provided to SCBs and RRBs for agriculture and rural development and other purposes as determined by NABARD. Long-term loans (up to 25 years) and advances by way of refinance were to be provided to the LDBs, RRBs, SCBs, other scheduled banks, and OFIs for promoting agriculture and rural development, as well as for giving loans to artisans, SSIs, industries in tiny and decentralised sectors, and village and cottage industries. NABARD also extended short-term loans along with long-term loans, where such composite loans were considered necessary. It could also make loans and advances to the state governments for periods not exceeding 20 years to enable them to subscribe directly or indirectly to the share capital of co-operative credit societies.

NABARD was also required to maintain a R&D fund. Another provision in the NABARD Act stipulated that for the first 15 years, it would, after making provision for bad and doubtful debts, depreciation of assets and other provisions necessary or expedient, transfer the remaining surplus to the R&D fund. This, it was felt, would help promote research in agriculture and rural development, and aid NABARD in formulating and designing projects/programmes to suit the requirements of different areas.

#### INDUSTRIAL RECONSTRUCTION BANK OF INDIA

Industrial sickness had emerged as a major area of concern during the 1980s. The Industrial Reconstruction Corporation of India<sup>35</sup> (IRCI), a company registered under the Companies Act, was converted into the IRBI, a statutory corporation with the purpose of attempting to overcome the inherent difficulties faced by the IRCI in its efforts to rehabilitate and

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35. Established in 1984.

reconstruct sick industrial concerns. The IRBI was to function as the principal credit and reconstruction agency for industrial revival; it was also envisaged to co-ordinate similar work of other institutions, to assist and promote industrial development, and to facilitate rehabilitation of industrial concerns.

#### DISCOUNT AND FINANCE HOUSE OF INDIA LTD

The DFHI<sup>36</sup>, set up jointly by the Reserve Bank, PSBs and the FIs to deal in short-term money market instruments with the primary objective of imparting improved liquidity, commenced operations from April 25, 1988. The DFHI was incorporated under the Companies Act, 1956, with an authorised and paid-up capital of ₹ 100 crore, of which ₹ 51 crore was contributed by the Reserve Bank, ₹ 33 crore by public sector banks and ₹ 16 crore by the FIs.

In the initial stages, the DFHI focused on two money market instruments, namely, 182-day Treasury Bills and rediscounting of short-term commercial bills. The DFHI's operations in 182-day Treasury Bills were aimed at imparting greater flexibility to banks in their management of short-term funds. As regards short-term commercial bills, the aim of the DFHI was to provide liquidity to commercial bills that had already been discounted or rediscounted by banks and the FIs by further rediscounting these bills. A line of credit of ₹ 200 crore at 12.0 per cent per annum was provided to the DFHI by the PSBs. In addition, to be able to perform its functions more effectively, the Reserve Bank provided the DFHI with back-refinance lines. By varying the quantum rate of interest on refinance to the DFHI, it was envisaged that the Reserve Bank would transmit signals to the short-term money market.

The DFHI was allowed to participate in the call and notice money market as both a lender and a borrower. This was a step towards providing some flexibility to the money market. The operations of DFHI in the call/notice money market were exempted from the provisions of the ceiling rate of interest set by the IBA. This resulted in freeing the call money markets in a limited way and also enabled the DFHI to contribute effectively to the overall stability of the money market.

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36. Set up in 1988.

## STOCK HOLDING CORPORATION OF INDIA LTD

The Stock Holding Corporation of India Ltd<sup>37</sup> (SHCIL), a depository institution jointly promoted and sponsored by seven all-India FIs (IDBI, IFCI, ICICI, UTI, LIC, General Insurance Corporation [GIC] and IRBI), commenced operations in August 1988. It was established to introduce a book entry system for transfer of scrips in lieu of the physical transfer of paper shares. The SHCIL began by offering custodial and post-trading services, and added depository and other services to its portfolio over time.

## NON-BANKING FINANCIAL COMPANIES

Non-bank financial entities were a part of the financial architecture in India since time immemorial. With the significant expansion of banking in the 1970s, particularly after bank nationalisation, the importance of non-bank financial intermediaries was expected to wane. The NBFCs, however, mushroomed in the 1970s and 1980s, despite marked expansion and consolidation of the banking business in these two decades. The setting-up of targets for priority sector lending and higher allocation of bank credit to neglected sectors of economic activities pursued by weaker sections of the population did not seem to have any impact on the conditions of credit availability for the common man at large. Although commercial banks decisively enjoyed the confidence of the public, the NBFCs continued to record a manifold increase in their business after the nationalisation of banks. This could be attributed to a variety of factors. On the demand side, growth in farm and non-farm activities expanded rural incomes, and the sprouting of the small scale sector in urban and semi-urban areas escalated the credit requirements of small entrepreneurs, traders and transport operators. Though the banking business expanded, it however, could not keep pace with the credit requirements of several segments of society. On the supply side, a large size of funds that shied away from the banking system because of a reluctance to declare sources of funds appeared to have been channelled into NBFCs and such funds were aggressively deployed by these companies to earn reasonable returns. In fact, high rates of income tax in the 1970s fuelled the generation of such funds on a large scale, which was also vindicated by the impressive mobilisation of resources through voluntary disclosure schemes (VDS). Further, either the bank branches did not exist or the systems and procedures of banking institutions were

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37. Established in 1988.

too complicated for the common customer. The procedural hassles, compounded by widespread illiteracy, often discouraged borrowers from approaching the banks. For the ordinary citizen, it was not easy to raise loans from the banks which required several documents, tangible collaterals and margins. This caused a large section of the rural poor, in particular, to keep away from the formal banking sector and seek alternative sources of funds. The NBFCs, thus, came up to complement commercial banks by filling the gaps in a range of services provided by the banks. Another positive feature of this development was that the growth of NBFCs offered competition to commercial banks, making them more efficient and responsive to customer needs. Also, substantial growth in the NBFCs supported the overall savings and investment in the economy, auguring well for economic growth. On the flip side, the NBFCs were said to have influenced liquidity, asset creation and interest rates in the economy, rendering monetary policy less effective.

A few NBFCs and non-banking non-financial companies also mobilised deposits from the public. The deposit-taking activities of the former were regulated by the Reserve Bank under the provisions of the non-banking financial companies' directions, 1977, and the deposit-taking activities of the latter category were regulated by the provisions of the Companies Act by the Government. Resources mobilised by these institutions were deployed in various economic activities undertaken directly by these companies.

The activities of the NBFCs such as those engaged in the business of hire-purchase, housing finance, investments, loans, mutual benefit financial and residuary financial companies, and convertible chit funds continued to be regulated by the Reserve Bank. However, chapter III B of the RBI Act, 1934 vested the Reserve Bank with powers to prohibit the issue of advertisements by a non-banking institution soliciting deposits from the public. The Bank scrutinised their books of accounts either through on-site inspection or through an offsite supervision mechanism. The Reserve Bank was empowered to prohibit the NBFCs from accepting deposits from the public and to prosecute defaulters for violating the directives in the said Act. The NBFCs and miscellaneous non-banking companies, including chit fund companies, could accept deposits for a minimum period of 6 months and a maximum of 36 months, except for the HFCs for which the maximum period for acceptance of deposits was laid down at 60 months during 1982–83. The HFCs could offer a maximum interest rate of 15.0 per cent per annum. Investment and loan companies could accept total

deposits of up to 40.0 per cent of net owned funds (NOF); hire-purchase companies could accept 10 times the NOF; and for HFCs, no such ceiling was prescribed. NBFCs were required to maintain liquid assets in cash, bank deposits or unencumbered government or approved securities that were not less than 10.0 per cent of the outstanding deposits.

There was no uniform legislation to control massive growth of chit funds and money circulation schemes throughout the country. Barring a few, the states had not enacted legislation to control and monitor these activities. To plug this loophole and to bring about a uniform legislation applicable throughout the country, the Chit Funds Act, 1982 was enacted by Parliament. The Act received the assent of the President of India on August 19, 1983. The responsibilities of administration of the Act and framing of the rules under the Act were vested in the state governments. The Reserve Bank, therefore, issued a circular to the Chief Secretaries of all the state governments/UTs in December 1983 for adoption of the Act. The Reserve Bank continued to follow up with the state governments/UTs for speedy adoption of the legislation. Under the provisions of the Act, for commencing chit fund business, the minimum capital of the chit fund company was required to be not less than ₹ 1 lakh. Existing companies with a capital of less than ₹ 1 lakh were given three years to increase their paid-up capital. Before declaring dividends at the end of each year, a chit fund company had to transfer not less than 10.0 per cent of the net profits to a reserve fund. Also chit fund institutions were required to utilise the funds only to carry on the chit business, give loans to non-prized subscribers, invest in trustee securities or make deposits with approved banks. Besides the state governments, the Reserve Bank was also given the powers to inspect the operations of chit fund companies. The civil courts were barred from entertaining proceedings in respect of the chit business and deterrent penalties were provided for contravening the provisions of the Act.

The Prize Chit Money Circulation Scheme (Banning Act), 1978 prohibited the conduct of prize chits, lotteries and money circulation schemes. Prize chit companies included the Peerless General Finance and Investment Company Ltd, which filed 37 writ petitions challenging the applicability of the Act to their schemes. The Reserve Bank was impleaded as a respondent, while the Government and respective state governments were the main parties to the petition. On the grounds of violating the Prize Chit Money Circulation Scheme (Banning Act), 1978, the Government of West Bengal conducted raids on the office premises and partners of

Sanchaita Investments, Calcutta, which was accepting deposits from the public and reportedly offering very high interest rates. The partners of the firm filed a writ petition in the Calcutta High Court challenging the proceedings initiated after the raids.<sup>38</sup>

Some unincorporated bodies offered rates of interest more than they could earn, which resulted in default in repayment of principal and interest thereon. As per the Banking Laws (Amendment) Act, 1983, which prohibited unincorporated bodies from accepting deposits from the public except to a specified extent, an individual could not accept deposits from more than 25 depositors and a partnership firm from 25 depositors per partner with a maximum of 250 depositors. Thus, the ceiling imposed was on number of depositors rather than on the quantum of deposits. This amendment came into force in February 1984 by including a new chapter 111-C in the Act. In terms of this amendment, the Reserve Bank was not required to regulate the deposit-taking activities of unincorporated bodies. Unincorporated bodies that accepted deposits from the number of persons exceeding the prescribed limit were required to bring down the number of depositors within two years. Under the provisions of the Act, failure to adhere to these provisions attracted a penalty by way of imprisonment up to two years, or a fine up to twice the amount of deposits received or ₹ 2,000, whichever was more, or both. Officials of the Reserve Bank and the state governments were vested with powers to obtain search warrants under section 45 T of the Act; this enabled officers to enter and search premises suspected to be used for keeping documents relating to deposit acceptance in contravention of the provisions of section 45 S, and to launch prosecution.

The Department of Non-Banking Companies (DNBC) in the Bank was renamed as the Department of Financial Companies (DFC). In terms of the Banking Laws (Amendment) Act, 1983, it was possible for banks to undertake the business of equipment-leasing through subsidiaries set up for the purpose. Amendments were made to the directions to incorporate regulation of a new category of financial companies called equipment-leasing companies. These companies could accept deposits for periods ranging between 6 months and 36 months. The distinction between hire-purchase and leasing business was very narrow. Leasing companies were

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38. The petitions were settled much later. Details of the procedures do not fall within the purview of Volume 4 of the RBI history.

permitted to raise deposits up to 10 times of their NOFs. However, for computation of the ceiling, all borrowings, *viz.*, borrowings from banks and funds raised in the form of bonds and debentures, were clubbed with deposits. Dr P.D. Ojha,<sup>39</sup> Deputy Governor stated:

Equipment-leasing was a contractual agreement between two parties, *i.e.*, lesser and lessee for the hire of a specific asset selected from a manufacturer or a vendor of the asset by the lessee. The lessor, *i.e.*, the leasing company retained the ownership of the asset, while the lessee had its possession and used it against payment of specified rentals, over an agreed period. There were mainly two types of leases-financial lease and operating lease. A financial lease was akin to instalment credit, *i.e.*, a method of acquisition of an asset without making any payment for it.

The selection of equipment was the lessee's function. Under such an arrangement, the rentals covered the full cost of the equipment along with the interest component and profit. Most of the industrial and agricultural plants and equipment, mining and transportation and service facilities, printing presses, office machinery, computers, ships and aircraft could be available on lease.

Since 1983, leasing was slowly finding acceptance in the field of industrial and capital equipment, and during the late 1980s it developed as an important source of equipment finance. As per the prevalent practice in India, the lessor provided financial assistance for purchase of equipment selected by the lessee. The period of lease was normally lower than that of the depreciated life of the asset. The total rental payment during the obligatory period, which was not cancellable, was sufficient to amortise the full capital outlay. This approach was commonly called 'full pay out'. The lessee bore the risk of obsolescence and paid the maintenance fees, insurance premium and taxes. The main advantages of leasing to the lessee were the rentals which were reckoned as business expenditure for tax purposes; the lessor got a tax benefit in respect of depreciation provided. Further, there was no clause of a buy-back option in the lease agreement. One of the major benefits to a lessor was that the tax burden was borne by the lessee, and this enabled a leasing company to declare high levels of profit and distribute dividend from the very first year of its operations. In

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39. Ojha, P.D. (1988). Address at the *Tenth Lease Financing Seminar*. Asian Leasing, March 10.

the absence of any prudential accounting procedure laid down for such companies by the Reserve Bank, some companies recognised larger portion of rentals as income than warranted, which tempted them to distribute larger dividends.<sup>40</sup>

Hire-purchase companies were regulated by the Reserve Bank under the provisions of the directions of 1977 as applicable to NBFCs. The number of such companies increased from 209 in 1983 to 412 in 1986, and the amount of deposits raised by these companies from the public increased from ₹ 158 crore to ₹ 278 crore during this period. A hire-purchase company was permitted to accept deposits payable between not less than 6 months and not exceeding 36 months from the date of deposit. A hire-purchase company was permitted to raise deposits from the public to the extent of 10 times of its NOFs calculated as the aggregate of the paid-up capital and free reserves as appearing in the latest audited balance sheet of a company, net of the accumulated balance of loss, deferred revenue expenditure and other intangible assets, if any, as disclosed in the balance sheet. These companies had to maintain an account in India with a scheduled bank or in unencumbered approved securities for a sum which was required to be not less than 10.0 per cent of its deposits outstanding at the close of business on any day. These companies were also required to comply with other provisions of the directions relating to submission of returns, balance sheet and issue of advertisements relating to soliciting deposits. The Reserve Bank was also empowered to prohibit acceptance of deposits by a company in case of non-compliance with the provisions of the directions. Management of these companies had the responsibility to utilise the mobilised funds in the most efficient manner and strictly for the purpose for which such deposits were mobilised.

On May 15, 1987, the Reserve Bank issued a fresh set of directions known as the residuary non-banking companies' directions, 1987. These directions were applicable to companies that were not in the business of hire-purchase, leasing or in other such prescribed activities under non-banking business. These companies were conducting deposit schemes that did not contain a prize element. The direction stipulated the minimum period of deposits at 12 months, the maximum period of deposits at 120 months and interest payable at 10.0 per cent compounded annually. They were also required to keep deposited or invested not less than 10.0 per cent

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40. Ojha (1988) *op. cit.*

of the deposits accepted in the form of fixed deposits with PSBs, not less than 70.0 per cent in approved securities and not more than 20.0 per cent or 10 times their NOFs, whichever was less, in other investments which in the opinion of the company were safe. Such investments were required to be made with the approval of the board of directors. The directions further provided that no such companies could forfeit any amount deposited by a depositor or interest, premium, bonus or other advantage accrued thereon. Every company was required to disclose as a liability in its books of account and balance sheet the total amount of deposits received, with interest and bonus accrued or payable to depositors. Companies in this category were required to keep the securities lodged with a designated PSB under its lien on behalf of the depositor, and these could be withdrawn only for repayment of deposits. These companies were also required to comply with other provisions relating to the submission of returns and advertisement rules, as applicable to other NBFCs.

The Reserve Bank's directions were amended, which provided for raising the minimum and maximum periods of deposits in respect of hire-purchase finance, equipment-leasing and HFCs. It imposed ceilings on the quantum of deposits and rate of interest to be paid for the first time.

From time to time, the Bank, with the assistance of the state governments, conducted raids on the office premises of unincorporated bodies. Prosecution proceedings were also initiated for violating the provisions of chapter III C of the RBI Act, 1934.

The Reserve Bank, through the guidelines and directions, was trying to provide protection to depositors. These guidelines related to the ceiling on quantum of deposits in relation to NOFs of a company, tenure of deposits, rate of interest, brokerage payable on deposits and the format for inviting deposits from the public. Companies inviting deposits from the public were required to comply with the advertisement rules known as non-banking (advertisement) rules, 1977, framed under section 58A read with section 642 of the Companies Act, 1956. These rules were administered by the Reserve Bank. In terms of these provisions, any company intending to invite deposits from the public was required to issue an advertisement in a leading English newspaper and a vernacular newspaper circulating in the state in which the registered office of the company was situated. These advertisement rules required disclosure of certain information in the prescribed format.

During the 1980s, certain companies issued advertisements soliciting deposits from the public, which deviated from the prescribed rules and

TABLE 6.11  
*Deposits with Non-Banking Corporate Sector*

<i>Deposits with Non-Banking Corporate Sector Category</i>	1983		1984		1985	
	<i>No. of Reporting Cos.</i>	<i>Amount ₹ crore</i>	<i>No. of Reporting Cos.</i>	<i>Amount ₹ crore</i>	<i>No. of Reporting Cos.</i>	<i>Amount ₹ crore</i>
Financial Companies	2296	2,201	3599	4,995	4270	2,779
Non-Financial Companies	2557	6,746	2558	2,680	13113	7,963
MNBCs	503	229	641	1,066	689	382
Aggregate Deposits	5356	9,176	6798	8,741	18072	11,124
	1986		1987		1988	
	<i>No. of Reporting Cos.</i>	<i>Amount ₹ crore</i>	<i>No. of Reporting Cos.</i>	<i>Amount ₹ crore</i>	<i>No. of Reporting Cos.</i>	<i>Amount ₹ crore</i>
Financial Companies	4134	3,914	5957	5,206	6355	9,778
Non-Financial Companies	2510	11,784	2803	15,459	2498	18,016
MNBCs	864	442	1156	735	1235	855
Aggregate Deposits	7508	16,140	9916	21,400	10088	28,649
	1989					
	<i>No. of Reporting Cos.</i>	<i>Amount ₹ crore</i>				
Financial Companies	6327	5,852				
Non-Financial Companies	2691	18,289				
MNBCs	1148	776				
Aggregate Deposits	10166	24,917				

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09*.

format. Some companies even offered promises of benefits that did not strictly conform to the advertisement rules and were not related to the types of business in which they were engaged. The Reserve Bank initiated appropriate action against all the erring companies as per the provisions of the advertisement rules. The Bank also issued a press note in 1987 asking non-banking companies to strictly abide by the rules so that the public could take well informed investment decisions.

The aggregate deposits of financial companies, non-financial companies and miscellaneous non-banking companies (MNBCs) (Table 6.11) showed an increase of 171.5 per cent during the period 1982–83 to

1988-89 and stood at ₹ 24,917 crore as on March 31, 1989. The deposits of financial companies, non-financial companies and miscellaneous non-banking companies recorded a rise of 444.0 per cent, 267.0 per cent and 373.0 per cent, respectively, during the period. The aggregate deposits of all three types of companies constituted 22.2 per cent of all SCBs' deposits during 1984-85, 21.1 per cent during 1985-86 and 20.8 per cent during 1986-87.

## CONCLUDING OBSERVATIONS

### BANKING

The broader objective set for the banking system during the 1980s was that as an institution, it should touch the lives of millions; should necessarily be inspired by a larger social purpose and subserve national priorities and objectives. This was achieved through various measures such as extending banking facilities to unbanked areas, covering in particular — the rural and semi-urban areas and mobilising financial savings; reorienting the flow of bank credit from a relatively few large and medium industry and trade accounts to a vast number of borrowers from agriculture, SSIs, small business and weaker sections of society; promoting a new class of entrepreneurs, so as to widen the industrial and economic base of society; and imbuing professionalism on the part of both bank management and the staff.

Thus, in the early 1980s, the banking system in India broadly reflected the priorities of the Government and functioned in line with the directions provided by the Government. The resource constraints of the Government, the poor economic conditions of a vast segment of the population engaged in agriculture residing in remote rural areas and the socio-political compulsions in a plural democratic system were the compelling factors influencing the performance and functioning of the banking system. The Reserve Bank being the regulator of the financial system, however, equally emphasised the need to carry out banking business on sound banking and commercial principles.

The rapid expansion in branch banking, entry into mass banking, a virtual expansion in banking transactions and lengthening the lines of command and control, however, brought in their wake considerable strains on the banking system. Fortunately, the importance of running banks along professional lines and to making banks a viable and reliable financial infrastructure to support the economy on an enduring basis was realised

in the middle of the 1980s and all efforts were made to make amends and consolidate banking. Making the banking system viable and profitable became a subject of serious and conscious discussion at all forums and concrete steps were initiated towards this end from the mid-1980s. The Reserve Bank began the process of consolidation by bringing changes in banking policy and introducing appropriate measures in the areas of banking organisation and structure, training, housekeeping, customer service, credit management, recovery of bank dues, productivity and profitability, and technology and communication. Special emphasis was laid on viability and operational efficiency, strengthening the capital base of banks, and allowing them flexibility regarding determination of bank charges. The other changes brought about covered, *inter alia*, legislative measures, operational freedom, strengthening systems and procedures, diversification of business and building up of specialised institutions.

#### FINANCIAL INSTITUTIONS

FIs in India played a vital role in meeting the long-term credit requirements of the industrial sector. In order to ensure that these institutions were subjected to prudential practices and to apply standard procedures, the Reserve Bank laid down broad guidelines, keeping in view the nature of operations of the FIs. The MIS was devised to capture information for facilitating monetary control and to examine the quality of assets from the regulatory standpoint.

A number of FIs received assistance from the Reserve Bank either under the LTO fund or through short-term credit. The IDBI was designed to cater to the long-term financial requirements of the corporate sector. It provided two types of advances *viz.*, direct assistance and indirect assistance besides providing guarantees for loans. The IFCI was established by an Act of Parliament to provide medium and long-term loans to industrial concerns in the corporate and co-operative sectors. The objectives of Exim Bank were to provide financial assistance to importers and exporters, to act as the principal FI in co-ordinating the work of other institutions financing international trade, and to undertake certain development and merchant banking activities.

Towards the late 1980s, a need was felt to devise adequate safeguards for effective monitoring and control of the FIs. With this in view, an in house group on FIs headed by Shri S.S.Tarapore was constituted. Some of the major recommendations of the group related to monitoring the financial health of these institutions and the introduction of an annual

financial review to ensure effective supervision. The group also suggested that an FIC be set up in the Reserve Bank. Most of the recommendations of the in house group were implemented by the Reserve Bank. As a result, the operations of IDBI, ICICI, Exim Bank, NHB, IRBI, DFHI and SHCIL were brought under effective monitoring and the control of the Reserve Bank.

The national housing policy formulated by the Central Government during 1988 set out the priorities and framed a strategy to eradicate the shortage of usable dwelling units by the turn of the 20<sup>th</sup> century. To achieve the above objective, the NHB was set up with the entire share capital subscribed by the Reserve Bank. To promote savings for acquisition of a house, a new scheme called HLAS was introduced by the NHB in co-operation with scheduled banks. Another major initiative of the NHB was the preparation of guidelines on formation of HFCs in the private and joint sectors. The objective of the guidelines was to create an enabling environment for the growth of housing finance institutions along sound lines. NHB also introduced refinance schemes for SCBs, scheduled state co-operative banks, scheduled UCBs and HFCs.

#### NON-BANKING FINANCIAL COMPANIES

The activities of NBFCs such as those engaged in the business of hire-purchase, housing finance, investments, loans, mutual benefit financial and residuary financial companies continued to be regulated by the Reserve Bank. Chapter III B of the RBI Act, 1934 vested the Reserve Bank with powers to prohibit the issue of advertisements by a non-banking institution soliciting deposits from the public. The Reserve Bank was empowered to prohibit NBFCs from accepting deposits from the public and to prosecute defaulters for violating the directives in the said Act. The period for which deposits could be accepted by NBFCs, the quantum of deposit and the interest to be paid on various maturities were prescribed by the Reserve Bank.

During the early 1980s, there was massive growth of chit fund companies and money circulation schemes throughout the country. Barring a few, the states had not enacted any legislation to control and monitor these activities. To plug this loophole and to bring about a uniform legislation applicable throughout the country, the Chit Funds Act, 1982 was enacted by Parliament. The Reserve Bank followed up with all state governments and UTs for adoption of the Act. The Reserve Bank was given powers to inspect the books and accounts of the chit fund companies. Hire-purchase companies were also regulated by the Reserve Bank under the provisions

of the directions of 1977 as applicable to NBFCs. These companies were allowed to raise deposits from the public within permissible limits linked to their NOFs. These companies were required to comply with directions relating to submission of returns, balance sheet and issue of advertisements soliciting deposits. The Reserve Bank was empowered to prohibit acceptance of deposits by such companies in case of non-compliance with the provisions of directions. From time to time, the Reserve Bank, either singly or with the assistance of the state governments, conducted raids on the office premises of unincorporated bodies. Prosecution proceedings were also initiated against such unincorporated bodies for violating the provisions of chapter III C of the RBI Act, 1934.

The 1980s witnessed the mushrooming of NBFCs, posing a challenge to regulators. They carried out multifarious activities, some of which were apparently not permissible under the law resulting in regulatory arbitrage. Many unregistered companies also operated in many states and UTs. It was a difficult task, both for the Reserve Bank and the concerned state governments and UTs, to exercise proper regulation and control over irregular practices of such institutions and take action. However, stringent action by the regulators and other enforcement agencies within available powers brought back stability to the system and restricted the activities of such companies. This brought some transparency into the functioning of these companies, which was further strengthened by the prudential norms introduced by the Reserve Bank during the subsequent decade.



# 7

## Developments in Banking Supervision

### INTRODUCTION

One of the main objectives of bank nationalisation was taking banks to the masses and getting them to finance the credit needs of less well-off sections of society. These socio-political objectives were pursued vigorously in the 1970s. By the beginning of the 1980s, however, it was clear that sooner or later issues concerning the profitability and viability of banks had to be recognised.

At the global level, the focus was on safety and prudential issues. The international crisis in bank lending in the early 1980s led the Bank for International Settlements (BIS) to contemplate central bank co-operation in the matters of supervisory and prudential norms. The BIS macro-prudential approach first came to the fore in the Cross Report (1986). It defined the macro-prudential domain as “the safety and soundness of the broad financial system and payments mechanism.” These developments also engaged the attention of the Reserve Bank, which began taking steps in the field of supervision, payments and settlements, and capital adequacy norms.

The concern voiced by the Reserve Bank at various forums on the need to improve the profitability of banks and make them viable resulted in a change of mindset at all levels, including the Central Government, and contributed to some well-considered reforms in banking in the latter half of the 1980s. This gradually led to a major overhaul of policies, particularly after the balance of payments (BoP) crisis of 1991. The necessity to reform the banking system was spelt out by Dr Manmohan Singh, Governor in a

speech,<sup>1</sup> where he identified new challenges and responsibilities that the Indian banking system was called upon to meet during the Seventh Five Year Plan. He hoped that this exercise would set in motion a process of thinking and debate about structural reforms, organisational improvements and procedural progression that were urgently needed to enable the banking system to perform successfully in the next phase of India's development.

#### BANKING POLICY *VERSUS* PRUDENCE

Banking policy as defined under section 5 (ca) of the Banking Regulation (BR) Act, 1949, entailed “any policy which is specified from time to time by the Reserve Bank in the interest of banking system or in the interest of monetary stability or sound economic growth, having due regard to the interest of the depositors and other resources of the bank and the need for equitable allocation and efficient use of these deposits and resources.” Thus, prudence was an integral part of the banking policy. The banking policy, along with monetary and credit policies in the early 1980s, subserved the objectives of budgetary policies and the Five Year Plan priorities, irrespective of its impact on the functioning of the banks. The emphasis in the early 1980s was on growth and expansion. The banking system was getting a social orientation and hence had other goals to achieve. The Reserve Bank, as regulator and supervisor, became an intermediary in carrying out the directions of the Central Government and ensuring that banks complied with the instructions. As the majority of banks were in the public sector with little operational flexibility, they helped promote this strategy without much strain.

In this context, an observation on the Indian financial system by Robin Leigh-Pemberton, former Governor of the Bank of England in the L.K. Jha memorial lecture on Economic Liberalism, Central Banking and the Developing World delivered on October 16, 1990, is pertinent. He stated, “Clearly a system which is conducive to the mobilisation and efficient allocation of savings is important to India, but it is probably also fair to say that financial liberalisation is not the first priority of everyone in India. I would also acknowledge that the particular economic and social circumstances of India may be felt to justify a certain amount of official encouragement of the way the financial sector develops.” He, however, added that a market economy needed clear property rights and benefits from a wide measure of private ownership. In the banking sector it required

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1. Singh, Manmohan (1984). *Indian Banking System in the Seventh Five Year Plan*, Speech delivered at founders' day of the Bank of Maharashtra. Pune. September 16.

avoiding the moral hazard, to which bank managements could be a prey, if they were not made accountable for performance and profitability.

Deposits were mobilised as per the rates prescribed and loans were disbursed as per the directions and terms and conditions predetermined by the Reserve Bank in consultation with the Central Government. The issue of margin of profit was hardly a matter of concern. Banks were advised to spread their wings to every corner of the country and, to achieve that, the licensing policy was suitably liberalised and modified. State governments were advised to provide the logistic support in terms of adequate land and other needed infrastructure. Lending rates were prescribed with a conscious policy of cross-subsidisation, which resulted in minimum viability or profitability; loan targets were fixed without taking into account the bankability of projects; and bank funds were earmarked in the form of liquidity requirements for the Government/public sector undertakings (PSUs).

The rapid expansion and diversification of banking led to many stresses and strains. An accelerated expansion in the branch network, rapid growth in the volume of business, increased responsibilities on account of development work connected with the priority sector lending, lead bank schemes (LBS), preparation of district credit plans (DCPs) and the annual action plans (AAPs) led to relaxations in procedures and practices of lending, mounting arrears of work in housekeeping and stretching the lines of supervision and control. The persistence of these factors affected the quality of loan assets. Environmental factors like natural calamities coupled with wilful defaults and lack of appropriate supervision and follow-up on loan recovery also contributed to overdues and a rise in the level of non-performing assets (NPAs). Professionalism and commercial considerations were overlooked in view of the political and economic compulsions of using banks as agents of social change and for equitable distribution of credit.

#### BANKS AS AGENTS FOR EQUITABLE GROWTH

The other view of the public policy of the time was that after nationalisation of the banks in 1969, the central bank had adopted an aggressive supply-led approach to financial development, an integral part of which was to locate branches in unbanked (mainly rural and semi-urban) areas. There was a close co-relation of this policy with the Government's objectives of resource mobilisation to finance the Five Year Plans. The pattern of establishing bank branches was broadly based on the Government's scheme

of development administration, so as to cover each of the community development blocks; this was also considered necessary for implementing government-sponsored rural development programmes.

In the 1970s, the branch licensing policy of opening bank branches in rural and semi-urban areas was guided by considerations of social benefit. The high fixed cost of establishing financial intermediaries coupled with a relatively low demand for banking services in rural areas made it unprofitable for private agents to open branches in these areas. The societal gains of providing banking services in such areas outweighed the private benefits. The presence of financial intermediation provided the consumers with a choice to borrow or lend some of their incomes, offered avenues for owning liquid financial assets as an alternative to holding illiquid assets, such as the real estate and gold, ensured a supply of loanable funds with investment opportunities and reduced transaction costs. It was to bridge this gap that the branch licensing policy was regulated in the period after nationalisation.

Banks emerged as effective catalytic agents of socio-economic change, gearing up their operations according to Plan priorities. The philosophy of bank credit itself underwent a change from a security-oriented to a production-oriented system of lending, bringing succour to the vast majority of needy agriculturists in rural areas.

A balanced view of the 1980s reflects that the very policies that were supposed to promote a more equal distribution of funds also led to inefficiencies in the Indian banking system. Besides the restrictions on the use of funds, the Government also had control over the price of the funds, *i.e.*, the interest rates on deposits and loans. The situation changed only at the beginning of the 1990s when a BoP crisis triggered far-reaching reforms.

By the mid-1980s, operational and allocative inefficiencies caused by the distorted market mechanism led to a serious deterioration in the profitability of public sector banks (PSBs). The Government was aware of this and in 1985, the Finance Minister,<sup>2</sup> while addressing at the golden jubilee celebrations of the Reserve Bank said “the time has come for the banking system to embark on a phase of consolidation in which improvement in operational efficiency must be the key concern.” It became necessary to enhance the profitability of PSBs so as to ensure the stability of the financial system. The restructuring measures for PSBs included

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2. Address by Shri V.P. Singh.

improving profitability, debt recovery, customer service, and streamlining the payment and settlement mechanisms, besides continuing efforts to update the legal system. The major policy changes were the introduction of Treasury Bills, the creation of money markets, and rationalisation and a partial deregulation of interest rates.

## MAJOR ISSUES IDENTIFIED

### CHANGES IN SUPERVISORY APPROACH

To improve the efficiency and image of the banking system, banks were advised in April 1983 to review and revamp their vigilance machinery, tone up control and supervision, strengthen the management information system (MIS), streamline their follow-up and inspection/audit arrangements, and draw a time-bound programme to clear arrears in book balancing and reconciliation of inter-branch and other accounts. In a meeting of department heads of the Bank held on April 29, 1985, the Governor, Shri R.N. Malhotra, expressed concern on issues of the declining profitability of banks, low capital-to-assets ratios and the inadequate loan-loss provisions made by banks. While advising the departments to make an introspective self-assessment of their functioning as central bank supervisors and to identify areas where there were weaknesses or deficiencies, the Governor stressed that financial viability should be one of the prime considerations for regulating the banking system. Further, that in India, as in many other countries, the role of the central bank regulators had not received enough attention, and this should be the focus as many banks were confronted with solvency and viability problems arising from a spurt in the magnitude of bad advances. He emphasised the need to review and revise the regulatory system with a view to reversing the trend of non-viability of many banking units in the country.

### PROFITABILITY

On one hand, banks were facing increasing competition in mobilising resources with the emergence of new institutions and a series of new savings instruments that combined the attraction of special tax benefits with better returns. With the continuing shift of public preference towards long-term high-return deposits, the interest costs of bank deposits were rising. On the other, the pre-emption of the resources of banks for various special purposes became sizeable. While the compulsions of monetary policy took the average cash reserves maintained by banks to as high as

around 15.0 per cent of banks' demand and time liabilities, the growing need to mobilise resources for development pushed up statutory liquidity ratio (SLR) to 38.5 per cent. There were further pre-emptions arising from policy prescriptions on the remaining loanable funds of the banks. Credit for food procurement and distribution accounted for between 8.0 per cent and 10.0 per cent of total credit, and fetched banks an interest rate at 12.5 per cent. Although banks were given refinance against food credit, the amount provided was regulated in accordance with overriding monetary considerations. The allocation of a larger slice of credit to the priority sector was a major thrust of banking policy since the nationalisation of banks. This shift accounted for 40.0 per cent of total credit, the greater part of which was extended at relatively low rates of interest. Thus, only about 20.0 per cent of the resources raised by banks were available for lending at what might be termed as commercial rates of interest. Export credit at subsidised rates also adversely affected the banks' lendable resources available for lending at commercial rates. Apart from these factors, banks' operating costs were rising due to compulsions of fulfilling social objectives such as geographical dispersion and increased coverage of small accounts. Inefficiency in handling the ever-increasing volume of transactions, low productivity due to lack of mechanisation coupled with high wage costs, poor recoveries and huge lock-up of funds in sick units affected the viability of banking, drawing the attention of all concerned.

In a meeting of the finance minister with the chief executives of PSBs held on May 28, 1985 at New Delhi, the Minister of State for Finance pointed out that "the banking system is converted from class banking to mass banking." Commenting on the profitability of banks, he stated "if maximum output and better service is rendered, the profitability of the bank will certainly go up and it will also demonstrate the satisfaction of the people. But it does not happen so and often excuses are given." Further, that the unions had become militant and the management was not in a position to assert itself. He laid stress on the need to enforce discipline among employees and reduce the influence of unions in the banking industry.

#### OVERSEAS OPERATIONS

Another issue in commercial banking related to the overseas operations of banks. Over the decade, these operations expanded in both volume and range, with the number of banks involved also rising. The overseas

network of Indian banks comprised 141 branches, 5 subsidiaries and 11 representative offices. By and large, foreign operations had proved profitable; in the case of some individual banks, they accounted for a significant portion of the profits. These operations were conducted in highly competitive and volatile conditions, and the risk involved was often very high. It was, therefore, necessary to devise appropriate measures of control and regulation of these operations and implement them assiduously. There was also a need for proper country assessment and introduction of appropriate MIS to avoid or reduce, wherever necessary, unduly large risk concentration in countries and/or borrower groups.

#### CREDIT QUALITY

The fourth issue related to the quality of bank credit to industry and agriculture. The outstanding bank credit to sick units in the industrial sector stood at ₹ 2,793 crore or 7.9 per cent of total bank credit at the end of June 1983. As regards lending to agriculture, poor recovery position was a matter of concern. The ratio of recovery to direct agricultural advances granted by PSBs as at the end of June 1983 was only 53.3 per cent. Locking-up of funds to such an extent, in the industrial units or in agriculture, affected the capacity of banks to recycle funds in a profitable manner. An improvement in the quality of the loan portfolio of banks was imperative. A more careful appraisal of loan requests and a continuous monitoring of the use of loans were called for.

#### OTHER ISSUES

The other problems encountered by the system related to difficulties faced on account of the spread of branches — communication and control of operations, deteriorating customer service, poor housekeeping, reconciliation of inter-branch accounts, and inefficient payment and settlement systems. Low productivity and lack of co-operation and understanding from the employees under the influence of strong unionism also contributed to the increased cost of operations. With regard to customer service, banks were asked to pay special attention to the critical areas of banking service. The Reserve Bank's approach to address the issues relating to customer service, internal control and housekeeping is detailed in Appendix 7.1.

## CHANGES IN THE SUPERVISORY APPROACH

The primary tools employed for bank supervision included statutory/statistical returns and reports, inspection, statutory audit and statutory auditor's report, feedback from the Reserve Bank's nominees/additional directors on the boards of banks, and discussions with the chairmen/top executives of banks.

The most significant supervisory function exercised by the Department of Banking Operations and Development (DBOD) continued to be the inspection of banks. The objective of these inspections was to safeguard the interests of the depositors and to ensure that the development of the banking system conformed to the banking laws and regulations *vis-à-vis* the country's socio-economic interests. In other words, inspections served as a medium for overall appraisal of the financial and managerial systems and performance of banks, their methods of operations and prevention of irregularities.

At the conference of regional heads of departments in February 1981, it was decided to discontinue with the surprise element in conducting the annual appraisal of banks and instead to inspect a representative number of branches, which were exclusively attending to development functions, and certain branches in rural and semi-urban centres, 50.0 per cent of which were located in the lead districts of the respective banks.

It was also decided to watch the time factor and to adopt the programme evaluation review technique (PERT) designed by the Management Services Department (MSD) in the conduct of inspection, initially for PSBs and subsequently for other banks. Accordingly, a PERT discipline was introduced to monitor progress and expedite inspection mechanism. It was also decided to increase the frequency of inspection of branches of Indian banks abroad.

### WORKING GROUP TO REVIEW THE EXISTING SYSTEM OF INSPECTION OF BANKS

In a meeting of the Committee of the Central Board, the Governor indicated the desirability of engaging a working group to examine the Reserve Bank's system of inspection. Accordingly, a working group under the chairmanship of Shri V.G. Pendharkar<sup>3</sup> was appointed on December 10, 1981, to review the existing system of inspection of commercial banks, regional rural banks (RRBs) and urban co-operative banks (UCBs) with

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3. Former Executive Director, Reserve Bank of India.

particular regard to the objectives of banking and credit policy of the Reserve Bank and the scope, coverage, methodology and periodicity of the inspection mechanisms. The terms of reference of the working group also included examining the question of in-class as well as on-the-job training of inspection staff and examining the machinery deployed to monitor the progress of inspections and the follow-up of their findings.

The report of the working group was submitted to the Reserve Bank on October 22, 1983. The recommendations were intended for the internal guidance of the Reserve Bank and National Bank for Agriculture and Rural Development (NABARD) in the matter of inspection of banks. A memorandum (June, 1984), examining the major recommendations relating to inspection of commercial banks was submitted to the Central Board and was approved in their meeting on July 11, 1984.

It was decided to introduce changes in the periodicity, type and time frame of inspections. The system of annual appraisal/inspection of PSBs was replaced by a system of annual financial review and the financial inspections of both PSBs and private sector banks.

- (i) **Annual Financial Review:** The financial review exercise would be done every year after the annual audit of banks was completed on the basis of audited accounts, management information available at the head office of the bank and formats of the reporting system (including classification of advances health-wise) prescribed by the Reserve Bank. The long audit report submitted by statutory auditors and the action taken by the bank would also be looked into in preparing the review. The annual review would be completed in the head office of the banks within a fortnight and would be forwarded to the Government and the concerned bank within a period of one-and-a-half months.
- (ii) **Financial Inspection:** The periodicity of financial inspection would be reduced from once in five years to once in four years for PSBs in general. It would be once in three years in the case of banks experiencing special problems or whose financial position or methods of operation were not satisfactory. In the case of private sector banks, the periodicity would be normally once in two years, but annual inspections, where warranted, might be taken up. The banks which were working under direction would be inspected annually.
- (iii) **Selection of Branches for Financial Inspection:** It was decided that for the purpose of financial inspection, the coverage of branches

and controlling offices would include all major branches, all controlling offices, and 5.0 per cent of rural and semi-urban branches (as decided by the central office of the DBOD). The issue of inspection of branches/controlling offices should be taken up well in advance with the head office.

The regional offices were advised in August 1983 that the features observed during inspection of each controlling office/branch of a bank should be pointed out to the respective controlling office of the concerned bank within a month of the submission of the inspection note. The controlling office of the bank had to send a compliance report in this regard within two months from the date of receipt of the features.

At a conference held on February 1 and 2, 1984, in the Reserve Bank to improve the quality of inspection reports, a decision was taken that the gamut of inspections and reporting should cover, *inter alia*, a trend analysis of factors affecting the performance of banks. Inspecting officers should adopt a positive approach and highlight favourable aspects relating to the bank's performance; they should also look into the small loans portfolio of banks and composite loans on a selective basis in order to see, among other things, whether banks complied with the Reserve Bank's instructions in regard to such advances and security norms. Feedback on the findings was to be made available to the Rural Planning and Credit Department (RPCD).

A system for monitoring inspection of controlling offices and branches of banks was also introduced. Follow-up of inspection reports on the basis of findings was to be taken after obtaining the bank's comments in discussion with their chief executive officers (CEOs)/directors and in light of other material available with the Reserve Bank. The follow-up action included calling for half-yearly progress reports and the issue of specific steps/directions and appointment/continuance of additional directors on the bank's boards, depending on the seriousness of the findings of the inspection or the extent of deterioration in their financial position.

Directions were usually issued to banks whose financial position was not satisfactory and whose methods of operation were unsatisfactory. The directions issued by the Reserve Bank required banks to take certain steps to eradicate the defects observed in their working and bring about an improvement in their financial position and mode of operation within a certain time frame.

## PRUDENTIAL SUPERVISION

*Action Plans*

As a general principle, the framework for supervision was to evolve in such a manner that self-regulation by banks gained pre-eminence. This necessitated the establishment of efficacious internal management and control systems. As a result, a system of action plans was introduced in the banks with effect from 1986. The Reserve Bank advised PSBs to prepare a two-year action plan to bring about substantial improvement in their working during the Seventh Plan. The annual plan envisaged to cover the period from November 1985 to December 1987. The areas to be covered were organisation, structure and personnel policies; human resources development including training, credit management, productivity, financial viability and profitability; housekeeping; internal audit and inspection; customer service; deposit mobilisation and technology upgrading. These plans aimed at qualitative and quantitative advancements within a time frame and their progress was reviewed by the Reserve Bank management with banks' chairmen every three or four months. The Reserve Bank created a cell to closely monitor the implementation of the action plans and periodically assess the progress made by each bank.

As a result of these plans, banks took several steps to strengthen their structure and internal systems of supervision and control. Training capacities were improved and training courses diversified. Credit management was tightened through regular annual reviews of credit limits, health coding of accounts, ongoing supervision of large limits and detection of incipient sickness for timely remedial action. Cost control, productivity of business per bank employee and reduction of loss-making branches received added attention. There were improvements in housekeeping, internal audit and inspection, customer service, and technological upgrading of major branches, zonal offices and bank head offices. Since action plans helped to establish a strong management culture within the banks, they constituted a powerful adjunct to the supervisory role of the Reserve Bank.

The second round of action plans of commercial banks covered the period up to March 1990, and the banks took various measures to implement these detailed plans. The progress in the implementation of the plans was reviewed with the concerned chairmen and senior executives of PSBs continually by the Reserve Bank.

While continuing to use onsite inspections as a major tool to evaluate the performance of banks and strengthen the area of prudential supervision, proposals were being considered regarding the introduction of suitable capital adequacy norms in relation to risk assets, including the off-balance sheet business. Guidelines were issued regarding exposure and risk management in the domestic sector by laying down norms for individual and group exposure, covering both funded and non-funded limits in relation to owned funds. Such norms were already in vogue in the overseas operations of Indian banks. Suitable guidelines were issued regarding recognition of non-performing loans (NPLs) based on health codes and banks were advised not to take to income, the interest on loans so classified.

#### *Safety and Prudential Norms*

A beginning was made in prescribing certain prudential norms to be observed by the banks. These related to risk exposure management and non-crediting of interest on NPLs. In respect of foreign banks operating in India, the measures taken related to retention of reserve fund created out of profits, prescription of higher minimum capital for entry and stipulation of priority sector advance levels to be reached.

#### *Risk Exposure*

As a prudential measure aimed at better risk management and avoiding concentration of credit risks, it was decided to fix limits on a bank's exposure to individual borrowers and groups of borrowers. All scheduled commercial banks (SCBs) were advised that the exposure ceiling should be fixed in relation to the bank's capital funds, not exceeding 25.0 per cent in the case of individual borrowers and 50.0 per cent in the case of groups of borrowers. Credit exposure included funded and non-funded credit limits, underwriting and similar commitments. The sanctioned limits or outstandings, whichever were higher, were to be reckoned by the banks to arrive at an exposure limit. Only 50.0 per cent of limits or outstandings in respect of non-funded credit limits needed to be taken into account for the purpose. In the case of PSUs, the single borrower exposure limit was only applicable. Borrowers for whom credit limits were directly allocated by the Reserve Bank, as in the case of the Food Corporation of India (FCI), were exempted from fixation of exposure limit. In respect of existing credit facilities to borrowers, which were in excess of the prescribed credit

exposure ceiling, banks were asked to take necessary action to comply with the stipulations within one year. Banks were advised to review the existing credit limits in light of the above stipulations and forward to the Reserve Bank a list of the existing borrowers/groups whose credit limits exceeded the prescribed ceiling, with an action plan to regularise the position. An annual review of the implementation of exposure management measures was required to be placed by banks before their board of directors and a copy of each review was required to be furnished to the Reserve Bank. Besides limiting credit exposures as indicated above, banks were also advised to consider fixing internal limits for aggregate commitments to specific sectors, such as textiles, jute and tea, so that the exposures were evenly spread over various sectors. The limits so fixed were proposed to be reviewed periodically and revised as necessary.

The progress by PSBs in implementing the respective action plans was reviewed twice by the Governor: in April 1989 for the quarter ended December 1988 and in August 1989 for the period ended March 1989. The performance and results of each bank were discussed in detail during the reviews. Since the increasing number of NPAs and poor recoveries had adversely affected the ability of banks to recycle funds, the Governor impressed upon the chairmen the need to improve the quality of their loan assets. Low productivity in relation to rising costs also strained banks' profitability. The banks were counselled to look into the staffing pattern of the controlling offices *vis-à-vis* their business and take steps to control expenditure. They were also advised to introduce a regular system to evaluate the performance of controlling offices and to develop certain branches into model branches. The Governor reiterated that the service area scheme had to be implemented with a constructive and flexible approach and that there should be no disruption of credit flow in any manner during the switch over to the new arrangements.

In the area of credit management, the importance of improving the standard of credit appraisal, timely review, renewal and other measures of follow-up and supervision were highlighted. In particular, it was emphasised that banks should introduce, at the operational level, a system to exercise continuous surveillance over large borrowal accounts so that warning signals were picked up early for necessary remedial action.

Discussions were also held with the chairmen of private sector banks to review progress in implementing the action plans. The banks were advised on important aspects to which they were to devote specific attention.

COMMITTEE TO CONSIDER FORMATS OF PUBLISHED ACCOUNTS OF  
BANKS AND FULL DISCLOSURE IN SUCH ACCOUNTS

The banks were publishing their annual accounts in formats prescribed under the BR Act, 1949. The banking commission (Chairman: Shri R.G. Saraiya) made recommendations regarding the need for full disclosure by banks of their liabilities and assets. It was suggested that these formats needed to be revised, given the large scale expansion in banking operations and the need to improve the presentation of accounts. Accordingly, in March 1982, the Reserve Bank appointed a committee under the chairmanship of Shri A. Ghosh, Deputy Governor. The committee laid the foundations for strengthening regulatory and supervisory practices in commercial banks in the early stages of their establishment. The health code system of classification of assets, provisioning and income recognition norms recommended by the Ghosh Committee paved the way for further reforms in assessing the credit risks of banks' loan portfolios. The terms of reference of the committee were:

- (i) to examine the desirability of greater or full disclosure in the published accounts of banks, having regard to the need for disclosure, public accountability of banks, requirement of maintenance of confidentiality between banker and customer, and the requirement of maintaining the image, reputation and creditworthiness of banks;
- (ii) to suggest, if greater or full disclosure was not considered necessary or appropriate, whether it was necessary to make any further provisions in the existing laws;
- (iii) to suggest suitable changes/amendments in the formats of the balance sheet and profit and loss accounts, having regard to: (a) the need for greater or full disclosure; (b) the expansion of banking operations both area-wise and sector-wise, over the period; (c) the need for improving the presentation of accounts; and (d) the presentation of accounts of other companies;
- (iv) to look into, broadly, the practices followed by banks in accounting/classifying various items of liabilities and assets as well as income and expenditure, and to suggest standard accounting concepts which would facilitate a uniform, comparable presentation of such items in the published accounts and compliance with various statutory requirements;
- (v) to consider the question of evolving suitable norms for creating provisions for various purposes, particularly for income tax

and other taxes, bad and doubtful debts, and depreciation in government securities on a scientific basis; and

- (vi) to make any other recommendations which were incidental or related to the above terms of reference.

The committee submitted its report in April 1985.<sup>4</sup> The important recommendations of the committee revealed that the time was not opportune for full disclosure in respect of secret reserves and loan-loss provisioning; banks should disclose their accounting policies with respect to certain key areas; norms for making provisions for various purposes had been laid down, which included a detailed scheme of review and classification of advances based on health codes. The system would be useful for exercising proper supervision over the advances portfolio, apart from facilitating loan-loss provisioning on a rational basis; and the investment portfolio of banks should be bifurcated into permanent and current categories, the levels of securities in each category to be determined by the Reserve Bank.

Following the committee's recommendations, the SCBs were instructed in November 1985 to introduce a comprehensive and uniform grading system (called the health code system), which would indicate the quality (or health) of individual advances as also the extent of advances causing concern in relation to total advances. The grading system was envisaged for effective monitoring and follow-up of the growing volume of bank credit and also for making adequate provisions for bad and doubtful debts. This classification helped the banks to assess the actual profit earned and accrued profit included in the profit and loss account through sticky accounts. Under this system, each bank was required to classify its advances into eight categories with a health code assigned to each borrowal account, *viz.*: (1) satisfactory; (2) irregular; (3) sick-viable-under nursing; (4) sick-non-viable/sticky; (5) advances recalled; (6) suit-filed accounts; (7) decreed debts; and (8) bad and doubtful debts.

To begin with, the health code system was to be adopted for all accounts with limits/outstanding balances of ₹ 5 lakh in the case of banks with deposits of ₹ 1,000 crore and above and ₹ 2 lakh for other banks

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4. The committee submitted its report on April 6, 1985, on account of a delay in finalisation of the report as the terms of reference of the committee included certain sensitive issues with far-reaching implications and needed thorough and detailed discussions at various levels and study of practices in other countries (DBOD internal note, BP Section dated December 26, 1985, Reserve Bank of India).

as on December 31, 1984. The above cut-off points were valid only for the maiden classification to be done with reference to the position as on December 31, 1985. Thereafter, the classification had to be done on the basis of the lower cut-off point of ₹ 1 lakh. The system also covered the advances of branches outside India. Information under the system was to be updated on a half-yearly basis.

#### TAX TREATMENT OF INTEREST ON NON-PERFORMING LOANS

The Central Board of Direct Taxes (CBDT) decided vide their circular of September 19, 1984, that interest credited to suspense accounts by banks would be subject to tax but that interest applied on an account where there had been no recovery for three consecutive accounting years would not be subjected to tax from the fourth year. However, if there was any recovery in the fourth year or later, the actual amount so recovered would be subjected to tax in the year of realisation. The Reserve Bank sent a letter to the Government indicating that the relief afforded to banks by way of exemption from income tax in respect of interest credited to interest suspense account from the fourth year onwards was not adequate. Further, any partial or nominal recoveries in the accounts during the first three years would have the effect of postponing the relief to a further period of three years. Under these circumstances, the banks had two options, viz.: i) to treat the interest on doubtful advances as income in the profit and loss account as tax was being paid on it, or ii) not to charge interest on such accounts. In the first instance, taking such interest to the profit and loss account would not be prudent accounting because taking credit for income which was doubtful of realisation in the profit and loss account would artificially inflate the profits of banks; further, a sizeable amount thus got locked up in the form of tax paid on such interest, even though the banks would be eligible for a rebate when the amounts were actually written off. Under the second alternative, which was followed by many banks, no interest was charged on such doubtful debts.

The question of treating the amount credited to interest suspense account as income came up in January 1986, before a three-member bench of the Supreme Court in the case of *State Bank of Travancore versus Commissioner of Income Tax, Kerala*. By a majority verdict pronounced by the bench, it was held that such income credited to an interest suspense account should be treated as income liable to tax. The main argument adduced by the judges was that banks maintained their

accounts on a mercantile basis and, as such, the income and expenditure were deemed to arise as and when they accrued; as such, the interest which accrued on such accounts needed to be treated as income and could not be allowed as an outlet of income from the taxman's net for assessment, on the plea that though shown in the account book as having accrued, the same became bad debt and not earned at all. They held that where the law was clear, considerations of hardship, injustice or anomaly did not afford justification for exempting income from taxation. However, the dissenting judge disagreed with the majority view and in his separate judgement held that interest calculated on bad and doubtful debts, and taken to an interest suspense account was not chargeable to income tax as it was not real income but only hypothetical income. Crediting interest on sticky or doubtful accounts to interest suspense accounts was a well recognised and accepted practice wholly consistent with mercantile methods of accounting; it prevented wrong crediting and improper and illegal distribution or remittance of inflated and unreal profits and by making the appropriate entries, the assessee had clearly indicated that the sum in question, being interest on sticky loans, constituted hypothetical income and not real income.

In light of the majority judgement, the Reserve Bank pointed out to the Government that the banks were likely to be subjected to tax on all the interest credited to interest suspense accounts and some tax authorities might even take the line that the limited concession allowed by the CBDT did not hold good any more. There was a considerable increase in the bad and doubtful debt portfolios of banks and, hence, the quantum of interest on such amounts was also on the increase. The profits of banks were already affected by not taking this interest income to the profit and loss account. Coupled with this, if banks were required to pay income tax on this unrealised income, it would weaken the financial position of banks considerably and also lead to negative working results in the case of a few banks, which was not in the interest of the banking system. The Government advised the Reserve Bank in February 1986 to study the implications of the Supreme Court decision on the profitability of banks. The Reserve Bank accordingly requested the Government to exempt banks from paying income tax on interest credited to a suspense account till its actual realisation by making an appropriate amendment to the Income Tax Act. The chairman of the State Bank of India (SBI) and Indian Banks' Association (IBA) also took up the issue with the Government.

## INTEREST ON NON-PERFORMING LOANS

The accounting practice followed by banks in classifying loans as non-performing and stopping income recognition on such loans was considered by the Reserve Bank. It was observed that the practices followed by banks in this regard were not uniform and, in some cases, were not sound. The banks were, therefore, advised in May 1989 to adopt certain minimum standards in identifying NPLs on which interest was not to be applied and not to be taken to the profit and loss account.

The minimum standards envisaged were: (i) banks should not take to their income account any interest on loans classified under health code classifications 6, 7 and 8 (*i.e.*, suit-filed accounts, decreed debts, and bad and doubtful debts) from the quarter in which the individual accounts were so classified under these categories; (ii) as regards advances classified under health codes 4 and 5 (*i.e.*, sick non-viable/sticky and advances recalled), application of interest would depend on the availability of adequate security, taking into account the prospects of realisability of the security. The banks should put in place a system by which at the time of annual review of each account under the above categories at the appropriate level, a view was taken whether interest application should continue and, in case it was decided to apply interest on such advances, the reasons were duly recorded.

Not charging interest on certain advances was a prudent internal accounting practice to avoid inflating the income by adding interest that was not likely to be realised. It did not in any way affect the right of the bank to recover the full interest due from the borrower in due course. While the foregoing parameters constituted the minimum acceptable standard, it was open to banks to follow a more prudent policy, particularly regarding advances falling under categories 4 and 5 of the health code. The intent was that these instructions should be followed by the banks from the accounting year commencing from April 1, 1989. The banks were advised to review their loan portfolio and take necessary action to comply with these stipulations. An annual review of NPLs as on March 31 was to be placed before the board of directors before June 30 of every year and a copy needed to be furnished to the DBOD of the Reserve Bank.

## CAPITAL BASE OF BANKS

Since the nationalisation of banks — 14 major banks in July 1969 and 6 banks in April 1980 — there had not been any additional direct

contribution to their paid-up capital until February 1982. Some of these banks had, however, raised their paid-up capital by capitalising a part of the reserves.

With the growing international exposure of the Indian banks and the need to project their image abroad, it was decided that the capital base of the banks should be increased. Towards this end, the Government subscribed ₹ 25 crore towards the additional capital of eight nationalised banks in 1981–82.

The Finance Act, 1982 amended section 36 of the Income Tax Act and enabled the Indian scheduled banks engaged in banking operations abroad, notified by the Government, to create a special reserve account by transferring thereto, from the total income each year, an amount not exceeding 40.0 per cent of the income and claim rebate for the purpose of computing tax. The question of notifying the bank for the purpose of amended section 3(i) (viii) of the Income Tax Act was discussed with officials of the finance ministry and the CBDT. Based on the prescribed norms, the Reserve Bank recommended the names of seven PSBs to the Government; they were the SBI, Bank of Baroda (BoB), Bank of India (BoI), Indian Overseas Bank (IOB), United Commercial (UCO) Bank, Punjab National Bank (PNB) and the Central Bank of India.

The Government of India (GoI), through a notification issued in September 1984, allowed these seven PSBs to create a special reserve account by transferring thereto from their incomes each year an amount not exceeding 40.0 per cent of their incomes and claim rebate on tax from April 1983 and any subsequent year based on the criteria that the ratio of owned funds to deposits should be below 2.5 per cent and the aggregate non-bank deposits of their foreign branches should be over US\$ 100.0 million. The second criterion was later revised to US\$ 50.0 million and the Government allowed Syndicate Bank and Indian Bank a similar facility for the assessment year commencing from April 1, 1986.

The Government approved a scheme to augment the capital of SBI and its associates, and SBI was advised to work out the modalities for implementing the scheme. The Reserve Bank proposed to contribute to the additional share capital of SBI in a phased manner over the next three years, so that SBI would contribute to the additional share capital of its associate banks.

In 1985–86, the authorised capital of SBI was raised from ₹ 20 crore to ₹ 200 crore. Through an additional issue of 44,37,500 shares, its subscribed and paid-up capital was raised from ₹ 5.6 crore to ₹ 50 crore. During 1985,

the authorised capital of the associates of the SBI was increased to ₹ 10 crore each, and their total issued and paid-up capital was increased from ₹ 5 crore to ₹ 22.45 crore each.

The Government provided ₹ 400 crore in 1985-86 to augment the capital of nationalised banks. In a letter to the finance ministry, dated August 8, 1985, the Reserve Bank indicated that the amount of ₹ 400 crore provided towards capital would have to be invested in non-negotiable government securities at a rate of interest of 7.75 per cent; thereby the Government would be paying to banks a sum of ₹ 31 crore per annum by way of interest and it should be ensured that banks took all possible measures to step up their rate of dividend to the Government on the enhanced equity base so that there was no net loss to the Government on this account. This objective had to be kept in view while working out the modalities and principles of allocating capital contribution among various banks.

With a view to achieving owned funds-to-deposit ratio of 2.5 per cent in the case of nationalised banks, it was estimated that the Government would have to contribute about ₹ 2,000 crore in five annual instalments of ₹ 400 crore over a period of five years (Seventh Plan period) beginning 1985-86. The Government provided a sum of ₹ 400 crore during the financial year 1985-86 and this was allotted among 20 more banks towards the objective of achieving an owned funds-to-deposit ratio of 2.5 per cent.

While allocating amount of ₹ 400 crore during 1986-87, the Reserve Bank made a slight departure from the criterion adopted in the previous year. In addition to the criterion of 2.5 per cent owned funds-to-deposit, it was felt that banks, which had suffered erosion in deposits as revealed in the bank's annual financial reviews, were given additional support. Accordingly, ₹ 174 crore, being 50.0 per cent of the total erosion in deposits, was to be allocated on the basis of erosion in deposits for seven banks and the balance of ₹ 226 crore on the criterion of 2.5 per cent owned funds-to-deposit ratio; two banks, *viz.*, the PNB and the United Bank of India (UBI), were not in a position to absorb the estimated allocated amount because their authorised capital was only ₹ 100 crore. With minor adjustments in the allocation, funds were distributed among banks based on these two criteria.

In a letter to the Reserve Bank, the Government indicated that the formula for allotment needed a change and the banks, which had an international presence, might need a boost. Though the Government's

suggestion merited consideration, the Reserve Bank felt that it was not possible to entirely move away from the basic approach of attaining the objective of 2.5 per cent owned funds-to-deposit ratio that had been uniformly fixed for all nationalised banks. An internal note highlighted that since nationalisation, Indian banks had presented a dismal picture *vis-à-vis* western banks, where norms were to look at the net worth-to-deposits and net worth-to-assets ratios. It was, therefore, suggested that while accepting the owned funds-to-deposit ratio as the prime criterion, the Reserve Bank had to take into account the support needed for banks which had an international presence and the back-up essential for banks, which had suffered erosion in deposits on a real and exchangeable value basis. A proposal factoring in all these considerations was made to the Government but there was no response.

In 1987–88, the Government allotted ₹ 200 crore to 20 nationalised banks, but the mode of allocation engaged serious attention of the Reserve Bank. After considering several options while deliberating on the issue, the Governor indicated that the primary concern of the Reserve Bank/Government was to eliminate/reduce the erosion in deposits. In this context, the Governor observed “It will therefore be appropriate to apportion the available funds, with this end in view. By this approach, banks with weak financial position will get some relief.” For this purpose, the bank-wise figures of deposit erosion on the basis of 1986 applicable federal rate (AFR) was worked out and put up. The allocation of capital funds on the basis of the percentage gap between the existing owned funds-to-deposit ratio and the envisaged 2.5 per cent was considered a lower priority. Taking into account the higher growth of deposits, the need to build up a satisfactory level of owned funds-deposit ratio and the actual figures of erosion in deposits, the Bank requested the Government to allocate additional funds towards the capital of banks.

In accordance with the scheme to augment the capital base of nationalised banks, the Government contributed ₹ 200 crore during 1988–89, bringing their aggregate contribution to ₹ 1,200 crore under the scheme since 1985–86. The SBI's paid-up capital was raised from ₹ 5.6 crore to ₹ 50 crore in October 1985 and it was further increased to ₹ 150 crore in November 1987. After this exercise, the Reserve Bank held 99.2 per cent of the paid-up capital of the SBI. Measures were introduced to strengthen the owned funds of private sector banks also, both by raising additional capital and making additions to reserves.

### COSTING IN COMMERCIAL BANKS

Following the recommendations of the working group on banking costs, operational efficiency and profitability of banks, a steering group was constituted comprising representatives from PSBs and the Reserve Bank. The group took decisions on the methodology for undertaking a costing exercise in banks on the basis of a minimum programme, guidelines for the introduction of costing, formats for collection of data and identification of a common agency for clustering of branches, processing the data and providing output information on a uniform basis. Based on these decisions, detailed guidelines were issued to banks to ensure that all PSBs undertook costing on an on-going basis.

The Reserve Bank convened a meeting of the chief officers of the costing cell of commercial banks on April 19, 1984, with a view to review the progress of data collection in banks, sorting out problems that banks faced, elaborating the types of control data and methods of collecting and consolidating control data that banks had to send for computerisation. The action points emerging from the discussion were advised to PSBs, who took the necessary follow-up action in this regard.

### PROFITABILITY

Improving the profitability of banks was an area of concern both for the Reserve Bank and the Government. According to Dr C. Rangarajan, Deputy Governor, the financial institutions (FIs) normally had to be judged by the twin criteria of operational efficiency and allocative efficiency. Operational efficiency referred to the difference between the rates at which funds were raised and deployed, while allocative efficiency referred to efficient allocation of funds by an institution among competing demands. The Indian banking system, it was viewed, suffered from both operational and allocative inefficiencies as it had no independence either in determining the rates on deposits and advances or in deciding how the funds should be allocated. While the interest spread as a percentage to working funds worked out to 3.23 per cent for all PSBs for 1986, the variation among banks ranged from 0.11 per cent to 4.20 per cent. The allocative mechanism was influenced not only by profitability but also by social compulsions.

It was recognised that there was a need for banks to improve the profitability of their operations. The onus of social banking on one hand and the statutory and other pre-emptions of the loanable funds of banks, on the other, undoubtedly constrained the ability of banks to earn profits.

It was therefore, important that banks stepped up their profitability by reducing their operating costs and improving the quality of lending. Some banks with foreign branches were able to show better results. Although foreign operations could improve profitability, banks had to guard against the risks inherent in the highly competitive and volatile conditions in which they operated abroad. The banks, therefore, had to devise appropriate measures of control and regulation of the operations of their foreign branches. Another area of concern under profitability related to the quality of credit to industry and agriculture. Advances to sick industrial units were high and rising and lending to agriculture was also bedevilled by the poor recovery position. It was imperative that funds were not inordinately locked-up in these sectors and remained available to banks for recycling so that better turnover of credit facilitated larger production growth and also improved the earning capacity of banks.

In the early 1980s, the profitability of banks tended to erode, even when judged in the framework of social banking. Again, this was an outward manifestation of deeper problems which emphasised the need for more efficient recycling of banks' resources, improving the productivity of the banking industry and streamlining the operations of overseas branches of the Indian banks.

For more efficient recycling of funds, two problems needed to be tackled effectively — the recovery of advances, particularly agricultural advances, and improvement in the working of sick industrial units. The recovery of agricultural advances by PSBs deteriorated from 53.2 per cent at the end of June 1983 to 51.3 per cent of the amount due at end-June 1984. The fact that such deterioration took place after two successive good agricultural years was disturbing. Another aspect of the recovery problem was the wide interstate differences. While the recovery ratio was as low as 28.3 per cent in West Bengal and 38.8 per cent each in Orissa and Bihar, the ratio was as high as 74.1 per cent in Punjab and 65.9 per cent in Kerala. These differences in the recovery performance indicated the wide scope for improvement. Turning to sick industries, the credit locked-up in these industries accounted for 7.0 to 8.0 per cent of total bank credit. Obviously, improvement in both these areas was imperative to enhance profitability of banks.

Factors, such as, the rise in interest rate on deposits with maturity of less than 3 years ranging from 0.5 per cent to 1.5 per cent, a step-up in SLR requirements by one percentage point, the rise in advances to priority sectors, which were not only risk-prone but costly in terms of supervision

and follow-up, and an increase in sick accounts tended to erode the profitability of banks. However, the Reserve Bank's decision to raise the interest rate on cash reserves maintained with the Bank in excess of 3.0 per cent from 6.5 to 7.0 per cent and measures taken by banks to curb overtime payments as also the profit from foreign branches helped banks improve their overall profitability. The induction of capital, diversification of activities, mechanisation of operations, improved housekeeping and customer service, and better productivity also contributed enormously to better performance in terms of the profitability.

### FINANCIAL DIVERSIFICATION BY BANKS

Banks in India were diversifying their functions by taking up activities such as merchant banking, equipment leasing, housing finance, venture capital and mutual funds. With the approval of the Reserve Bank, six equipment leasing-cum-merchant banking subsidiaries were set up — five by PSBs and one by a private sector bank. Three more subsidiaries were set up exclusively to provide housing finance. One PSB was permitted by the Reserve Bank to set up a subsidiary jointly with the Bombay Stock Exchange (BSE) to provide share clearing and stockholding services. Two PSBs had also set up mutual funds. In order to ensure orderly functioning of mutual funds set up by the banks, the Reserve Bank issued detailed guidelines on important aspects of the mutual fund business.

### LEASING

Consequent to the issue of the necessary notification under the BR Act by the Government in August 1984, commercial banks were allowed to undertake the business of equipment-leasing. Commercial banks could, with the prior approval of the Reserve Bank, set up a subsidiary with not less than 51.0 per cent of shareholding to transact equipment-leasing business or to make portfolio investments in shares of a leasing company within certain specified limits. The subsidiaries promoted were, however, prohibited from transacting hire-purchase business and financing of other companies or concerns engaged in equipment-leasing. Banks were prohibited from undertaking the business of equipment-leasing or acting as promoters of companies (other than their subsidiaries) in which they had made portfolio investments. Aggregate investment of a bank in a subsidiary and/or in shares of other leasing companies was stipulated not to exceed 10.0 per cent of the paid-up capital and reserves of the bank.

Till the end of April 1986, the Reserve Bank approved proposals from six banks to make portfolio investments in equipment-leasing companies and one proposal to set up a fully-owned subsidiary to undertake merchant banking and equipment-leasing business.

#### PORTFOLIO MANAGEMENT: PROHIBITION OF BUY-BACK ARRANGEMENTS

The banks were prohibited from entering into buy-back arrangements in government and other approved securities with non-bank clients with effect from April 4, 1988. They were instructed to ensure that the extant arrangements were terminated on the date they expired or on July 1, 1988, whichever was earlier. While banks were permitted to undertake outright purchases/sales, such transactions were to be effected at market prices. It was further clarified that outright sale and purchase transactions with the same party and for identical or similar amounts would be construed as tacit arrangements that violated the instructions prohibiting buy-back arrangements with non-bank clients. The banks were also advised to submit a report to the boards, setting out compliance with the instructions prohibiting buy-back arrangements with non-bank investors, and report on phased unwinding of buy-back commitments to the Reserve Bank every month. A full compliance report was required to be submitted to the Bank immediately after July 1, 1988. The Reserve Bank also advised the banks that the units of the Unit Trust of India (UTI) were not approved securities for buy-back arrangements.

#### OVERSEAS OPERATIONS

With the increase in the presence of Indian banks abroad, growth in the volume of business and diversification of their activities, there was a need to improve the mechanism for supervising their operations. The measures included steps to improve the machinery within the banks to monitor the functioning of their overseas branches and strengthen the systems in their international divisions for better oversight of operations of their branches abroad. A more comprehensive reporting system was introduced to reflect the financial position of the overseas branches. The system was designed to be used both in the Reserve Bank and the banks. A forum under the auspices of the Reserve Bank was organised where executives in charge of the international divisions of banks with overseas operations could exchange views on country risk assessments, data on country

risk exposures, international debt rescheduling and control systems. A working group was set up comprising representatives from the Reserve Bank, banking division of the finance ministry and major banks to review and recommend an appropriate control system to be adopted by banks for their overseas operations. Further, a system of functional inspection of overseas branches was instituted.

Steps taken by the Reserve Bank and the concerned banks facilitated closer supervision and control of the overseas operations. With the professional skills that the Indian banks had acquired over the years, overseas operations continued to contribute to the profitability of the Indian banking system. Thus, a lasting solution to the problem of improving the profitability of banks seemed to lie in successfully tackling these medium-term problems.

The emphasis on strengthening the working and financial position of the overseas operations of the Indian banks continued. No new branches were opened by Indian banks abroad and the overseas branches of 9 Indian banks declined from 141 as at end-June 1985 to 116 as on June 30, 1989. The number of representative offices of 4 Indian banks and overseas subsidiaries/affiliates remained unchanged at 10 and 12, respectively, as on June 30, 1989.

To improve the lines of communication between the Reserve Bank and the Indian banks that had overseas operations, the Reserve Bank advised the chairmen and managing directors of these banks in May 1989 to furnish information about their overseas operations through a monthly demi-official letter. Further, banks were advised to provide information in a specified format on a half-yearly basis on problem credits and the provisions for problem exposures in the overseas branches.

## CREDIT QUALITY

### MEASURES TO ENFORCE FINANCIAL DISCIPLINE ON DEFAULTING BORROWERS

The banks were advised not to consider applications for sanction of fresh term finance (including deferred payment guarantee) for new projects, or expansion of existing units of companies, which had persistently defaulted in payment of term credit granted to them by the same bank/other banks/term-lending institutions without justifiable reasons. Regarding working capital assistance, in the case of defaulting units whose managements were suspected to be indulging in malpractices like siphoning off the company

funds, banks were to withhold fresh sanctions and release of funds and even freeze operations on the accounts if such an action was necessary to make the management comply with the required financial discipline.

#### CO-ORDINATION BETWEEN BANKS AND FIs

The banks were not following satisfactorily the guidelines issued for effective co-ordination between commercial banks and state-level FIs (state financial corporations [SFCs], state industrial development corporations [SIDCs] and state industrial and investment corporations [SIICs]) as per the recommendations of the Bhide Committee. As a result, timely and adequate finance to industries was not ensured. To bring about greater co-ordination between commercial banks and FIs, banks were advised to not only scrupulously follow the comprehensive guidelines but also take specific measures for joint appraisal of projects, sanction and release adequate working capital finance before the borrowing units commenced production, estimate working capital requirements for appraisal of projects in accordance with banking norms and entrust bank officials with adequate discretionary powers.

#### RELATED ISSUES

##### WORKING GROUP TO REVIEW THE ACCOUNTING SYSTEM AT BANK BRANCHES

On July 11, 1981, the Reserve Bank appointed a working group under the chairmanship of Shri M.N. Goiporia, chairman and managing director (CMD), Dena Bank and comprising senior officers from banks, the Government, the Reserve Bank and the National Institute of Bank Management (NIBM) to review the accounting system at bank branches. The terms of reference included, *inter alia*: (i) to examine the existing systems of maintaining main books of accounts at the branch level, particularly at the rural and semi-urban branches, and suggest changes to facilitate generation of summary data on deployment of funds and lending to various categories of the priority sector and to compile returns required by the Reserve Bank and head/controlling offices of banks; (ii) to review the information system introduced by the Reserve Bank and examine feasibility of integrating the same with the control/statistical returns required by banks; and (iii) to suggest other measures to ensure that data was made available without delay. The working group submitted its report within nine months from its constitution.

The banks were asked to implement the recommendations of the working group relating to maintenance of separate subsidiaries for different segments of priority sector advances, separate loan ledgers for different segments of priority sector borrowers and introduction of the loose-leaf system of maintenance of loan ledgers.

#### GOVERNANCE STRUCTURE: CONTROL OVER MANAGEMENT

##### *Constitution of Boards of Directors*

The Banking Laws (Amendment) Act, 1983, which came into effect from February 15, 1984, restricted the tenure of a director on a bank's board to eight years at a stretch; it also empowered the Reserve Bank to appoint a chairman on the board of any bank, if considered necessary. In terms of the amended provisions of section 10 A of the BR Act, 1949, some directors with various interests vacated office, but subsequently most of them complied with the statutory provisions. Wherever banks faced problems in appointing a chairman or where there was an urgent need to appoint chairmen for smooth functioning of the banks (*e.g.*, at Lord Krishna Bank Ltd and Bari Doab Bank Ltd, the entire board was dissolved on account of the new provision), the Reserve Bank took recourse to section 10(BB) and appointed them under the powers vested with it. The erring banks were advised to achieve the objective by complying with the statutory provisions both in letter and spirit, and the position regarding compliance with the provisions by banks was under scrutiny.

##### *Appointment of Statutory Auditors of Banks*

In June 1984, all Indian private sector commercial banks and foreign banks operating in India were instructed to change their statutory auditors after a continuous association of four years instead of five years hitherto; however, branch auditors were allowed a period of five years of continuous association with any bank. This was done to bring uniformity in the principles adopted for PSBs.

The working group appointed by the Reserve Bank in May 1983 to evolve suitable norms for fixing the scales of remuneration payable to statutory auditors of PSBs (central/branch) submitted its recommendations in June 1984. These recommendations, with minor modifications, were sent to the Government for acceptance.

*Appointment of Additional Directors on  
the Boards of Private Sector Banks*

The Reserve Bank was empowered under section 36 AB of the BR Act, 1949 to appoint, wherever necessary, additional directors on the boards of private sector banks. The expertise and professional knowledge of such persons, it was felt, would help strengthen the management of the concerned banks and bring about rapid improvement in the working of these banks.

In terms of the provisions of section 36 AB of the BR Act, 1949, the number of such directors appointed by the Reserve Bank was not to exceed five or one-third of the maximum strength fixed for the board by the Articles, whichever was less. To enable the Reserve Bank to have proper control over the management of banking companies, this restriction was removed when the Banking Laws (Amendment) Act, 1983, came into force in February 15, 1984. Consequent to this enactment, 13 non-officials were appointed as additional directors and, in all, 32 banks in the private sector were working under formal observation through the appointment of additional directors, both official and non-official.

FOREIGN BANKS

Section 11(2) (b) (ii) of the BR Act, 1949 provided that a foreign bank operating in India shall, at the end of each accounting year, deposit and keep deposited with the Reserve Bank either in cash or in the form of unencumbered approved securities, or partly in cash and partly in the form of such securities, an amount calculated at 20.0 per cent of its profits for that year in respect of all business transacted through its branch/es in India, as disclosed in the profit and loss accounts prepared with reference to that year under section 29 of the Act. In March 1989, the Reserve Bank advised foreign banks operating in India that, while complying with the above requirements, they should retain the Indian books in a separate reserve account with 20.0 per cent of the profits of Indian operations as disclosed in the annual accounts every year, commencing with the accounting period ended March 31, 1989. They were also advised that the separate reserve account would be permanent and form a part of the owned funds of the bank and that any withdrawals from the same could be made only with the prior approval of the Reserve Bank.

Besides, the minimum start-up capital for a new bank seeking entry into India was raised to ₹ 15 crore. Foreign banks were also required to

achieve, in respect of priority sector lending, a target of 10.0 per cent by end-March 1989, which was increased to 12.0 per cent by March 1990 and to 15.0 per cent by March 1999.

#### REVIEW OF THE FUNCTIONING OF PRIVATE SECTOR BANKS

The position of private sector banks (excluding foreign banks) operating in the country was reviewed to determine their place in the existing banking system and to consider the desirability of their continuance as individual units. Their financial soundness, methods of operation and contribution to economic development in their area of operations were examined and the Government was apprised of the position.

The Governor met the chairmen of all private sector banks in February 1989 to discuss the performance of the banks. In the light of the weak capital base of some banks, the unsatisfactory quality of their loan portfolios and the overall deteriorating position, it was suggested that the banks should voluntarily explore the possibility of getting together and merging to form reasonably sized and relatively strong and viable units. The attention of the chairmen was also drawn to the poor performance in lending to priority sectors, direct finance to agriculture and assistance under various poverty alleviation programmes. The banks were advised to make concerted efforts to fulfil their social obligations.

As at end-June 1989, there were 32 private sector banks including United Industrial Bank Ltd, which was placed under moratorium on June 10, 1989. Of these 32 banks, the position of 13 banks was rated as 'good', that of 8 banks as 'satisfactory', 1 bank as 'not satisfactory' and the remaining 10 banks as 'unsatisfactory'. Besides United Industrial Bank Ltd, 4 banks that were rated 'unsatisfactory' were placed under moratorium subsequent to the half-yearly review.

#### CUSTOMER SERVICE

The decade of the 1980s witnessed an emphasis on improving customer service in banks, which had become a casualty in the process of giving a social orientation to the functioning of banks. A small group was set up by the Government in 1982 to examine the recommendations of the working group on customer service in banks, to assess the notes prepared by the Reserve Bank on the performance of the banks in implementing the recommendations and suggest measures for further consideration by the Reserve Bank, the Government, and the IBA.

Apart from monitoring the implementation of the recommendations by the banks, steps were taken to improve the quality of customer service rendered by banks. Speaking at a conference of the chief executives of PSBs, the Union Finance Minister laid particular emphasis on improving customer service; he described the customer counter as the 'face' of the banking industry that determined the quality of its public image. A media report,<sup>5</sup> commenting on better customer service, observed that for a system not designed for dynamic and diversified role brought about by bank nationalisation, with a several-fold increase in the number of branches, swelling deposits and unheard of advances requiring new linkages between credit expansion and development priorities, naturally caused tremendous strain, affecting the organisational structure in a variety of ways. Perhaps the worst sufferer in the process was the customer who in the post-nationalisation euphoria was hailed as 'the most important visitor' doing the bank a 'favour' by giving it an opportunity to serve him.

An impressionistic survey was carried out during July/August 1985 to assess the quality of customer service in PSBs. Based on the findings, PSBs were advised to take measures to remove the deficiencies and submit quarterly reports indicating the follow-up action taken. Banks were also asked to consider constituting special squads in areas of frequent complaints to hold on-the-spot enquiries into such complaints and to include customer service in the curriculum in their training programmes. Another survey was conducted in May/June 1986 at the instance of the Government at selected branches of PSBs across the country to ascertain the position regarding the implementation of the measures initiated by the Government and the Reserve Bank. The Government was apprised of the findings of the survey.

The Government advised the bank officials at all levels to meet customers on specified dates each month so that they could gain insights into customers' problems. Further, customer service centres were opened at all state capitals for redressal of complaints. To improve customer service in banks in rural areas, it was decided that senior officers ranging from regional managers, managing directors and even the chairmen should visit some of the rural branches once a month and send a copy of their visit notes to the concerned branches for necessary action.

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5. *The Hindu*, Editorial, July 22, 1985.

## OTHER DIRECTIVES

Interest rates on a wide range of alternative savings instruments were lowered to maintain *inter se* relativity. A co-ordinated across-the-board reduction in interest rates on savings instruments was implemented in April 1987, covering bank deposits, post-office deposits, national savings certificates (NSCs), company deposits, debentures, public sector bonds and other schemes. For the first time, a conscious policy measure was taken to avoid unhealthy competition among various avenues of savings.

To develop bills finance as a payment mechanism, the following steps were initiated: (i) reduction in the effective interest rate for bills discounting on behalf of borrowers in the highest interest range; (ii) raising the ceiling on the rediscount rate from 11.5 per cent to 12.5 per cent in order to attract additional funds into the rediscounting business; and (iii) fixing a time-line for gradual substitution of cash credit limits with bills in the case of credit authorisation scheme (CAS) parties.

The CAS was substantially liberalised during 1986-87. The liberalisation reduced the number of bank borrowers coming under prior authorisation and the vesting of large discretionary powers with banks. The CAS parties, which were able to comply with the prescribed credit discipline, were exempted from such prior authorisation. There was also a commitment by the Reserve Bank for disposal of applications/references from banks under the scheme within a period of one month.

Other policy changes were in the nature of rationalisation and effective implementation of existing measures. The rationalisation of selective credit controls initiated in 1985-86 continued during 1986-87. Where the commodity balances were favourable, such controls were relaxed, and where such controls were no longer needed, they were abolished.

The new branch licensing policy emphasised consolidation while ensuring the availability of a bank branch within a distance of 10 kms in rural and semi-urban areas and a coverage of 17,000 population per bank office in rural and semi-urban areas of each block. More liberalised norms were adopted for branch expansion in hilly and tribal areas. During the period July 1986-March 1987, 300 new branches were added, of which four-fifth were in unbanked centres. Branch offices in the rural areas formed nearly 56.0 per cent of the total at the end of March 1987 as compared with only 22.0 per cent in June 1969. To improve the functional efficiency of rural branches, in August 1986 banks were advised to observe one day in a week as non-public business working day at the rural branches so that the managers could spend the day exclusively in the field to contact

their present/prospective clientele for development/promotional work, for mobilisation of deposits, credit allocation, supervision over the end-use of credit, recovery of loans and for rendering appropriate guidance to the borrowers. The banks were also urged to set up satellite or mobile branches in the areas where the volume of business and other conditions did not warrant setting-up of a regular branch.

Satisfactory progress was made in implementing the action plan in 1986–87. Steps were taken, especially to revamp credit management through health coding, timely review and renewal of credit limits, time-bound action to detect sickness, determining the viability of sick units and activating nursing programmes, and/or initiating recovery procedures in respect of non-viable units. There were improvements in housekeeping and customer service. The Reserve Bank continued to hold quarterly meetings with the chairmen of PSBs to monitor the progress in implementing the action plans. All banks continued to meet the credit targets for the priority sector and sub-sectors within it. Data from 50 SCBs on sectoral deployment of credit showed that from July 1986 to April 1987, advances to the priority sector increased by ₹ 3,056 crore as compared with ₹ 2,534 crore during the corresponding period of the previous year.

The share of priority sector advances in total outstanding net bank credit formed 43.0 per cent at end-April 1987 as against 41.1 per cent the year before. The share of outstanding advances to agriculture at ₹ 10,592 crore was 41.8 per cent of total priority sector advances at end-April 1987. The outstanding loans to small scale industries (SSIs) at ₹ 9,300 crore constituted 36.7 per cent of priority sector lending. Direct credit to agriculture by PSBs constituted 16.2 per cent of the total net bank credit at end-December 1986 as against the target of 16.0 per cent set for March 1987. Advances to the weaker sections at end-December 1986 formed 10.8 per cent of net bank credit as against a target of 10.0 per cent set for March 1985. The loans outstanding under the differential rate of interest (DRI) scheme at ₹ 561 crore at end-December 1986 accounted for 1.2 per cent of the total lending portfolio and were spread over 48 lakh accounts.

During 1986–87, the sphere of social banking was further widened by introducing a lending scheme to alleviate poverty of the urban poor. Also, measures were taken to increase the flow of credit to minority communities. There was a marginal improvement in the percentage of recovery to demand in respect of direct agricultural advances, which rose to 56.2 per cent at end-June 1986 from 54.2 per cent a year earlier. However, there was considerable scope for improving the overall recovery

performance of banks. Further, industrial sickness continued to affect bank profitability adversely.

Addressing the concerns that emerged about the overseas operations of PSBs in the past two/three years, the Reserve Bank, in consultation with the Government took steps to rationalise the overseas branch networks. Two approaches were adopted: banks were asked to either review and close down non-viable branches or consolidate their branches (for example, in London where there were many branches of several banks). Eleven overseas branches were closed, bringing down the number to 123 as at end-June 1987. The process of rationalisation entailed withdrawal of four PSBs from international banking, all operating in the United Kingdom (UK). The assets and liabilities of these banks were transferred to other Indian banks operating in the country from the beginning of January/February 1987. This brought down the number of Indian banks having offices abroad to nine. To strengthen the operating and monitoring systems in these banks in relation to the international banking business in their overseas branches; guidelines were issued covering exposure norms, country risk management, control of liquidity, interest rate mismatches and currency lending exposures.

The widening spectrum of banking activities gathered further momentum in 1986–87 which continued in 1987–88. The larger Indian banks and foreign banks diversified their activities into new business areas like lease financing and were also contemplating entry into mutual funds, venture capital and housing finance. Some of these activities were being undertaken through the promotion of subsidiaries or equity holding in other financial companies. The interface with the capital market also expanded, subject to directives and prudential guidelines of the Reserve Bank. The thrust was on merchant banking activities, especially on management and underwriting of new issues.

There was also a general improvement in the overall profitability of banks in 1986. Certain decisions taken by the Government and the Reserve Bank, such as, augmenting the capital base of PSBs, higher coupon rates on government securities and higher returns on cash balances maintained with the Reserve Bank, improved the profitability of banks. The hike in service charges and enhanced staff productivity were also contributory factors.

The Reserve Bank continuously monitored the situation and reiterated its guidelines to banks on safeguards to be taken on operational aspects, such as, clearing of instruments, kite-flying operations by unscrupulous

clients, security arrangements and the preventive and punitive aspects of frauds. Other areas where detailed instructions were issued and compliance followed up included appraisal of advances and post-sanction follow-up to minimise the incidence of frauds and resultant heavy losses; observing safeguards while opening accounts and issuing cheques; methods of issuing opinion reports on borrowers; hiring of contract workers, such as, ex-servicemen or paramilitary personnel to work as armed guards in disturbed areas till police force became available; discontinuing extending advances to directors of other banks or firms in which the director was an interested partner or guarantor, or any company in which the director of another bank held a substantial interest, or to relatives of the bank's directors/other banks' directors; refining the existing system to strengthen the preventive measures to curb malpractices in banks and periodic review of donations by banks' boards.

The improved bank profitability achieved in 1986–87 could be attributed, to a large extent, to the policy responses of the Government and the Reserve Bank. However, for commercial banks to sustain their profitability at a reasonable level in the coming years, endogenous factors had to be effectively addressed, especially those concerning the internal structure, cost control, including special establishment costs, housekeeping, credit and funds management, and customer service. Improving the quality of loan assets and timely recovery of dues were two important areas to which increasing attention was sought to be paid. In this context, commercial banks as well as governments, especially at the state level, had to strive to create and maintain an environment conducive to financial discipline and recovery of dues. The composition of banking business was undergoing changes as banks undertook new activities. It was, however, essential for them to eschew speculative business and to ensure that their major function of providing working capital to agriculture, industry and exports was effectively performed.

The recovery performance in direct agricultural advances showed a small improvement from 56.5 per cent at end-June 1986 to 57.1 per cent at end-June 1987. The schemes for social banking also made further progress during the year. Under the self-employment scheme for educated unemployed youth (SEEU), 1.01 lakh beneficiaries were assisted with an aggregate credit of ₹ 208 crore during the year 1987–88, against the target of 1.25 lakh beneficiaries. During the year, 3.63 lakh beneficiaries were also sanctioned loans aggregating ₹ 132 crore under the self-employment programme for urban poor (SEPUP).

## CONCLUDING OBSERVATIONS

### CONSOLIDATION PAID DIVIDENDS

The involvement of banks and their responses were encouraging and they were able to maintain their professional competence in a substantive manner as evidenced by their improved performance from 1985 onwards. All banks drew up a two-year comprehensive plan to improve their overall operations and efficiency. These plans included measures to: (i) strengthen the internal administration for ensuring better supervision and control; (ii) improve customer services; (iii) improve credit appraisal and the quality of loan assets; (iv) improve recovery of bank dues; (v) reduce costs; and (vi) introduce new work technologies. Effective implementation of these plans called for strenuous efforts. Their fulfilment, in turn, resulted in better customer service and improved financial viability of banks. The importance of running banking along professional lines was realised both by the authorities and the banks, which rendered it easy to introduce subsequent reforms.

Notwithstanding the perceptible progress achieved under the action plans, there still were certain areas of concern. Even though banks had health coded their borrowal accounts and improved follow-up of irregular cases, industrial sickness and defaults in repayment of bank dues continued to adversely affect the quality of their assets. While banks had to make all efforts to step up recycling of funds, it was important to improve the general climate for recovery of bank dues. The existence of a sizeable number of loss-making branches was also a drag on the profitability of banks. It was, therefore, necessary to impart financial viability to such branches through expansion of business within a reasonable time frame. The ongoing tasks of human resource development and personnel management needed focus with a view to further improving motivation, discipline, efficiency, output and work culture at various levels in the industry. Greater effort was called for in the field of technology upgrading, wherever needed, to improve customer service.

In view of the above concerns, banks were advised to draw up new action plans covering the period from April 1988 to March 1990, broadly along the lines of the previous action plans, with an added emphasis on the qualitative aspects of banking. These plans placed emphasis on various aspects of bank performance including rationalisation of systems and procedures, introduction of efficient MIS, strengthening of the

organisational structure, financial viability, proper implementation of the service area approach (SAA), effective credit management, use of the health code of borrowal accounts as a management tool to enhance the quality of bank assets, faster response to signs of industrial sickness and appropriate mechanisation of operations.

Apart from responding to the immediate situation, the policy measures introduced during the year 1988–89 contained a strong thrust on structural changes so as to promote efficiency in the operations of the financial system. Some important measures in this respect were: continuing the restructuring of deposit rates; replacing the ceiling rate by a floor rate for the general category of large bank borrowers; replacing the requirement of prior authorisation by the Reserve Bank under the CAS with a post-sanction scrutiny; freedom to transfer borrowal accounts between banks; relaxations in the stipulations regarding consortium lending; freeing the entire short-term money market from interest rate regulation; introduction of new money market instruments; and steps to implement proposals regarding factoring services.

In the area of branch expansion, while the process of consolidation continued, it was necessary to allow the opening of additional branches so as to achieve appropriate coverage under the SAA — a new strategy of rural lending, which became operative from April 1, 1989.

Apart from strengthening the capital base of nationalised banks, a number of steps were taken during the late 1980s to strengthen prudential supervision, such as, issuance of guidelines on exposure risk management and recognition of NPLs. To achieve greater transparency, aspects relating to the modification of accounting policies and practices of banks also received attention.

The commercial banks diversified into services, such as merchant banking, leasing, mutual funds, venture capital and housing finance, and some banks set up specialised subsidiaries for such activities. The provision of these services was a natural affiliate of the diverse and growing needs of the economy following the economic liberalisation measures initiated in the country and reflected the adaptability of commercial banks to the changing needs of the financial system. As at end-June 1989, three banks, *viz.*, the SBI, Canara Bank and BoB were permitted to set up mutual funds. While the SBI and Canara Bank set up mutual funds and introduced several individual investment schemes immediately, BoB followed suit in due course. Six commercial banks, *viz.*, the SBI, Canara

Bank, PNB, BoB, Central Bank of India and Vysya Bank Ltd, were granted permission to set up subsidiaries, either wholly-owned or jointly with other banks/FIs. While all six banks were permitted to undertake merchant banking, equipment leasing and other financial services through their subsidiaries, four of them, *viz.*, the SBI, Canara Bank, BoB and Central Bank of India, were permitted to also operate venture capital financing. Subsidiaries were set up by all six banks to undertake these activities. In addition, the SBI, Canara Bank and PNB had, with the permission of the Reserve Bank, set up separate subsidiaries, either wholly-owned or jointly with other institutions, to provide housing finance. Thus, in all, six banks established nine subsidiaries to undertake diversified activities. Besides, some banks opened specialised branches to cater to corporate customers and the investing public. It was at this point of time that the question of extending prudential supervision over the subsidiaries of banks received the attention of the Reserve Bank.

#### BEYOND SUPERVISION

The Governor, Shri R.N. Malhotra, in a speech<sup>6</sup> identified some constraints that the banking system was facing in maintaining its health and viability. These were:

- (i) Delays faced in enforcing their claims in the courts of law, thereby encouraging defiance on the part of borrowers and the need to establish special tribunals to deal with large bank claims.
- (ii) Cross-subsidisation on account of priority sector targets at highly concessional rates and with greater risk could place an undue burden on banks which should not be pushed beyond a point.
- (iii) The environment for recycling bank funds needed improvement to enable the banks to maintain financial health, and the pressures for lending to essentially non-viable units, which were counterproductive, had to be avoided.
- (iv) The autonomy, professionalism and accountability of banks, which were intimately linked, needed to be preserved while meeting the national policy objectives. Credit decisions needed to remain the sole responsibility of bank personnel in both the priority and non-priority sectors. Departures from well-recognised principles like credit evaluation and lending norms could erode accountability,

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6. Malhotra, R.N. (1989). *Changing Practices of Central Bank Supervision*. Address on the occasion of 125<sup>th</sup> anniversary of Allahabad Bank. Calcutta. December 6.

lead to deterioration in the quality of bank assets and encourage insider abuse; and

- (v) To make the banking system efficient and competitive, the process of mechanisation and computerisation of its operations needed to be accelerated.

It was well recognised that regulation had to be compatible with socioeconomic objectives. Deregulation and liberalisation appropriate to Indian conditions required reinforcing the capital and prudential norms in banks and OFIs to counter enhanced risks arising from such changes. Reinforcing the legal framework, standardising the accounting practices, increasing disclosure of the state of bank operations and consolidating supervisory functions, preferably under a single agency in the context of the progressive integration of financial markets, were some of the issues under active consideration in the late 1980s.

Several steps were taken in the late 1980s to impart flexibility to the financial system and to encourage a measure of competition. The measures related to: (i) the CAS, which was first liberalised and then abolished and replaced by *ex post* monitoring; (ii) interest rate prescriptions with regard to money market instruments were abolished; (iii) a floor of 16.0 per cent was fixed without a ceiling rate for most non-priority sector borrowers, enabling banks to charge interest in the light of borrowers' track records. At the same time, parties were allowed to transfer their accounts from one bank to another, provided they cleared their liabilities to the existing banks; (iv) banks were permitted to issue certificates of deposit (CDs) for large amounts, with the interest rate determined by negotiation between the bank and the depositor; (v) commercial paper (CP) was introduced to enable highly-rated companies to raise money at rates lower than what they paid on their bank borrowings; and (vi) banks were allowed to diversify their activities in several new business areas, either directly or through specialised subsidiaries. The money and capital markets were activated by introducing several new instruments.

While continuing with onsite inspections and follow-ups as a major tool for evaluating the performance of banks, a number of steps were taken to strengthen the area of prudential supervision. Keeping in view the developments abroad, proposals were considered regarding the introduction of suitable capital adequacy norms in relation to risk assets, including off-balance sheet business. Guidelines were issued regarding exposure risk management in the domestic sector by laying down norms

for individual/group exposure, covering both funded and non-funded limits in relation to owned funds. Such norms were already in vogue in respect of the overseas operations of banks. Suitable guidelines were also issued regarding recognition of NPLs based on health coding, and banks were advised not to take into account interest income arising from loans so classified. The transparency of the accounting policies and practices of banks also engaged the attention of the Reserve Bank at this juncture.

The Reserve Bank was actively involved in the establishment of BANKNET, a data communications network for the banking industry. To assess the requirements of banks as well as to co-ordinate the activities of user banks for speedy implementation of BANKNET phase I, a user group was constituted. Similarly, 37 banks in India (including the Reserve Bank) were accepted as members of the Society for Worldwide Interbank Financial Telecommunications (SWIFT), a co-operative society based in Belgium. Action was taken to install the SWIFT Regional Processor in Bombay to act as an international gateway. Message formats conforming to SWIFT specifications were standardised jointly by the Reserve Bank and the IBA.

The pressure on bank profitability was, to a large extent, attributable to the irregular accounts of sick or mismanaged industrial units and the unsatisfactory recovery of bank dues from agricultural and other priority sector advances. As regards the first category, in order to make the legal processes for enforcing banks' claims more expeditious and effective, special tribunals were established during the 1990s. With regard to the dues in agricultural and other priority sector advances, banks were required to step up efforts towards recycling their funds. Besides, it was important to ensure that the general environment for recovery of dues by commercial and co-operative banks was not vitiated. Towards this end, the Reserve Bank and NABARD undertook measures to make refinancing of state co-operative banks contingent on adherence to the prescribed interest rate and other credit disciplines.

There was increased emphasis on consolidation in the banking system. This was sought to be achieved through comprehensive action plans prepared by commercial banks. The objectives of these action plans were: improving the operational efficiency of banks by strengthening the organisational structure, upgrading internal supervision and control systems, enhancing capacity and quality of training for human resource development, improving customer service and housekeeping, reinforcing

financial viability through better credit management, higher productivity, economy of expenditure and recovery of bank dues, and introducing new technology in a phased manner. These efforts yielded results but there was considerable scope for further improvement. Though customer service showed significant progress, it needed to be further reinforced.



# 8

## Rural Credit Policy

### INTRODUCTION

Recognising the importance of the rural and, in particular, agricultural sector in India's development, the Government and the Reserve Bank emphasised a broad-based institutional framework for catering to the increasing credit requirements of the sector. While the overall objective of rural credit delivery was guided by the considerations of ensuring adequate and timely availability of credit at reasonable rates of interest through the expansion of institutional framework, the relevant approach and policies including the credit delivery mechanism were periodically reviewed to attune to the changing requirements of the rural sector. The rural credit system in the country thus witnessed significant changes over time in terms of focus, structure and approach.

The institutional arrangement for purveying rural credit consisted of a three-tier co-operative structure till 1969, with the Reserve Bank playing a promotional and developmental role since its inception in 1935. The all-India rural credit review committee<sup>1</sup> expressed that co-operatives did not measure up to expectations in mobilising deposits and disbursing credit. The committee, therefore, felt that efforts of the co-operatives had to be supplemented and it recommended adoption of a multi-agency approach to cater to credit needs of rural areas with a much larger role for commercial banks. Thus, after nationalisation of 14 major commercial banks in 1969, followed by another 6 banks in 1980, commercial banks assumed a relatively dominant role in purveying rural credit during the decades of the 1970s and the 1980s. Since institutional credit was perceived

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1. Reserve Bank of India, 1969.

to be inadequate in meeting the requirements of weaker sections of the rural community, regional rural banks (RRBs) were established in 1975 as an institutional innovation combining both commercial and co-operative principles to especially meet the credit needs of weaker sections of society. This multi-agency system for purveying rural credit came to be accepted as a viable and appropriate mechanism for rural development during the Sixth and Seventh Five Year Plan periods.

The policies towards rural credit during the 1980s were influenced by the thinking that in developmental planning, the trickle-down theory did not work and provision of credit and employment to vulnerable sections needed to be targeted and prioritised for better distribution of benefits accruing from economic growth. Thus, priority sector lending — directing institutional credit flow through regulatory guidelines and directives — characterised the approach to rural credit. This policy, which had strong political backing, was at times taken to the extreme of overriding the regulatory and prudential banking operations. The controversial loan *melas* were thus organised during this period.

The targeted lending was complemented by evolution of an integrated and area-based approach at different levels, *viz.*, the village, the block, the district and the state, with supporting institutional arrangements, such as, district and state-level committees aided by regulatory participation, aimed at planning and monitoring the flow of credit to the desired groups, activities and sectors.

In this milieu, the Reserve Bank continued to play a promotional role, though its efforts were dispersed and were somewhat diluted after the creation of the apex institution, the National Bank for Agriculture and Rural Development (NABARD) in July 1982. Most of the supervisory functions in the context of rural credit were transferred to the new institution.

The Governor, Dr Manmohan Singh,<sup>2</sup> commenting on the changed role of the Reserve Bank, said:

...the establishment of NABARD, in a sense, marks the end of an era of the Reserve Bank's direct involvement in rural credit and the Reserve Bank's legacy becomes the heritage of NABARD. Of course, this change will in no way affect the Reserve Bank's deep and abiding interest in the orderly growth of the rural credit system, in line with the broad national objectives and priorities of development.

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2. Reserve Bank of India (1985). "Foreword", in *The Reserve Bank and Rural Credit*.

Though NABARD was set up as the apex development finance institution (DFI) to regulate rural credit and promote integrated rural development in the country, the Reserve Bank did not delegate all its powers to NABARD. The Agricultural Credit Department (ACD) monitoring the short-term credit structure ceased to exist, and the functions of the erstwhile Agricultural Refinance and Development Corporation (ARDC), a Reserve Bank subsidiary, were subsumed in the new institution. The Rural Planning and Credit Department (RPCD) was at the same time set up in the Bank, which assumed the overall regulatory role for rural credit.<sup>3</sup> The obligations cast upon the Reserve Bank under section 54 of the Reserve Bank of India (RBI) Act were amended envisaging that the Bank maintained expert staff to study various aspects of rural credit and development, tendered expert guidance and assistance to NABARD, and conducted special studies in rural areas, which it considered necessary for promoting integrated rural development.

#### BANKING POLICY AND RURAL CREDIT: REACHING OUT TO MASSES

The government policy towards rural credit in the 1980s maintained a thrust on eradicating poverty and reducing inequality of income. This was achieved by developing agriculture, providing employment opportunities and uplifting the weaker strata of the society. The policy found expression in various budget speeches of the period 1982–83 to 1988–89. In the 1982–83 budget speech, the Finance Minister, Shri V.P. Singh observed that the operations of public sector banks (PSBs) had been further oriented towards extending banking facilities to under-banked rural and semi-urban areas, and enlarging the flow of credit to priority sector, particularly the weaker sections. He categorically stated that the objective of the policy in 1982–83 was to maintain the momentum of growth and make efforts to achieve the socioeconomic objectives of the Sixth Plan. This called for increasing investments, achieving higher productivity levels, enhancing efficiency and reducing disparities. The approach continued in 1983–84 with an increased outlay under various government-sponsored schemes, such as the twenty-point programme and the integrated rural development programme (IRDP).

The budget speech of 1985–86 quoted former Prime Minister, Smt Indira Gandhi, who emphasised, “No section of our vast and diverse

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3. RRBs were regulated by the Reserve Bank of India and not by NABARD.

population should feel forgotten. Their neglect is our collective loss.” The Finance Minister added, “Agriculture and rural development is at the centre of our planning. Control of inflation, reduction in poverty levels, promotion of employment and improvement in our balance of payments are goals which are linked with our success in agriculture.” The subsequent budgets endorsed the earlier policies and gave an impetus to rural development through necessary budgetary provisions and improved institutional spread.

The argument that rural presence energised rural credit was the guiding philosophy of the Government and the Reserve Bank after some of the major commercial banks were nationalised in 1969. This led to large-scale branch expansion by the nationalised banks in rural areas. It also cast the Reserve Bank in a unique role of harmonising the principles and discipline of commercial and social banking. In line with its developmental role, the Reserve Bank began to work in partnership with the Government in guiding and directing the banking system to cater to the social and economic needs of the people. Development of FIs, institutionalisation of savings, meeting the credit requirements of major and critical segments of the economy, particularly the weaker sections of society, and channelling the resources according to Plan priorities were some of the challenges that the Reserve Bank tried to address during this period.

The spirit, with which the Reserve Bank associated with the Government in nurturing social banking in the 1980s, while at the same time maintaining that banking indeed was a commercial proposition, was unique for any central bank. The approach to branch licensing policy, savings mobilisation and use of the instruments of credit as part of the policy in the 1980s were the building blocks of social banking: they fostered banking habits among masses, without seriously jeopardising the commercial character of the banking business. As a result, the institutional structure for rural finance received an unprecedented stimulus and social banking came to be recognised as an inevitable proposition for all institutions associated with rural credit in general, and agricultural credit in particular. The Reserve Bank, thus, played a pioneering role in developing such a framework for the short, medium and long-term financing of agriculture.

The Reserve Bank on its own or in co-ordination with the Government introduced several schemes at concessional rates of interest, with favourable treatment in credit appraisal in order to facilitate credit access to the priority sector; in particular, agriculture, the weaker sections and

scheduled castes and scheduled tribes (SCs/STs). It continually monitored and reviewed the progress of these schemes so as to introduce the required corrective steps, as and when necessary.

The justification for offering credit at concessional rates to certain categories of borrowers was based on the premise that farm-based investment activities, in the short run, did not always yield returns to enable regular servicing of loans, while at the same time meeting the minimum consumption requirements. Since concessional lending impacted the profitability of rural financial institutions, a policy of cross-subsidisation and refinance from the Reserve Bank and later NABARD was put in place simultaneously. This was broadly the policy framework, which prevailed for over two decades.<sup>4</sup>

These strategies, however, brought with them some negatives. Extending banking to rural areas was not an easy task. Governor Malhotra<sup>5</sup> observed in this context:

Inadequate development of infrastructure has been a serious constraint. Recruitment, training, reorientation and placement of banks' staff, mostly with urban backgrounds have posed difficult problems. Chains of command within banks have stretched, making supervision and control less effective. Add to this the hazards of rural lending, social pressures, the multiplicity of purposes for which credit is needed and the relative inexperience of young bank managers and you get an idea of the stupendous effort that banks have made in establishing a strong presence in and increasing manifold the flow of lending to rural areas.

Social banking and mass banking received significant target orientation in the late 1980s without adequate emphasis on their implications for the viability of such activities. While cross-subsidisation was accepted as a conscious policy to support rural and other priority sector bank lending, poor recoveries and increase in non-performing loans (NPLs) became serious issues. The Narasimham Committee report<sup>6</sup> in this context noted:

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4. Thorat, Y.S.P. (2005). *Rural Credit in India and Concerns*. Presidential Address at the Society of Agricultural Economics. November 24.
  5. Malhotra, R.N. (1986). *Role of Banking in Rural Development*. Speech delivered at the Fifth Anniversary Lecture. Colombo: Rural Banking and Staff Training College, Central Bank of Sri Lanka. September 19.
  6. The committee on the financial system (Chairman: M. Narasimham), 1991.

Priority sector lending was supposed to be a means to the broader end of improving the economic condition of ‘the neglected sectors of the economy’. However, the way the policy was interpreted and pursued, the means became the ends in lending. Banks were pulled up for not meeting their credit target; and what happened in banks down the line was that bank managers were interested in ensuring that they lent more money to these sectors...the emphasis was on providing the credit and there was no equal emphasis on recovery of credit...loan melas which showed an official blessing for the abandonment of the principle of credit appraisal...the credit appraisal took a backseat...loan waivers can be regarded as the prodigy of those melas.

A number of scholarly studies outside the Reserve Bank pointed to the impact of rural credit since the beginning of the 1970s. These helped to understand the challenges faced by the Reserve Bank and the Government in working out necessary programmes for rural and agricultural development. Burgess and Pande (2003, 2005)<sup>7</sup> in their study on the economic impact of the explosive growth in rural banking during the period 1970–1992 found that branch expansion in the banked and unbanked areas had a significant positive impact on the growth of non-agricultural output, contributed to the growth of small businesses and led to an increase in the share of non-agricultural labour in the total workforce as also to rise in the real wages of agricultural labour. The study also found that the penetration of banks into unbanked areas reduced aggregate poverty and the rural-urban poverty differences besides facilitating a reduction in aggregate inequality in the economy. The study concluded that the favourable results were precisely due to the social elements of India’s banking experiment, *viz.*, expansion into unbanked locations and priority sector lending.

Another study by Cole (2008)<sup>8</sup> encapsulated the performance of government-owned banks in the rural credit area: the growth rate of agricultural credit lent by public banks was 5.0–10.0 percentage points higher in the election years than in the years after an election, and in election years more loans were made to the districts in which the ruling

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7. Burgess, R. and R. Pande (2003, 2005). “Do Rural Banks Matter? Evidence from the Indian Social Banking Experiment”, *BREAD Working Paper* No. 037/2003 and *American Economic Review* 95(3): 780-95. June 2005.

8. Cole, Shawn A. (2008). “Fixing Market Failures or Fixing Elections? Agricultural Credit in India”, *Harvard Business School Working Paper* No. 09-001. July.

state party had faced a narrow margin of victory (or a narrow loss) in the previous election. This targeting did not occur in the non-election years. The paper showed that politically motivated loans were economically costly. They were less likely to be repaid. Nor were they put to good use; election year credit booms did not measurably affect agricultural output. Finally, the measure of whether the average agricultural loan was beneficial, using variation induced by bank nationalisation of the 1980 showed that agricultural credit in villages with nationalised bank branches grew more than twice as quickly than in the villages with private branches over the 1980s. However, this additional credit had no effect on measured agricultural outcomes.

To quote Dr C.H. Hanumantha Rao, “In our planning, we wanted to bring land development and eradicate poverty in 2–3 Plans, but this never happened. Instead of planning influencing our social structure, our social structure began influencing planning. By and large, in the late 1980s, the rural credit situation became very discouraging because of loan write-offs, waivers and all kinds of things; that was a very bad period for rural credit system when political interference was at its highest. Some of the things are consequences, but not because of the nationalisation *per se* but because of political interference which was perhaps made easier because of nationalisation of banks.”<sup>9</sup>

Contributing to the public debate on Indian banking system, an eminent economist<sup>10</sup> observed:

The nationalised sector of the banking system is subject to other forms of intervention, all designed to serve one or another public policy and almost all, without exception, making a severe dent in the viability of the system. Targets of rural branch expansion, priority sector lending, repressive interest rate policies have all been responsible for the deterioration in the quality of performance, even as quantitative growth has been spectacular. Perfectly legitimate public policy objectives have been sought to be pursued by sub-optimal instruments, which have caused many distortions in the allocation of resources. As if this were not enough, the personalised style of interventions, and political gimmicks such

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9. Transcript of the interview with Dr C.H. Hanumantha Rao, former Member, Planning Commission, Government of India, November 16, 2006.

10. Shroff, Manu (2009). “Reform in Indian Banking: Agenda for Action”, in *Indian Economy: A Retrospective View*. Edited by Deena Khatkhate. p.168: para 2.

as loan melas and loan waivers, have brought the legitimate social objectives into disrepute. Successive Governments have thought of bank deposits as public resources to be deployed at will by the elected representatives of the people, totally confusing the term public in its two senses. Such perverse perceptions of the accountability of the banking system are at the root cause of the problem faced by the system.

Politicians have to be made to recognise that banks are primarily accountable to the depositors, just as the insurance companies are to policyholders and mutual funds to their investors. Ownership means little or should mean little in such financial organisations.

Adding to the debate, another view expressed in this context was that the significant increase in credit flow from institutional sources brought forth a strong sense of expectation from PSBs. This expectation, however, could not be sustained as the emphasis throughout was on achieving certain quantitative targets. As a consequence, inadequate attention was paid to the qualitative aspects of lending, resulting in loan defaults and erosion of repayment ethics for all categories of borrowers. The end result was a disturbing growth in overdues, which not only hampered recycling of scarce resources of banks but also affected profitability and viability of FIs. Ultimately, financial deepening occurred but the development impact of rural finance was blunted. Resultantly, in 1991, on the eve of reforms, the rural credit delivery system was in a poor shape.

Notwithstanding such pressures and hurdles, the overall achievement in spreading banking to rural areas was commendable. This, combined with aggressive strategies for expanding rural credit, exerted a positive influence on agricultural production. The number of rural branches increased sharply from 1,833 in June 1969 to 17,656 in March 1981 and further to 35,206 in March 1991. The proportion of rural branches to total branches increased from 22.0 per cent in June 1969 to 49.4 per cent in March 1981 and further to 58.5 per cent in March 1991.

According to the All-India Rural Debt and Investment Survey (AIRDIS), the relative share of borrowing of cultivator households from commercial banks improved significantly during the 1980s from 28.8 per cent in 1981 to 35.2 per cent in 1991, whereas that of co-operatives declined from 29.8 per cent to 23.6 per cent during the same period. The proportion of credit availed from the non-institutional sources declined from 36.8 per cent to 30.6 per cent during the review period.

The share of institutional flow of short-term credit through commercial banks improved significantly. In terms of disbursements, while scheduled commercial banks (SCBs) improved their share from 27.2 per cent to 36.4 per cent, the co-operatives saw their shares declining from 72.8 per cent to 61.3 per cent. The share of RRBs, after improving from 3.8 per cent in 1982–83 to 5.4 per cent in 1989–90, declined to 2.2 per cent in 1990–91. Similar trends were seen in the case of outstanding short-term credit from these sources (Table 8.1). The share of respective institutions with regard to term credit flow also followed a similar pattern (Table 8.2).

The share of term credit in gross capital formation in agriculture and allied activities also improved from 28.4 per cent in 1980–81 to 35.1 per cent in 1990–91 (Table 8.3).

TABLE 8.1

*Shares of Institutional Sources in Short-term Credit to Agriculture 1980–1991**(Per cent)*

Year	Disbursements			Outstanding		
	SCBs	Co-ops.	RRBs	SCBs	Co-ops.	RRBs
1980–81	27.2	72.8	–	34.5	65.5	–
1981–82	29.0	71.0	–	32.3	67.7	–
1982–83	22.0	74.2	3.8	36.7	60.4	2.9
1983–84	27.7	68.5	3.8	37.7	58.9	3.4
1984–85	29.6	66.6	3.8	39.2	56.6	4.1
1985–86	30.0	65.8	4.2	40.2	55.3	4.5
1986–87	34.4	60.9	4.7	42.0	52.8	5.2
1987–88	33.2	61.9	4.9	41.8	52.7	5.4
1988–89	31.5	64.1	4.5	39.9	54.5	5.6
1989–90	30.6	64.0	5.4	42.0	51.9	6.0
1990–91	36.4	61.3	2.2	42.3	51.8	5.9

Note: '–': not available.

Source: Aggarwal, K.P., V. Pugazhendhi and K.J.S. Satsai (1997). "Gearing Rural Credit for Twenty First Century", *Economic and Political Weekly*, October 18–24.

TABLE 8.2  
*Shares of Institutional Sources in Term Credit to Agriculture 1980-1991*

(Per cent)

Year	Disbursements			Outstanding		
	SCBs	Co-ops.	RRBs	SCBs	Co-ops.	RRBs
1980-81	53.7	46.3	—	43.9	56.1	—
1981-82	54.5	45.5	—	44.6	55.3	—
1982-83	41.4	50.8	7.8	46.6	48.9	4.6
1983-84	51.6	40.9	7.5	50.7	44.3	4.6
1984-85	58.5	34.1	7.3	53.6	40.7	5.7
1985-86	56.1	35.3	8.6	58.4	35.7	5.8
1986-87	57.7	33.7	8.6	57.8	35.8	6.3
1987-88	50.4	43.2	6.4	60.8	32.6	6.6
1988-89	58.6	36.6	4.9	61.9	31.1	7.0
1989-90	57.7	34.7	7.5	62.1	30.9	7.0
1990-91	62.4	32.6	5.0	66.3	27.7	6.0

Note: '—': not available.

Source: Same as in Table 8.1.

TABLE 8.3  
*Real Private Capital Formation in Agriculture vis-à-vis Institutional Credit*

(₹ crore)

Year	Public Sector		Private Sector		Total		Flow of Term Credit	Credit as Per cent to Capital Formation in Agri+ Allied Sectors
	Agricu- lture	Agri+ Allied Sectors	Agricu- lture	Agri+ Allied Sectors	Agricu- lture	Agri+ Allied Sectors		
1980-81	1,796	1,892	2,840	2,972	4,636	4,864	1,382	28.4
1981-82	1,779	1,878	2,720	2,863	4,499	4,741	1,337	28.2
1982-83	1,725	1,857	2,850	3,008	4,575	4,865	2,063	42.4
1983-84	1,707	1,843	2,390	2,563	4,097	4,406	1,405	31.9
1984-85	1,673	1,822	2,878	3,066	4,551	4,888	1,511	30.9
1985-86	1,516	1,631	2,806	3,010	4,322	4,641	1,931	41.6
1986-87	1,428	1,550	2,587	2,810	4,015	4,360	1,916	43.9
1987-88	1,450	1,576	2,964	3,202	4,414	4,778	1,952	40.9
1988-89	1,362	1,482	2,985	3,252	4,347	4,734	2,029	42.9
1989-90	1,156	1,301	3,197	3,490	4,353	4,791	1,969	41.1
1990-91	1,154	1,313	3,439	3,761	4,593	5,074	1,782	35.1

Source: Same as in Table 8.1.

## AGRICULTURAL REFINANCE AND DEVELOPMENT CORPORATION

The emphasis on flow of credit to agriculture in the framework of a multi-agency approach raised certain issues such as, multiple regulators and lack of co-ordination in credit delivery.

The ARDC continued to play an active role in providing refinance for viable investments in agriculture and allied activities, and in promoting development and technical assistance in these areas of economic activity during the year 1981–82. The participatory role of the ARDC increased in line with the emphasis on the IRDP and rural credit expansion in the Sixth Five Year Plan. The cumulative number of schemes sanctioned up to end-June 1982 by the ARDC since its inception was 19,611, involving ₹ 4,650 crore of commitment and ₹ 2,808 crore of disbursements. The purposes covered under ARDC assistance were minor irrigation, land development/command area development, farm mechanisation, plantation/horticulture, poultry/sheep breeding/piggery, fisheries, dairy development, storage/market yards and others. The agencies assisted by the ARDC were state land development banks (SLDBs), SCBs and state co-operative banks. The corporation concentrated on developing and promoting agricultural investments in less developed and/or under-banked states.

The corporation sought to cover more and more small farmers in line with the national objective of assisting small farmers in an attempt to improve their economic lot. As at end-June 1982, it provided assistance to 918 schemes for an amount of ₹ 137 crore. It offered small farmers a concessional rate of interest of 10.25 per cent as against 12.5 per cent generally payable by the farmers.

During 1981–82, the corporation took some major decisions, which, *inter alia*, included enhancing the rate of its contribution to special debentures floated by the SLDBs between September 1981 and March 1985 on a request by the Central Government; providing interim finance to banks in consultation with the Reserve Bank with a view to helping farmers purchase tractors during the 1981–82 *kharif* season; and liberalising its refinance scheme to enable the state electricity boards (SEBs) to obtain enhanced financial assistance from banks.

During 1981–82, the corporation successfully completed credit projects, such as the International Development Association (IDA)/International Bank for Reconstruction and Development (IBRD) projects involving an amount of US\$ 350.0 million. These included the Himachal

Pradesh Apple Processing and Marketing Project and the Chambal Command Area Project. As at end-June 1982, 41 projects were sanctioned assistance by the World Bank Group, involving a sum of US\$ 1,550.0 million to be routed through the corporation.

### FORMATION OF NABARD

In 1979, the Reserve Bank set up a committee to review arrangements for institutional credit for agriculture and rural development (CRAFICARD). The major outcome of the committee's recommendations, submitted to the Reserve Bank in 1981, was the establishment of NABARD. The institutional credit structure for agricultural and rural development got a fillip with the creation of NABARD.<sup>11</sup> The necessary legislation was enacted in 1981–82 and NABARD commenced operations on July 12, 1982.

The statute, under which NABARD was formed provided for an organic link between NABARD and the Reserve Bank. NABARD worked under the general guidance of the Reserve Bank during its formative years. As Governor Manmohan Singh<sup>12</sup> observed:

NABARD has inherited the tradition from RBI which has rendered 50 years of great service in the area of agricultural credit, institution building, rural development which is a glorious chapter in the RBI history. Continuing, NABARD has to proceed ahead with this rich heritage and on it rests a great deal, for bringing about a satisfactory rural delivery edifice. RBI, however, as the Central Bank of the country which derives more than 40 per cent of GDP coming from agriculture and 70 per cent of population deriving their income from agriculture as vocation, would continue to take interest in rural development — in fact, no central bank of the country can afford to be a passive body in ensuring for it the needed health in the vital sector of the economy. RBI cannot get away from the task of alleviating the poverty in the country and NABARD is the arm through which RBI is going to implement this.

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11. The third volume of the history of the Reserve Bank of India (1969–1981) extensively covers the setting-up of NABARD.
  12. Address at the first conference of officers-in-charge of regional offices of NABARD held in April 1983. Also recorded as Foreword by Dr Manmohan Singh to "The Reserve Bank and Rural Credit", Reserve Bank of India, 1985.

## RURAL PLANNING AND CREDIT DEPARTMENT

The core activities of the RPCD included formulating policies relating to priority sector advances, assessing the quantitative and qualitative performance of commercial banks in lending to the priority sector, weaker sections and under special poverty alleviation programmes; monitoring the implementation of the lead bank scheme (LBS) and service area approach (SAA); providing financial support to NABARD, guiding and advising it on matters of rural credit; and ensuring that the state and central co-operative banks as well as RRBs complied with the provisions of the RBI Act, 1934, the Banking Regulation (BR) Act, 1949, and the rules framed under these Acts.

The policies governing commercial banks' lending to priority sector of the economy and the definitions of priority sector were laid down by the department in co-ordination with the Government as also in consonance with the general credit policy pronouncements made by the Reserve Bank. The department was required to closely monitor the banks' performance, sector-wise, to ensure that they met the targets fixed by the Reserve Bank. The RPCD had 16 regional offices and a cell at Nagpur that worked under the Bombay Regional Office.

Conceived as an exercise in decentralisation of the Reserve Bank's functions in the sphere of rural credit, NABARD took over the entire functioning of the ARDC. Also, the refinancing functions in relation to state co-operative banks and RRBs were separated from the Reserve Bank and entrusted to NABARD. With a view to promoting integrated rural development and securing rural prosperity, NABARD provided refinance to promote agriculture, small scale industries (SSIs), cottage and village industries, handicrafts, other rural crafts and allied economic activities in rural areas.

NABARD was made into a statutory body under an Act of Parliament, and financing of non-farming activities were included as part of the activities of the institution. The Deputy Governor, Shri M. Ramakrishnaya carried out the functions of the Board in the early period till a formal board was constituted. Efforts were made to persuade the Reserve Bank staff to continue in NABARD in an attempt to retain the experienced manpower, though these attempts did not meet with much success. Endeavours were also made to get a short-term line of credit from the Reserve Bank to sustain the viability of co-operative institutions in rural lending, despite some reservations on the part of the Reserve Bank.

The authorised share capital of NABARD was ₹ 500 crore and the paid-up capital was ₹ 100 crore, contributed equally by the Reserve Bank and the Government. The national agricultural credit (long-term operations) [NAC (LTO)] fund with the Bank was transferred to NABARD to form part of its national rural credit (long-term operations) [NRC (LTO)] fund, which could be used to provide term loans. NABARD was permitted to raise resources from the Government and the market. It could also draw on assistance from the Reserve Bank for short-term credit and working capital loans.

The role and activities envisaged for NABARD encompassed:

- (i) Provision of refinance for all categories of production and investment credit to agriculture, SSIs, artisans, cottage and village industries, handicrafts and other allied economic activities.
- (ii) Funds for its loan operations to be drawn from the Central Government, the World Bank and other multilateral and bilateral agencies, by borrowing from the market and the NRC (LTO& stabilisation[S]) funds. The resources of the NAC (LTO) fund and the NAC(S) fund stood transferred to the above-mentioned funds of NABARD. The Reserve Bank also committed to provide a line of credit for NABARD's short-term operations.
- (iii) Besides providing short-term, medium-term and long-term credits to SCBs, RRBs, LDBs and other FIs approved by the Reserve Bank, NABARD extended loans to state governments for periods not exceeding 20 years to enable them to subscribe directly or indirectly to the share capital of co-operative credit societies. It also provided long-term loans directly to any institution approved by the Central Government and contributed to the share capital or invested in the securities of any institution concerned with agriculture and rural development.
- (iv) NABARD took over the responsibility of co-ordinating the activities of the Government of India (GoI), the Planning Commission, the state governments and other all-India and state-level institutions entrusted with the development of SSIs, industries in the tiny sectors, village and cottage industries, and rural crafts.
- (v) It was entrusted to maintain a research and development fund to promote research in agriculture and rural development, supported by a database to be created for the purpose. This fund was envisaged to help in formulating and designing projects/

programmes to suit the requirements of different areas and to cover activities requiring special attention.

- (vi) The responsibility for monitoring and evaluating the implementation of the projects rested with NABARD.
- (vii) NABARD was also made responsible for inspection of RRBs and co-operative banks, other than primary co-operative banks, while the licensing powers in respect of these institutions remained with the Reserve Bank.
- (viii) RRBs and co-operative banks (other than primary co-operative banks) submitting returns to the Reserve Bank under various sections of the BR Act, 1949, were expected to furnish copies of the respective returns to NABARD, which was accorded powers to call for information or statements from these banks.

As envisaged, NABARD continued to extend softer lines of refinance for investment credit. It helped in farm planning, training manpower to handle rural development projects, extending technical assistance in a few cases to promote entrepreneurial development and facilitating forward integration in several projects in co-ordination with the state governments.

#### FINANCIAL SUPPORT TO NABARD FROM THE RESERVE BANK

The balance remaining in the NRC (LTO) fund and the NRC (S) fund amounting to ₹ 1,025 crore and ₹ 365 crore, respectively, were transferred to NABARD. The unutilised portion of the two funds aggregating ₹ 630 crore was, however, kept with the Reserve Bank as a non-interest-bearing deposit of NABARD. This sum was released in stages on an annual basis for investment in government securities, as agreed upon between NABARD and the Reserve Bank. The Reserve Bank continued to contribute to these funds. The total contribution by the Reserve Bank to the NRC (LTO) fund and the NRC (S) fund stood at ₹ 2,355 crore and ₹ 630 crore, respectively as at end-June 1987, including the provision of ₹ 300 crore and ₹ 10 crore, respectively for 1986–87. The transfers to the NRC (LTO) fund with NABARD ranged from 23.8 per cent of the Reserve Bank profits in 1981–82 to 36.1 per cent in 1985–86, with the average working out to 31.1 per cent.

#### GENERAL LINE OF CREDIT TO NABARD

The Reserve Bank sanctioned a general line of credit to NABARD for granting short-term advances to state co-operative banks for specified purposes and to RRBs for working capital limits. A limit of ₹ 1,400 crore

was sanctioned for the year 1986–87. In view of improved profitability of NABARD, the lending rate for this line of credit was progressively raised from 5.5 per cent in 1985–86 to 5.7 per cent in 1986–87 and further to 6.0 per cent in 1987–88. The amount contributed by the Reserve Bank to NABARD by way of capital, NRC (LTO) fund, NRC (S) fund and general line of credit worked out to ₹ 3,985 crore as at end-June 1987, forming 53.0 per cent of NABARD's resources.

### TARGETS AND ACHIEVEMENTS

A noteworthy aspect of rural credit was the rapid increase in the share of institutional agencies as distinguished from non-institutional sources. According to AIRDIS, the dependence of rural households for cash debt on non-institutional agencies came down from about 93.0 per cent in 1950–51 to 83.0 per cent in 1961, further down to 71.0 per cent in 1971, to reach a low of 39.0 per cent and then to 33.0 per cent in 1981 and 1991, respectively. There was a major thrust on channelising institutional credit to the weaker sections of society in the 1980s. The outstanding credit to the agriculture and allied activities from all agencies increased from ₹ 10,200 crore to ₹ 35,300 crore between 1980–81 and 1988–89, showing an annual compound growth rate of 16.8 per cent. This strongly supported the presumption that the share of institutional credit in total rural credit increased considerably during the 1980s and that the Reserve Bank played a key role in facilitating the institutions to post such a performance.<sup>13</sup>

The Reserve Bank took several policy measures with regard to rural credit which, *inter alia*, included: a credit-deposit ratio of 60.0 per cent to be attained by rural and semi-urban branches of commercial banks; credit planning, co-ordination and monitoring under the lead bank mechanism; structural transformation at the apex and retail levels through the creation of NABARD, RRBs and farmers' service societies; ceding of primary agricultural co-operative credit societies (PACS) to a few commercial banks in areas where district co-operative central banks were weak; standardisation of unit costs of investment to avoid under financing or over financing; and case-by-case analysis of loans to rectify the defects of loan periods and quantum.

The agricultural year 1980–81 witnessed a record index of agricultural production of 135.3, which increased to 158.1 by 1985–86. The total bank

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13. Malhotra, R.N. (1990). *India's Monetary Policy and the Role of Banking System in Economic Development*. Address at the 30<sup>th</sup> National Defence Course. New Delhi. March 12.

credit outstanding to agriculture as a percentage of gross domestic product (GDP) originating in agriculture and allied activities, which increased from 7.8 per cent in 1980–81 to 11.0 per cent in 1985–86, remained at that level until the early 1990s.<sup>14</sup> A few agriculturally developed states, however, accounted for a larger share of rural credit. Five states, namely, Andhra Pradesh, Tamil Nadu, Punjab, Uttar Pradesh and Maharashtra accounted for 45.0 per cent of the total direct agricultural credit in any year. In the state of Uttar Pradesh, it was the central and western parts that received most of the direct agricultural credit and in the state of Andhra Pradesh, the coastal districts and a few Telangana districts got the major share. However, in terms of banking spread, there were fewer imbalances within various regions than across the states.

The Indian banking system played a crucial role in increasing the national savings rate and in channelising the available savings into high-priority investments. Indian banks facilitated better utilisation of available capacities both in agriculture and industry through adequate supply of credit as working capital to promote social justice by placing emphasis on the hitherto neglected sectors and sections of population and by providing finance for anti-poverty programmes, such as the IRDP.<sup>15</sup>

The PSBs cast a network of branches throughout the country, in particular, in rural and semi-urban areas. The rural and semi-urban branches increased from 5,204 as on July 19, 1969 to 43,734 as on June 30, 1989. The number of PSB branches, which stood at 4,160 in the rural and semi-urban centres as on July 19, 1969 increased to 27,226 as on June 30, 1989, registering a sharp five-fold increase, which indicated the liberal policy pursued by the Reserve Bank in expanding the branch network. The pace of growth, however, slowed down during the period 1981–1989. With the emergence of RRBs in the late 1970s and the strengthening of the co-operative sector after NABARD was established, the expansion of commercial banks decelerated during the 1980s.

RRBs, set up exclusively as the common man's bank, expanded rapidly over a period. The total number of RRBs functioning in the country increased from 102 in June 1981 to 196 in June 1989 and their branches

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14. Shetty, S.L. (2002). "Regional, Sectoral and Functional Distribution of Bank Credit: A Critical Review", Paper presented at the workshop on *Financial Liberalisation and Rural Credit in India*. ISI, Kolkata. March.

15. Singh, Manmohan (1984). *Indian Banking System in the Seventh Five Year Plan*. Speech delivered at the founders' day of Bank of Maharashtra. Pune. September 16.

expanded from 3,598 covering 172 districts in 18 states to 14,090 spread over 370 districts in 23 states during the period. But for the Reserve Bank's support in terms of concessions in cash reserve ratio (CRR) and preferential treatment in opening of branches, such massive expansion and extensive reach of RRBs would not have been possible.

The progress of the three-tier expansion in the co-operative credit structure, *viz.*, the state co-operative banks, central co-operative banks and PACS, apart from the state/central LDBs, was rapid in terms of their spread and enhancement of membership in rural and semi-urban areas. At the grassroots level, the membership of PACS increased by more than 59.0 per cent during 1981 to 1989. These institutions assumed a critical position and undertook tasks, which in the pre-nationalisation period might not have been regarded as the legitimate responsibility of a credit institution. In this context, it was felt that transformation in credit deployment was brought about by conscious policy decisions. The switch away from the market mechanism guided by the criterion of maximisation of profits to financing was an important contributory factor in bringing about a dramatic change. The proportion of rural deposits to total deposits shot up from around 6.0 per cent in 1969 to 15.0 per cent in 1987, as a result of policy measures of the Reserve Bank in the 1980s.

To ensure that rural deposits were not used to finance urban credit, the Reserve Bank directed that each rural and semi-urban branch must attain a credit-deposit ratio of 60.0 per cent. Between 1969 and 1987, rural credit as a proportion of total credit outstanding went up from 3.0 per cent to 15.0 per cent. The credit-deposit ratio went up from under 40.0 per cent in 1969 to nearly 70.0 per cent in 1984, and remained above 60.0 per cent until the late 1980s. Fixing the quantum of lending to the priority sector and the rate of interest on the same varied from year to year. These decisions were taken in accordance with the economic policies, the annual budget commitments and indications from the Central Government.

The flow of resources to the priority sector and within these to the weaker sections of society increased during the year 1981-82 and general guidelines were issued to banks to enhance advances to these segments in such a way that these loans constituted 40.0 per cent of the aggregate bank advances by 1985. Further, 40.0 per cent of priority sector finance was earmarked for agriculture and allied activities, so that this segment would account for at least 16.0 per cent of the total credit by 1985. Specific measures were also introduced to ensure that weaker sections within the

priority sector received the maximum benefit. The weaker sections<sup>16</sup> were defined and banks were advised to ensure that at least 15.0 per cent of direct advances went to agriculture, and at least 12.5 per cent of their total finance to SSIs flowed to weaker sections by March 1985. Banks were further advised to earmark ₹ 100 crore for housing finance. They were also counselled to pay greater attention to attaining sub-targets in respect of weaker sections of society identified under the new twenty-point programme, small and marginal farmers, SCs/STs and women entrepreneurs. Command area of irrigation projects and financing of infrastructure for successful implementation of the IRDP were other points of emphasis for the purpose of adequate funding.

In 1985, the Credit Planning Cell (CPC) received a reference from the RPCD to examine the possibility of revising priority sector targets and sub-targets, as desired by the Government. The CPC took the stand that 82.0 per cent of banks' resources were pre-empted by statutory requirements, *i.e.*, CRR and statutory liquidity ratio (SLR) reserves at 56.0 per cent including incremental requirements, food credit at 8.0 per cent and priority sector advances at 18.0 per cent. This left banks with only 18.0 per cent of lendable resources<sup>17</sup> to manage the other credit portfolio. The flexibility of banks to further stretch loan provisions for the priority sector was narrowed, as banks were also required to undertake a speedy rectification of any shortfalls in daily maintenance of SLR. The cell was of the view that a further step-up in the overall target for priority sector advances would dilute the concept of priority, as bulk of credit would be deemed as priority. It was, therefore, suggested that in the next few years, the focus should be on effectively attaining already stipulated targets/sub-targets.

It was also reiterated that the issue of revising targets/sub-targets for priority sector had to be viewed from the angle of profitability of banks. In support of this, the cell highlighted the observations of the committee to review the working of the monetary system (Chakravarty Committee):

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16. The weaker sections were defined in the third volume of the RBI history as small and marginal farmers, landless labourers, and borrowers from allied activities with credit limits up to ₹ 10,000. Similarly, in the SSI sector, units and borrowers with credit limits up to ₹ 25,000 were to be treated as weaker sections. Third, the socially weaker sections of society (also known as underprivileged) were, as a class, financially weak, and lacked bargaining power and articulation in getting their grievances redressed.

17. Reserve Bank of India, internal note, CPC, January 1, 1986.

Credit planning and monitoring by the central bank, and credit budgeting by the larger public sector banks are, therefore, tools which must be employed to ensure the desired allocation of credit, irrespective of the level of target set for money supply in the light of macro-economic considerations by making use of monetary targeting techniques. Again, the special features of credit extension to the preferred sectors and the complex institutional arrangements necessitated by the nature and magnitude of the task would call for major modifications in the operational and policy framework within which the traditional instruments of monetary policy are generally expected to be used.

The Chakravarty Committee stressed the need for co-ordination between banks and the government agencies for successful implementation of programmes for priority sector lending and improving the recovery of dues. During 1985-86, SCBs achieved the stipulated target of 40.0 per cent for priority sector advances. The data for 50 SCBs, which accounted for 95.0 per cent of gross bank credit, showed that loans to the priority sector had recorded an expansion of ₹ 3,175 crore during 1985-86 (April-March), raising the share of such advances in net bank credit to 40.9 per cent as at end-March 1986 as compared with 39.8 per cent achieved in the previous financial year. As at end-March 1986, the share of finance to agriculture and SSIs in total priority sector credit also increased marginally to 42.0 per cent and 36.2 per cent, respectively. A year before, the respective percentage shares were 41.6 per cent and 35.9 per cent.

The government policy in the 1980s towards rural credit continued to be liberal and, as indicated in an earlier section, the thrust on eradicating poverty, reducing inequality of income through the development of agriculture, providing employment opportunities and uplifting weaker strata of the society was explicit in the budget speeches of the respective Finance Ministers during the period 1982-83 to 1988-89. The sustained expansion in bank credit in real terms for agriculture, SSIs and other informal borrowers during the latter half of the 1970s and the decade of the 1980s served, *inter alia*, as an important factor in acceleration of growth rates in agriculture and unregistered manufacturing. Similarly, acceleration in employment growth from 1.5 per cent per annum during the period 1977-1983 to 2.7 per cent during 1983-1994 and, more significantly, the non-farm employment growth in rural areas that showed outstanding performance in the 1980s, appeared to have been brought about by better sectoral, regional and size distribution of bank credit. Overall, rural branch

expansion appeared to be an important causal factor, which helped the Indian economy pierce through the low rate of growth of 3.5 per cent during the three decades after independence and attain a growth rate of 5.5 per cent per annum in the 1980s. On a substantive plane, this was explained by various policy interventions during the period, such as the IRDP bank lending for priority sector, the progressive taxation system and greater involvement of the public sector in development programmes.

In September 1987, in a meeting of the chief executives of PSBs, the Minister of State for Finance, while expressing satisfaction over the achievements of the banking system asked banks to do much more in implementing anti-poverty and employment promotion programmes. He also called on bank chiefs to motivate their staff to provide a helping hand to weaker sections of the community with a sense of devotion and commitment, since people had great expectations from them.

Apart from improving banking facilities in rural and semi-urban areas, banks continued their efforts to reduce disparities in credit-deposit ratio across regions. For the banking system as a whole, credit-deposit ratio for rural branches improved from 62.5 per cent in June 1984 to 65.6 per cent in June 1985. In the case of semi-urban branches also, the credit-deposit ratio improved to 52.8 per cent from 50.9 per cent the year before.

During 1987–88, PSBs continued to meet the targets and sub-targets fixed for priority sector advances and stepped up lending under special schemes. The proportion of priority sector advances of PSBs to total outstanding bank credit registered an increase from 44.1 per cent as at end-December 1986 to 45.7 per cent as at end-June 1988. PSBs achieved the target of extending 10.0 per cent of their total advances (or 25.0% of their priority sector advances) to weaker sections. They not only complied with the requirement of lending at least 16.0 per cent of their total credit as direct advances for agriculture as on March 1987 but also almost reached the level of 17.0 per cent required to be maintained by March 1989. The 28 PSBs extended financial assistance under the twenty-point programme to the tune of ₹ 8,855 crore under approximately 190 lakh borrowers' accounts as on the last Friday of March 1988, constituting 31.1 per cent of their total priority sector advances or 14.3 per cent of their total bank credit.

Lending under the differential rate of interest (DRI) scheme for PSBs made considerable progress and exceeded the prescribed targets well ahead of schedule. Credit disbursal up to June 1984 constituted 1.1 per cent of aggregate advances as at the end of the previous year, thus exceeding the

target of 1.0 per cent. The coverage of DRI scheme in respect of SC/ST borrowers also expanded beyond expectations with 49.4 per cent of total advances going to them against a target of 40.0 per cent during the year 1984. The number of accounts covered under the scheme increased from 27 lakh as at end-June 1981 to 47.7 lakh as at end-March 1989, and the amount of loan outstanding in these accounts, which was ₹ 598 crore in December 1987, increased to ₹ 680 crore at end-March 1989. The extent of involvement of SCBs in financing the priority sector is reflected in Table 8.4.

TABLE 8.4  
*Position of Priority Sector Advances of SCBs*

(₹ crore)

<i>Year</i>	<i>Agricultural Advances</i>	<i>Total Priority Sector Advances</i>	<i>Net Bank Credit</i>
June 1982	4,594 (43.0)	10,673 (37.0)	28,821
June 1983	5,375 (42.5)	12,637 (36.8)	34,298
June 1984	6,551 (41.2)	15,894 (38.4)	41,378
June 1985	7,978 (41.5)	19,208 (40.0)	48,050
June 1986	9,391 (42.1)	22,302 (41.8)	53,381
June 1987	10,852 (41.8)	25,980 (43.2)	60,104
June 1988	12,285 (41.2)	29,845 (44.0)	67,792
June 1989	14,133 (40.1)	35,242 (42.4)	83,192

- Notes:*
1. Data relate to 50 SCBs which account for about 95.0 per cent of gross bank credit.
  2. Net bank credit data are exclusive of bills rediscounted with the Reserve Bank, Industrial Development Bank of India (IDBI), Exim Bank and other financial institutions (OFIs).
  3. Under agriculture: figures in parentheses indicate percentage share to total priority sector advances.
  4. Under priority sector advances: figures in parentheses indicate percentage share to net bank credit.

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

During 1988-89, PSBs continued to exceed targets and sub-targets fixed for priority sector finance. The proportion of priority sector advances of PSBs stood at 44.6 per cent of the net bank credit as at end-June 1989, which was higher than the prescribed target of 40.0 per cent. Similarly, the proportion of PSBs' credit to weaker sections was 11.1 per cent of their total outstanding resources disbursed as loans as at end-

June 1989 as against a target of 10.0 per cent. The share of credit to SCs and STs in priority sector advances stood at 7.6 per cent at the end of the above period. The PSBs provided financial assistance under the twenty-point programme to the tune of ₹ 11,270 crore in approximately 230 lakh borrowers' accounts on the last Friday of June 1989, constituting 32.3 per cent of their total priority sector lending or 14.4 per cent of the net bank credit. Under the DRI scheme, the outstanding credit as at end-June 1989 was ₹ 665 crore, which constituted 0.9 per cent of their total outstanding loans. The resources granted under the scheme to beneficiaries belonging to the SC/ST also exceeded the prescribed target of 40.0 per cent of DRI advances.

Advances to priority sector by Indian banks in private sector as at end-June 1988 constituted 39.8 per cent of their total loans; their direct finance to agriculture formed 9.1 per cent of the total sum lent, while those to weaker section constituted 5.2 per cent of their total advances. The DRI advances formed only 0.4 per cent of the total credit extended as against the target of 1.0 per cent. In August 1988, foreign banks were advised that their priority sector advances should reach a level of 10.0 per cent of their aggregate outstanding credit by end-March 1989. This target was increased to 12.0 per cent and further to 15.0 per cent by end-March 1990 and end-March 1992, respectively.

Yet another area of banks' involvement was the special foodgrains production programme (SFPP), which was a two-year programme implemented in 169 'thrust districts' in 14 states from the 1988 *kharif* season. Under this programme, commercial banks provided credit of the order of ₹ 352 crore.

The credit-deposit ratio of SCBs increased to 60.1 per cent at end-June 1989 as against 57.3 per cent the year before. The credit-deposit ratio of rural branches of all commercial banks stood at 64.3 per cent at end-December 1988, which was well above the stipulated target of 60.0 per cent. The rural branches of PSBs had attained a credit-deposit ratio of more than 60.0 per cent in as many as 14 states/UTs; however, the ratio in their semi-urban branches was around 50.0 per cent as against the envisaged level of 60.0 per cent. The economic profile of semi-urban areas with a predominance of trading and service activities, which had less potential for bank lending but generated relatively larger deposits, explained this persistent low level of credit-deposit ratio in those areas.

## REGIONAL RURAL BANKS

RRBs, established in the late 1970s as the common man's bank, made rapid progress in terms of branch expansion, deposit mobilisation and dispensation of credit to the desired sectors and sections of society. The steering committee on RRBs identified additional districts for setting-up RRBs and as a result, 183 RRBs were established as against the target of 170 to be achieved by 1985. During the period 1985-87, 13 more RRBs were established taking the total number to 196, covering 354 districts as at end-April 1987, and the number stood at that since then.

Based on the recommendations of the working group on the development of scheduled castes and scheduled tribes in September 1982, RRBs were asked to formulate their credit plans, taking into account the needs of these communities and to draw up special bankable schemes to ensure a large flow of credit to them for self-employment. The banks were encouraged to consider loan proposals from such communities favourably.

A field study on quality of lending by RRBs conducted in the early 1980s revealed, *inter alia*, that the basic aim of setting-up RRBs was largely achieved and that they had successfully maintained their image as a small man's bank by confining their credit facilities to the target group.

In 1987, the Government set up a working group chaired by Shri Kelkar to examine the structure of RRBs and suggest measures to improve their overall capabilities. The recommendations, which were accepted included, *inter alia*, to increase the paid-up capital from ₹ 25 lakh to ₹ 100 lakh; sponsor banks should reduce the lending rate for refinance to RRBs from 8.5 per cent to 7.0 per cent; allow RRBs to invest their surplus funds in government and other trustee securities instead of keeping them in current account with the sponsor banks in order to improve their profitability; and sponsor banks should play a more proactive role in funds management, staff training and internal audit of RRBs. The committee recommended that these banks should abstain from financing bigger borrowers so as to retain their stature of the small man's bank.

As at end-June 1986, nearly 80 RRBs had a recovery rate of less than 50.0 per cent, and as many as 150 RRBs were posting losses, which amounted to ₹ 90 crore. In the case of 49 RRBs, the accumulated losses had used up their entire share capital. A number of RRBs were also unable to comply with the statutory requirements in respect of liquidity and cash reserve maintenance.

CRAFICARD had recommended that RRBs should continue their operations to support weaker sections. Earlier, the Dantwala Committee (1978) had termed RRBs as an integral part of the rural credit structure, and considered routing the credit through the PACS, thereby strengthening them. The agricultural credit review committee under the chairmanship of Shri A.M. Khusro, constituted in August 1986, submitted its report in August 1989. The committee came out with critical observations and made far-reaching recommendations in this context.<sup>18</sup> In the case of RRBs, the Khusro Committee concluded that there was no place for RRBs in the rural credit system and that they should be merged with the sponsor banks. It was emphasised that the merger recommendation did not mean any dilution of concern for the common man. On the contrary, the intention was to give the common man a stronger institution to serve his needs more efficiently. The objective was to ensure service to the poor and not poor service.<sup>19</sup>

## DEVELOPMENTS IN CO-OPERATIVE CREDIT

### REORGANISATION OF PACS

Recognising the need for a strong and viable base-level co-operative structure as an important prerequisite and to make co-operatives an effective channel for purveying rural credit, the Reserve Bank continued efforts in this direction through the 1980s. The state governments were urged to complete the reorganisation of primary-level institutions expeditiously. Barring three states, *viz.*, Gujarat, Maharashtra and Jammu & Kashmir, all the others had more or less completed the re-organisation programme.

### STUDY GROUP ON FINANCING OF PACS BY COMMERCIAL BANKS

The study group on financing of PACS by commercial banks submitted its Report in August 1981. The findings revealed that this arrangement had failed to achieve its major objectives and did not make a perceptible impact on the functioning of such societies associated with commercial banks. The group, therefore, felt that no useful purpose was served by continuing with this arrangement. The agricultural credit board (ACB)

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18. Appendix 8.1 provides a summary of the observations and recommendations of the Khusro Committee.

19. Khusro Committee report, p.935.

considered the report and recommended that it should be left entirely to the concerned societies to decide whether they preferred to continue their links with the commercial banks or wanted to be transferred back to the district central co-operative banks to which they were affiliated.

STUDY ON DEPLOYMENT OF RESOURCES BY STATE  
AND CENTRAL CO-OPERATIVE BANKS

A study group was constituted on deployment of resources by the state and central co-operative banks in March 1981 to examine the problem of surplus resources and profitable investments of lendable internal resources. The report of the group submitted in August 1981, made recommendations for profitable deployment of resources. In light of these recommendations, the Reserve Bank issued guidelines to state co-operative banks, advising them of avenues to deploy their surplus resources.

STANDING COMMITTEE ON TERM LENDING  
THROUGH CO-OPERATIVES

The Reserve Bank appointed a standing committee on term lending through co-operatives (COTELCOOP) in November 1981 under the chairmanship of a Deputy Governor to review, on a continuing basis, the operations, policies and procedures of land development banks (LDBs).<sup>20</sup> The terms of reference of the committee included: to review the organisational capabilities of LDBs in the context of project lending and prompt recycling of resources; to examine the loan policies and procedures of LDBs, and provide guidance for their rationalisation and improved financial management; to review the recovery performance of LDBs; to formulate a time-bound rehabilitation programme for weak LDBs and monitor its implementation; to review the norms for fixing the lending programme of LDBs; and to bring about functional co-ordination between LDBs and PACS in order to ensure sound growth of SLDBs. In light of the reports submitted by expert groups, which examined measures for improving the overall organisation, management and finance of LDBs in six states, *viz.*, Tamil Nadu, Karnataka, Bihar, Madhya Pradesh, Gujarat and Maharashtra, the committee communicated to these state governments various measures that they should adopt to improve the overall operational efficiency of the primary LDBs/branches of the SLDBs.

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20. Reserve Bank of India, *Annual Report, 1981-82*.

## OTHER DEVELOPMENTS

The Reserve Bank communicated to the state co-operative banks various areas covered in the new twenty-point programme where the banks could play a meaningful role. These included financing of minor irrigation schemes; provision of credit to bring more areas under intensive cultivation of pulses and vegetable oilseeds; provision of full finance for various schemes under the IRDP, particularly to SCs/STs so as to alleviate their poverty; financing of co-operatives engaged in distributing essential commodities in order to build a strong consumer movement and make available the necessities to the common man at competitive prices by eliminating the middlemen; and encouraging handloom weavers and other rural artisans to set up co-operatives by providing adequate credit to ensure continuous gainful employment.

The Khusro Committee remarked on the performance of the co-operative system and stated: "Co-operation has failed in India because it has been state-sponsored and state-patronised." The excessive state intervention in the affairs of co-operatives rendered the leadership ineffective and democratic management of co-operatives unsuccessful. The committee noted that a major weakness of the system was the neglect of base-level institutions and the tendency of high level institutions to look after their own interests, often at the cost of the primaries. Further, "The co-operative credit system had failed miserably in executing its basic responsibility towards mobilising deposits, with the lower tiers looking up to the higher tiers for refinance at all levels. Progressive politicisation had caused extensive damage to the system and had reached such immense proportions that unless the trend was reversed, the agricultural credit system and the co-operative credit system, in particular, would get seriously jeopardised." The committee recommended the setting-up of a National Co-operative Bank of India (NCBI) as well as a separate corporation to implement the crop insurance scheme.

## SPECIAL SCHEMES AND PROGRAMMES

During the period, there was a continued interplay between the Government and the Reserve Bank in harmonising regulatory guidelines to banks and aligning them with the Government's schemes and programme objectives. The Government, in consultation with the Bank, regularly monitored these developments and brought in necessary changes to improve programme effectiveness.

## INTEGRATED RURAL DEVELOPMENT PROGRAMME

The IRDP was introduced in the mid-1970s to improve the lot of the poorest of the poor. The official review in 1981 established that the progress in the disbursal of institutional credit under this programme was not satisfactory and the Reserve Bank had to issue fresh guidelines in December 1981 to all the operational agencies to gear up their machinery to achieve stipulated annual targets. This was followed by a meeting of the Governor with the chief executives of PSBs in February 1983. Banks were asked to ensure that effective action was taken to meet their targets and to monitor the end-use of funds to realise the programme objectives. They were advised to issue loan passbooks to IRDP beneficiaries to apprise them of the exact amount of the loan, the amount outstanding and the period of repayment; to strictly comply with the guidelines on additional security for small loans; to appoint staff with the necessary aptitude, skills and expertise; to finalise repayment schedules in a realistic manner; and to fix the repayment period taking into account factors such as repayment capacity and the life of the asset created from the loan amount.

The Reserve Bank advised the lead banks in July 1984 to ensure that they actively organised workshops in their lead districts to train bank personnel (commercial and co-operative) as well as government officials at the district level. During the Sixth Plan, 16.6 million families were assisted under the programme against the target of 15.0 million families, and term-credit to the tune of ₹ 3,102 crore was disbursed. However, since evaluation reports on implementation of IRDP by various agencies indicated that 60.0 per cent of the assisted families were unable to cross the poverty line, a scheme to provide supplementary assistance to certain eligible categories of borrowers assisted during the Sixth Plan was initiated in 1985-86, besides covering new beneficiaries. The supplementary assistance was extended to help borrowers who were not defaulters and had either maintained the financed assets in good condition or lost them for reasons beyond their control. The central sector outlay for the programme was ₹ 1,187 crore. A target of 20.0 million families was set for assistance under the IRDP during the Seventh Plan period. This included 10.0 million families who were assisted during the Sixth Plan but could not cross the poverty line and were to be given a second dose of assistance. The banks extended assistance to 11.1 million families during the first three years of the Seventh Plan. Of the beneficiaries, 4.9 million belonged to SCs/ STs and 1.2 million were women.

The Government issued fresh guidelines for the implementation of the IRDP during the Seventh Five Year Plan, revising the poverty line from an annual family income of ₹ 3,500 to ₹ 6,400. However, for identifying the families, a lower cut-off point was fixed, *i.e.*, an annual income of ₹ 4,800. Further, in view of interstate variations and disparities in the incidence of poverty, it was decided to allocate funds under the IRDP in relation to the incidence of poverty in each state. A separate target of 30.0 per cent was fixed to cover women beneficiaries.

A study group was set up by the Reserve Bank in November 1985 under the chairmanship of Shri A. Ghosh, Deputy Governor, to streamline the arrangements for flow of credit and supply of inputs and assets to the IRDP beneficiaries so that they could draw full benefits of the anti-poverty programme. Banks were advised to implement, on an experimental basis, a system of cash disbursement of the IRDP assistance for specified purposes in 22 selected blocks all over the country effective April 1, 1986. The achievements under the programme are highlighted in Table 8.5.

The Government's concurrent evaluation of assistance provided under the IRDP on a continuous basis, beginning October 1985, found several irregularities in implementing the scheme, such as, accommodating ineligible borrowers, excluding eligible borrowers, inordinate delays in sanctions, concentration of the scheme in one or two categories as against the directives to cover wider segments and non-adherence to the selection process. Banks were advised to arrange crash training programmes for officers in rural branches at the district level to familiarise them with the instructions/guidelines relating to bank finance for special programmes like the IRDP.

TABLE 8.5  
*Achievements under the IRDP*

	(Lakh)				
	1985-86	1986-87	1987-88	1988-89	1989-90
No. of families assisted	30.6	37.5	42.5	37.7	33.5
No. of SC/ST families	13.2	16.8	19.0	17.5	15.4
No. of women beneficiaries	3.0	5.7	8.3	8.7	8.6

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

## THE NEW TWENTY-POINT PROGRAMME

After the Prime Minister announced the new twenty-point programme<sup>21</sup> in January 1982, the Reserve Bank appointed a working group chaired by Shri A. Ghosh, Deputy Governor, in March 1982, to formulate the modalities of implementing the programme. The group was to identify the tasks for the banking system. The other terms of reference were to review the targets and sub-targets within the priority sector with specific reference to the needs of weaker sections; to examine the scope for modifications in the definition of the priority sector; and to review the reporting and monitoring system regarding the flow of credit to the new programme with a view to simplifying and expediting flow of information and making evaluation more effective.

The group identified the beneficiaries and the type of assistance, which could be rendered. The group also stressed the need to ensure that the schemes for the beneficiaries were viable and that there was effective co-ordination between the state governments and banks.

The Reserve Bank accepted the recommendations of the working group on the role of banks in implementing the new programme, with some modifications. Banks were accordingly urged to draw up detailed operational plans to achieve various targets and to assess their performance *vis-à-vis* the overall priority sector target; attention was drawn to the sub-targets in respect of direct finance to agriculture (15.0% of total credit to be attained as at end-March 1985 and 16.0% as at end-March 1987) and advances to weaker sections (10.0% of total credit to be attained at end-March 1985).

The amount of ₹ 100 crore earmarked by banks for housing finance during 1982-83 was raised to ₹ 150 crore. Banks were advised to pay greater attention to the attainment of sub-targets for weaker sections of society as identified under the new Programme, the credit needs of small and marginal farmers, SC/ST categories, women entrepreneurs, command areas of irrigation projects, banking infrastructure for successful implementation of the IRDP and quality and promptness of customer service.

Target groups of beneficiaries under the new programme were also identified within the priority sector. The scope of advances to priority sector

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21. The third volume of the Reserve Bank's history refers to the twenty-point programme that was conceived to assist specific economic activities in villages and rural areas.

was widened to cover housing loans for SCs/STs and economically weaker sections and also to cover consumption loans under the programme. The banks were asked to pay special attention to providing assistance to beneficiaries within the district credit plans (DCPs). The lending procedures of the banks were simplified further to ensure that small loan applications were disposed of within three to four weeks. Security and margin requirements were relaxed for this purpose; for example, banks were to take only demand promissory notes for crop loans of up to ₹ 1,000. For artisans, craftsmen and village and cottage industries, banks were asked not to insist on securities other than hypothecation of assets. Moreover, the IRDP was extended to all blocks with a view to providing greater financial assistance to weaker sections of society.

The PSBs extended financial assistance amounting to ₹ 5,531 crore under the new programme as at end-March 1985, covering 115 lakh accounts.

#### LEAD BANK SCHEME

The Reserve Bank set up a working group chaired by Shri U.K. Sarma, Executive Director, in November 1981, as per the recommendations of CRAFTICARD to review the working of the LBS. The terms of reference of the group included, *inter alia*, to review the working of the LBS in preparing and implementing DCPs and to suggest, in light of recommendations of CRAFTICARD, improvements for proper and effective co-ordination of activities among the participating organisations; to review the role of the lead banks and suggest measures to make them more effective; to advocate ways to improve the organisational structure of lead banks and non-lead banks at the district and other levels; and to examine the role of district consultative committees and standing committees and make suggestions for their effective functioning. The recommendations were accepted, *albeit* with modifications, for implementation in 1982.

As per the instructions issued to state governments and commercial banks, DCPs for 1983–1985 and annual action plans (AAPs) for 1983 were prepared and launched in all the districts, except for a few in the north-eastern region. The AAPs for 1983–84 were also finalised for most districts. The third round of DCPs ended in March 1985.

Pending a decision on the coverage of the fourth round of DCPs under the Seventh Five Year Plan, the AAP for 1985 was finalised and launched in all the lead districts, except for a few in the north-eastern region. In September 1984, the Reserve Bank issued guidelines to banks to ensure

integration of targets under the AAP outlays and performance budgets of bank branches.

The Government set up a working group under the chairmanship of Shri A.K. Agarwal, Joint Secretary, Banking Division, Ministry of Finance in March 1985 to review some aspects of the LBS and suggest measures to make the scheme more effective and result-oriented. The terms of reference included, *inter alia*, examining the role of various forums at the block/district/state levels and suggesting a more rational framework for such three-tier committees.

Pending finalisation of the guidelines for the fourth round of DCPs, lead banks were advised to prepare the AAPs for the subsequent years and, accordingly, the AAPs for 1986 (except for three districts in Nagaland) and 1987 were prepared and launched for implementation in all districts of the country.

As at end-December 1987, the LBS covered 438 districts in the country. According to the guidelines, the preparation of DCPs for 1988–1990 (fourth round) and the AAPs for 1988 were complete and the plans were implemented in all the districts. The achievement under the AAPs for 1987 was ₹ 10,940 crore as against ₹ 10,110 crore under similar plans for 1986.

At this point, a question was raised regarding the effectiveness of the Lead District Officers (LDOs). There were representations from various quarters that the status of the LDO did not give him sufficient authority to co-ordinate with other banks and government officials, and it was suggested that his rank should be elevated to at least that of an assistant general manager (AGM). The Reserve Bank, however, did not consider it necessary to upgrade the status of the LDOs.

The performance of the United Bank of India (UBI) was not considered satisfactory and there was a demand to change the lead bank in the state of Assam to the State Bank of India (SBI). The Reserve Bank, however, decided not to bring in any change in view of the pattern of branch network and lending by these banks in the state. The UBI was, against this backdrop, advised to shore up its delivery capabilities in the state.

In the context of the implementation of the LBS, the position of banks and branches in the 1980s was very vulnerable. No event could take place in such offices without the participation of a Member Parliament (MP) or the local Members of Legislative Assembly (MLAs). The local MP had to be invited even for opening of a branch and he had to be involved in all district level review committee (DLRC) meetings of banks. In one case where a branch was opened without inviting the local MP, the MP took up

the matter with the Ministry of Finance, stating that the bank authorities were not following the instructions of the Government regarding the issue of loans to the grieved persons under the government schemes and also for various functions conducted by them. It was further emphasised that the MPs should be invited for all the functions.<sup>22</sup> The Reserve Bank was asked to offer its comments by the finance ministry.<sup>23</sup> On the basis of the decision taken by the Central Government, the Reserve Bank advised the regional offices of RPCD to issue necessary instructions to the convenor banks that local MLAs/MPs were to be invited to all the DLRC meetings.

In several states there were demands from political quarters to put in place the above arrangements. The Reserve Bank had on an earlier occasion permitted inviting non-officials to cover principal groups of beneficiaries of bank credit in cases where activity/occupation was central to the district economy. The matter of inviting MPs and MLAs for the DLRC meetings was discussed internally and views of the concerned officials from the states were also considered. In this context, it was observed:<sup>24</sup>

The attitude of the elected representatives of people has generally a political bias and very often considerations other than economic and social are reflected in the views aired by them. By throwing open the doors of the DLRCs to MPs and MLAs, we feel that the entire LBS will be gradually politicised and the day will not be too far when entry will have to be allowed to politicians into DCC meetings as well. Further, the question as to whether elected representatives of people could represent any principal group of beneficiaries of bank credit central to the economy of the district is a debatable issue. Our experience in associating a cross-section of non-officials other than politicians with DLRC meetings has been generally satisfactory.

Subsequently, the Government decided that all local MPs and MLAs should be extended invitation to attend DLRC meetings. There was, however, disagreement in the Reserve Bank top management on the issue. In this context, Dr P.D. Ojha, Deputy Governor noted:<sup>25</sup>

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22. Letter dated June 15, 1989 from Shri C.K. Kuppuswamy, MP, Coimbatore.

23. File No.PL 09.02 RPCD, guidelines on advances to priority sector, Reserve Bank of India.

24. Letter from District Co-ordinating Office (DCO), Thiruvananthapuram dated January 7, 1989 to RPCD Central Office.

25. Reserve Bank of India, internal note dated March 1, 1989.

As per our present policy, non-officials are allowed to be invited to attend the District Level Review meetings convened by lead banks. There is no need to change it. Village *panchayats*/local MLAs/MPs having special knowledge of the activities of the areas can be associated with the meetings of District Level Reviews. District Consultative and Block-level Bankers' committees should be business-like and only officials should be associated with these as at present.

The Governor, Shri R.N. Malhotra, expressed that the proposed instructions were vague. He observed that "we should instruct that at the meetings of DLRC, MPs and MLAs of the district should be invited."<sup>26</sup> Accordingly, the Reserve Bank issued a circular to the chairmen of all lead banks on April 13, 1989, instructing them to invite all local MPs and MLAs to DLRC meetings in future.

#### SERVICE AREA APPROACH

The SAA, introduced in 1988, was expected to contribute to orderly and planned development of credit in identified service areas (a group of contiguous villages) of each rural/semi-urban branch of commercial banks and RRBs. The approach was intended to help intensify supervision of end-use of credit and recovery of loans. The scheme was also expected to assist in harmonising the efforts of banks in providing credit for rural development activities with those of co-operative institutions and other development agencies and avoid diffusion of efforts. The Reserve Bank instructed banks to adopt this new approach early. The process of identifying service areas and allocating villages to each branch, which was the first stage of implementation, was largely completed by June 30, 1988. The service area of each branch normally comprised 15–25 villages but could vary from state to state. At the next stage, the respective branches took up a potentiality survey of the service area and formulated credit plans on an annual basis. Other basic features of this system of lending were systematic implementation of credit plans along with a mechanism for continuous monitoring of progress, avoiding duplication of efforts and co-ordinating with other institutional agencies that provided non-credit inputs. A country-wide training programme was launched to ensure that the new approach was made effective. Instructions were issued to avoid disruption of credit flow during the transition period.

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26. Reserve Bank of India, internal note dated March 9, 1989.

The basic objective of the SAA, which became operational effective April 1, 1989, was to make rural lending more productive and purposeful. As at end-June 1989, credit plans were prepared by all 42,000 branches covering 6 lakh villages. The annual branch credit plans were grouped into block credit plans, which in turn were regrouped into the DCPs. To conform to the norms prescribed under this system, additional licences were issued to banks (including RRBs) to open branches at 1,416 out of 3,049 identified centres up to November 1989. Block-level bankers' committees were constituted for effective co-ordination among credit institutions and with field-level development agencies. The new system was expected to lead to distinct improvement in the quality of rural lending and help forge better links between bank credit, productivity and income levels.

In the mid-1980s, when the loan *melas* reached a feverish pitch, the Reserve Bank defined the service area for each branch, which helped bankers withstand the pressure of indiscriminate lending. The move, however, invited the displeasure of the Government, as per a media report released at a later date.<sup>27</sup>

#### DIFFERENTIAL RATE OF INTEREST SCHEME

The DRI scheme was introduced in June 1972. Under this scheme, banks were to provide credit at a very low rate of interest of 4.0 per cent per annum to the weakest among the weaker sections of society to enable them to improve their income levels and economic conditions through productive endeavours on a modest scale. The scheme was reviewed periodically and modifications were made therein, in order to maintain consistency with the social and economic objectives in raising the share of poorer sections in national income, consumption and utilisation of public services. Such specific action programmes designed essentially to assist in eliminating unemployment and poverty, were in focus during the 1980s also and the Reserve Bank placed special emphasis on such endeavours in conformity with government policies and priorities.

A study by the National Institute of Bank Management<sup>28</sup> (NIBM) showed that the DRI scheme had penetrated into a large number of small and far-flung areas in the country and had made the common man conscious of the efforts being made collectively by the Government and

27. *The Economic Times*, May 6, 2010.

28. Chawla, O.P., K.V. Patil and N.B. Shete (1983). "Impact of Differential Rate of Interest", *NIBM Faculty Occasional Papers* (Book Review). December. p.214.

banks for his economic upliftment. The proportion of DRI advances by banks to total credit touched 1.2 per cent in December 1981, thereby exceeding the target of 1.0 per cent set under the modified DRI scheme. The coverage of SCs and STs under the scheme also improved; the share of these categories of borrowers in total DRI advances of banks was 47.9 per cent in 1981 as compared with the target of 40.0 per cent. Further, 73.2 per cent of the banks' DRI advances in 1981 were channelled through their rural/ semi-urban branches as compared with the target of two-thirds fixed for advances in these areas.

Nevertheless, the NIBM study highlighted some disturbing features in the working of the DRI scheme. It was found that many people were not aware of the DRI scheme or its benefits for borrowers. Further, many ineligible borrowers had managed to secure loans under the DRI scheme by understating their family incomes. In a large number of borrowers' accounts, there was a mismatch between the loan amount sanctioned, the amount actually needed for the activity, the loan terms and the periodicity of repayments, thus sowing the seeds of borrower delinquency and non-fulfilment of the DRI objectives right from the beginning.

The DRI scheme was extended to include private sector banks so that its coverage could be widened to the entire country. Private sector banks were directed to ensure that at least two-third of their advances under this scheme were routed through their rural and semi-urban branches. The scheme was also modified to allow banks to route such advances through RRBs on a refinance basis.

#### COMPREHENSIVE CROP INSURANCE SCHEME

From the 1985 *kharif* season, the Government introduced a comprehensive scheme for crop insurance throughout the country, covering major crops, *viz.*, rice, wheat, millets, oilseeds and pulses. The scheme was to operate in the defined areas for each crop as notified by the Government. The scheme was intended to cover all the farmers availing of crop loans from co-operative credit institutions, commercial banks and RRBs to raise these crops, and insurance cover was built in as part of the loan. The sum insured was 150.0 per cent of the amount of loan disbursed and the insurance premium was included in the scale of finance for the crop loan. The Reserve Bank advised commercial banks to participate actively in the scheme.

Initially, the scheme was implemented in states where the state governments agreed to implement the same. During the 1988 *khari*f season, the scheme was implemented in 13 states and 2 UTs. The Government decided subsequently that the comprehensive crop insurance scheme (CCIS) be continued in the 1988–89 *rabi* season only in states where premia towards the scheme had already been recovered.

#### CREDIT TO MINORITY COMMUNITIES

In line with the Prime Minister's fifteen-point programme for the welfare of minority communities, the Reserve Bank advised all banks in July 1986 to take steps to facilitate the flow of adequate credit to minority communities. These included setting-up of special cells to look after minorities' interests in areas that had a large concentration of minority communities, conducting periodic reviews of steps taken as well as progress made and publicising anti-poverty programmes in such areas with a large population of minorities.

As at end-December 1987, priority sector advances by PSBs to minority communities in 40 identified districts amounted to ₹ 429 crore with 8 lakh borrowal accounts. All PSBs set up special cells at their head offices and at the lead banks of the identified districts and designated one officer in each to exclusively look after various aspects of credit flow to minority communities.

#### CREDIT FACILITIES TO SCHEDULED CASTES AND SCHEDULED TRIBES

In the context of the discussions held in the meeting of the parliamentary committee on the welfare of SCs/STs in early 1983, it was considered necessary for all commercial banks to assess, at periodic intervals, the implementation of the guidelines issued by the Reserve Bank by their branches. The Reserve Bank advised all banks in August 1983<sup>29</sup> that:

- (i) A special cell should be set up at the head office to monitor the flow of credit to SC/ST beneficiaries. The cell should collect relevant information/data from the branches, consolidate them and submit the requisite returns to the Reserve Bank and the Government.
- (ii) The board of directors of the banks should review, on a quarterly basis, the measures taken to enhance the flow of credit to SC/ST borrowers.

29. Reserve Bank of India, RPCD circular no. PS.BC.4/C.594-83 dated August 22, 1983.

- (iii) The board should consider the progress made in lending to these borrower categories directly or through state-level SC/ST corporations based, among others, on field visits by senior officers from the head office/controlling offices. In January 1984, all commercial banks were advised that if SC/ST applications were to be rejected (under IRDP or other programmes), it should not be done at the branch level but at one higher level. A cell was set up in the RPCD of the Reserve Bank to exclusively monitor credit flow to SCs/STs.

The Reserve Bank advised all banks to step up their lending to SC/ST beneficiaries, making greater use of the state-level corporations set up for the welfare of such beneficiaries. The progress made by PSBs in lending to SC/ST members out of priority sector advances during the period 1986 to 1988 showed that both in terms of number of borrowal accounts and outstanding amount, advances to SC/ST categories had increased.

The parliamentary committee on welfare of SCs/STs (8th Lok Sabha) had desired that the LDOs of the Reserve Bank should visit some loanees, especially the SC/ST loanees, to assess their difficulties in securing loans. The Reserve Bank accepted the recommendation and the LDOs were instructed to contact SC/ST loanees during their visits to rural branches of banks.

The Ministry of Finance apprised the RPCD<sup>30</sup> that it had been brought to the Prime Minister's notice that nomads were not entitled to bank loans for self-employment activities. The RPCD was asked for its comments on the suggestion that suitable means needed to be devised to provide nomads access to bank finance. The RPCD in its reply on February 27, 1989 informed the finance ministry that it was difficult for banks to provide credit assistance to nomads, who did not have any fixed place where they could be contacted. The reply also stated that extending bank finance could be considered to nomads who had some fixed base for at least a major part of the year.

Further, in April 1989, the finance ministry, indicated to the Reserve bank<sup>31</sup> that the Prime Minister's Office (PMO) desired that specific instructions be issued to all PSBs to provide bank finance for productive activities to nomads who had some fixed base for at least a major part of

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30. Telex from the Ministry of Finance to RPCD, Reserve Bank of India, February 22, 1989.

31. Telex from the Ministry of Finance to RPCD, Reserve Bank of India, April 1989.

the year and that the PMO wanted to have a report on the matter by May 1, 1989. Accordingly, a circular was issued on May 4, 1987 to this effect by the Reserve Bank.<sup>32</sup>

#### SELF EMPLOYMENT SCHEME FOR EDUCATED UNEMPLOYED YOUTH

This scheme, introduced in September 1983, aimed at encouraging educated unemployed youth to undertake productive self-employment ventures. The target of beneficiaries to be assisted was fixed at 2.5 lakh per annum. In August 1985, the Reserve Bank instructed SCBs to consider credit proposals recommended by the district industries centres (DICs), district rural development agencies, and *khadi* and village industrial centres, so that young men and women trained by the vocational guidance units could take up self-employment projects in agriculture, horticulture, animal husbandry, fisheries and forestry as well as in small and village industries including agro-processing.

The Government initiated various schemes to provide assistance for the development of the rural sector. Some of these were contributions through budgetary provisions to the agricultural credit stabilisation fund maintained at the level of the apex co-operative bank, risk fund for consumption credit, cadre fund of the reorganised base level credit institutions and co-operative credit institutions in relatively underdeveloped states. The state governments were also involved in extending financial assistance.<sup>33</sup>

#### CONCESSIONS IN ASSISTANCE BY BANKS UNDER SPECIAL SCHEMES

##### EXEMPTION OF ADVANCES TO BENEFICIARIES UNDER SPECIAL SCHEMES

With a view to enabling the IRDP beneficiaries to avail of the concessions provided under the IRDP scheme, the Reserve Bank advised SCBs in February 1984 that advances against commodities (covered under the selective credit control) sanctioned to the IRDP beneficiaries would be completely exempt from the purview of selective credit control. In May 1984, banks were advised about additional categories of advances, which were also to be completely exempt from the purview of selective credit control. These were: advances to beneficiaries under the scheme of providing self-

32. Reserve Bank of India, RPCD, BC Plan 113 A 22, May 4, 1989.

33. Reserve Bank of India, *Report on Currency and Finance, 1981-82*, p.199.

employment to educated unemployed youth in their endeavour to take up processing, manufacturing or trading activities in commodities covered by selective credit control; advances against such commodities to borrowers satisfying all the conditions under the DRI scheme; and small advances up to an aggregate limit of ₹ 5,000 per borrower, subject to the condition that the borrower dealt with only one bank.

With a view to exercising control over the sanction of credit limits by state co-operative banks and central co-operative banks in respect of sensitive commodities subject to selective credit control, NABARD<sup>34</sup> was advised to obtain prior approval of the Reserve Bank for proposals covering such commodities and involving amounts exceeding ₹ 5 crore.

#### LIBERALISATION IN TERMS AND CONDITIONS

The interest rate on short-term loans from SCBs (including the RRBs) to farmers for agricultural purposes for amounts above ₹ 15,000 and up to ₹ 25,000 was reduced effective March 1, 1989 from a range of 12.5 to 14.0 per cent to 12.0 per cent per annum. Simultaneously, the margin and security norms were also relaxed. Concession of margin money waiver was extended from up to ₹ 5,000 for certain loan categories to ₹ 10,000 for all agricultural loans. Banks were advised not to obtain collateral through mortgage of land/charge on land or third-party guarantee for crop loans and term loans of up to ₹ 10,000 each, where movable assets were created. In the case of genuine difficulties in creating a mortgage of land or charge on land, where it was required, banks could ask for a third-party guarantee or similar security as considered appropriate. Effective November 24, 1988, the interest rates on term loans for wasteland development were prescribed at 10.0 per cent in the case of individuals or group of individuals, such as co-operatives, and 12.5 per cent for corporate and other borrowers.

#### LOANS WRITE-OFFS

The banking system, which was reeling under pressure because of poor profitability, was also expected to bear the losses arising from agricultural loan write-offs used as a means to garner votes by the politicians. The Reserve Bank was not in favour of writing-off or rescheduling loans, but the state governments paid scant heed. They went ahead with write-offs,

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34. NABARD had begun to administer CAS to these institutions from 1982.

creating an atmosphere of wilful default and making recovery efforts very difficult.<sup>35</sup>

In a meeting on June 22, 1987 with the Deputy Governors, Executive Directors, and in-charges of some departments, the Governor indicated his views on the Haryana Government's decision to move farmers' liabilities onto the banking system: "The Government taking over the liabilities would totally vitiate the climate for recovery of loans and seriously impair the capacity of financial institutions to recycle their loans and provide fresh financing. The decision, therefore, has a far-reaching effect on the whole system of rural credit."

The Reserve Bank's attention was drawn to media reports that state government of Haryana had decided to write-off loans by commercial banks and co-operatives aggregating ₹ 227 crore to several categories of borrowers. Of this ₹ 162 crore was stated to be due to commercial banks. The Reserve Bank indicated in this regard that no authority other than the commercial banks themselves could write-off loans that they had granted. It was also clarified that any deterioration in the environment of recovery of bank dues and the consequent defaults would seriously affect fresh lending by banks to the detriment of the rural community and credit system.

In the context of the prevalent situation concerning bad loans and recovery position of the banks, a media report noted, "Terms like recovery rate and bad debt write-off which related to the management of bank credit and which not long ago used to figure mostly in deliberations within the four walls of boardrooms and in highly professional forums had become matters of public debate and controversy."<sup>36</sup>

While the loan *melas* pushed by the Minister of State for Finance invited sharp criticism from many including the bank staff, on the grounds of heavy leakage, corruption, and partisanship, the political leaders tended to adopt a public posture which generated a feeling among borrowers that they did not need to worry about discharging their debt. Promises of loan write-offs were offered generously, especially on the eve of elections. The ministers in the Government did not hesitate to instruct the officials of the bank to oblige certain favoured loan applicants, who had strong political backing. An organisation of bank employees went to the extent

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35. Write-off of Farm Loans: Notes from the Reserve Bank of India Board Memorandum File F 4159 30-11-87 to 11-12-87.

36. "A Mounting Problem", Editorial, *The Hindu*, August 17, 1987.

of suspecting a nexus among politicians, industrialists and top bank executives and demanded that a parliamentary committee be set up to look into the write-off cases.

### STUDIES AND WORKING GROUPS RELATING TO RURAL DEVELOPMENT

As part of the World Bank-aided NABARD-1 credit project, an extensive review of the agricultural credit system in India was undertaken. The review consisted of five studies, *viz.*: (i) role and operations of the agricultural credit system; (ii) role and effectiveness of individual lending institutions; (iii) scope of supervisory and regulatory functions of the apex-level institutions in agricultural credit; (iv) cost of lending and profit margins; and (v) efficacy of operations of NABARD. These studies were envisaged to be conducted under the guidance and supervision of a senior-level expert group, which was expected to evaluate major problems and issues affecting the agricultural credit system and make recommendations for a programme to strengthen the sector.

The working group appointed in June 1984 to study the operational problems of the state handloom development corporations in relation to bank credit completed its field studies in Karnataka, Tamil Nadu, West Bengal, Uttar Pradesh and the north-eastern region. The field visits helped the working group to understand operational problems, such as supply and distribution of yarn to weavers, marketing of handloom products, and raising finance for production and marketing under local conditions.

The Reserve Bank set up a high level standing committee in November 1985, under the chairmanship of Dr P.D. Ojha, Deputy Governor, to review the flow of institutional credit to the rural sector and other related matters. The committee was required to suggest measures to improve the credit delivery system for greater benefit of weaker sections. The terms of reference of the committee were: (i) to review and assess the requirements and availability of institutional credit for agricultural and rural development; (ii) to identify operational shortcomings, which inhibited effective delivery of institutional credit to intended beneficiaries and suggest remedial measures; (iii) to examine the progress made in correcting regional imbalances in the matter of agricultural credit and related facilities, and to recommend appropriate steps for improvement; (iv) to suggest measures for co-operatives and LDBs at state and district levels to become effective agencies to facilitate flow of rural credit; (v) to review the progress of flow of credit and complementary inputs to weaker sections of

society and recommend measures for improvement; (vi) to recommend measures for improving the effectiveness of co-ordination between credit institutions and various state government agencies at or below the district level; (vii) to suggest improvements in needed infrastructure support and packages of complementary inputs including technological back-up to make rural credit more effective; (viii) to identify factors which adversely affected the timely recovery of rural credit and suggest ways and means to improve recycling of funds of credit institutions; and (ix) to promote co-ordination at the national and state levels among credit institutions and other agencies associated with institutional credit for agricultural and rural development.

The committee constituted a working group: (i) to consider problems relating to non-availability of credit to new and non-defaulting members of co-operative credit institutions and to suggest measures to ensure smooth flow of credit to such borrowers; and (ii) to recommend measures for assisting the co-operative credit structure in areas susceptible to repeated natural calamities and assess their impact on recovery of loans.

The committee had periodic meetings and reviewed the issue of flow of credit to rural and other related sectors. The reviews, *inter alia*, included extending agriculture credit card facilities, crop insurance scheme, strengthening of co-operatives, performance of banks in lending for the activities included under priority sector, steps taken by the Government with regard to creating infrastructure facilities in rural areas, and implementation of the SAA for rural lending by banks. In one of the meetings, the chairman of the committee observed that the banks did not own the funds that they lent; instead these were deposits mobilised from the public, who trusted banks with their money not only with the objective of earning interest but also because they had faith in the banking system. Hence the committee felt that the goal was to strengthen this trust and earn the confidence of depositors by creating a healthy investment climate. The committee emphasised that there should be effective integration of development plans and the Planning Commission should initiate steps in that direction.

### CONCLUDING OBSERVATIONS

In the early 1980s, the concern about inadequate flow of credit to agriculture and other priority sector activities continued despite several initiatives both from the Government and the Reserve Bank. A landmark

was establishment of NABARD in 1982, converting the erstwhile ARDC and merging ACD of the Reserve Bank, to exclusively focus on agriculture and rural development. NABARD was entrusted with a pivotal role in the sphere of policy planning and providing refinance facilities to rural FIs to augment their resource base. The overall regulatory function was, however, retained by the Reserve Bank in view of its overarching statutory responsibilities over rural credit system. A separate department, namely the RPCD was set up in the Reserve Bank simultaneously to encourage and, at the same time, to exercise regulation and supervision over rural credit and priority sector activities of banks and other institutions. The Reserve Bank also set up several committees and working groups from time to time to closely monitor the flow of credit to rural sector and improve the performance of the institutions involved in rural credit.

The Government formulated a series of schemes and implemented a variety of programmes subsidising rural credit and financing rural development. The Reserve Bank, as a partner in the process, issued a series of instructions to banks in the form of circulars and guidelines and relaxed credit norms to support such government programmes including lending targets and sub-targets.

The emphasis on achieving specific quantitative targets with respect to rural credit, however, had certain adverse consequences. The supervisory focus tended to be biased towards target achievements rather than adhering to prudential requirements and ensuring viability. Adequate attention was not paid to qualitative aspects of lending. Poor loan recoveries and defaults in rural lending became a serious concern in the 1980s. This was partly due to natural causes such as volatile agricultural production in non-irrigated areas, and to an extent on account of other factors such as wilful defaults, especially among relatively better-off farmers; direct interventions by elected representatives often leading to full or partial across the board loan write-offs, thereby creating strong disincentives for loan recovery; and weak legal processes and support for recoveries. The co-operation from some state governments was also inadequate to improve the recovery climate. The result was a disturbing growth in overdues, which not only hampered recycling of scarce resources of banks but also adversely affected the profitability and viability of FIs.

Despite such shortcomings, the overall objective of broadening and deepening of the rural credit system was achieved over the Plan decades. The dependence of rural households for cash debt on non-institutional

agencies declined substantially during the period 1971 to 1991. The share of formal lending more than doubled, reflecting the persistent efforts of the Government and the Reserve Bank. The strategies adopted in the 1980s in respect of rural credit resulted in substantial gains, and these primarily related to broadening of the rural infrastructure for credit delivery and improvements in credit outreach.



# 9

## Conclusion: The Decade of the 1980s

The decade of the 1980s saw significant policy shifts in response to the changing economic circumstances. Reforms were initiated in various segments of the economic system during the decade, though such efforts lacked an overarching framework. Therefore, the outcomes were mixed and several macroeconomic distortions enveloped the economy by the end of the decade.

### MONETARY-FISCAL INTERFACE

The Chakravarty Committee report provided a framework for the reforms in the monetary system. The committee made a number of recommendations relating to the objectives of monetary policy, regulation over money and credit, interest rate policy and co-ordination in fiscal and monetary policy; and most of these recommendations were accepted. The report of the committee emphasised co-ordination between the Government and the Reserve Bank to facilitate formulation and implementation of the policies. This was expected to be achieved giving due regard to the desirable levels of government borrowings, the Reserve Bank's support for the same and the resultant increase in reserve money. It was expressed that such co-ordination was essential as well as feasible. The committee clarified that the Government and the Reserve Bank were required to show due concern for achieving the objective of price stability, and this must motivate government action for raising output levels and the Reserve Bank action for modulating expansion in reserve money and money supply.

Against the backdrop of the continually deteriorating state of Central Government finances during the 1980s due to political compulsions of an

expansionary fiscal policy, managing the finances of the Government took precedence over prudence in monetary management. However, to the extent possible, the Reserve Bank neutralised the expansionary impulses of government deficits and the attendant monetisation using available tools of credit control. Though fiscal dominance was the order of the day, the necessity for integrating monetary and fiscal policies was reinforced on several occasions. Such sentiments were voiced at various forums by the Governor of the Reserve Bank. It was emphasised that fiscal deficit had a direct bearing on money supply and thus a high degree of co-ordination was necessary between fiscal policy and monetary policy so that the growth in money supply was kept within limits.

The Reserve Bank continually impressed upon the Government to contain the level of market borrowings in order to limit the net Reserve Bank credit to the Government and to raise the coupon rates on securities. The Reserve Bank's ability to formulate an effective monetary policy depended upon its success in co-ordinating with the finance ministry and ensuring non-inflationary means of financing fiscal deficits. By their very nature, often these functions came into conflict and the Bank at all times tried to persuade the successive governments not to cross the limits of fiscal prudence in the overall interest of maintaining price stability.

The inflationary impact of growing budgetary deficits had to be tackled by mopping up large increases in reserve money. Given the inflexibility in the interest rate structure, the much-needed absorption of excess liquidity in the system was undertaken by the Reserve Bank by increasing cash reserve ratio (CRR). Statutory liquidity ratio (SLR) had also to be progressively raised to meet the large financing requirements of the Government. This inevitably culminated in CRR reaching its statutory maximum limit, which had to be raised further by amending the Reserve Bank of India (RBI) Act in consultation with the Central Government. SLR was progressively raised to a high of 38.5 per cent by September 1990.

The automatic monetisation of budgetary deficits by issuing *ad hoc* Treasury Bills strained the conduct of credit policy in a number of ways. The practice assumed serious proportions during the 1980s and had several adverse implications. In this context, deeply concerned with increasing monetisation of the deficits, the Reserve Bank came up with a proposal to amend the RBI Act in 1988, whereby the Bank was not to be subject to any direction from the Central Government regarding its (*i.e.*, the Reserve Bank's) holdings of government securities, notwithstanding any powers which the Central Government possessed to direct the Reserve Bank under

section 7 of the RBI Act, and that any such directive be issued with the consent of the Cabinet along with a statement placed before Parliament within the stipulated time. The communication from the central bank also contained certain other suggestions, the important being a progressive reduction in the overall budget deficit spread over the ensuing three years, the longer-term resource requirements of the Government to be met through flotation of dated securities and not Treasury Bills, and a limit to be fixed on the outstanding level of ways and means advances (WMA). It was also envisaged that the Reserve Bank should not be required to provide any support to the market borrowing programme of the Central Government from 1990–91, which meant that the Government should move towards a system of market-related rates on government securities as part of the progressive efforts towards placing the Treasury Bills outside the Reserve Bank; the rate of interest on 182-day Treasury Bills be allowed to move up from the existing level; and as and when the budget deficit reached a point close to zero, 182-day Treasury Bill auctions be replaced by 91-day Treasury Bill auctions. In 1988, it was an idea and an attempt that did not culminate into a concrete proposal or a policy. Well after six years, beginning 1994, however, a definite procedure in this regard took effect.

From the Reserve Bank's point of view, perhaps the most profound change that took place was monetary policy assuming the position of an important variable in the toolbox of economic policy. Fiscal dominance did not end, but the two-decade-long tendency to formulate fiscal policy independent of monetary policy and then asking the latter to adjust to the former gradually diminished.

#### MONETARY MANAGEMENT

During the period 1981–1989, two major objectives of monetary and credit policy of the Reserve Bank continued to be maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy. These were, to a great extent, interrelated. However, the objective of price stability or inflation control was the dominant one on the rationale that real growth would be unsustainable if the rate of inflation exceeded acceptable levels. Therefore, the overall stance of credit policy remained cautious. Nevertheless, the focus of credit policy was at times modulated to respond to endogenous developments in the economy, *e.g.*, high inflation induced by oil price hikes (1981–82), sluggish economic conditions (1982–83) and a slump in agricultural output consequent upon the severe drought (1987–88).

The high rate of inflation and the difficult balance of payments (BoP) position faced in the early 1980s were tided over with assistance under the extended fund facility (EFF) from the International Monetary Fund (IMF), supported by tight monetary policy and prudent fiscal measures. After May 1984, when a part of the IMF loan was terminated by India, the monetary and credit policy issues became more complex on account of uncontrolled increase in public expenditure financed by higher public debt, causing a widening of India's fiscal deficit.

The onerous task of limiting the prevalence of excess liquidity present in the economy was carried out mainly through the instrument of CRR, which had a direct impact on monetary expansion. It, however, tended to take a unidirectional upward movement (except on two occasions in 1982–83). Its auxiliary version, *i.e.*, incremental CRR, served a useful purpose to the Reserve Bank in adjusting liquidity in the economy by rendering flexibility to the operations. The fact that the Reserve Bank was required to pay interest on such impounded balances at rates approximating those of term deposits blunted the effectiveness of the instrument. This was compounded by the fact that CRR had already reached the statutory ceiling of 15.0 per cent, and the decision on Reserve Bank's request to the Government in July 1988 to take legislative measures to increase the ceiling to 20.0 per cent for more effective liquidity management was delayed, becoming effective only in January 1991. Thus, with its most potent credit control instrument left effectively non-operational, the Reserve Bank found it challenging to control the excessive liquidity in the economy.

Due to the compulsions of the policies carried over from the earlier years, the refinance windows of the Reserve Bank turned out to be another source of reserve money creation. The first was the export credit refinance, which was formula-based. The other was the general refinance window, which provided short-term funds to banks to tide over temporary liquidity shortages. The Reserve Bank had to fine-tune these to integrate them with the overall stance of credit policy. Nevertheless, the central bank subtly used them to its advantage for quick reassessment of the volume of liquidity in the economy as well as to caution banks that happened to breach any of its prescriptions.

In the context of the Reserve Bank's regulation over bank credit to the public, there were two major statutory pre-emptions over the banks' lendable resources. CRR, at the time of the establishment of the Reserve Bank, was intended to serve as a prudential measure for ensuring solvency of banks, but over the years was transformed into a powerful monetary

control tool. Under the SLR prescription, banks had to statutorily invest a portion of their deposits in government and other approved securities; these securities earned interest at below market rates. During 1981–82, both these pre-emptions totalled well over 40.0 per cent and climbed to 49.0 per cent by 1988–89. Of the remaining lendable resources of banks, the first allocation was food procurement credit and credit to the priority sector (which, at the maximum, was 40.0% of total outstanding credit) at subsidised rates of interest. Credit to the export sector was another preferred sector advance. The differential rate of interest (DRI) scheme claimed 1.0 per cent of outstanding advances at a rate of 4.0 per cent interest. Due to the combination of the statutory pre-emptions of deposit resources of the banking system on one hand and the policy of directed credit based on societal considerations on the other, the impact of the credit policy measures of the Reserve Bank was borne by the commercial sector. The Reserve Bank also made efforts to introduce some degree of rationalisation and simplification in the administered interest rate structure, which had an in-built element of cross-subsidisation.

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

### THE EXTERNAL SECTOR

On the external sector front, ironically, India began the 1980s with a severe BoP crisis and ended it with another. In the 1980s, the Indian external sector scenario largely mirrored the global situation. In varying degrees, almost all non-oil developing countries (NODCs) ran into BoP problems, with India being no exception.

The 1980s began with the current account deficit (CAD) rising sharply to 1.6 per cent of the gross domestic product (GDP) in 1980–81. Though the deficit in the BoP was partly because of transitory influences such as a rise in the international price of oil and the drought, the deterioration in terms of trade contributed to worsening of the CAD. Therefore, India entered into an EFF arrangement with the IMF for financial assistance to tide over the immediate BoP difficulties. The performance criteria set by the IMF were consistently observed, thanks to constant review and close monitoring by the Reserve Bank. This gradually led to an improvement in

the BoP position in 1983–84 and the Government chose to terminate the IMF loan in May 1984, about six months before the original schedule.

During the period 1984–85 through 1989–90, growth accelerated due to a combination of external and internal developments, but the BoP came under pressure once again, especially after 1987. An important reason for this was high government expenditure resulting in a steep increase in the fiscal deficit from 5.9 per cent of GDP in 1983–84 to 7.3 per cent in 1988–89. An issue causing concern was that despite strong exports growth and softening of international commodity prices, the strain on the BoP did not ease. The fiscal excesses of the Government in the latter half of the 1980s evidently spilled over into widening of the CAD, thereby leading to a gradual build-up of a crisis situation by 1989–90.

With the abandonment of the Bretton Woods system in 1971, major currencies floated relatively free in the world currency market. Most developing countries, including India, were not in a position to allow their currencies to float independently. They chose to either peg to a single currency or to a group of currencies. The choice depended on factors such as the degree of trade concentration and the extent of openness. The choice of currencies and the weights to be assigned to them in the currency basket were matters on which each country had to decide independently. In India, the exchange value of the rupee was determined in relation to a basket of currencies with the pound sterling as the intervention currency. The Reserve Bank thus announced the day's buying and selling rate of the rupee in terms of pound sterling. The market was free to operate within the prescribed bands of the Reserve Bank rate, supplemented by exchange margins allowed within the range prescribed by Foreign Exchange Dealers' Association of India (FEDAI). The authorised banks were also free to deal among themselves in any currency. The Reserve Bank regulations on forward market operations were extensive and well documented with the objective of making the market a useful tool for covering the exchange risk of importers and exporters.

Throughout the 1980s, the exchange rate policy was implicitly aimed at a gradual depreciation of the rupee, in real terms, in order to maintain the price competitiveness of the exports sector. The rupee value underwent several adjustments over the period from 1985, resulting in a real depreciation of about 27.0 per cent cumulatively by 1989–90. As a result, despite the official stance that the rupee was pegged to a currency basket, the IMF, in its classification of exchange rate arrangement of member countries, included India among the group of 'other managed floating currencies.'

By 1988–89, the signs of an oncoming external payments crisis were clear. During the second half of the 1980s, non-concessional borrowing increased. Between 1984–85 and 1989–90, the total debt to gross national product (GNP) ratio increased from 17.7 per cent to 24.5 per cent and the debt-service ratio increased from 13.6 to 30.9 per cent during the same period. The difficulty of financing the widening CAD through external short-term commercial borrowings remained at the heart of the problem. The foreign exchange reserves shrank dramatically by December 1990. India thus ended the decade with a full-blown BoP crisis lurking around the corner.

### BANKING

In the early 1980s, the banking system in India broadly reflected the priorities of the Government and functioned in line with the directions provided by the Government of India (GoI). The resource constraints of the Government, the poor economic condition of a vast segment of population engaged in agriculture residing in remote rural areas, and the socio-political compulsions in a plural democratic system were the compelling factors influencing the performance and functioning of the banking system. The Reserve Bank being the regulator of the financial system, however, continually emphasised the need to maintain the soundness and operational efficiency of the banking system.

The banking system during the 1980s was viewed as an institution that should touch the lives of millions, be necessarily inspired by larger societal goals and subserve national priorities and objectives. Towards this end, several measures were initiated. These included, *inter alia*, extending banking facilities to unbanked areas, covering in particular the rural and semi-urban areas; mobilising financial savings; reorienting the flow of bank credit from a relatively few industry and trade accounts to a vast number of borrowers from agriculture, small scale industries (SSIs), small businesses and weaker sections of society; promoting a new class of entrepreneurs, so as to widen the industrial and economic base of the society; and facilitating enhanced professionalism on the part of both bank management and the staff.

The rapid expansion in branch banking, entry into mass banking, vast escalation in banking transactions and lengthening the lines of command and control, however, brought in their wake considerable strains on the banking system. The importance of running banks on professional terms and making banks a viable and reliable financial infrastructure to support the economy on an enduring basis was realised in the middle of the 1980s

and all efforts were made to consolidate banking. Ensuring viability and profitability of the banking system became a subject of serious and conscious discussion at all forums. The Reserve Bank began the process of consolidation by bringing in changes in banking policy and introducing appropriate measures in the areas of organisation and structure, training, housekeeping, customer service, credit management, recovery of bank dues, productivity and profitability, and technology and communication.

The concern voiced by the Reserve Bank at various forums on the need to improve the profitability of banks and make them viable resulted in a change of mindset at all levels, including the Central Government, and contributed to some well-considered reforms in banking in the later part of the 1980s. This gradually led to a major overhaul of policies, particularly after the BoP crisis of 1991. The necessity to reform the banking system was spelt out by the Governor, Dr Manmohan Singh, in his address at the founders' day of the Bank of Maharashtra in Pune on September 16, 1984, where he identified new challenges and responsibilities that the Indian banking system was called upon to meet during the Seventh Five Year Plan. He hoped that this exercise would set in motion a process of thinking and debate about structural reforms, organisational improvements and procedural progression that were urgently needed to enable the banking system to perform successfully in the ensuing phase of India's development.

### FINANCIAL INSTITUTIONS

Financial institutions (FIs) played a vital role in meeting the long-term credit requirements of the industrial sector in India. In order to ensure that these institutions were subjected to prudential practices and to apply standard procedures, the Reserve Bank laid down guidelines, keeping in view the nature of operations of the FIs. The management information system (MIS) was devised to capture information on working of the FIs for facilitating monetary control and to examine the quality of assets from the regulatory standpoint.

A number of FIs received assistance from the Reserve Bank either under the long-term operations (LTO) fund or through short-term credit. Towards the late 1980s, a need was felt to devise adequate safeguards for effective monitoring and control of the FIs. With this in view, an in house group on FIs headed by Shri S.S. Tarapore was constituted. Some of the major recommendations of the group related to monitoring the financial health of these institutions and introducing an annual financial review to ensure effective supervision. The group also suggested that a

financial institutions cell (FIC) be set up in the Reserve Bank. Most of the recommendations of the in house group were implemented by the Reserve Bank. As a result, the operations of Industrial Development Bank of India (IDBI), Industrial Credit and Investment Corporation of India Ltd (ICICI), Export-Import (Exim) Bank of India, National Housing Bank (NHB), Industrial Reconstruction Bank of India (IRBI), Discount and Finance House of India Ltd (DFHI) and Stock Holding Corporation of India Ltd (SHCIL) were brought under effective monitoring and the control of the Reserve Bank.

### NON-BANKING FINANCIAL COMPANIES

The 1980s witnessed the mushrooming of non-banking financial companies (NBFCs) posing a challenge to regulators. The NBFCs carried out multifarious activities, some of which were apparently not permissible under the law, resulting in regulatory arbitrage. Many unregistered companies also operated in various states and union territories (UTs). It was a difficult task, both for the Reserve Bank and the concerned state governments/UTs to exercise proper regulation and adequate control over the practices of such institutions and penalising them for not adhering to the norms. However, stringent action by the regulators and other enforcement agencies within available powers brought back stability to the system. This also brought transparency into the functioning of these companies, which was further strengthened by the prudential norms introduced by the Reserve Bank during the subsequent decade.

The activities of NBFCs such as those engaged in the business of hire-purchase, housing finance, investments, loans, mutual benefit financial and residuary financial companies continued to be regulated by the Reserve Bank. The Reserve Bank was empowered to prohibit NBFCs from accepting deposits from public in case irregularities were observed in their operations and to prosecute defaulters for violating directives under the applicable Act.

During the early 1980s, there was substantial growth of chit fund companies and money circulation schemes throughout the country. Barring a few, the states had not enacted any legislation to control and monitor these activities. To plug this loophole and to bring about a uniform legislation applicable throughout the country, the Chit Funds Act, 1982 was enacted by Parliament. The Reserve Bank followed up with all state governments and UTs for adoption of the Act. The Bank was empowered to inspect the books and accounts of the chit fund companies.

Hire-purchase companies were also regulated by the Reserve Bank under the provisions of the directions of 1977 as the NBFCs. These companies were allowed to raise deposits from public within permissible limits, linked to their net owned funds (NOFs) and were also required to comply with directions relating to the submission of returns, balance sheet and issue of advertisements soliciting deposits. The Reserve Bank was empowered to prohibit acceptance of deposits by such companies in case of non-compliance with the provisions of directions. From time to time, the Reserve Bank with the assistance of the state governments, conducted raids on the office premises of unincorporated bodies. Prosecution proceedings were also initiated against such unincorporated bodies if the related provisions of chapter III C of the RBI Act, 1934 were violated.

### SAFETY AND PRUDENTIAL ISSUES

As a result of the efforts of the Reserve Bank and the Government, banks were able to maintain their professional competence and operational efficiency. All the banks drew up a comprehensive plan to improve their overall operations and efficiency, which, *inter alia*, included measures to strengthen the internal administration for ensuring better supervision and control; improving customer services; strengthening credit appraisal and the quality of loan assets; ensuring progress in the recovery of bank dues; reducing costs; and introducing new work technologies. Effective implementation of these tenets, in turn, resulted in better customer service and improved the financial viability of banks. The importance of running banking along professional lines was realised both by the authorities and banks, which rendered it easy to introduce subsequent reforms.

Notwithstanding the perceptible progress achieved under the action plans, industrial sickness and defaults in repayment of bank dues continued to adversely affect the quality of bank assets. While banks were making efforts to step up recycling of funds, it was important to improve the general recovery climate. The existence of a sizeable number of loss-making branches was also a drag on the profitability of banks. It was, therefore, necessary to impart financial viability to such branches through expansion of business within a reasonable time frame. The ongoing tasks of human resource development (HRD) and personnel management needed focus with a view to enhance motivation levels, discipline, efficiency and output as also improve work culture at various levels in the industry. Greater efforts were required in the field of technology upgrading, to improve customer service.

In view of the above concerns, under the directives from the Reserve Bank, banks drew up new action plans with an added emphasis on the qualitative aspects of banking. These plans emphasised various aspects of bank performance including rationalisation of systems and procedures, introduction of efficient MIS, strengthening of the organisational structure, financial viability, proper implementation of the service area approach (SAA), effective credit management, use of the health code of borrowal accounts as a management tool to enhance the quality of bank assets, faster response to signs of industrial sickness and appropriate mechanisation of operations.

In the area of branch expansion, while the process of consolidation continued, it was necessary to allow opening of additional branches in order to achieve appropriate coverage under the SAA — a new strategy of rural lending was introduced in 1988. Apart from strengthening the capital base of nationalised banks, a number of steps were taken to strengthen prudential supervision, such as, issuing guidelines on exposure risk management and recognising non-performing loans (NPLs). To achieve greater transparency, aspects relating to modification of accounting policies and practices of banks also received attention.

The commercial banks diversified into services, such as merchant banking, leasing, mutual funds, venture capital and housing finance, and some banks set up specialised subsidiaries to undertake such activities. The provision of these services was a natural affiliate of the diverse and growing needs of the economy following the economic liberalisation measures initiated in the country and reflected the adaptability of commercial banks to the changing needs of the financial system.

It was well recognised that regulation had to be compatible with socioeconomic objectives. Deregulation and liberalisation appropriate to Indian conditions required reinforcing capital and prudential norms in banks and other FIs to counter enhanced risks arising from such changes. Strengthening the legal framework, standardising accounting practices, improving disclosure of the state of bank operations and consolidating supervisory functions, preferably under a single agency in the context of progressive integration of financial markets, were some of the issues under active consideration in the late 1980s.

Several measures were taken to impart flexibility to the financial system and to encourage competition. The measures, *inter alia*, included modifications in the CAS, which was first liberalised and then abolished and replaced by *ex post* monitoring; interest rate prescriptions with regard

to money market instruments were abolished; and a floor of 16.0 per cent was fixed without a ceiling rate for most non-priority sector borrowers, enabling banks to charge interest in the light of borrowers' track record. At the same time, parties were allowed to transfer their accounts from one bank to another, provided they cleared their liabilities to the existing banks; banks were permitted to issue certificates of deposit (CDs) for large amounts, with the interest rate determined by negotiations between the bank and the depositor; commercial paper (CP) was introduced to enable highly-rated companies to raise money at rates lower than what they paid on their bank borrowings; and banks were allowed to diversify their activities in several new business areas, either directly or through specialised subsidiaries. The money and capital markets were activated by the introduction of several new instruments.

While continuing with onsite inspections and follow-ups as a major tool for evaluating the performance of banks, a number of steps were taken to strengthen prudential supervision. Keeping in view the developments abroad, proposals were considered regarding the introduction of suitable capital adequacy norms in relation to risk assets, including off-balance sheet business. Guidelines were issued regarding exposure risk management in the domestic sector by laying down norms for individual/group exposure, covering both funded and non-funded limits in relation to owned funds. Such norms were already in vogue in respect of the overseas operations of banks. Suitable guidelines were issued regarding recognition of NPLs based on health coding, and banks were advised not to take into account interest income arising from loans so classified. The transparency of the accounting policies and practices adopted by banks in this regard also engaged the attention of the Reserve Bank at this juncture.

The Reserve Bank was actively involved in establishing BANKNET, a data communications network for the banking industry. To assess the requirements of banks as well as to co-ordinate the activities of user banks for speedy implementation of BANKNET phase I, a user group was constituted. Similarly, 36 banks in India and the Reserve Bank were accepted as members of the Society for Worldwide Interbank Financial Telecommunications (SWIFT), a co-operative society based in Belgium. Action was taken to install the SWIFT regional processor in Bombay (now Mumbai) to act as an international gateway. Message formats conforming to SWIFT specifications were standardised jointly by the Reserve Bank and the Indian Banks' Association (IBA).

The pressure on bank profitability was, to a large extent, attributable to irregular accounts of sick or mismanaged industrial units and the unsatisfactory recovery of bank dues from agricultural and other priority sector advances. As regards the first category, in order to make the legal processes for enforcing banks' claims more expeditious and effective, special tribunals were established during the 1990s. With regard to the pending dues in agricultural and other priority sector advances, banks were required to step up efforts towards recycling of funds. Besides, it was important to ensure that the general environment for recovery of dues by commercial and co-operative banks was not vitiated. Towards this end, the Reserve Bank and National Bank for Agriculture and Rural Development (NABARD) undertook measures to make refinancing of state co-operative banks contingent on adhering to the prescribed interest rate and other credit disciplines.

#### RURAL CREDIT

In the early 1980s, the concern about the inadequate flow of credit to agriculture and other priority sector activities continued, despite several initiatives both from the Government and the Reserve Bank. A landmark was the establishment of an apex development finance institution (DFI), NABARD, in 1982, converting the erstwhile Agricultural Refinance and Development Corporation (ARDC) and merging of Agricultural Credit Department (ACD) of the Reserve Bank to exclusively focus on agriculture and rural development. NABARD was entrusted with a pivotal role in the sphere of policy planning and providing refinance facilities to rural FIs to augment their resource base. The overall regulatory function was, however, retained by the Reserve Bank in view of its overarching statutory responsibilities over the rural credit system. A separate Rural Planning and Credit Department (RPCD) was also set up in the Reserve Bank to encourage and, at the same time to exercise regulation and supervision over the rural credit and priority sector activities of banks and other institutions. The Reserve Bank set up several committees and working groups from time to time to closely monitor the flow of credit to rural areas and improve the performance of the institutions involved in rural credit.

The Government formulated a series of schemes and implemented a variety of programmes subsidising rural credit and financing rural development. The Reserve Bank, as a partner in the process, issued a series of instructions to banks and relaxed credit norms to support such government programmes, including lending targets and sub-targets.

The emphasis on achieving quantitative targets with respect to rural credit, however, had certain adverse consequences. Supervisory focus tended to be biased towards target achievement rather than ensuring meeting prudential requirements and maintaining viability. Adequate attention was not paid to qualitative aspects of lending. Poor loan recoveries and defaults in rural lending became a serious concern in the 1980s. This was partly due to natural causes such as unstable agricultural production in non-irrigated areas, and partly on account of other factors such as wilful defaults, especially among relatively better-off farmers; direct interventions by elected representatives leading often to full or partial across-the-board loan write-offs on a massive scale; creating strong disincentives for loan recovery; and weak legal processes and support for recoveries. The support from some state governments was also not encouraging to improve the recovery climate. The result was a disturbing growth in overdues, which not only hampered recycling of scarce resources of banks but also affected the profitability and viability of FIs.

Despite such shortcomings, good progress was made in achieving the overall objectives of broadening and deepening the rural credit system over the Plan decades. The dependence of rural households for cash debt on non-institutional agencies declined drastically during the period from 1971 to 1991. The share of formal lending more than doubled between 1971 and 1991, reflecting the persistent measures taken by the Government and the Reserve Bank. The strategies adopted in the 1980s in respect of rural credit resulted in substantial gains, and these primarily related to broadening of rural infrastructure for credit delivery and improvements in credit outreach.

## II

### CRISIS AND REFORMS: 1989 TO 1997



# 10

## Economic and Financial Environment

As the 1990s began, the Indian economy faced several uncertainties emanating from the political situation at home and the economic scenario worldwide. There was political uncertainty during 1990–91 with no stable government at the Centre until general elections were held in the middle of 1991. The macroeconomic imbalances were pronounced, which reflected in persisting fiscal constraints, external payment difficulties and elevated inflationary pressures. Despite the upheavals, the gross domestic product (GDP) growth was significant at 5.0 per cent during 1990–91. The sustainability of the growth process was, however, impeded by the structural rigidities and imbalances in the economy.

The deterioration in merchandise trade was almost entirely attributable to the rise in petroleum, oil and lubricants (POL) imports, which registered a sizeable increase in volume and a large spurt in value due to the escalation in the international oil prices. The substantial loss in the foreign exchange reserves during the early 1990s considerably reduced the pace of broad money expansion. This combined with a sluggish real economy on account of infrastructural constraints dampened savings and investment. Trends in various macroeconomic variables during the 1980s and first seven years of the 1990s are captured in Table 10.1.

Several adverse domestic and external developments precipitated the balance of payments (BoP) crisis in 1991. The combined fiscal deficit of the central and state governments, which was around 8.0 per cent during the first half of the 1980s, increased to 10.0 per cent during the second half of the decade and further to 12.0 per cent in 1990–91. Nevertheless, in the 1980s, the Government had introduced many reform measures in the areas of trade, industry and investment. The Reserve Bank, on its part,

TABLE 10.1  
*Decadal Trends in Key Macroeconomic Variables*

Key Macro Variables	1980–81 to 1989–90	1990–91 to 1996–97
I. <i>Real GDP Growth Rate</i> (% , base 1993-94=100)	5.8	5.8
Agriculture	4.4	3.7
Industry	7.4	6.9
Services sector	6.4	6.6
II. <i>Sectoral Shares</i>		
Agriculture as % of GDP	36.4	30.4
Industry as % of GDP	19.5	21.8
Services as % of GDP	44.0	47.8
III. <i>Index of Industrial Production (IIP)</i>	7.8	6.5
IV. <i>Fiscal Indicators</i>		
Centre's GFD (as % of GDP)	6.8	5.9
States' GFD (as % of GDP)	2.9	2.8
Combined GFD (as % of GDP)	8.0	7.4
V. <i>Gross Domestic Savings as % of GDP</i>	19.4	23.2
VI. <i>Gross Domestic Capital Formation as % of GDP</i>	21.2	24.7
VII. <i>Inflation (Wholesale Price Index) (% , average, base 1993-94=100)</i>	8.0	9.7
VIII. <i>Money, Credit and Banking Indicators (Growth rate)</i>		
Money supply (M <sub>3</sub> )	17.2	17.1
Reserve money	16.8	14.7
Aggregate deposits of SCBs	18.1	17.2
Bank credit of SCBs	16.8	15.7
Non-food credit of SCBs	17.8	15.7
XI. <i>External Sector</i>		
Export/GDP ratio	4.7	7.8
Import/GDP ratio	7.9	10.3
CAD/GDP	-1.8	-1.3

Notes: 1. For IIP, nine-years average was taken for the decade 1980–81 to 1989–90 at 1980–81=100.

2. SCBs: Scheduled Commercial Banks.

3. GFD: Gross Fiscal Deficit; CAD: Current Account Deficit.

Source: Reserve Bank of India, *Database on Indian Economy; Handbook of Statistics on the Indian Economy*, various issues; *Handbook of Monetary Statistics of India, 2006*.

rationalised the interest rates, initiated development of the money and foreign exchange markets, and reoriented its monetary management in the wake of the recommendations of the report of the committee to review the working of monetary system (Chairman: Prof Sukhamoy Chakravarty). The early reform measures were, however, sporadic and *ad hoc* and lacked a coherent approach. These did not culminate in the promotion of competition and efficiency. As a result, several macroeconomic distortions emerged. The fragile economic situation in the beginning of the year 1990 was compounded by the immediate impact of the Iraq war and led the country deeper into the crisis by mid-1991.

The Government responded quickly and put in place a programme of structural reforms. Measures were introduced to restrain imports. Alongside, the official reserves were drawn down to finance essential imports. Despite purchases of US\$ 1.8 billion from the International Monetary Fund (IMF) in January 1991, gross official reserves declined rapidly to US\$ 5.8 billion (equivalent of 1.3 months of imports) by end-March 1991. Inflation touched 12.0 per cent. By June 1991, there was a crisis of confidence in the country's ability to manage the BoP. The loss of confidence undermined the Government's capability to deal with the crisis and resulted in drying up of all sources of external aid. For the first time in Indian history, default on external payments had become a distinct possibility in June 1991. The Government of India (GoI), in an attempt to retrieve the situation, entered into a 20-month stand-by arrangement with the IMF on August 27, 1991 for an amount equivalent to SDR 1,656 million. This facility was formally approved on October 31, 1991.

In cognisance of the severe external sector constraints and the need to manage short-term BoP taking precedence in the economic policymaking, two sharp downward adjustments were effected in quick succession in the external value of the rupee on July 1 and July 3, 1991, in an attempt to preserve the competitiveness of India's exports. Major policy reforms were carried out on July 4, 1991 to liberalise the system from administrative controls and licences. The liberalised trade policy regime was reinforced on August 13, 1991, when higher rates of Exim scrips and decanalisation of certain import and export items were provided. Such far-reaching policy shifts were aimed at achieving macroeconomic stabilisation and structural adjustment. Despite such measures, there was no improvement in the economic scenario. Rather, a vicious cycle of events in the form of a large and growing fiscal deficit caused misalignment between monetary

expansion and real economic growth, thereby generating severe demand pressures and accelerating the pace of inflation.

It was against this backdrop that the stabilisation efforts and structural adjustment dominated the economic scene during 1991–92. This comprised fiscal correction, exchange rate adjustment and reform, fixing the monetary growth targets and inflation control as immediate measures, supported by structural reforms in the form of industrial deregulation, liberalisation of the foreign direct investment (FDI), trade liberalisation, overhauling of public sector enterprises and financial sector reforms. The reforms enveloped almost all segments of the economic system and the results were positive.

Liberalised exchange rate management system (LERMS) was introduced in March 1992. LERMS, a dual exchange rate system in transition, subsumed the explicit objective of moving towards current account convertibility in the near future. On one hand it provided a boost to exports, and on the other, it aimed at efficient import substitution with as little bureaucratic and discretionary controls as possible. The high level committee on balance of payments (Chairman: Dr C. Rangarajan) appointed by the Government in November 1991, recommended a series of measures to improve the external account.

The Union Budget for 1992–93 set out to reform the tax system based on the recommendations of the interim report of the tax reforms committee (Chairman: Dr Raja J. Chelliah). Rationalisation of the system and widening of the tax base along with lowering of tax rates for better compliance were the major tenets of the committee's advocacy.

The high level committee on the financial system (Chairman: Shri M. Narasimham) submitted its report in November 1991. The thrust of its recommendations was to ensure operational flexibility and functional autonomy for the financial system so as to enhance efficiency, productivity and profitability. The committee also advocated that the Securities and Exchange Board of India (SEBI) undertake the role of the market regulator in the capital market.

Besides the turbulence in the economic environment caused by the global and domestic circumstances, a major scam erupted in 1991 in the form of irregularities in the transaction of government securities, public sector bonds, units of the Unit Trust of India (UTI) and similar instruments. Such irregularities in securities trading by certain banks constrained the availability of liquidity and caused a crisis of confidence. At the instance of the Government, the Reserve Bank set up a committee

under the chairmanship of the Deputy Governor, Shri R. Janakiraman on April 30, 1992. The committee on trading in public sector bonds and units of mutual funds (Chairman: Shri S.S. Nadkarni) was appointed by the Reserve Bank as a follow-up to the Janakiraman Committee. On the political front, the riots in December 1992 and January 1993 resulted in severe disruptions in transport, suppressed industrial production, a decline in export volumes and revenue losses.

The mid-1990s witnessed efforts on the part of the authorities to further widen and deepen the reforms process. The initiatives in this direction led to a distinct strengthening of the BoP situation, although the GDP growth moderated. Increasing foreign capital inflows and a sharp improvement in the current account of the BoP resulted in a substantial expansion in the foreign exchange reserves. The composition of capital inflows exhibited a major shift from debt creating to non-debt creating flows. On the flip side, there was monetary expansion and consequent inflationary pressures. The macroeconomic developments brought the focus squarely on the necessity of the monetary policy and the exchange rate policy to be aligned. It was in this context that the Reserve Bank moderated monetary expansion through open market operations (OMOs) while the foreign exchange reserves increased.

As a consequence, there was a turnaround in terms of higher real GDP growth, recovery in the agricultural and industrial sectors, subdued inflationary pressures, resilient export performance, comfortable foreign exchange reserves and improved economic confidence. These positives rendered the manoeuvre of macroeconomic policies easier. India's sovereign rating was revised by a host of agencies including Moody's and the Japan Bond Research Institute, that reflected the prudence exercised in management of the external debt.

External current account convertibility was formalised, trade restrictions were relaxed and tariff rates were rationalised. The financial sector witnessed expansion with the entry of a number of entities offering a wide range of services. Greater financial integration resulted in enhanced competitive efficiency and banks showed improved performance. There were, however, concerns on capital inflows and sharp credit expansion.

The second half of the 1990s, therefore, experienced distinct signs of stability, strengthening of the process of fiscal consolidation and a clear upward shift in the perception of the long-term growth prospects of the economy. In an open economy framework, while the foreign exchange reserves increased, the real effective exchange rate (REER) appreciated

to a certain degree with an impact on export performance, against the backdrop of subdued global demand. The lower-than-expected industrial sector performance continued to cause concern to policymakers. There was, however, growing consensus in political circles in favour of the reforms process.

A historic agreement was reached between the Government and the Reserve Bank on September 9, 1994 to phase out automatic monetisation of the budget deficit through the issue of *ad hoc* Treasury Bills over a period of three years and discontinue this instrument from 1997–98. This was followed by the introduction of ways and means advances (WMA) facility with effect from April 1, 1997 to help the Central Government meet mismatches in its revenue and expenditure. The period 1990–91 to 1996–97 was, thus, marked by conscious efforts on the part of the Government and the Reserve Bank to strengthen fiscal discipline, which provided much needed space to the Reserve Bank for monetary management.

The most striking aspect of the Indian economy in the 1990s was that it not only managed its worst BoP crisis in the 1991 remarkably well, besides turning around its external sector, but also remained relatively insulated from the contagion of the South-East Asian crisis that began in 1997–98.

# 11

## The Balance of Payments Crisis of 1991

### INTRODUCTION

Until the early 1980s, India's economic policy was dominated by pervasive administrative controls and had a strong inward orientation. The process of gradual decontrol and easing of restrictions began in the mid-1980s. The initial focus of liberalisation was on relaxation of licensing for entry, expansion in industry and on freeing access to imports, particularly of inputs and capital goods for export production. From 1985, there was also an emphasis on promoting exports encompassing some direct measures such as easier access to imports, tax relief, preferential credit, subsidies to compensate for differences between international prices and domestic prices of inputs, and a supportive exchange rate policy. The Reserve Bank on its part also initiated several measures to rationalise interest rates and develop the money and foreign exchange markets, and gave a new orientation to monetary management, following the Chakravarty Committee report. These early reform measures, however, suffered from the lack of an overarching framework to promote competition and efficiency. Consequently, the emergence of several macroeconomic distortions could not be averted.

India achieved significant pick-up in the growth rate averaging 6.0 per cent during the Seventh Five Year Plan period and a high of 7.6 per cent during the three-year period ending 1990–91. While this was partly induced by highly expansionary fiscal policy, it was aided by the measures of liberalisation introduced in trade, the industrial sector and taxation policies at that point.

The first half of the 1980s saw a large increase in the central government deficit, primarily on account of high expenditure levels, especially on agricultural subsidies, defence and interest payments. On the external account, higher imports dominated over acceleration in exports. A steady deterioration in the services account resulted in widening of the current account deficit (CAD) and, with the aid inflows not increasing commensurately, the increasing reliance on commercial sources for financing resulted in the debt-service ratio rising to nearly 30.0 per cent in the late 1980s.

By 1990, there was a realisation in official circles that the widening of fiscal deficit and the related rise in money growth were contributing to a rise in inflation and exerting pressure on the balance of payments (BoP). The Reserve Bank had evidently been expressing its concern to the Government about the adverse implications of the deteriorating BoP position and the impact of rising fiscal deficit since the late 1989, but timely preventive measures were stalled by the uncertain political situation.

There was a step-up in external commercial borrowings (ECBs) in 1988–89 and 1989–90. The policy stance was that commercial borrowings were to be resorted to only for financing designated institutions and activities and not for general BoP support. Commercial borrowings were expected to drop in 1990–91. Reliance on non-resident deposits continued, with interest rates on these deposits kept slightly above international market levels. These deposits were considered to be advantageous as a stable source of external financing.

India was thus faced with large internal and external financial imbalances and was vulnerable to adverse external shocks around 1990. Previously India had relied almost exclusively on aid on concessional terms. The 1980s saw a growing resort to financing on commercial terms and therefore by the end of the decade its debt-service ratio became relatively high by regional standards. Second, the official reserves, which until then had been relatively stable at a high level, were drawn down from about five months of imports in the mid-1980s to only a little over two months of imports at the end of 1989–90. Despite purchases of US\$ 1.8 billion from the International Monetary Fund (IMF) in January 1991, gross official reserves stood at US\$ 5.8 billion (1.3 months of imports) by end-March 1991.

Inflation rose to 12.0 per cent. The consequent fragile economic situation was compounded by the sudden impact of the Iraq war, leading

the country deeper into the crisis by the mid-1991. The higher oil prices and loss of workers' remittances weakened the current account position by US\$ 1.5 billion in 1990–91. The impact of the crisis was further exacerbated by policy slippages. A sizeable reduction in fiscal deficit had been planned for 1990–91, but it did not materialise, and bank credit to the Government continued to grow rapidly. Expansionary financial policies continued to put pressure on domestic prices and the external CAD widened to 3.0 per cent of gross domestic product (GDP). Owing to market concerns about the deteriorating external position and domestic political uncertainty, recourse to ECBs was not available from the mid-1990.

The external liquidity situation remained extremely tight in the first quarter of 1991–92 owing to a number of factors, such as the withdrawal of non-resident Indian (NRI) deposits, outflows of short-term capital from banks, and lacklustre export performance. The withdrawal of NRI deposits, which started in September 1990, intensified and was accompanied by an outflow of short-term capital as commercial banks failed to renew credit lines. Exports stagnated, largely because of slack demand in key markets in the industrial nations and the Middle East, as well as growing disruptions to trade with the USSR. Political events, in particular the resignation of the Government in March, 1991 and the postponement of general elections, prevented major fiscal action, and the burden of adjustment fell mainly on monetary tightening and direct import compression measures. Despite a sharp fall in import volumes, gross official reserves declined further to US\$ 1.7 billion (about three weeks of imports) by end-June 1991.

By the mid-1991, the BoP crisis turned into a crisis of confidence in the country's ability to manage the BoP. The loss of confidence undermined the Government's capability to deal with the crisis by closing off all recourse to external credit. A default on payments for the first time in Indian history became a serious possibility in June 1991.

The Reserve Bank in its Annual Report for the year 1991–92 enunciated the underlying causes and events that resulted in the economic crisis:

The preceding decade had seen acceleration in economic growth, but the relatively high rate of growth of GDP was also associated with macro-economic imbalance and the persistence of structural rigidities, a certain degree of which constrained the sustainability of the growth process. Continuing macro-economic imbalance and a delay in taking corrective action in time accentuated the impact of global economic shock of 1990.

Large and growing fiscal deficit with a sizeable component of monetised deficit inevitably resulted in rapid growth of monetary liquidity far out of alignment with the real economic growth, thereby generating severe demand pressures and accelerating the pace of inflation. These imbalances in turn spilt over onto the external sector in the form of a large and unsustainable current account deficit. The persistently high levels of fiscal deficit and current account deficit on the balance of payments (BoP) gave rise to a sizeable public debt, both domestic and external. The country was faced with a risk of default on external debt servicing during the early months of the fiscal year 1991–92. The strain on external and internal resources, the threat to monetary stability and the resultant inflationary process, had begun to hinder investment plans both in the public and private sectors, giving rise to distortions in production and employment generation. The situation called for strong stabilisation measures: fiscal correction, monetary tightening, inflation control, and strengthening of the competitiveness of India's exports.

In essence, a confluence of economic and political factors was under play in the build-up to the crisis. The Government requested a 20-month stand-by arrangement from the IMF on August 27, 1991, for an amount equivalent to SDR 1,656 million. This facility was approved by the IMF on October 31, 1991. The arrangement became an opportunity for both the Government and the Reserve Bank to embark upon a series of home-grown reforms in the real and financial sectors.

## MAJOR CONTRIBUTING FACTORS: PRE-CRISIS DEVELOPMENTS

### WORSENING FISCAL SITUATION

From 1979 onwards, the second oil shock, agricultural subsidies and consumption-driven growth had pushed up fiscal deficit. It further enlarged in the mid-1980s as defence expenditure was substantially increased and direct taxes were progressively reduced. The result was that fiscal deficit as a percentage of GDP escalated to 9.4 per cent in 1990–91 as against the average of 6.3 per cent in the first half of the 1980s.

The monetisation of fiscal deficit resulted in higher liquidity growth over and above the overhang of liquidity carried forward from the earlier years and the consequent expansionary impact on money supply. To

some extent, the Union Budget for 1989–90 sought to correct the growing imbalances between revenues and expenditures. However, the outcome turned out to be much worse because the imbalances did not stem from any let-up in government revenue mobilisation but due to increases in the government expenditure, which in turn was financed by larger borrowings and the budget deficit. The Centre's budgetary deficit in 1989–90 (according to the Reserve Bank's records) was much higher, by about 30.0 per cent, than the budgeted amount. Likewise, the Reserve Bank credit to the Central Government in 1989–90 was more than twice the actual for 1988–89.

The widening of the budgetary deficit on revenue account and the growing recourse to borrowings from domestic and external sources to finance the deficit had several adverse consequences. First, to the extent that this entailed recourse to the Reserve Bank, the deficit turned out to be the principal factor propelling high rates of monetary growth, which, in turn, fuelled inflationary pressures and expectations. Second, the greater recourse by the Government to borrowing from the commercial banking system as well as directly from the households claimed a higher proportion of household savings for government expenditure, leaving a lower proportion for use in directly productive sectors, such as industry and agriculture. Third, the mounting stock of public debt led to mounting interest payments on the Government's revenue account, which exacerbated the problem of continuing revenue account deficits and preempted an increasing fraction of the government expenditure to meet such debt-service obligations. Finally, the high deficit spilled over into the BoP gap, with the resultant drawdown of foreign exchange reserves.

#### THE SPILL OVER OF FISCAL DEFICIT INTO CURRENT ACCOUNT DEFICIT

Imbalances in the external sector reflected the fundamental fact that aggregate absorption in the economy was in excess of domestically produced goods and services. In other words, imbalances between aggregate demand and supply ultimately spilled over onto the BoP and the gap had to be met by either running down the reserves or increasing debt.

In India, it was the fiscal deficit of the Government that was associated with excess demand and the consequent deterioration of the current account balance. The fiscal deficit was nurtured principally by a large expansion in net Reserve Bank credit to the Central Government against the issue of *ad hoc* Treasury Bills, which came to be popularly known as

automatic monetisation of deficit. The Seventh Five Year Plan period also witnessed deterioration in the fiscal imbalances as the ratio of gross fiscal deficit (GFD) to GDP escalated from 6.3 per cent in the first half of the 1980s to 8.2 per cent during 1985–1990. The net outcome of this pattern of financing was that the spiral of increased borrowings and deficit financing pushed up the interest payments, liquidity growth and inflation.

The not-so-apparent and yet the close link between the budget deficit and CAD was aptly stated in the Economic Survey for the year 1988–89 thus:

Though it has not been appreciated, it must be recognised that high levels of fiscal deficits tend to spill over and contribute to high current account deficits in the balance of payments. An improvement in the current account of the balance of payments requires a commensurate reduction in the overall savings-investment gap of the economy. In a situation such as ours where the recent widening of the savings-investment gap is largely attributable to deterioration in the budgetary savings, the turn-around in the budgetary performance will contribute substantially towards a sustained improvement in the balance of payments.

The same relationship was highlighted in the Annual Report of the Reserve Bank for the year 1992–93:

Quite often, monetary policy and exchange rate policy are discussed as separate and distinct segments of overall financial policy. These two segments are invariably intertwined and as a market-based system develops, it would no longer be meaningful to view these as separate segments of policy. If these two segments are not made mutually consistent, one or the other segment of policy could be greatly attenuated.

#### WIDENING CURRENT ACCOUNT DEFICIT

Before the onset of the 1991 crisis, two instant external shocks contributed to widening of the CAD. First, Iraq's invasion of Kuwait in 1990 exposed India to sudden shifts in global oil prices. This also caused the return and rehabilitation of the Indians working in that region, adversely affecting the inflow of remittances. The petroleum import bill in 1990–91 increased over 50.0 per cent to US\$ 6.0 billion. By September 1990, the net inflow of NRI deposits had turned negative. Access to commercial borrowings became costlier and more difficult, and by December 1990 access to even

short-term credit, particularly the bankers' acceptance facility (BAF), was constrained. The foreign exchange reserves fell to US\$ 1.2 billion in January 1991.

The second shock was the slow economic growth in India's export markets. Growth in the US — India's largest export destination — fell from 4.1 per cent in 1988 to (-)0.2 per cent in 1991. Conditions in another major export market — the Soviet Union — worsened due to the oil shock. World growth declined from 4.5 per cent in 1988 to 2.2 per cent in 1991. Consequently, India's export growth was only 4.0 per cent during 1990–91. Further, India's export competitiveness was adversely affected by a steady appreciation in the rupee's real effective exchange rate (REER): 20.0 per cent between 1979 and 1986. From 1987, the rupee steadily depreciated, but the real exchange rate remained overvalued until the year of the crisis.

The Reserve Bank in its Annual Report for the year 1989–90 expressed the view that given the small size of the external sector, the CAD experienced in the Seventh Plan period was of a large order and was worrisome, and the Bank wanted the CAD to be reduced to around 1.5 per cent of GDP by according emphasis to higher exports. On the issue of financing the CAD, which assumed grave proportions soon thereafter and hastened the crisis (of imminent default in repayments), the Reserve Bank made the following pertinent observations in the report:

So far the bulk of financing the current account deficit has been provided by external assistance, commercial borrowings and NRI deposits. The outlook for concessional aid is not bright. There has already been a hardening of the terms from multilateral institutions and there are many more claimants to the resources of multilateral and bilateral donors. As regards commercial borrowings, although we have pursued a prudent policy, the recourse to this source of borrowing has been rising in the last few years. While India can continue to borrow from the capital market at fine terms on account of its impeccable record of debt service, the recent policy stance for still greater caution is appropriate. The inflow of NRI funds under FCNRA scheme is also becoming a high-cost source of financing given the rise in the interest rates abroad. The inflow of direct foreign investment capital into India is very small being around \$200 million a year as compared with much higher inflows in respect of many other countries in Asia. A larger inflow of direct foreign investment will help to reduce the pressure on the balance of payments.

## CHANGING COMPOSITION OF EXTERNAL DEBT

The changing composition of external debt, which shifted from official to commercial and towards the short-term, was one of the factors contributing to the external imbalance. Besides long-term and medium-term debt, there was also short-term debt in the nature of trade credit and suppliers' credit, and the BAF relating to imports. Such facilities were contracted for public sector undertakings (PSUs), and the outstandings were being financed through rollover of inter-bank borrowings. This amounted to US\$ 3,551.0 million as at end-March 1991.

The increasing trend of availability of ECBs during the later part of the 1980s was reversed in 1990. A major reason was a fall in the overall availability of international credit due to the capital adequacy requirements of the Bank for International Settlements (BIS). Commercial banks were compelled to restrict credit expansion and were expected to strengthen their capital base. The gulf crisis created an atmosphere of uncertainty in the international capital market, with an adverse impact on developing countries that depended on oil imports, like India. The third factor was the downgrading of India's credit rating for long-term funds by international rating agencies in March 1991; India's rating slipped to the bottom of the investment grade. This prompted international banks to restrict the renewal of the rollover facility of inter-bank borrowings for Indian banks. The situation led to difficulties in the retirement of import bills for Indian importers and PSUs.

The share of external assistance in total debt stock declined to less than 70.0 per cent in 1989-90 as against almost 90.0 per cent during the Sixth Five Year Plan. The declining share of external assistance in external capital inflow, hardening of the terms for such assistance and a rapid rise in the rate of interest contributed to bunching of the debt-service payments in the late 1980s.

## OVERVALUATION OF THE RUPEE

Since 1987, the Indian rupee had been depreciating in real terms as compared with many of India's trade competitors. However, between October 1990 and March 1991, the REER of the rupee appreciated by about 2.0 per cent as a result of widening inflation differentials between India and the major industrialised countries, and the REER increase was continuing, albeit slower than the nominal depreciation (2.4% against five currencies, over the same period). Further, in the 5-month period between February 1991 and June 1991, the nominal effective exchange rate (NEER)

decreased by only 2.5 per cent, while the inflation differentials continued to widen. All this resulted in eroding India's international competitiveness.

#### DOMESTIC POLITICAL UNCERTAINTY

The country also faced intense political uncertainty during this period. The general elections were held in November 1989, followed by the formation of a coalition Government. Internal political conflicts among the coalition partners on a variety of issues caused the Government's fall by November 1990. A group of Members of Parliament (MPs) broke off from the erstwhile Government and a new Government was formed in November 1990. This support was, however, withdrawn in February 1991, and the scheduled budget could not be passed. In the midst of campaigning for general elections, the Prime Minister was assassinated in May 1991. General elections were held in May 1991 and the elected Government took over only by June 1991. Thus, within a span of two years, during which the country faced a strained BoP position, there were three unstable governments at the Centre.

#### BREAK-UP OF THE SOVIET BLOC

Rupee trade with the Soviet bloc was an important element of India's trade in the 1980s. Exports to Eastern Europe comprised 22.1 per cent of total exports in 1980 and 19.3 per cent in 1989. A significant proportion of the trade, constituting imports of capital goods and defence equipment, was financed by long-term trade credits. The trade with these countries was carried out under the rupee payment agreement (RPA), which provided a framework for the size of turnover and commodity composition with each country. During 1990–91, only three countries, *viz.*, the USSR, Czechoslovakia and Romania, settled their payments under the RPA. However, the trade was dominated by the USSR, which accounted for 95.0 per cent of the total trade turnover between India and the three countries under the RPA. Further, India enjoyed a surplus trade balance with the USSR for almost the entire period of the 1980s. The trade surplus in favour of India rose from US\$ 268.0 million<sup>1</sup> (₹ 212 crore) in 1980–81 to US\$ 1,456.5 million (₹ 2,425 crore) in 1989–90 and further to US\$ 1,512.6 million (₹ 2,714 crore) during 1990–91.

With the introduction of Glasnost and the breaking away of the Eastern European countries, several rupee payment arrangements were terminated

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1. Conversions are based on annual average rupee-dollar exchange rate.

in 1990–91. Thus, the RPA with the former German Democratic Republic ended in December 1990 with German reunification, and with Poland the agreement ended in January 1991. As a consequence of these and other political developments in Eastern Europe, the flow of new rupee trade credits declined abruptly in 1990–91. The exports share of the Eastern European countries in India's external trade also declined to 17.9 per cent during the same period. Such developments raised concerns about future difficulty in exporting to these markets. The collapse of the USSR in December 1991 added further woes to rupee trade arrangements with Eastern European countries. As a result, the share of Eastern Europe in India's exports collapsed to 10.9 per cent in 1991–92. The breakdown of traditional arrangements also meant an interruption in new rupee credits and a consequent increase in the net repayment on the rupee debt account.<sup>2</sup>

#### THE GULF WAR

The gulf crisis, which began with the invasion of Kuwait by Iraq on August 2, 1990, lasted about seven months until February 28, 1991. The gulf crisis was different in terms of its impact from the earlier two oil shocks. First, it did not have some of the compensating features of the earlier shocks, *viz.*, large inflows of remittances, a surge in exports and a tendency for non-fuel commodity prices to rise in sympathy with oil prices. Second, it imposed an additional cost of repatriating NRIs from affected countries in the region. Third, the crisis adversely impacted international capital markets.

The turmoil in the world oil market emanated from the trade embargo on Iraq and Iraq-occupied Kuwait, which together contributed about 6.8 per cent and around 7.5 per cent of the world oil per day consumption and production, respectively, during 1991. Given that in the short run the price elasticity of both supply and demand was rather low, an increase in oil prices in response to supply decline was inevitable.

The gulf crisis had a serious impact on India's petroleum, oil and lubricants (POL) import bill. First, alternative sources for imports of crude oil and petroleum products had to be identified to substitute for imports earlier obtained from Iraq and Kuwait. Second, since contracts for crude oil and products were market-related, higher prices entailed a sharp escalation in the import bill of POL. The level and volatility of oil prices increased sharply after the invasion of Kuwait by Iraq in August

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2. Virmani, Arvind (2001). "India's 1990–91 Crisis: Reforms, Myths and Paradoxes", *Working Paper No. 4/2001-PC*. New Delhi: Planning Commission, December.

1990. From an average of about US\$ 15 per barrel during April–July 1990, the average prices paid by India for crude in the world market doubled to US\$ 30 per barrel during August–November 1990 and then declined to an average of US\$ 19 per barrel during the rest of 1990–91. Similarly, the average price of petroleum products rose from about US\$ 182 per tonne to US\$ 354 per tonne and then declined to US\$ 313 per tonne, over the same period. The prices, both of product and crude, softened from December 1990 to March 1991. However, while crude oil prices fell sharply, product prices declined relatively slowly. The fall in crude prices was more than 36.0 per cent during December 1990–March 1991 over the preceding four months, while product prices declined by only about 12.0 per cent over the same period.

The spurt in the prices of crude oil and petroleum products caused a sizeable increase in the POL bill. The POL bill during 1990–91 was estimated at around ₹10,820 crore (US\$ 6.0 billion) as against ₹ 6,273 crore (US\$ 3.8 billion) for 1989–90. This indicated an increase of about 72.0 per cent in rupee terms and 58.0 per cent in dollar terms. Assuming that the price of oil and products had remained at the same level (US\$ 14.77 per barrel for crude and US\$ 181.5 per metric tonne for products) prevailing during April–July 1990 for the rest of the year as well, the direct additional cost of POL imports would have been around US\$ 2.2 billion (₹ 3,900 crore). After adjusting for exports of petroleum products, the net POL burden was estimated at US\$ 2.0 billion (₹ 3,625 crore).

The gulf crisis constrained India's export performance during 1990–91 in more than one way. In 1989–90, the West Asian countries accounted for 7.2 per cent of India's exports, with Kuwait accounting for 0.7 per cent and Iraq about 0.5 per cent. The immediate impact of the gulf crisis arising out of the trade embargo on Iraq and occupied Kuwait, and dislocation of trade to other countries in West Asia led to a significant loss in exports. The total loss of exports in the gulf region was estimated at US\$ 3,003.0 million, including US\$ 1,622.0 million on account of loss of exports to Kuwait and Iraq alone. Besides, India could not realise her dues to the extent of US\$ 64.0 million under deferred payment arrangements and about US\$ 50.0 million under the projects outside deferred payment arrangements during 1990–91.

The direct overall adverse impact of the gulf crisis lasting for about seven months from August 1990 to February 1991 on the current account of India's BoP for the fiscal year 1990–91 was estimated at US\$ 2,987.0 million, equivalent to ₹ 5,180 crore (Table 11.1). It must be emphasised

that this impact assessment was relative to a normal situation free of the gulf crisis.

TABLE 11.1

*Direct Balance of Payments Impact of the Gulf Crisis during 1990–91*

<i>Item</i>	<i>₹ crore</i>	<i>US\$ million</i>
Additional POL import bill (net of POL exports)	3,625	2,020
Export loss to West Asia (of which: Iraq and Kuwait)	500 (270)	280 (150)
Non-realisation of other export dues from Iraq	205	114
Loss in remittances from Iraq and Kuwait	490	273
Foreign exchange costs of emergency repatriation	360	300
Total	5,180	2,987

*Source:* Government of India, *Economic Survey, 1990–91*.

The gulf crisis clearly impacted the balance of trade situation. During 1990–91, imports were 22.0 per cent higher than that in 1989–90, largely on account of POL imports, while exports rose by 17.5 per cent, as a result of which the trade deficit at US\$ 9,437.0 million was 38.0 per cent higher than that in 1989–90. Consequently, there was a rapid drawdown of foreign exchange reserves during 1990–91. Foreign currency assets (FCA) held by the Reserve Bank declined by US\$ 3,460.0 million during the year despite the BoP support received from the IMF.

REPATRIATION OF INDIAN NATIONALS FROM  
IRAQ: IMPACT ON INVISIBLES

The gulf crisis had a significant adverse impact on the flow of remittances into India. During the period 1982 to 1986, Iraq and Kuwait accounted for 12.0 per cent of annual labour outflows from India. In 1987, these two countries accounted for about 14.0 per cent of the estimated migrant population of about one million in West Asia. In 1988–89, about 8.5 per cent and 0.2 per cent of total private transfer receipts (remittances) came from Iraq and Kuwait, respectively. As estimated by the Government, the loss in private remittances from Kuwait and Iraq was placed at US\$ 273.0 million (₹ 490 crore) during 1990–91.

The gulf crisis also had an adverse impact on the capital account. The fall in capital inflows compounded the problem of financing the rising level of CAD. Inflows into non-resident accounts and ECBs were the two

major components of the capital account, which suffered most under the impact of the gulf crisis.

The gulf countries accounted for about 35.0 per cent of foreign currency non-resident (account) [FCNR (A)] flows, with Kuwait contributing 2.0 to 3.0 per cent of these and Iraq only a negligible amount during the early 1990s. Net inflows into these accounts from all sources declined to US\$ 142.0 million in 1990–91 from US\$ 1,309.0 million in 1989–90. The gulf countries contributed about 65.0 per cent of non-resident (external) rupee account [NR(E)RA] flows, with Kuwait accounting for 18.0 per cent and Iraq an insignificant proportion during the period 1982–86. During the years 1989–90 and 1990–91, there were net outflows from the NR(E)RA amounting to US\$ 2.4 million in 1989–90 and US\$ 30.0 million in 1990–91. It was estimated that the gulf crisis was responsible for a shortfall of at least US\$ 500.0 million in the non-resident accounts.

In 1990, there was a marked slowdown in borrowings from the international capital market by the developing countries as a group. All major segments of the international financial market experienced a contraction during the year against the background of deteriorating global conditions and uncertainties arising from political and economic consequences of the gulf war. From the second half of 1990, markets became increasingly selective and were reluctant to take risks. Creditworthiness considerations became paramount and capital adequacy requirements constrained the lending activity of banks. These adverse conditions persisted till the end of 1991. Against this backdrop, India's commercial borrowings in terms of commitments dropped sharply to US\$ 1,903.0 million in 1990–91 from US\$ 3,291.0 million in 1989–90. The gulf crisis triggered adverse market perceptions about Indian risk during the year. This affected the availability of commercial funds to India during 1990–91. The evacuation of about 1,80,000 Indian workers from Kuwait and Iraq and their repatriation to India was estimated to have cost the country US\$ 200.0 million.

#### LOSS OF CONFIDENCE ABROAD

By November 1990, the Government lost the crucial vote of confidence in Parliament. In its place, a minority Government was formed. The Union Budget due at the end of February 1991 was postponed and instead, a vote on account was presented on March 4, 1991.

The memorandum to the Central Board of Directors of the Reserve Bank dated November 24, 1990 summed up the fiscal response of the Government as follows:

The Gulf crisis adversely affected the domestic fiscal scenario. In order to deal with the steep rise in the international price of crude and its concomitant rise in the import bill as also to meet the cost of evacuating non-resident Indians from Kuwait and Iraq, the Government adopted a combination of measures such as rise in petroleum prices, curbs in consumption of petroleum products and enhanced tax effort. These included a 'Gulf evacuation' surcharge of 10 per cent on passengers on Indian Airlines to yield Rs. 40 crore in the current year and Rs. 100 crore in the full year and an additional surcharge on corporate incomes of 7 per cent to yield Rs. 100 crore in the assessment year 1991–92. Furthermore, a 25 per cent increase was announced on October 14, 1990 in prices of petrol and most other petroleum products, excluding domestic cooking gas (LPG).

It became clear by the beginning of 1991–92 that the payments crisis was no longer primarily due to the trade deficit, and there were expectations of default and therefore devaluation. This created longer leads in the payments for imports and lags in the realisation of export proceeds, which attenuated the foreign exchange shortage.

A mention may be made of the conscious attempt by international banks to reduce exposures in order to meet capital adequacy norms. Following this, the country's access to short-term credit, particularly the BAF, became restricted. International rating agencies lowered the credit ratings of India/Indian entities, which made it difficult to raise funds in the commercial markets. Short-term credit by way of bankers' acceptance lines and six-month credits were available at 0.25 per cent above London interbank offered rate (LIBOR, the standard reference interest rate in international commercial borrowings) until November 1990. Thereafter, the cost above LIBOR went up to 0.65 percentage points in March 1991, which rose further to 1.25 percentage points by May that year. By June, the overall cost of credit was even higher. Under such circumstances, the Government had to accord top priority to ensure that external payment obligations were met and that the foreign exchange reserves were maintained at a reasonable level.

## RESERVE BANK ALERTS THE GOVERNMENT

From 1988–89, the Reserve Bank had been continually alerting the Government regarding the adverse consequences of growing government deficits, their impact on the external payments situation and the worsening BoP position. The Governor also hinted at the possibility of approaching multilateral institutions to find a remedy.

APPRAISING THE GOVERNMENT OF DETERIORATION  
IN BALANCE OF PAYMENTS

In December 1988, the Reserve Bank drew the attention of the Government to the severe strains in the BoP of the country. A review done in May 1990 showed that the position had continued to be difficult in the previous year and that the prospects for improvement in the ensuing year appeared bleak. The foreign exchange reserves (comprising the foreign currency assets, gold and SDRs) continued to decline during 1988–1989, and the real loss in reserves was much higher if special transactions were excluded. These special transactions included the funds brought in, receipts from the India Supply Mission (Washington), the Indian Embassy (Tokyo) and sales of foreign currencies to the Reserve Bank by Industrial Credit and Investment Corporation of India (ICICI) Ltd, Industrial Development Bank of India (IDBI) and the Industrial Finance Corporation of India (IFCI). Besides, there was an increasing resort to short-term credit, the outstandings of which went up by US\$ 1,186.3 million (₹ 1,718 crore) to US\$ 2,162.7 million (₹ 3,132 crore) during 1988–89, *i.e.*, more than twice the rise of US\$ 547.6 million (₹ 710 crore) during 1987–88. The CAD during 1988–89 was then estimated to be 2.7 per cent of GDP as against 1.9 per cent in 1987–88, which exceeded the earlier high of 2.3 per cent, reached in 1985–86.

The Reserve Bank in a communication dated May 24, 1989 to the Government focused on wide-ranging key policy measures needed to correct the situation, *i.e.*, export promotion, exchange rate policy and containment of the fiscal deficit of the Government. After recounting the disturbing trends in the foreign exchange reserves, the Reserve Bank conveyed its concerns over the situation as follows:

From all accounts, it appears that if no strong policy actions are initiated, the trade deficit in 1989–90 will even be higher than that in 1988–89. Oil prices have already started rising and the increase in commodity prices in general may cause the import bill to

increase faster. Apart from the fact that the rising current account deficit has serious implications for debt servicing in the future, even in the short run there can be difficulties in financing a deficit of this order. Last year, we had allowed the reserves to fall to the extent of Rs. 1,500 crore. We cannot allow any further decline in reserves which are now equivalent only to two-and-a-half months of imports. All these point to the need for decisive action to limit the trade and current account deficits.

The Reserve Bank urged the Government to accord more attention to the export sector by creating adequate surpluses out of production for the purposes of export, and at least in some sectors it emphasised that exports must become a matter of primary concern rather than being a residual after meeting domestic demand. This was in addition to the number of incentives provided to exporters and a highly supportive exchange rate policy. Turning next to the exchange rate policy, the letter explained that the NEER of the rupee against five major currencies had come down from 100.0 in 1979 (average) to 52.1 in 1988 (average). The REER of the rupee in relation to five major currencies, which took into account the movement of prices in the respective countries, had come down from 100.0 in 1979 to 81.9 in 1988. Thus, there was a considerable depreciation of the rupee in real terms in relation to the currencies of India's major trading partners and competing countries. The communication from the Reserve Bank to the Government added, "There is no doubt that exchange rate adjustments have played an important role in accelerating exports in the recent period." The letter suggested that having achieved a strong measure of real depreciation, exchange rate adjustments in future must be used primarily to correct price differentials between India and its trading partners. The ground rules under which the exchange rate policy could be effective and its linkages with other policy areas were described thus:

Exchange rate depreciation works through improving the competitiveness of Indian exports and curbing import demand. The extent to which external imbalances can be corrected depends upon the elasticity of exports and imports to price changes. And more importantly, a reduction in trade deficit through exchange rate changes can be brought about only if the overall expenditure are contained in the economy and increase in the domestic price level is effectively contained. Otherwise, the advantages of devaluation will be wiped out very soon.

The next topic of discussion in the communication was the link between the fiscal deficit and the CAD. The Reserve Bank stressed that if the CAD in 1989–90 was not to exceed that in the previous year, the fiscal deficit should be contained at the level actually achieved in 1988–89 and that one way of doing this was for the Government to examine the expenditures under all heads and bring about overall reduction and also make efforts to reduce the import content of government expenditure, including those on defence. This was considered to be particularly pertinent because exchange rate depreciation might not by itself be adequate to contain import demand and this was all the more so in commodities, such as POL products and fertilisers, whose ultimate prices to the consumers had not been suitably altered upwards. In the case of bulk commodities for which exchange allocation was made directly by the Government, a careful pruning of imports was needed. Another relevant point made was that while trade policy did not encourage the import of finished consumer products, care had to be taken that this policy was not undermined by liberal imports of their components.

The concluding paragraph of the letter from the Reserve Bank summed up the responsibilities of the Government in order that the BoP situation did not get out of control:

The balance of payments position of the country is passing through a very difficult phase. Current account deficits of the order seen in 1988–89 cannot be sustained. A comprehensive policy package needs to be drawn up to limit the deficits to more reasonable levels. In any such scheme, besides accelerating exports, equal attention must be paid to import planning so as to limit the growth of imports. A greater control over Government expenditures and a reduction in budget deficit are equally necessary, if the various policy measures aimed at increasing exports and reducing the volume of imports is to become effective.

#### UPSURGE IN INFLATIONARY PRESSURES

The large growth in overall liquidity and the consequent pressure on the price level was evident until September 1989. The Reserve Bank was, however, constrained from deploying the cash reserve ratio (CRR) as it had reached the statutory ceiling of 15.0 per cent. This prompted the Governor to bring the situation to the notice of the Principal Secretary to the Prime Minister. While the main message in the letter to that effect is covered in

the subsequent chapter on monetary management, it suffices to state here that the thrust of the letter was to supplement the monetary measures by fiscal measures for an effective anti-inflationary package.

#### CRITICAL BALANCE OF PAYMENTS SITUATION

The Governor was closely monitoring the developments and was seriously concerned with the alarming scenario in the country's BoP situation. The Reserve Bank communicated its concerns in a detailed letter of February 19, 1990 to the Government, giving the factual details of the external position as follows:

Foreign exchange reserves during the current financial year up to February 2, 1990 had declined by Rs. 1,409 crore to Rs. 5,630 crore, as against a fall of Rs. 1,948 crore in the corresponding period. However, the real loss in reserves turned out to be much higher. But for the special transactions the loss of reserves would have been higher. Reserves in the current year had benefited from the inflow of funds under the Foreign Currency (Non-Resident) Accounts (FCNRA) Scheme. The net inflow of funds under this scheme during the current year up to February 2, 1990 amounted to Rs. 2,377 crore, higher by 48.0 per cent than those of Rs. 1,607 crore in the corresponding period of 1988–89. The net inflow of aid, however, had been lower than in the last year. Coming to the crux of the balance of payments problem, the grim picture was as follows.

The balance of payments had been under considerable pressure since the beginning of the Seventh Plan. Foreign exchange reserves in SDR terms steadily declined from SDR 6,004 million at the end of March 1985 to SDR 2,815 million by the end of December 1989. The current account deficit more than doubled from Rs. 2,852 crore in 1984–85 to Rs. 5,927 crore in 1985–86. Although it came down somewhat in the following year, it went up to Rs. 6,293 crore in 1987–88 and is estimated to have reached an all-time high of the order of (Rs. 10,430 crore) in 1988–89 or 2.7 per cent of GDP. The balance of payments continues to be under pressure during the current financial year. Based on the capital transactions, the current account deficit during April to December 1989 would seem to be running higher than in the corresponding period of 1988, although in U.S. dollar terms, it would be somewhat smaller

than in the last year. The annual average ratio of current account deficit to GDP of 2.2 per cent during the first four years of the Seventh Plan as against the targeted average of 1.6 per cent for the Plan period underscores the pressure on balance of payments.

The reasons for the large CAD experienced in the Seventh Plan period were both large trade deficits and deterioration in the invisibles account. While India had large trade deficits, the invisibles account — which had given a measure of support to BoP — had also deteriorated. Net invisibles receipts excluding official transfers, which financed as much as 92.0 per cent of the trade deficit in 1978–79 and 65.0 per cent in 1980–81, could offset only 51.0 per cent of the trade deficit in 1984–85, and were as low as 21.0 per cent in 1988–89. The surplus on the invisibles account was mainly due to private transfers. If private transfers were excluded, the invisibles account would show a deficit from 1987–88. Net invisibles excluding private transfers showed a steady deterioration from a surplus of US\$ 2,044.3 million (₹ 1,615 crore) in 1980–81 to a modest surplus of US\$ 18.0 million (₹ 23 crore) in 1986–87 and turned into a deficit of US\$ 792.1 million (₹ 1,027 crore) in 1987–88, a major reason being the persistent rise in interest payments on debt due to continued higher CAD.

The analysis showed that the large order of CAD in the Seventh Plan period had been financed partly by drawing down reserves, but mainly by a larger inflow of capital both on concessional terms and commercial terms and by way of NRI deposits. In addition, short-term debt of acceptance credits was quite substantial. India's total short, medium and long-term external debt, as well as NRI deposit liabilities as at end-March 1989, amounted to nearly US\$ 60,062.1 million (₹ 86,970 crore), which worked out to 22.0 per cent of GDP or about 280.0 per cent of current receipts (exports plus invisible receipts) during 1988–89. By the end of the Seventh Plan, short, medium and long-term debt and NRI deposit liabilities were estimated to exceed a staggering US\$ 6,009.6 million (₹ 1,00,000 crore). The Reserve Bank was categorical that the existing level of reserves of about US\$ 3,383.4 million (₹ 5,630 crore) was 'very low' and worked out to barely 1.6 months of imports. The Reserve Bank emphasised that the country could not afford to lose any further reserves and must aim at rebuilding them to the equivalent of two to two-and-a-half months' imports in the Eighth Plan period. The Bank sounded a note of caution that the country's credit standing in the international markets might be adversely affected unless the CAD was quickly reduced in absolute terms. The prognosis communicated to the Government was:

The large current account deficits can be financed by larger inflows of capital from abroad, by way of higher inflow of funds under FCNR(A) Scheme and larger utilisation of commercial borrowings. But this will add to debt burden and debt servicing liabilities. International bankers have already started raising questions in private conversations as to whether our debt servicing levels are not already excessive. Therefore, though we continue to raise commercial credit on competitive terms there is a clear and urgent need for caution. At the same time, it is important that we present a balanced view of our external account. Any impression of panic or serious deterioration would create doubts in the external financial markets, affect our credit standing and result in higher interest rates on new loans. The pressures on balance of payments can be contained only through a reduction in current account deficit in absolute terms as quickly as possible.

To arrest the deterioration in the invisibles account and thereby reduce the CAD, the Reserve Bank offered a number of recommendations, some of them having been already suggested to the Government. These included an improvement in the domestic fiscal balance by reducing the budget deficit, augmenting exportable surplus by limiting domestic consumption of some commodities, a closer examination of the import intensity of exports, containing imports in defence and bulk items, and a careful pruning of imports for which the Government was making the exchange allocation. The two new suggestions pertained to restraining domestic consumption of petroleum products and to further increasing earnings from tourism. However, the most pertinent and rather practical proposition was to augment foreign direct investment (FDI) as an alternative or supplement to external borrowings. Conceding that this was a 'sensitive' issue and tended to create apprehensions in some quarters, the Reserve Bank espoused the need to take a 'rational' view of the matter in light of pressures on the country's external account, the widespread interest that existed in investment in India provided the terms were attractive, the huge surpluses in countries like Japan and Germany, the high level of self-confidence that Indian industry had developed in partnering with foreign investors, and the urgent need for better technology and higher exports. In this context, the letter also noted the possibility of greater investment in Eastern Europe, where rapid political changes were under way to the detriment of Indian interests. The Reserve Bank emphasised, "There are

thus important opportunities which could be gained or lost depending on what decisions we take on the issue at this crucial time.” To attract substantial investments from abroad, the Governor expressed the view that some changes in the policies were necessary and in this regard the Government needed to address the following crucial issues: an increase in foreign holdings in new industries from 40.0 per cent to, say, 51.0 per cent, simplification and quickening of the procedures for such investment, and the need and justification for a more liberal mix of export obligation and sales in the domestic market.

#### WORSENING OF THE CRISIS TRIGGERED BY THE GULF WAR

Following the discussions between the Reserve Bank and the Government on August 13, 1990, regarding country's BoP situation, the Governor sent a detailed letter to the Finance Minister, dated August 16, 1990. After going over the main causes and effects of the rapidly deteriorating state of the BoP and the foreign currency reserves position with special focus on the impact of the gulf crisis on the economy, the letter reviewed the pattern of financing the looming CAD, namely, external assistance, commercial borrowings, NRI deposits and foreign exchange reserves.

The main conclusions of the review of the situation were that though the annual commitment of assistance was still quite high, most of it was tied to projects, actual utilisation was slow and doubts were expressed about whether donors would be prepared to provide quick disbursing, essentially BoP assistance. As regards commercial borrowings, international rating agencies had expressed concerns about India's rising debt and debt-service ratio and, in fact, Moody's had placed India on a watch list as a precursor to a possible downgrade of its credit rating. This meant that international banks would become more cautious in lending to India and the cost of borrowings would rise; already the margins over LIBOR had started moving up. NRI deposits, although a somewhat costlier source of external finance, had provided strong support to the country's BoP and were rising from year to year. These deposits were seen to be sensitive to the changing market perceptions about India and the Reserve Bank's assessment was that it would be too optimistic to assume a rising curve of net receipts on this account. The picture was also not bright in the case of acceptance credits; because of the rollover beyond 180 days, which had been estimated at nearly US\$ 1.0 billion, the cost had gone up. The State Bank of India (SBI), which had raised most of this finance, was finding it difficult to substitute this credit with medium-term facilities. The commercial paper

(CP) market was becoming tighter and, with outstanding acceptance credits already on the higher side, the Reserve Bank felt that there might be limited scope for raising them further. Foreign exchange reserves having already declined to a low level, the Reserve Bank opined that it would be 'inadvisable' to allow them to fall further. The Reserve Bank suggested that it would be useful to revalue the gold assets held by the Reserve Bank closer to international prices by amending the Reserve Bank of India (RBI) Act, 1934. Also, to improve flexibility in the use of gold reserves, an idea was mooted that 15.0 per cent of the reserves might be kept outside India as already permitted under the Act. The extant position was thus summed up as that apart from the inevitable increase in the cost of commercial borrowings, there might also be some difficulty in obtaining increasing amounts of funds from foreign commercial banks to finance the CAD not covered by external assistance and NRI deposits.

The Reserve Bank offered a number of policy options in this letter to arrest the CAD, which was difficult to sustain. The prime and most important corrective action was seen in fiscal consolidation, *viz.*:

There is need for a strong adjustment to restore viability of the balance of payments. In fact, such adjustment is overdue. The elements of the needed adjustments are well known. There has to be substantial fiscal consolidation through reduction of budget deficits, growth of liquidity has to be reined in, exports have to be increased still further, and a better balance brought about between exports and imports.

As the oil import bill accounted for a major strain on the BoP, the Reserve Bank advocated raising domestic prices to reflect import costs; this was expected to conserve energy use by restraining, in particular, consumption of oil and, to the extent feasible, increasing domestic production of oil.

On its part, the Reserve Bank suggested taking recourse to extraordinary financing from external sources to tide over the immediate situation, a strategy that was in fact eventually adopted. In the same letter, the Government was urged to take a policy decision to make the requisite adjustments with recourse to extraordinary financing (*e.g.*, from the IMF and/or under the fast-disbursing facilities of the World Bank). The desirability, advantages and disadvantages of such a method were persuasively expressed:

The advantage of such extraordinary financing would be that adjustment will take place in a more orderly fashion and will be less disruptive of the growth process. Also, arrangements with the aforesaid multilateral institution/institutions will give the right signals to the financial markets and enhance the willingness of the banking community to lend more money to India. However, recourse to the IMF has political overtones and will involve strong conditionality. Such conditionality will, however, involve more or less similar measures that will have to be taken even if there is no recourse to the IMF. One important difference, however, could be that under a Fund programme tightening imports may be more difficult than would be the case otherwise. Adjustment without extraordinary financing will have to be much stronger implying substantial reduction in the current account deficit in a shorter span of time. Either way, the policy with regard to the exchange range of the rupee may not be different from what is being pursued at present.

The advice of the Reserve Bank to choose the option of approaching multilateral institutions to prevent the occurrence of the crisis was eventually followed. It was, however, for the Governor, Reserve Bank and the newly elected Government at the Centre to carry forward the immediate measures to contain the crisis and to undertake reform measures for sustained long-term growth with stability.

### CONCLUDING OBSERVATIONS

The serious external payments crisis that struck in 1991 could be attributed mainly to the highly expansionary fiscal policy pursued since the mid-1980s that caused some serious distortions in macroeconomic management of both the domestic and external sectors. This was exacerbated by certain coincidental geopolitical developments. The early reform measures introduced from the mid-1980s were implemented without an overarching framework, resulting in the emergence of macroeconomic distortions. The fiscal deficit as a percentage of GDP enlarged to 9.4 per cent in 1990–91 as against the average of 6.3 per cent in the first half of the 1980s. A sizeable component of monetised deficit in the already large fiscal deficit resulted in rapid growth of monetary liquidity that was far out of alignment with real economic growth, thereby generating severe demand pressures and accelerating the pace of inflation. These imbalances, in turn,

spilt over on to the external sector in the form of a large and unsustainable CAD. The persistently high level of fiscal deficit and CAD resulted in a sizeable increase in public debt, both domestic and external. There was a step-up in short-term commercial borrowings in 1988–89 and 1989–90. India was thus faced with large internal and external financial imbalances and was consequently vulnerable to adverse external shocks around 1990.

In 1990, two instant external shocks contributed to further widening of the CAD. The first was Iraq's invasion of Kuwait, which resulted in the return and rehabilitation of Indians working in that region. The gulf crisis had a serious impact on India's POL import bill, which increased over 50.0 per cent. The direct overall adverse impact of the gulf crisis, lasting for about seven months from August 1990 to February 1991, on the current account of India's BoP for the fiscal year 1990–91 was estimated at US\$ 2,987.0 million. The gulf crisis had a significant adverse impact on the flow of remittances into India. By September 1990, the net inflow of NRI deposits had turned negative. Access to commercial borrowings became more expensive. The fall in capital inflows compounded the problem of financing the rising levels of the CAD. The second shock was slow economic growth in India's export markets. Further, India's export competitiveness was adversely affected by steady appreciation in the rupee's REER by 20.0 per cent between 1979 and 1986.

The country also faced intense political uncertainty during this period. Within a span of two years, *i.e.*, November 1989 and May 1991, there were three unstable governments at the Centre.

Rupee trade with the Soviet bloc was an important element of India's trade in the 1980s. During 1990–91, only three countries, *viz.*, the USSR, Czechoslovakia and Romania settled their payments under the RPA. However, the trade was dominated by the USSR, which accounted for 95.0 per cent of the total trade with countries under the RPA. With the introduction of Glasnost and the breaking away of Eastern European countries, several rupee payment arrangements were terminated in 1990–91.

The changing composition of external debt, which shifted from official to commercial and towards the short-term, was another factor contributing to external imbalances. Besides long-term and medium-term debt, there was short-term debt in the nature of suppliers' credit and BAF. The downgrading of India's credit rating by international rating agencies prompted international banks to restrict the rollover facility. The share of external assistance in total debt declined. The hardening of terms for

such assistance and the rise in the rate of interest contributed to bunching of debt-service payments. In 1990, there was a marked slowdown in borrowings from the international capital market. Creditworthiness considerations became of paramount importance and capital adequacy requirements constrained the lending activities of banks. Against this background, India's commercial borrowings in terms of commitments dropped sharply.

In November 1990, the Government lost a crucial vote of confidence in Parliament. The Union Budget due at the end of February 1991 was postponed and a vote on account was presented, which eroded the confidence of the international community in India's ability to steer through the crisis. By June 1991, the BoP crisis had become a crisis of confidence in Government's ability to manage the external sector situation, with a serious possibility of a default in its external payments.

Ever since 1988–89, the Reserve Bank had been continually alerting the Government regarding the adverse consequences of increasing government deficit, its impact on the external payments situation and the worsening BoP position. The Reserve Bank in its communication to the Government focused on policy measures, which were required to correct the situation, *i.e.*, export promotion, exchange rate policy and containment of the fiscal deficit of the Government. The analysis by the Reserve Bank showed that a large order of the CAD in the Seventh Plan period was financed partly by drawing down the reserves, but mainly by the larger inflow of capital on commercial terms. In addition, short-term debt was substantial. India's total short, medium and long-term external debt as well as NRI deposit liabilities at end-March 1989 worked out to 22.0 per cent of GDP or about 280.0 per cent of current receipts.

The crisis had assumed grave proportions when India was faced with the possibility of a default in external payments in June 1991. The Government and the Reserve Bank at official levels, amidst deep political uncertainties, took corrective steps with a resolve not seen any time before in India's economic history. The country, besides managing its BoP position, also embarked on a series of enduring macroeconomic and financial sector reforms.



# 12

## Management and Resolution of the 1991 Crisis

### INTRODUCTION

The experience with the onset of the balance of payments (BoP) crisis of 1991, the responses and reactions from both official and political circles, and the strategic decisions and action taken during the period 1990 to 1992 unfold an eventful story. The year 1991 is important not only because of the country's active engagement with the International Monetary Fund (IMF), but also because of the commitment with which the policymakers undertook long-term economic and financial sector reforms that had the potential to bring about a major structural break in India's growth trajectory and its integration with the global economy.

This chapter discusses serious dimensions of the crisis of 1991, the scope and content of the IMF programme that resulted in an arrangement of support, the actions taken by the Government in close co-ordination with the Reserve Bank and the roadmap for medium-term economic and financial sector reforms.

### DIMENSIONS AND INTENSITY OF THE CRISIS

In 1990–91, a slowdown in world trade following the recessionary conditions in the industrialised countries and the economic disruption in Eastern Europe, including the USSR, began to affect India's exports during early 1990–91 and, in the face of rising imports, contributed to widening of the trade deficit. The trade deficit at US\$ 9,437.0 million increased by US\$ 1,981.0 million or 26.5 per cent over the previous year, *i.e.*, 1989–90. Net invisibles receipts turned negative to US\$ (-)242.0 million from US\$ 615.0

million, showing a decline of 139.5 per cent over the previous year. As a result, the current account deficit (CAD) showed a sharp increase of 41.5 per cent during 1990–91 over the previous year. The CAD as a proportion of gross domestic product (GDP) stood at (–) 3.0 per cent for the year.

Signs of the payments crisis became evident in the second half of 1990–91 when the gulf war led to a sharp increase in the oil prices. Foreign exchange reserves began to decline from September 1990. The reserves declined by 71.2 per cent between the end of August 1990 and January 16, 1991, from a level of US\$ 3.1 billion to US\$ 896.0 million.

#### CRISIS-RELATED DEVELOPMENTS IN 1990–91

The immediate cause for the loss of reserves beginning in September 1990 was a sharp rise in the import bill of oil. From an average of US\$ 287.0 million per month in June–August 1990, the oil imports increased by 133.8 per cent to US\$ 671.0 million per month in the ensuing six months. The world oil prices surged on annexation of Kuwait, and spot purchases made to prevent the emergence of shortages in the domestic market were very expensive. The effect of the rise in oil prices was aggravated by the events that followed. Indian workers employed in Kuwait had to be airlifted back to India and their remittances ceased to flow in. Further, the consequent UN trade embargo on Iraq led to the cessation of exports to Iraq and Kuwait. The loss of exports to West Asia was estimated at about US\$ 280.0 million during 1990–91.

The payments crisis of 1991 was not, however, due simply to deterioration in the trade account; it was accompanied by other adverse developments on the capital account. Short-term credit had started drying up, thus imposing a severe strain on the BoP position. In 1989–90, canalising agencies increased their recourse to short-term credit. Such credit by way of bankers' acceptance lines and six-month credits were available at 0.25 per cent above London interbank offered rate (LIBOR), (the standard reference interest rate in international commercial borrowings) until November 1990, but the cost rose to 0.65 per cent above LIBOR in March 1991, and to 1.25 per cent above LIBOR by May. By June, the overall cost of credit was far higher. Margins over LIBOR settled at 2.0 per cent.

#### DECLINE IN EXTERNAL COMMERCIAL BORROWINGS

The volume of external commercial borrowings (ECBs) abroad with maturity of over a year (and going up to 12 years) that was approved in the

3 years between 1989 and 1992 is shown in Table 12.1. The ECBs approved by the Government amounted to US\$ 3,377.0 million in 1989–90. These came down by 42.2 per cent in 1990–91. In the first half of 1991–92, the volume of approved commercial borrowings further declined by 69.2 per cent. These loans were intended for financial institutions (FIs) and public sector enterprises to finance capital goods imports. They imparted flexibility to the funding pattern and facilitated cash management, and were relatively cheap as long as India's credit rating was good. The fall was accounted for by the bank loans, bonds placed abroad as well as the export credits. Though this period witnessed a decline in the overall availability of international credit due to tightening of Basel norms and uncertainty caused by the gulf crisis, in the case of India, the decline could be attributed primarily to the downgrade in its credit rating.

The outflow from non-resident Indian (NRI) deposits was also substantial. NRI deposits are effectively a form of short-term debt, because although they take the form of time deposits for different periods, the depositor could withdraw such deposits with some penalty and loss of interest. The outflow from NRI deposits amounted to US\$ 952.0 million in April–June 1991, and continued at the monthly average rate of US\$ 120.0 million in July–September and then at US\$ 83.0 million in October–December. The trend was reversed only in January 1992.

TABLE 12.1  
*Approvals of External Commercial Borrowings*

	<i>(US\$ million)</i>		
	<i>1989–90</i>	<i>1990–91</i>	<i>April–Sept. 1991</i>
Bank Loans	1,415 (2,296)	356 (624)	19 (50)
Bonds	751 (1,219)	660 (1,155)	–
Export Credits	1,209 (1,963)	934 (1,635)	582 (1,509)
Total	3,375 (5,479)	1,950 (3,414)	601 (1,559)

*Notes:* 1. Exchange rate of the Indian rupee taken at annual average of calendar year.

2. Figures in parentheses indicate rupees in crore.

3. '–': Nil.

*Source:* Government of India, *Economic Survey, 1991–92*.

## FOREIGN EXCHANGE RESERVES 1990-91

The fiscal year 1990-91 and the first quarter (April-June) of 1991-92 witnessed a steep fall in the foreign exchange reserves due to a combination of adverse short-term factors, such as a surge in the POL import bill, continued erosion in net invisibles earnings, reduced access to international financial markets and lower inflows into non-resident deposit accounts. At the end of March 1990, India's foreign exchange reserves stood at a little below two months of import requirements. In addition, during the year, there were some special transactions. The amount of SDR 487 million in the reserve tranche of the IMF was drawn in three instalments on July 20, August 14 and September 4, 1990, and by the end of September 1990, the reserves had declined to SDR 2,523 million. With effect from October 17, 1990, gold holdings were revalued closer to the international market price as against the previous practice of ₹ 84.39 per 10 fine gms. During the quarter October-December 1990, excluding the revaluation, gold reserves recorded a drastic fall of SDR 1,080 million. The import cover of the reserves thus declined to three weeks of import value as at end-December 1990. As part of liquidity management, India negotiated with the IMF a drawal of SDR 717 million under the compensatory and contingency financing facility (CCFF) and SDR 552 million under the first credit tranche of its stand-by arrangement.

Excluding the revaluation of gold, the reserves rose by SDR 668 million during the last quarter of the financial year and amounted to SDR 2,111 million as at end-March 1991. This, however, resulted in an overall decline in reserves during the year to the extent of SDR 934 million. Inclusive of the revaluation of gold, the foreign exchange reserves amounted to SDR 4,329 million and SDR 3,564 million at the end of March 1991 and June 1991, respectively. The BoP position as at end-March 1991 and March 1992 *vis-à-vis* that of 1989-90 brings out the comparative deterioration in various components of the BoP and other indicators (Tables 12.2 and 12.3).

The rapid loss of reserves prompted the Government to take several short-term measures in the second half of 1990-91 to mitigate the adverse impact of the deteriorating reserves position. In October 1990, the Reserve Bank imposed a cash margin of 50.0 per cent on imports other than those of capital goods, which were allowed only against foreign sources of credit. In December 1990, the Government imposed a surcharge of 25.0 per cent on the prices of petroleum products, except domestic gas, and also raised

TABLE 12.2  
Key Components of India's BoP

(US\$ million)

	1989-90	1990-91	1991-92
Merchandise			
a. Exports (fob)	16,955	18,477	18,266
b. Imports (cif)	24,411	27,914	21,064
I. Trade Balance (a-b)	-7,456	-9,437	-2,798
II. Invisibles (Net)	615	-242	1,620
III. Current Account (I+II)	-6,841	-9,680	-1,178
IV. Capital Account (a to f)	6,977	7,188	3,777
a. Foreign Investment	410	103	133
b. External Assistance (net)	1,856	2,210	3,039
d. Commercial Borrowings (net)	1,777	2,248	1,456
e. Rupee Debt Service	--	-1,193	-1,240
e. NRI Deposits (net)	2,403	1,536	290
f. Other Capital	531	2,284	101
V. Overall Balance (III + IV)	+136	-2,492	2,599
VI. Monetary Movements (VII+VIII+IX)	-136	2,492	-2,599
VII. Reserves (increase -/decrease +)	740	1,278	-3,384
VIII. IMF (Net)	-876	1,214	785
IX. SDR Allocation	0	0	0

Note: '--': Nil.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008-09*.

TABLE 12.3  
BoP Indicators

(Per cent)

	1989-90	1990-91	1991-92
Trade			
Exports/GDP	5.8	5.8	6.9
Imports/GDP	8.3	8.8	7.9
Invisibles:			
Receipts/GDP	2.6	2.4	3.6
Payments/GDP	2.3	2.4	2.9
Net/GDP	0.2	-0.1	0.7
Current Account			
Current receipts/GDP	8.2	8.0	10.3
Current receipts/Current payments	76.4	71.5	94.3
CAD/GDP	-2.3	-3.0	-0.3
Capital Account			
Foreign investment/Export	2.4	0.6	0.7
Foreign investment/GDP	0.1	0.0	0.1
Import cover of reserves (in months)	1.9	2.5	5.3

Note: Capital account includes errors and omissions.

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008-09*.

auxiliary customs duties. The cash margin imposed by the Reserve Bank was raised to 133.3 per cent in March 1991 and further to 200.0 per cent in April 1991. In May, the Reserve Bank imposed a 25.0 per cent surcharge on interest on bank credit for imports. These stringent measures brought about a considerable degree of import compression. Non-oil imports in October–December 1990 were 16.8 per cent higher in dollar terms than a year earlier. In the subsequent quarter, non-oil imports were 4.1 per cent below the level in the corresponding period of the previous year. In April–June 1991, these were 23.1 per cent lower in dollar terms. Details of various measures implemented by the Reserve Bank and the Government in close co-ordination, in an otherwise politically sensitive environment, are elaborated in the subsequent section, showing that the crisis was managed in a manner that was unprecedented in the economic history of the country.

To restore the competitiveness of Indian exports and reduce trade deficit and CAD, there were several downward adjustments to the rupee value from 1985. The exchange rate of the rupee was adjusted downwards sharply by about 18.0 per cent in two stages — on July 1 and July 3, 1991.<sup>1</sup> The dual exchange rate system introduced in March 1992 reduced the impact of exchange rate volatility. Further progress was made after an 11-month experience in favour of unifying the exchange rate. In addition, several structural measures were taken to move away from the conventional mechanism of import compression.

#### THE CRISIS SITUATION CONTINUED IN 1991–92

By June 1991, it was clear that import compression as an instrument for managing the BoP was proving to be counterproductive. The adverse impact of import compression can be gauged by comparing the import figures for April–September 1990–91 with those for 1991–92. Merchandise imports (in terms of US dollars) decreased by 17.5 per cent between April–September 1991–92 and April–September 1990–91. Essential imports consisting of oil and refined products, food grains, edible oils, fertilisers and non-ferrous metals fell by 17.2 per cent, while export-related imports slid down by 14.8 per cent. Of the rest, bulk imports — steel, coal, ores, paper and pulses — fell by 25.4 per cent, primarily on account of a conscious policy, and the rest by 32.8 per cent. The proportion of these residual goods in total imports declined to 13.5 per cent by April–September 1991; there

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1. For details, refer to the section on crisis management in this chapter.

was not much room left for their compression. Further import reduction of such products would have meant a cutback in the availability of essential inputs in industry and transport, petroleum products and fertilisers. The adverse effect of import compression was felt in the decline in the index of industrial production (IIP) during 1991–92. Additional compression would have caused an even sharper fall in industrial production, disruption of transport and a fall in exports, as export-related imports would have shrunk. Thus, import compression had reached a stage where it could have caused widespread loss of production and employment.

The adverse developments in the capital account continued through 1991. While the trade deficit came down from US\$ 781.0 million per month in October–December 1990 to US\$ 382.0 million per month in January–March 1991 and further to US\$ 172.0 million per month in April–June 1991, the outflow of foreign currency non-resident (FCNR) deposits accelerated from US\$ 59.0 million a month in October–December 1990 to US\$ 76.0 million in January–March 1991 and further to US\$ 310.0 million in April–June 1991. There was also evidence that expectations of default, and therefore of sharp devaluation, were creating longer leads in the payments for imports and lags in the realisation of export proceeds, which exacerbated the foreign exchange shortage in the market.

On March 18, 1991, the Governor held prolonged discussions with the Finance Secretary on the BoP prospects in the ensuing months. The gist of the discussions was communicated to the Government on March 25, 1992, which presented a clear but grim picture of the BoP position. The Reserve Bank pointed out:

The commercial banks were having serious difficulties in sustaining the level of their short term borrowings. The SBI was borrowing about 1.7 billion in the overnight market which had increased the cost of borrowing substantially. So far these funds were available, though at a high price. The SBI New York was also drawing funds from their overseas branches in London, Paris and Frankfurt. The availability of credit had however become more difficult as some international commercial banks had withdrawn the lines of credit to SBI New York. In order to support SBI and the overseas branches, RBI had transferred \$250 million to SBI New York and about \$80 million to UCO Bank. Further support was required by the overseas branches of Indian Banks.

The Reserve Bank further explained that the BoP prospects were bleak and the possibility of getting more funds from international banks was not bright. The Governor informed the Government that although the Federal Reserve Bank of New York had assured that they would extend all possible support to the Indian banks, since then some international banks had, in fact, withdrawn their support to the State Bank of India (SBI). The Governor did not support suspending imports under the open general licence (OGL), but favoured restricting imports through credit control. In view of the precarious situation, it was agreed that it was both necessary and desirable to restrict import demand by increasing the requirement for credit margins for all imports and that the Reserve Bank would work out the guidelines based on the discussions.<sup>2</sup>

The analysis of the BoP data during 1991–92 indicated that there was a sharp contraction in the merchandise trade deficit as compared with 1990–91, largely due to a massive reduction in imports. Invisibles were higher by 10.3 per cent compared with a decline of 8.6 per cent during the preceding year. Due to accruals of US\$ 863.0 million under the foreign exchange (immunities) scheme, 1991, private transfer receipts during 1991–92 showed an increase, though other remittances from NRIs working abroad, which were a major component of private transfers, were estimated to be at the same level as in the preceding year. Interest payments, as well as outward remittances for royalties and technical know-how continued to show an increase. Nevertheless, essentially as a result of the drastic cut-back in the trade deficit, the CAD was compressed by 87.8 per cent during 1991–92 over the preceding year.

The capital account was characterised by mobilisation of funds from NRIs and larger assistance from bilateral and multilateral donors. During the year, there was an outflow of US\$ 1,627.0 million under the FCNR (A) scheme as against an inflow of US\$ 168.0 million during 1990–91 and the bulk of these outflows, amounting to nearly US\$ 1 billion, occurred during April–June 1991 — a period of overall uncertainty. With some rapid measures of stabilisation, the outflows tapered down to US\$ 152.0 million in the last quarter of the year 1991–92, which seemed to represent portfolio switches in favour of other schemes. Non-resident (external) rupee [NR(E)R] deposits also suffered, although marginally, showing an outflow of about US\$ 90.0 million during April–December, 1991 against

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2. D.O. letter of the Finance Secretary, No. 47/FS/91-TS dated March 25, 1991.

an inflow of US\$ 30.0 million in the same period in the previous year. As a result, the total outstanding balances under these two accounts put together declined from US\$ 10.6 billion at end-March 1991 to US\$ 8.5 billion at end-December 1991 (Table 12.4).

TABLE 12.4  
*Stocks and Flows under Non-Resident Deposit Accounts*

(US\$ billion)

Year	NR(E)R Accounts		FCNR Accounts		Total	
	Outstanding at year end@	Inflow(+)/ Outflow(-)	Outstanding at year end**	Inflow(+)/ Outflow(-)	Outstanding at year end@	Inflow(+)/ Outflow(-)
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1985-86	2.8	0.5	1.8	0.9	4.6	1.4
1986-87	3.3	0.4	2.7	0.9	6.1	1.3
1987-88	3.9	0.4	3.8	1.0	7.8	1.4
1988-89	3.8	0.2	5.3	1.5	9.0	1.7
1989-90	3.8	-	6.6	1.3	10.4	1.3
1990-91	3.7	0.1	6.8	0.1	10.6	0.2
1991-92*	3.0	-0.1	5.5	-1.5	8.5	-1.6

Notes: @ Inclusive of accrued interest.

\* Up to December 31, 1991 and provisional.

\*\* Exclusive of accrued interest.

'-' Nil.

Source: Government of India, *Economic Survey, 1991-92*.

The large outflow under the FCNR (A) scheme was, however, recouped to a great extent by subscription to India development bonds (IDBs) aggregating US\$ 1,627.0 million. The IDBs had the added advantage of elongated maturities. The utilisation of external assistance, excluding exceptional financing of US\$ 1.0 billion from the World Bank, the Asian Development Bank (ADB) and Japan, was at the same level as in 1990-91. Commercial borrowings other than the IDBs were significantly lower during the year due to India's downgraded rating by rating agencies.

The Aid-India Consortium committed aid during 1991-92 amounting to US\$ 6.7 billion for India, of which US\$ 2.3 billion could be drawn immediately. At this crucial stage, on October 31, 1991, the IMF approved an upper credit tranche stand-by arrangement amounting to SDR 1,656 million (US\$ 2.2 billion), which was to be availed of in instalments over 20 months from the date of approval. The first instalment of SDR 85 million (US\$ 117.0 million) was drawn in November 1991 and the second

instalment of SDR 185 million (US\$ 263.6 million) in January 1992. In July 1992, there was a drawal of a third instalment of SDR 462 million (US\$ 663.0 million).

#### FOREIGN EXCHANGE RESERVES 1991-92

India's foreign exchange reserves rose from US\$ 5,834.0 million at end-March 1991 to US\$ 9,220.0 million at end-March 1992, reflecting a distinct easing of foreign exchange constraints (Table 12.5).

TABLE 12.5  
*Foreign Exchange Reserves*

<i>End of Financial Year</i>	<i>SDR</i>	<i>Gold</i>	<i>FCA</i>	<i>Total</i>
1989-90	107	487	3,368	3,962
1990-91	102	3,496	2,236	5,834
1991-92	90	3,499	5,631	9,220

(US\$ million)

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008-09*.

#### EXTERNAL DEBT

With the gradually growing deficit in the current account, India's external debt liabilities comprising multilateral and bilateral assistance, commercial borrowings and NRI deposits rose over the years. India's medium and long-term debt, *i.e.*, with the original maturity of more than one year and excluding NRI deposits, increased from US\$ 47.0 billion at end-March 1990 to US\$ 51.7 billion at end-March 1991 and further to US\$ 57.6 billion at end-March 1992, showing an increase of 10.0 per cent and 11.4 per cent, respectively over the corresponding previous years. Including NRI deposits of all maturities and short-term debt in the nature of trade credit, suppliers' credit and credit under bankers' acceptance facility (BAF), India's external debt liabilities as at end-March 1991 stood at US\$ 67.1 billion, which increased to US\$ 68.8 billion at end-March 1992. The increase in rupee terms was much larger, which could be attributed to a downward adjustment of the rupee *vis-à-vis* major currencies in July 1991 and the introduction of liberalised exchange rate management system (LERMS) in March 1992.

In relation to GDP at current market prices, the medium and long-term external debt and NRI deposits rose to 31.2 per cent at end-March

1992 as against 23.4 per cent at end-March 1991, reflecting the depreciation of the rupee. The debt-to-exports ratio was around 259.0 per cent at end-March 1991 and rose to about 303.0 per cent at end-March 1992. The debt-service ratio, *i.e.*, ratio of debt-service payments to current receipts excluding official transfers, declined to 30.2 per cent during 1991–92 from 35.3 per cent in 1990–91.

The gulf crisis and a downgrade in India's credit rating below the investment grade prevented India from accessing international markets for funds. This also resulted in net outflows on account of ECBs both in 1990–91 and 1991–92 (Table 12.6).

TABLE 12.6  
*External Commercial Borrowings*

	<i>(US\$ billion)</i>					
	1987–88	1988–89	1989–90	1990–91	1991–92	1992 April–December
I. Authorisation	2.05	2.98	3.29	1.90	2.13	1.59
II. Gross Disbursements	1.74	2.81	2.52	1.70	1.10	0.55
III. Debt-Service Payments	1.34	1.54	1.83	2.23	2.18	1.01
a. Amortisation	0.67	0.76	0.87	1.19	1.17	0.60
b. Interest payment	0.67	0.77	0.95	1.04	1.01	0.41
IV. Net Capital Inflows (II–IIIa)	1.07	2.05	1.65	0.51	–0.07	–0.05
V. Net Transfers (II–III)	0.40	1.27	0.69	–0.53	–1.08	–0.46

*Note:* ECBs include long-term loans from commercial banks, other FIs, bonds and floating rate notes, suppliers' credit, buyer's credit, and credits from export credit agencies of concerned Governments, International Finance Corporation (IFC) (W) and private sector borrowings from ADB.

*Source:* Government of India, *Economic Survey, 1992–93*.

The crisis led to a situation where international markets did not open up on a normal note for Indian borrowers to take recourse to such borrowings on a significant scale. Moreover, the Government had decided to reduce the share of short-term borrowings in total debt. Consequently, a major portion of the commercial borrowings raised during the two years (1990–1992) was by way of export credits supported by official export credit agencies, such as the US Export-Import Bank and the Export Credit Guarantee Corporation (ECGC) of the UK.

## THE ADJUSTMENT PROCESS AND ALTERNATIVE OPTIONS

At a critical time and in the thick of the BoP crisis, the main task of the Reserve Bank under the leadership of the Governor, Shri S. Venkitaramanan, turned out to navigate the country through the troubled waters. After successfully resolving the BoP crisis, the Reserve Bank had to address issues related to an unexpected breakout of irregularities in securities transactions from April 1992.

The adjustment process was complicated partly because of possible adverse public opinion and the consequent political overtones, and to some extent due to the absence of a stable Government. The official and political circles, however, considered several options from time to time and tried to wade through the crisis till a wide-ranging programme of stabilisation and structural adjustment was signed with the IMF in the late 1991. There is evidence that the country's authorities maintained close liaison with the IMF and the World Bank all along when drawals of funds were made from these institutions. The IMF programme of 1991 was a natural culmination of this ongoing co-operation between the country's authorities and the IMF. The various options that were considered and dropped or partially implemented to avert the crisis are summarised below.

In 1991, with the foreign exchange reserves dwindling, the Government and the Reserve Bank had four options. The first was to default on the country's external obligations. This action would have been self-defeating given that since December 1990, India had been borrowing on a daily basis and, as a result, market confidence had eroded. A default would not have been a strategic act of hard bargaining; rather, it would have destroyed any remaining credibility. India had a history of repaying its debts on time and policymakers did not want to sour that record. For a country that respected its national sovereignty, a default would have left it completely dependent on international institutions and creditors.

The second option was to seek private funds from abroad. However, commercial borrowings had dried up and NRIs were withdrawing their deposits; there was, in relative terms, a massive net outflow of US\$ 1.3 billion from such accounts during April–September 1991. Seeking further support from this source was neither a feasible nor a realistic option.

The third option was to use gold reserves as an emergency measure. In April 1991, the Government raised US\$ 200.0 million from the Union Bank of Switzerland (UBS) through a sale (with a repurchase option) of

20 tonnes of gold confiscated from smugglers. Again, in July 1991, India shipped 47 tonnes of gold to the Bank of England (BoE) to raise another US\$ 405.0 million. This action helped the country repay its international donors and creditors, though it was not sufficient to completely absolve the country of the crisis.

The fourth option entailed seeking emergency bilateral assistance. Such assistance came in from Germany (US\$ 60.0 million) and Japan (US\$ 300.0 million). India's problem, however, was not merely the amount needed to avoid a default, but getting away fast from recurring liquidity squeezes. Additional measures were, therefore, needed.

In view of the overvaluation of the rupee in the later part of the 1980s *vis-à-vis* its Asian counterparts and the loss of competitiveness, devaluation, however unpopular, became necessary. In June 1991, the Finance Minister with his vast experience in the Government and at the Reserve Bank felt that making exchange rate adjustments, pursuing fiscal reforms and influencing business expectations were the most immediate and necessary policy responses. To minimise political opposition and institutional constraints, the Government implemented the devaluation policy in two steps through the Reserve Bank, which agreed to announce new intervention rates. The Reserve Bank had been intervening to stabilise the fall in the rupee value since 1987, so a lower rate of intervention signalled that the Government was willing to let the rupee fall further.

The devaluation took place in two steps. On July 1, 1991, the Finance Minister wanted to 'test the waters' before effecting any large change in the value of the rupee. Only when the markets reacted positively, a second devaluation was permitted on July 3, 1991. The two-step downward adjustment in the value of the rupee worked out to 17.38 per cent in terms of the intervention currency *i.e.*, pound sterling and about 18.7 per cent in US dollar terms. Further, to counteract any inflationary impact, the Bank increased the Bank Rate, term deposit rates and the lending rate for large borrowers.

Devaluation was an emergency measure and needed political tact. What mattered in 1991 were the follow-up policies and the people who executed them. The crisis gave policymakers the opportunity to pursue liberalisation, which the economic administration of the Government had been pushing for since the late 1980s. Industrial licensing for all, except 18 industries was abolished; investment caps on large industrial houses were removed; only six industries remained exclusively in the public sector;

access to foreign technology was liberalised; import licensing was virtually abolished; import duties were sharply reduced; and exporters could open foreign currency accounts.

An important dimension to the entire process of adjustment was the role played by the government administration in carrying through the measures in co-ordination with the Reserve Bank during a period of considerable political uncertainty. The authorities also maintained good working relationships with the multilateral institutions. This environment, in no small measure, helped in the effective co-ordination of domestic policymakers with the IMF and the World Bank, in instituting necessary reforms and eventually in the smooth conclusion of the programme once a regular Government was formed in June 1991. The IMF history stated:<sup>3</sup>

The politics of borrowing from the IMF is always complex, but in India it was especially so. On the one hand, Indian politicians had long viewed IMF conditionality with some disdain. As soon as it became known that the government was applying for a stand-by arrangement, its leaders would be attacked in Parliament and in the press for subjugating the country's interests to foreign domination. On the other hand, most of the countries' economic and financial officials had good relations with the IMF, and an unusually high degree of trust had developed on both sides over the years.

The history further added:<sup>4</sup>

The working relationship was a little unusual, in that the authorities knew full well what they needed to do to qualify for the Fund's seal of approval and financial support. The decision to devalue, for example, was not made at the insistence of the Fund, but on the understanding that the Fund would approve it and that both sides believed it was necessary and was in India's interest. As had been true for the 1981 negotiations, these discussions were amicable and collegial.

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3. Boughton, James M. (2012). "Tearing Down Walls", *History of the International Monetary Fund 1990–1999*. International Monetary Fund.

4. Ibid.

## THE IMF PROGRAMME: 1991–1993

### STRATEGY AND KEY OBJECTIVES

In financial terms, the IMF's assistance was small compared with the dimensions of the crisis. In 1991–92, the withdrawals from the IMF amounted to US\$ 1.2 billion as against India's short-term debt of US\$ 6.0 billion at the end of 1990–91, with overnight borrowing in international capital markets of the order of US\$ 2.0 billion. India's decision to seek assistance from the IMF perhaps came a trifle late. The previous two short-lived governments, in fact, gave enough evidence of the concerns about the BoP crisis and their drawal of reserves to finance the high fiscal deficit.<sup>5</sup> The Governor's letter to the Government in late 1989 and early 1990 clearly hinted at the possibility of approaching multinational institutions. However, the elections due in November, which were postponed, seemed to be the main reason why negotiators could not make commitments back then.

The IMF's support for the ongoing reforms gave international credibility to the Government in power. The Government had already taken steps to compress imports through higher cash margin requirements, surcharges on petroleum products and on interest on import credit, and tightened import licensing. There was also an urgent need to bring about medium-term structural adjustment to shift resources from the non-traded to the traded goods sector; promote exports; liberalise imports; and reduce state intervention in economic activity and the scope of the public sector. The prevalent view was that the economic policy had to undergo a transition from a regime of quantitative restrictions to a price-based mechanism with less state control, but in a gradual manner.

Under the CCFE agreement, India had withdrawn US\$ 221.0 million and US\$ 637.0 million in July and September 1991, respectively. With more wide-ranging reforms on the anvil, additional support was sought. The Reserve Bank in its Annual Report for 1990–91 explained that the

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5. The Finance Minister stated in his budget speech (February 1990) that "the fiscal imbalance [was] the root cause of the twin problems of inflation and the difficult [BoP] position". A year later, the Finance Minister admitted that the Government had realised the economic situation was one of 'crisis proportions' by November 1990 itself. Between July and September 1990, the National Front Government drew US\$ 660.0 million from its reserve tranche in the IMF. By end-1990, when reserves could cover only three weeks of imports, India negotiated the purchase of US\$ 1.8 billion under the IMF's CCFE (to cover oil imports) and the first tranche of a stand-by arrangement. The CCFE was an emergency measure and had very low conditionality attached to it.

stabilisation measures would take time to have an effect on foreign exchange reserves. It estimated that external financing of US\$ 3.0 billion was needed in 1991–92 to ‘undertake reforms without undue disruption’. India’s letter of intent to the IMF outlined the requirements of external financing as well as India’s proposals for further policy reforms.

The Finance Minister in the budget speech of 1992–93 allayed public fears about compromising national interests by depending on the IMF assistance and subjecting the country to certain conditionalities in the following manner, which corroborated the home-grown nature of the intended reforms:

It has been alleged by some people that the reform programme has been dictated by the IMF and the World Bank. We are founder members of these two institutions and it is our right to borrow from them when we need assistance in support of our programmes. As lenders, they are required to satisfy themselves about our capacity to repay loans and this is where conditionality comes into the picture. All borrowing countries hold discussions with these institutions on the viability of the programmes for which assistance is sought. We have also held such discussions. The extent of conditionality depends on the amount and the type of assistance sought. However, I wish to state categorically that the conditions we have accepted reflect no more than the implementation of the reform programme as outlined in my letters of intent sent to the IMF and the World Bank, and are wholly consistent with our national interests. The bulk of the reform programme is based on the election manifesto of our Party. There is no question of the Government ever compromising our national interests, not to speak of our sovereignty.

In the November 1991 stand-by arrangement, the IMF promised to provide US\$ 2.2 billion over a period of 20 months, with a comprehensive set of performance criteria and structural benchmarks to be achieved by May 1993. Both sides also expected that this arrangement would have to be followed by concessional loans under the enhanced structural adjustment facility (ESAF), but this did not materialise. In addition, the Aid-India Consortium committed US\$ 6.7 billion in aid to India.

There was no extension of the IMF stand-by arrangement beyond 1993. There were, of course, positive signs in the economy: foreign

exchange reserves had climbed to US\$ 9.8 billion by the end of 1992–93 and economic growth had recovered to 4.0 per cent.

#### KEY MACROECONOMIC OBJECTIVES AND STRUCTURAL BENCHMARKS

The key macroeconomic objectives of the programme included an easing of the payments situation and the rebuilding of gross international reserves to over 1.5 months of imports by the end of 1992–93; economic growth of 3.0–3.5 per cent in 1991–92 followed by a gradual recovery in 1992–93; and a reduction in inflation to no more than 6.0 per cent by the end of 1992–93. Taking account of the sizeable new investments and related imports needed to support the restructuring of the economy, the CAD was targeted at about 2.5 per cent of GDP in 1991–92 and 1992–93. A decline in the surplus of private savings over private investment was expected, as the latter would respond to the new opportunities stemming from structural reforms. The private savings rate was also anticipated to temporarily decline as a result of the dip in economic growth and the fiscal adjustment measures. Thus, the targeted reduction in the overall public sector deficit was considerably larger than the projected adjustment in the external current account.

#### FISCAL CONSOLIDATION

The medium-term objective was to reduce the public sector deficit from an estimated 12.5 per cent of GDP in 1990–91 to 8.5 per cent of GDP by 1992–93 and further to 7.0 per cent by the mid-1990s.

The fiscal programme for 1992–93 had the dual objective of continuing deficit reduction while simultaneously initiating major tax reforms. Further, substantial expenditure reductions were needed; the items being considered included a curtailment in the government wage bill, a further cutback in defence spending, a continued reduction in transfers to public enterprises, and a further reduction in fertiliser and food subsidies through additional price increases and better targeting.

Since the time between the elections and the July 1991 budget was too brief to formulate comprehensive proposals, the Government had committed itself to a fundamental tax reform to remedy these deficiencies, while mobilising additional revenues to compensate for the revenue loss from tariff reduction and to support the programmed fiscal adjustment. A tax reform committee was appointed that was to report in time for the

first stage of reforms to be incorporated in the 1992–93 budget; technical assistance was also requested from the IMF.

#### OTHER PUBLIC SECTORS

Beginning in 1992–93, the authorities intended to reduce statutory liquidity ratio (SLR) imposed on commercial banks to ensure that the reduced borrowing requirements of the Government did not provide scope for increased bank borrowings by the states. Other borrowings were also to be contained; in particular, the interest rates paid on the Government's small savings schemes (from which three-quarter of the proceeds were automatically on lent to the states) were to be kept under close review to ensure that these schemes did not draw funds away from commercial bank deposits.

With regard to public sector enterprises, the priority in the reforms programme was to eliminate structural rigidities and inefficiencies and to ensure that investments faced a market test. The central public enterprises deficit was targeted to decline to 3.0 per cent of GDP in 1991–92 from 3.5 per cent in 1990–91, partly as a result of reduced capital spending.

In contrast to central public enterprises, which generated internal resources to help finance investments, the state public enterprises incurred losses on a net after-tax basis and the bulk of these losses stemmed from the operations of the state electricity boards (SEBs), reflecting a non-commercial orientation and uneconomic pricing, especially for rural consumers. Losses by the SEBs contributed to arrears in their payments to power generation companies. To address these issues, the Central Government was pursuing three initiatives. First, a portion of central transfers to the states were earmarked for direct payment to power generation companies to address the problem of arrears. Second, a uniform minimum electricity tariff for agricultural consumers was proposed. Third, the Central Government no longer contributed to state power projects that did not meet minimum financial criteria.

#### MONETARY POLICY

Monetary policy was tightened progressively in 1991–92 in response to the external liquidity crisis and the build-up of inflationary pressures. The tightening was achieved through a combination of indirect instruments that operated with an effect on bank liquidity and interest rates (including the introduction of a 10.0% incremental cash reserve ratio and several

increases in administered interest rates) and more direct instruments (including a reduction in incremental credit-to-deposit ratios and a tightening of various directed credit and refinance facilities). In addition, the imposition of high cash margin requirements on import letters of credit (LCs) contributed to tighter domestic credit conditions.

The financial programme provided for continued monetary tightening. The targeted reduction in broad money growth to 13.0 per cent in 1991–92 and 11.0–12.0 per cent in 1992–93 was consistent with the output and inflation targets of the programme and conservative assumptions about demand for money; specifically, the targets assumed a broadly unchanged velocity of money compared with the trend decline observed during the preceding years.

To encourage increased reliance on market-based instruments of monetary control, the monetary performance criteria were set to be achieved by the Reserve Bank. The targets for net domestic assets were established to be consistent with the external objectives of the programme and provided for adequate growth in credit to the commercial sector. Monetary policy was expected to defend the external reserves position, and tighten further if net international reserves fell below the targeted floors.

The interest rates were progressively liberalised after the effective decontrol of rates charged on bank loans to non-preferred sectors in the late 1989. The ceiling on long-term loan rates charged by development banks and the restrictions on private debenture interest rates were both eliminated in July 1991. Since this substantially raised the borrowing costs of public sector enterprises closer to market rates, it was expected to significantly reduce their borrowing. However, interest rates on deposits and on the preferred sector credits (almost half the total) remained subject to controls.

Deposit rates were increased by 1.0 percentage point in July (to a range of 9.0–13.0%), but rates were negative in real terms. Thus, to implement the tight monetary policy, the Reserve Bank relied primarily on a selective tightening of credit rather than on further increases in interest rates, especially for deposits. The Reserve Bank noted that household financial savings were already buoyant at the prevailing interest rates. The IMF viewed that under the prevailing conditions, the level of domestic deposit rates could have a significant influence on the external account. Readiness to adopt timely and decisive action on all interest rates was, therefore, an important element of the financial strategy, both to make the commitment to exchange rate stability credible and to prevent the burden

of monetary tightness from falling disproportionately on sectors that did not have access to preferential credit. The Reserve Bank indicated that further increases in deposit interest rates would be implemented in early October 1991.

#### EXTERNAL SECTOR

The policymakers reaffirmed their commitment to maintaining the unblemished payments record of India. Hence, the external policy response to the deteriorating liquidity position consisted of: (i) a substantial exchange rate depreciation combined with the elimination of cash export subsidies designed to improve and make export incentives more uniform; (ii) the initiation of fundamental reforms to integrate India more closely with the world economy; and (iii) the temporary implementation, beginning in September 1990, of several special import compression measures.

The exchange rate of the rupee depreciated cumulatively by 60.0 per cent in nominal effective terms and by 50.0 per cent in real effective terms from January 1985 to June 1991. Following the July 1991 depreciation, the Government and the Reserve Bank announced their intention to hold the nominal effective exchange rate (NEER) stable in order to maintain confidence. Thus, tight financial policies were the primary means of maintaining competitiveness. Since inflation during the programme period was projected to be higher than in the partner countries, partly as a result of administered price increases and the lagged effects of the exchange rate action, a moderate real appreciation of the rupee was expected. However, the real effective rate was expected to remain well below its pre-July level. The IMF agreed that nominal exchange rate stability would be an important part of the strategy to restore internal and external confidence and to reduce inflation. To be credible, however, such a policy had to be backed by decisive financial policies; in particular, a much more active use of interest rate policy was needed.

#### STRUCTURAL REFORMS

The objective of the reforms was to promote economic growth by reducing government intervention, enhancing domestic competition, and accelerating India's integration with the world economy. The Government had already made significant policy changes in several key areas. Specific policy actions in a number of areas — notably industrial deregulation, trade policy, public enterprise reforms, and some aspects of financial sector

reforms — were also the basis for a World Bank structural adjustment loan (SAL), as well as sector loans. A number of measures were announced to strengthen competition between the private sector and public enterprises, where *de facto* monopoly power and soft budget constraints had been the root causes of inefficiency. Specifically, the number of industries reserved exclusively for the public sector was narrowed down to eight (relating to defence production, atomic energy, minerals and railways); the system of monitoring public enterprises was strengthened; the budget constraints faced by the enterprises were hardened through a reduction in transfers and subsidies from the Union Budget; and the Government announced its intention to sell up to 20.0 per cent of equity in selected public enterprises to mutual funds during 1991–92.

#### TRADE

The Government intended to substantively dismantle the quantitative restrictions on international trade over the next three to five years, moving to a transparent price-based system with moderate protection for domestic industry. The initial steps in this direction were taken in July 1991 with the abolition of cash export subsidies, modest reductions in peak tariff rates, a halt to new phased manufacturing programmes, and partial substitution of quantitative import restrictions by a tradable import entitlement — the Exim scrip. The intention was to use the latter scheme as a transitional vehicle for further import liberalisation: the list of eligible imports was to be gradually expanded, along with a phased increase in the Exim scrip entitlement rate.

#### FINANCIAL SECTOR

There were three priority areas for financial sector reform. First, a more market-oriented allocation of credit was required. The fiscal consolidation would reduce the share of total lending that was pre-empted by the public sector, but needed to be accompanied by a scaling-back in the scope of preferred sector lending. Second, a number of banks were in a weak financial position, and a detailed programme to strengthen their capital base and improve the supervision procedures was needed. The Government and the Reserve Bank regarded action in both these areas as essential pre-requisites for further interest rate liberalisation; in particular, the heavy implicit taxation of financial intermediation and the fragile financial position of some banks had constrained the deregulation of bank

deposit rates. The IMF provided technical assistance in the area of bank supervision. The third priority area related to the strengthening of capital markets, including the term-lending institutions. A high level committee chaired by Shri M. Narasimham was asked to submit detailed proposals in all these areas by November 1991.

There were substantial restrictions on closure, relocation, and the shedding of labour in both public and private industry. It was agreed to formulate a suitable policy framework to facilitate industrial restructuring, but noted that success would require the building of a political consensus. Nevertheless, two key components of the policy framework were put in place. First, the Board for Industrial and Financial Reconstruction (BIFR), established in 1987 to formulate rationalisation programmes for ailing private sector firms, was to be strengthened; its scope had already been widened to include public sector units. Second, a social safety net — the national renewal fund (NRF) — was established in the budget for 1991–92 to provide compensation and, more importantly, training for retrenched workers.

#### PERFORMANCE CRITERIA AND REVIEWS

The fiscal objectives of the programme were monitored through quarterly ceilings on the overall borrowing requirement of the Union Government as well as an indicative benchmark on total bank credit to the general government sector. In addition, implementation of additional expenditure and revenue measures was set out as the performance criterion for December 1991. The monetary objectives were supervised through ceilings on net domestic assets with a sub-ceiling on Reserve Bank credit to the Union Government. The external objectives were examined through quarterly floors on net international reserves of the Reserve Bank; there was also the performance criterion regarding the exchange and trade system. Quantitative performance criteria were set through March 1992, with annual indicative targets for fiscal 1992–93. The drawals under the stand-by arrangement are shown in Table 12.7.

A number of structural benchmarks in the areas of industrial policy, trade liberalisation, domestic pricing policies, public enterprise reforms, financial sector reforms, tax reforms, and expenditure control were also established. In particular, arriving at a mutual understanding in the last two areas as well as on the 1991–92 budget formed an important condition.

TABLE 12.7  
*Drawings under IMF Stand-by Arrangement 1991–1993*

(US\$ million)

<i>Month/Year</i>	<i>Amount</i>
November 1991	117.0
January 1992	263.6
July 1992	663.0
December 1992	643.0
February 1993	319.0
June 1993	325.0

*Source:* Reserve Bank of India, *Annual Report, 1991–92; 1992–93.*

#### OVERALL ASSESSMENT

The 1993–94 budget speech of the Finance Minister provided a succinct assessment of the IMF programme and the Government's intention to carry forward the reforms in the coming years:

It is now twenty months since our government took office: twenty eventful months in which we have worked ceaselessly to overcome the very difficult economic situation we inherited.

The sense of crisis is now behind us. We have restored a measure of normalcy to our external payments. The annual rate of inflation has been reduced from the peak of 17% in August, 1991 to below 7%. International confidence has been restored. Agriculture has performed well in the current year and industrial production is beginning to recover. The growth of the economy, which had declined to 1.2% in 1991–92, is expected to be around 4% in 1992–93. The economic strategy we have followed, resting on the twin pillars of fiscal discipline and structural reform, has been vindicated by the decisive upturn.

We have made good progress by reducing the fiscal deficit from 8.4% of GDP in 1990–91 to about 5% in the current year.

Although the rupee has been floated for most current account transactions, the market exchange rate has remained relatively stable. The investment climate has improved considerably. Corporate capital issues by non-Government public limited

companies in April–October 1992 were 67 percent higher than in the same period of the previous year. Loans sanctioned by financial institutions in the first ten months of 1992–93 were 49% higher than in the same period of the previous year. Foreign investors are showing active interest in investment in many sectors, including critical infrastructure sectors such as power and petroleum. Since August 1991 the approvals given for foreign investment proposals up to the end of January amount to an equity investment of \$2.3 billion. These are of course only approvals at this stage and actual flows will take time to materialise, but they certainly indicate a substantial potential for larger investment inflows in the future.

As regards the success of the IMF programme, the history of the IMF stated:<sup>6</sup>

The 1991–93 stand-by arrangement with India proved to be an outstanding success story, both for the Indian government and for the IMF. Faced with a dangerous fiscal and political crisis, Rao's government seized the opportunity to begin a reform program that irreversibly altered the very nature of the Indian economy. Although by all accounts the reform agenda was still far from being completed, it continued throughout the decade, and it enabled the Indian economy to weather the turbulence in the world financial system in the late 1990s. In 2003, India became a creditor of the Fund. Through the end of that decade, it did not have to borrow.

#### CRISIS MANAGEMENT: MEASURES ADOPTED DURING 1990–91 TO 1992–93

There are a few measures that need to be spelt out in detail to appreciate the extent of crisis management in 1990–91 through 1992–93. There was no particular roadmap for these reforms. The measures were initiated by the Reserve Bank in consultation with the Government or on its own as responses to the evolving situation and drew, *inter alia*, on cross-country international developments and experience.

The first was the matter of gold revaluation. Until the 1990s, the gold held by the Reserve Bank as part of the country's foreign exchange reserves

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6. Ibid.

was valued at the rate of 0.118489 gms of fine gold per rupee (₹ 84.396 for 10 gms) as per section 33(4) of the Reserve Bank of India (RBI) Act, 1934. However, this rate was well below domestic and international prices. On September 3, 1990, the domestic price of gold was ₹ 3,372 for 10 gms, while the London Metal Exchange (LME) price, a standard indicator of international price, was ₹ 2,180 for 10 gms. The Reserve Bank valuation was about 1/40th of the domestic price and 1/26th of the international price. The value of gold held by the Bank under the different rates is given in Table 12.8.

TABLE 12.8  
*Gold Value*

	<i>Rate</i> ₹ /10 gms	<i>Value</i> ₹ crore
RBI	84.39	280.67
LME (as on September 3, 1990)	2,180	7,250.67
Domestic	3,372	11,214.02

*Source:* Reserve Bank of India, Department of External Investments and Operations.

The price adopted for valuation of gold in relation to the international price by the central banks varied widely across countries, with a few overvaluing and many undervaluing. Table 12.9 gives the details in this regard for select countries. The extent of undervaluation in the case of India was not only large compared with the international price but also *vis-à-vis* other developing countries.

It was viewed that revaluation of the gold holdings from time to time in accordance with international price movements could present a more realistic picture of India's foreign exchange reserves, particularly when making inter-country comparisons. Under the extant system, the flexibility for such periodic revaluation was limited as it called for an amendment to the RBI Act. Such a legislative process was time-consuming, whereas the Reserve Bank needed to respond quickly in such situations. To overcome this problem, the Ministry of Finance proposed<sup>7</sup> to amend section 33(4) of the RBI Act to allow for flexibility in periodic revaluation of gold.

7. D.O. Dy. No. S-63/TS (ECB)/90 on September 4, 1990.

TABLE 12.9  
*Valuation of Gold in Different Countries*

<i>Country</i>	<i>Dollar/troy ounce</i>	<i>Valuation in Percentage of International Price</i>
USA	42.24	10.9
Japan	45.93	11.8
FRG	85.60	22.1
UK	291.00	75.0
France	415.17	107.0
Thailand	401.05	103.4
Pakistan	365.83	94.3
Malaysia	46.15	11.9
Brazil	400.67	103.3
Argentina	324.95	83.8
Peru	313.63	80.8
Kenya	170.00	43.8
Ghana	355.20	91.5
India	15.24	3.9

*Notes:* 1. International price taken at US\$ 388 per troy ounce based on the LME price of September 3, 1990.

2. 1 troy ounce = 31.1035 gms.

*Source:* International Monetary Fund, computed from *International Financial Statistics*, July 1990.

The proposed amendment was as follows: In section 33, in sub-section (4), for the words and figures “gold coin and gold bullion shall be valued at 0.118489 gms. of fine gold per rupee”, the following words were substituted, *viz.*, “gold coin and gold bullion shall be valued at a price not exceeding the international market price for the time being obtaining.”

The amendment placed the prevailing international price as the ceiling for the rate of valuation; such revaluation was to be based on a standard norm with no scope for arbitrary valuation. Given that the international prices of gold were volatile, it was advisable to revalue gold assets periodically to present a more realistic picture of the country’s foreign exchange holdings. The proposed amendment made this possible. To prevent excessive recourse to this enabling provision, it was possible to prescribe, from time to time, the range within which such revaluation could be done. Cabinet approval was sought and obtained for the proposed amendment to section 33(4) of the RBI Act, 1934.

In view of the urgency and secrecy involved, the President promulgated the RBI (amendment) ordinance 1990 on October 15, 1990. With effect from October 17, 1990, the gold holdings of the Reserve Bank were revalued nearer to the international market price.

#### UTILISATION OF GOLD TO RAISE FOREIGN EXCHANGE RESOURCES

To meet the unprecedented BoP crisis, the Reserve Bank in consultation with the Government evaluated a difficult option, *viz.*, utilisation of the gold held by the Bank and confiscated gold held by the Government to raise foreign exchange resources. Even the option of selling the gold was considered. However, since it was felt that the arrangement should be temporary as well as reversible, the sale with repurchase option was considered superior and was seen as being acceptable to the Indian public. Given the constraints of administering the scheme quickly, avoiding publicity and ensuring buy-back of the gold, it was felt necessary to deal with reputable bullion dealers and not through the large number of NRIs across the different countries. On January 16, 1991, the SBI sent a proposal to the Reserve Bank and the Finance Ministry to lease the gold at an acceptable cost. The Reserve Bank examined the SBI proposal in detail. On March 13, 1991 the Governor advised the SBI to accept the proposal and it was approved by the Government within a fortnight.

Twenty metric tonnes (MT) of gold from the government account was made available to the SBI for sale with a repurchase option to yield a little more than US\$ 200.0 million. The financial terms and conditions and the procedure for sale and repurchase were finalised, based on the advice of the Reserve Bank on financial prudence and the need for secrecy and urgency. Accordingly, the UBS bought the gold from the SBI at the London fixing price prevailing on the day after the day of delivery for each consignment. The SBI was paid 95.0 per cent of the value of the gold as loan; the remaining 5.0 per cent of the payment was to be settled at the end of six months. The exact quantity of gold transacted by the SBI was 19.65 MT of assorted purity, corresponding to 18.36 MT of gold of 100.0 per cent purity. The consideration paid by the UBS to the SBI was US\$ 200.0 million. The effective rate of interest was 6.33 per cent, corresponding to the LIBOR. The gold, in effect, was acting as collateral for the loan given by the UBS to the SBI. It was further agreed that if the price of gold changed beyond the original price by more than 5.0 per cent, a fresh transaction would take place. If the price went up by more than 5.0 per cent, the UBS

was to make available an additional loan to the SBI so that the total loan was 95.0 per cent of the new value. The gold was repurchased by the SBI in November/December 1991 and the gold of 18.36 tonnes was subsequently sold by the Government to the Reserve Bank. The remaining 1.63 tonnes of gold was returned by the SBI to the Government. Both these transactions added to the Reserve Bank's gold holding to the extent of 65.27 tonnes, which was kept abroad at that time.

Earlier, the SBI used to import gold to meet the needs of jewellery exporters under the gold jewellery export promotion and replenishment scheme. In order to conserve foreign exchange, the Government decided to stop importing gold with effect from October 1, 1990, and asked the SBI to use confiscated gold lying in the government mint for use by jewellery exporters.

The gold holdings of the Reserve Bank at US\$ 3,499.0 million at end-March 1992 reflected an addition to gold stocks to the extent of 18.36 tonnes and reached a level of 350.92 tonnes. This addition resulted from the sale of gold by the Government to the Reserve Bank, equivalent to the value of US\$ 191.0 million. As part of the reserves management policy and as a means of raising resources, the Reserve Bank in July 1991 pledged 46.91 tonnes of gold with the Bank of Japan (BoJ) and the Bank of England (BoE) and raised a loan of US\$ 405.0 million. This loan was redeemed by the Reserve Bank by repayment between September and November 1991.

The Reserve Bank decided to approach the BoJ and the BoE for foreign currency loans against the pledge of gold, presumably because banks in Tokyo and London had not stopped accepting commercial bills. Also, the two central banks and commercial banks in these countries were favourably inclined to extend assistance to India. The Reserve Bank Governor paid a visit to the BoJ to hold discussions with his counterpart and deputed the chief of the Department of External Investments and Operation (DEIO), Reserve Bank to the BoE. Both the foreign central banking authorities were willing to extend loans only against securities like gold and that too against physical transfer of gold. They would not agree to the proposal that since the Reserve Bank was an IMF depository, it could keep the gold with itself. Accordingly, the Reserve Bank, under the personal supervision of the DEIO chief, arranged with utmost urgency and secrecy to airlift the gold to the BoE.<sup>8</sup>

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8. Transcript of the interview with Shri P.B.Kulkarni, former Executive Director, Reserve Bank of India.

In this connection, the Finance Minister made a statement in Parliament on July 18, 1991 articulating the entire issue of gold transactions by the SBI and the Reserve Bank and other measures envisaged to face the BoP challenge.

#### LIBERALISATION IN THE POLICY FOR IMPORT OF GOLD

The import of gold was considered to be non-productive and it was not considered prudent to use scarce foreign exchange resources for this purpose. Therefore, import of gold was highly restricted and was permitted only against a licence. The import of jewellery in passenger baggage was also restricted through the high rate of baggage duty and quantitative and value restrictions. There was, however, continuous and substantial import of gold over the years using illegal channels as indicated by the figures of seizures (Table 12.10).

TABLE 12.10  
*Seizure of Gold*

(In tonne)

<i>Year</i>	<i>Seizure in India</i>	<i>Estimated Gold Smuggled into India</i>
1987	2.3	—
1988	6.1	—
1989	8.2	—
1990	5.7	170
1991	5.0	157
1992	2.9	166

*Note:* '—': not available.

*Source:* Reserve Bank of India, internal records, DEIO.

This led the Government to re-examine the issue of gold imports. In the budget of 1992–93, the Government partially liberalised the import of gold by introducing a window for passengers to import gold by paying duty in foreign exchange. Subsequent to the import trade control (ITC) order, which was issued by the Directorate General of Foreign Trade (DGFT),<sup>9</sup> Ministry of Commerce, the rate of duty was reduced from ₹ 450 per 10 gms. to ₹ 220 per 10 gms and passengers were given the option not to carry the gold themselves, but to purchase gold from SBI's bonded warehouse.

9. Order No. 83/90-93 dated February 29, 1992.

A similar scheme for the import of silver in baggage was announced with effect from February 9, 1993. Under this scheme, eligible passengers were allowed to import silver by paying duty in foreign exchange at the rate of ₹ 500 per kg up to a limit of 100 kg.

#### INDIA DEVELOPMENT BONDS

To attract foreign exchange from NRIs, two additional schemes were introduced in the second half of 1991-92. On October 1, 1991, the SBI launched IDBs for NRIs and overseas corporate bodies (OCBs). The bonds had a five-year maturity period and were denominated in US dollars and pound sterling. The dollar bonds carried an interest rate of 9.5 per cent and the sterling bonds 13.25 per cent. These bonds were freely transferable among NRIs/OCBs as also among Indian residents who received them as gifts from the former. The bonds were also free from income, gift and wealth taxes in India. The offer, which was initially opened up to November 30, 1991, was extended to January 31, 1992. An amount of US\$ 1,085.0 million and GBP 165 million was collected under the schemes by February 1992.

The second scheme to mobilise additional foreign exchange was the remittance in foreign exchange (immunities) scheme of 1991. Under this scheme, the source of funds, purpose and nature of remittance were not subject to scrutiny under the exchange control regulations and direct tax laws. The Reserve Bank framed the scheme and advised all authorised dealers (ADs) in the country about the Remittance of Foreign Exchange and investment in Foreign Exchange Bonds (Immunities and Exemptions) Act, 1991, and section 3 (1) of this Act, which contained certain immunity clauses.

Under the above scheme, ADs were instructed to ensure that the remittances received were in convertible foreign exchange before issuing an immunity certificate to the declaring beneficiary. However, the Reserve Bank suspected that the scheme was being misused, when it noticed a sudden spurt in drawals from the accounts of the Reserve Bank for foreign economic affairs of the erstwhile USSR during December 1991. The Reserve Bank, therefore, conducted snap inspections of some ADs, which revealed that at some branches non-convertible rupee funds were erroneously used to claim immunity under the scheme, although only remittances received in free foreign exchange were eligible. In February 1992, the Reserve Bank advised ADs to carry out investigations at their

branches and furnish details of the cases where immunity was wrongly claimed. Based on the Reserve Bank circular, some ADs cancelled the immunity certificates that had been issued by mistake. These cases were also referred to the Enforcement Directorate and the Ministry of Finance. The Reserve Bank in a communication<sup>10</sup> to the Finance Secretary suggested taking penal action against the parties who had tried to misuse the scheme to evade tax. The issue was whether criminal liability could be fixed on the recipients of the remittance for claiming immunity under the scheme, where the remittance was by debit to an NRE account in India but the rupees were non-convertible rupees or where no remittance in convertible foreign exchange was received.<sup>11</sup> Under the above scheme, an amount of US\$ 766.0 million was received till February 10, 1992 to support the declining foreign exchange reserves.

#### NON-RESIDENT DEPOSITS

The gulf crisis had exerted enormous pressure on remittances from the gulf region. A special FCNR deposit scheme was introduced from August 21, 1990 to attract deposits from the gulf region. Deposits under the scheme were designated only in US dollars. These deposits were open-ended and, therefore, did not have a definite term. The scheme allowed withdrawal of full or part of the sum deposited without notice. There were no restrictions on the number of withdrawals from the account. It had a provision of exchange protection for NRIs as well as OCBs residing in the gulf region. While no interest was payable on balances under the scheme, the exemptions with regard to wealth tax and gift tax as applicable to balances under the existing FCNR scheme were applicable to balances held under this scheme. The interest rates on non-resident deposit schemes continued to be above the rates applicable to domestic deposits of comparable maturities. Some rationalisation of interest rate was effected in consonance with those of domestic deposits (Table 12.11).

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10. D.O. letter No. EC CO INSP 38/11R-92/93 dated July 3, 1992.

11. This was vetted by the Reserve Bank's Legal Department on the advice of the Ministry of Finance. The opinion of the department was communicated to the ministry through a D.O. letter signed by the Deputy Governor on November 3, 1992.

TABLE 12.11  
*Rate of Interest on Term Deposits under NR(E)RA and FCNR(A)*  
 (Per cent per annum)

Maturity	NR(E)RA	FCNR(A)			
		Pound Sterling	US Dollar	DM	Yen
1 year and above but less than 2 years	10.50	12.00	5.75	10.25	7.00
2 years and above but less than 3 years	11.00	12.00	6.75	10.50	7.00
3 years and above but less than 5 years	13.00	12.00*	7.50*	10.50*	7.00*
5 years and above	14.00	—	—	—	—

Notes: \*3 years only.

—: not applicable.

Source: Government of India, *Economic Survey, 1991-92*.

#### FCNR SWAP SCHEME

Deposits under the FCNR scheme could be accepted in four currencies, viz., pound sterling, US dollar, DM and Japanese yen. To facilitate interchangeability of the designated currencies, it was decided that if a customer with any other convertible currency wanted to place a deposit under the scheme, there would be no objection to ADs undertaking a fully covered swap in that currency against one of the four designated FCNR currencies with an NRI depositor. This enabled a depositor with a non-FCNR currency to participate in the FCNR scheme.

#### NEW NON-RESIDENT (NON-REPATRIABLE) RUPEE DEPOSIT SCHEME

With a view to providing further incentives to non-residents and OCBs owned by them, the captioned scheme was announced. Under this scheme, ADs were permitted to accept deposits through transfer of foreign exchange from abroad or from an existing NRE/FCNR account. The transferred funds were converted into rupees at the prevailing exchange rate and such funds were not repatriable. The new deposit scheme had a maturity period of six months to three years, and the deposits therein were not considered a part of demand and time liabilities for the purpose of reserve requirements. Further, lending out of these deposits was not considered as part of net bank credit for the purpose of priority sector lending. The deposits and advances out of them were not subject to interest rate regulations. With these attractive features, ADs were able to attract foreign exchange on a non-repatriable basis.

## LIBERALISATION OF IMPORT LICENSING

The import licensing system developed over the years was characterised by bureaucratic delays and arbitrariness and was vulnerable to charges of corruption and misuse. The system operated to the disadvantage of smaller enterprises, which typically found it difficult and more expensive to obtain licences. A step towards simplifying the system was taken in July 1991 with the introduction of Exim scrips. These were tradeable import licences issued to exporters for 30.0 per cent of the value of exports. Exim scrips could be used to import a wide range of items, which had earlier been imported against supplementary licences that stood abolished with the introduction of Exim scrips. Exim scrips traded at a premium, which accrued to exporters. The trade regime was further liberalised with a higher rate of 40.0 per cent Exim scrip entitlement for high value-added and other products. These were significant steps in moving away from a regime of quantitative restrictions. The new industrial policy set out a series of important policy initiatives in relation to industrial licensing, foreign direct investment (FDI), foreign technology agreements, public sector policy and the Monopolies and Restrictive Trade Practices (MRTP) Act. The basic thrust of the policy was to free industries from controls, which inhibited decision-making on business principles, and let entrepreneurs make investment decisions based on their commercial judgement.

In view of the depleting BoP position, the credit policy for the first half of the year announced on April 12, 1991 took certain steps directly aimed at import containment. Cash margins ranging between 50.0 and 200.0 per cent were prescribed for imports in certain categories. Significantly, imports related to exports were given a concessional treatment and there was an exemption from cash margins in general against such imports. The cost of import finance was increased sharply, which was expected to accelerate export realisation. Even while imposing tight monetary controls, care was taken to ensure that export efforts were not adversely affected. For this reason, in the case of imposition of cash margins, imports meant for exports were generally excluded from the restrictions.

## INCENTIVES FOR EXPORTS

It was realised that excessive resort to import compression measures to narrow the widening trade deficit had proved to be counterproductive. Hence, there was a paramount need to promote exports. To provide greater incentive to banks to render export credit, the export credit refinance formula was liberalised. The access of banks to funds under

this facility was increased. With effect from September 4, 1991, the refinance limit under the first tier was raised to 60.0 per cent as against 50.0 per cent earlier, while continuing export credit refinance at 100.0 per cent under the second tier. To provide additional incentive to banks, refinance under the second tier was raised to 110.0 per cent effective November 2, 1991 and further to 125.0 per cent from December 28, 1991. In view of the low interest rate on export credit, banks were not finding it remunerative to lend to the export sector. With large interest rate differentials between export credit and other credit, there was a strong possibility of seepage of credit. To provide greater incentive to banks and to enable them to provide credit support for export promotion, interest rates on pre-shipment and post-shipment export credit were raised in August 1991 and again in October 1991. Further, a series of relaxations were also offered in the prescribed cash margins for imports related to exports. A new refinance facility, refinance scheme for post-shipment export credit denominated in US dollars was introduced on January 4, 1992. Under this scheme, refinance was provided to banks equivalent to 133.33 per cent of post-shipment export credit denominated in US dollars. The rate of interest on refinance under the scheme was also reduced on three occasions during 1992. The Reserve Bank delegated powers to ADs to allow extension of the period for pre-shipment credit by 90 days in cases where exporters could not effect the shipment of goods within a period of 180 days for reasons beyond their control.

Export incentives to exporters and interest incentives and refinance facilities to banks were revised from time to time to boost India's exports. Such measures yielded desired results as indicated in Table 12.12.

TABLE 12.12  
*India's Export Trade*

(US\$ million)

Year	Exports		
	Oil	Non-oil	Total
1991-92	414.7	17,450.7	17,865.4
1992-93	476.2	18,061.0	18,537.2
1993-94	397.8	21,840.5	22,238.3
1994-95	416.9	25,913.6	26,330.5

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2009-10*.

## LIBERALISATION OF TARIFFS

The customs tariff reforms were focused on reducing protection by rationalising the average tariff rate and minimising arbitrary distribution of protection among industries by decreasing tariff dispersion. An array of exemptions had been built up over the years in the tariff structure in response to demands from various stakeholders, which were not in the interests of the economy. The Chelliah Committee report on tax reforms addressed these anomalies and helped remove these distortions.

With the peak customs tariff rate at around 300.0 per cent in 1990–91, the 1991–92 budget cut the peak rate to half (150.0%), followed by another cut in the peak rate to 110.0 per cent in the 1992–93 budget. In view of the significance of capital goods imports, a reduction in import duty on capital goods was effected by reducing the general rate to 55.0 per cent in 1992–93. For some categories of capital goods, the duty was set even lower (e.g., 50.0% for the electronic industry). As a result, the customs duty collection rate fell from 47.0 per cent in 1990–91 to 44.0 per cent in 1991–92 and further to 37.0 per cent in 1992–93.<sup>12</sup>

## INDUSTRIAL DEREGULATION

Industrial deregulation envisaged to abolish industrial licensing requirements except for a short list of industries. It abolished the concept of monopoly by introducing limits on the assets of large industrial houses. The policy also reduced the number of industries reserved exclusively for the public sector and ensured competition between the public and private sectors, besides prescribing measures to enhance incentives to promote small, tiny and village industries.

## FOREIGN INVESTMENT POLICY

Until 1990, foreign investments were limited. During the period 1986–1990, direct foreign investment approvals stood at ₹ 900 crore, resulting from the relatively restrictive foreign investment regime. Foreign investments were allowed in areas of hi-tech/sophisticated technology and substantial exports. The normal ceiling for investment was 40.0 per cent of the total equity capital, but a higher percentage of foreign equity was considered in priority industries, if the technology was sophisticated and not available within the country.

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12. Virmani, Arvind (2001). "India's 1990–91 Crisis: Reforms, Myths and Paradoxes", *Working Paper* No. 4/2001-PC. New Delhi: Planning Commission, December.

In July 1991, the Government announced a liberalised investment policy as part of a new industrial policy. The shift in the policy had important implications for the Reserve Bank as the manager of foreign exchange and its stocks. The new regime of foreign investment contained the following:

- (i) Automatic approval of direct foreign investment up to 51.0 per cent of foreign equity holding in 34 specified high-priority capital-intensive high-technology industries; provided the foreign equity covered the foreign exchange involved in importing capital goods and outflows on account of dividend payments were balanced by export earnings over a period of seven years from the commencement of production.
- (ii) Foreign technology agreements were also liberalised for 34 industries, with firms left free to negotiate terms of technology transfer based on their own commercial judgement and without prior government approval for hiring foreign technicians.
- (iii) To avail of professional marketing and exploration of world markets for foreign products, foreign equity holding up to 51.0 per cent was permitted for trading companies.
- (iv) The Foreign Investment Promotion Board (FIPB) was set up to look into where higher foreign equity limits of more than 51.0 per cent could be permitted.

The results of the new foreign investment policy were encouraging. Approvals of overseas investment reached a peak of US\$ 230.1 million during 1991, including approvals given by the Reserve Bank till December 1991 as against US\$ 73.1 million during 1990. Several additional measures were introduced during 1992–93 to encourage investment flows: FDI, portfolio investment, NRI investment and deposits, and investment in global depository receipts (GDRs). These measures were:

- (i) Existing companies were allowed to raise the foreign equity to 51.0 per cent subject to certain prescribed guidelines. FDI was allowed for exploration, production and refining of oil and marketing of gas.
- (ii) NRIs and OCBs predominantly owned by NRIs were permitted to invest 100.0 per cent equity in high-priority industries with repatriability of capital and income. NRI investment up to 100.0 per cent equity was permitted in export houses, hospitals, export-

oriented units (EOUs), sick industries, hotels, and tourism-related industries.

- (iii) Disinvestment by foreign investors no longer needed to be at a price determined by the Reserve Bank. It was allowed at the market rate on the stock exchange from September 15, 1992.
- (iv) On April 13, 1992, India signed the multilateral investment guarantee agency protocol for the protection of foreign investments.
- (v) Foreign companies were allowed to use their trademarks on domestic sales.

Between August 1991 and December 1992, the Government approved 2,154 foreign collaboration proposals, including 894 cases with foreign equity participation. The details of foreign investment inflows are given in Table 12.13.

TABLE 12.13  
*Foreign Investment Inflows*

Year	A. Direct Investment		B. Portfolio Investment		Total (A+ B)	
	₹ crore	US\$ million	₹ crore	US\$ million	₹ crore	US\$ million
1990-91	174	97	11	6	185	103
1991-92	316	129	10	4	326	133
1992-93	965	315	748	244	1713	559
1993-94	1,838	586	11,188	3,567	13,026	4,153
1994-95	4,126	1,314	12,007	3,824	16,133	5,138

Source: Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008-09*.

The Government allowed reputed foreign institutional investors (FIIs) including pension funds, mutual funds and asset management companies (AMCs) to invest in the Indian capital market on the condition that they registered with the Securities Exchange Board of India (SEBI) and obtained approval under Foreign Exchange Regulation Act (FERA) from the Reserve Bank. Portfolio investment by FIIs in the primary and secondary markets were subject to an overall ceiling of 24.0 per cent of issued share capital of a company and subject to the investment between equities and debentures in the ratio of 70:30.

## EXCHANGE RATE POLICY

The policy developments with regard to the exchange rate of the rupee were influenced by considerations such as immediate countering of market expectations and those of longer-term reforms. The rupee was linked to a basket of currencies of the country's major trading partners during September 01, 1975 to February 28, 1992. The GBP was the intervention currency until March 03, 1993, which was replaced by the US dollar on March 04, 1993. From the early 1980s, the exchange rate had been used as a policy instrument to achieve a sustainable CAD by ensuring improvement in the price competitiveness of exports. The rupee value underwent several adjustments over the years from 1985 onwards. The adjustment made in July 1991 was accompanied by the new trade policy. The Reserve Bank effected an exchange rate adjustment on July 1, 1991. There was another downward adjustment of the exchange rate on July 3, 1991. Overall, the two-step downward adjustment of the rupee worked out to 17.38 per cent in terms of the pound sterling and 18.7 per cent in US dollar terms. The adjustment was necessitated by the growing external and internal imbalances in the economy.

Since October 1990, there had been an appreciation in the real exchange rate of the rupee as a result of the relatively high rate of inflation in the country and much slower rate of depreciation in the nominal exchange rate, leading to erosion in the international competitiveness of the economy. It was equally necessary to curb destabilising market expectations. In determining the extent of adjustments, four factors were kept in mind: (i) inflation differentials between India and major industrial countries; (ii) the extent of real depreciation of the currencies of the countries competing with India; (iii) the degree of correction required in BoP; and (iv) broad indicators of market expectations. Taking all these factors into account, the depreciation in the rupee value against US dollar by 18.0–19.0 per cent seemed appropriate. The objective of this sizeable downward adjustment was to dampen market anticipation so as to offer incentives for remittances and capital inflows and also to treat it as a part of the stabilisation and structural reform programme.

The new trade policy of July 1991 introduced a system of Exim scrips under which exporters earned freely tradeable import entitlements equivalent to 30.0 per cent (or 40.0% in some cases) of the value of their exports. The system of Exim scrip, however, faced many operational and other problems. First, it was limited in scope, with invisibles receipts including private remittances left out of the incentive scheme. Any

extension of it to a large number of transactions could be cumbersome and difficult to operate. Second, Exim scrip assumed the character of yet another licence, which needed to be avoided, particularly because of the administrative work load required to issue and verify the licences. The high level committee on balance of payments (BoP) (Chairman: Dr C. Rangarajan) appointed by the Government in November 1991 was of the view that while retaining the essential elements of linking imports with exports and offering incentives to exporters, any new system should avoid the need for issue of licences, should cover service and remittance transfers, and should preferably operate through the banking system. On its recommendations, the concept of LERMS was developed after extensive discussions and conceptual inputs both from the Reserve Bank and the Ministry of Finance.

Initially, the concept of a full-fledged market determined dual exchange rate was considered, which had self-equilibrating properties and could automatically ensure BoP balancing. This system was, however, administratively tied to what was called a foreign exchange certificate and was considered to be a more comprehensive version of Exim scrip. A detailed concept paper on liberalising the foreign exchange market using a dual exchange rate was prepared in November 1991 by the Ministry of Finance. This was titled: *Towards Rupee Convertibility: The Convertible Rupee Account*. The paper was sent to the Governor, Reserve Bank on December 26, 1991, members of the Planning Commission and the Commerce Secretary for their comments.

The paper was vetted by the Reserve Bank and a detailed note prepared by the Department of Economic Analysis and Policy (DEAP), which brought out the deficiencies in the paper. The Ministry revised the paper in light of the Reserve Bank's comments and renamed it as: *Towards Rupee Convertibility: A Free Market Exchange Rate Channel*. The new document was forwarded by the Ministry on January 21, 1992 to the Reserve Bank with a request to ensure that all relevant points were captured in the paper. In the meantime, in mid-February, the Reserve Bank prepared a paper titled: *Liberalised Exchange Rate Arrangements (LERA)*, based on a joint note compiled by the Exchange Control Department (ECD), the DEAP and the DEIO. The Reserve Bank paper noted:

In the trade policy announcement of July 4, 1991, the Minister of State for Commerce, Government of India said he hoped that rupee would become fully convertible on trade account in three to five years. Since then there had been interaction between Government

and the Reserve Bank on the scope of convertibility and many ideas had been thrown up. In his interview to the *Economic Times* (January 6, 1992), the Finance Minister indicated his preference for convertibility on both current and capital accounts. The discussion so far had helped in convergence of certain ideas, which enabled us to focus on the action to be taken in the coming months. In fact the efforts of the Reserve Bank helped to prepare the blueprint of the future LERMS.

The paper spelt out in detail how the market channel of the exchange rate could be operated through the banking system, conforming to the recommendations of the Rangarajan Committee.

Discussions took place between officials of the ministry and the Reserve Bank on the operational issues covered in the concept paper. LERA was renamed as LERMS, as announced in the budget of 1992–93. LERMS was not to be viewed as a measure in isolation; it formed a part of the liberalisation measures undertaken by the Government and the Reserve Bank, including permission to NRIs to import gold. Apart from providing a boost to exports, it aimed at efficient import substitution with as little bureaucratic and discretionary controls as possible. It sought to encourage remittances through banking channels and reduced incentives for clandestine transactions. LERMS was a system in transition. It subsumed the declared objective of movement to full convertibility on the current account in future. The Rangarajan Committee had emphasised that to achieve the full benefit of integrating the Indian economy with the world economic system, the country had to move step by step towards full convertibility of current account transactions, keeping in view the developments in the macroeconomic situation and the world trading environment. It also envisaged that the proportion of official allocation of foreign exchange for the purposes of public good and other items could be gradually reduced, thus increasing the proportion of foreign exchange that the importers could buy from the market.

#### FOREIGN CURRENCY ACCOUNTS

All exporters of goods and services and other recipients of inward remittances in convertible currencies were allowed to retain up to 15.0 per cent of the receipts in foreign currency accounts with banks in India out of the amount to be surrendered at free market rates. They could utilise these funds to meet current account payments permitted under the trade and

exchange control regulations. In view of this, the existing blanket permit, CAFEX<sup>13</sup> permit and BAFEX<sup>14</sup> permit schemes were discontinued.

The existing broad-based facility for maintaining foreign currency accounts, either in India or abroad, for crediting proceeds of all exports to countries in the external group for making payments from such accounts for financing imports and repayment of foreign currency loans, continued at that point. Exporters holding such foreign currency accounts were, however, required to surrender 40.0 per cent of their export proceeds to ADs at official rates as per the provisions of LERMS with effect from March 1, 1992. No rupee loans were permitted to be sanctioned against balances in foreign currency accounts.

#### MARKET INTERVENTION

The Reserve Bank also undertook, at its discretion, foreign exchange operations at market rates. In pursuance of the notifications containing the details of LERMS issued by the Government under section 40 of the RBI Act, 1934, the Bank issued operational instructions to ADs through circulars. In addition to the salient features of the scheme, the Reserve Bank announced that the official exchange rate would be expressed in US dollars per ₹ 100. ADs were instructed to immediately report by fax or telex to the Controller, ECD, all their overbought and oversold foreign currency positions as well as their *nostro* account balances as at close of business on February 29, 1992. ADs were warned that if any of them maintained an overbought position in any foreign currency on the date cited above or built-up balance in *nostro* accounts in violation of the provisions of the exchange control manual, the Reserve Bank could take action for violation of the provisions. In the case of a forward purchase contract permissible under current account receipts, ADs were instructed to purchase forward from customers 40.0 per cent of foreign exchange receipts at rates based on the forward buying rate of the Reserve Bank. These purchases could be covered with the Reserve Bank. The balance 60.0 per cent could be purchased forward at the free market rate.

ADs were instructed to communicate to the dealing room of the DEIO at the Reserve Bank on every business day between 4.00 pm and 6.00 pm — the range (high and low) of their US dollar telegraphic transfer (TT) sales and TT purchase rates during the day in the free market. The

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13. Composite allocation of foreign exchange.

14. Block allocation of foreign exchange.

minimum amount and the multiples in which purchase of GBP, US dollar, DM and Japanese yen could be made by the Reserve Bank were revised. The minimum amount of spot sales of the US dollar by the Reserve Bank was also fixed. The minimum amounts and multiples in which purchases by the Reserve Bank were revised are given in Table 12.14.

TABLE 12.14  
*Sale/Purchase of Currencies*

<i>Currency</i>	<i>Existing</i>		<i>Revised</i>	
	<i>Minimum</i>	<i>Multiples</i>	<i>Minimum</i>	<i>Multiples</i>
GBP	10,000	1,000	1,00,000	10,000
US dollar	25,000	5,000	2,50,000	25,000
DM	40,000	5,000	4,00,000	40,000
Japanese yen	5,000,000	1,000,000	30,000,000	3,000,000

*Source:* Government of India, Notification on LERMS, March 1, 1992.

Restricted money-changers were instructed to sell daily their purchases of foreign currency notes and travellers' cheques (except to the extent of foreign currency cash floats permitted to be kept by them) to ADs, who would purchase 40.0 per cent of the amount at rates based on the official rate for surrender to the Reserve Bank and the balance 60.0 per cent at rates based on free market rates. Full-fledged money-changers had to sell daily to ADs at least 40.0 per cent of their gross collections at the official rate. Consequent to the new exchange rate arrangement, money-changers had to buy foreign currency travellers' cheques and currency notes and sell foreign currency notes from/to members of the public at suitable rates. ADs were instructed to bring these instructions to the notice of their money-changer constituents.

As observed by a government official, "The announcement of this system in the budget took the entire country as well as foreign observers and well wishers completely by a surprise. The extent of excitement among common people, those who may never have the opportunity to undertake foreign exchange transactions, took even those involved in its preparation by surprise. Even the common person welcomed the freedom that it implied and the confidence that it denoted on the part of the Government. Many economists predicted that there would be huge capital outflows and the rupee would sink to ₹ 40 per US\$ on the market channel. Some even predicted a free fall to ₹ 50 per US\$. The market exchange rate opened

around ₹ 31.27 per US\$ in March 1992 and rose to ₹ 30.87 per US\$ in January 1993.”<sup>15</sup>

#### INDO-USSR TRADE PROTOCOL

For the calendar year 1991, the Indo-USSR trade protocol (prior to the break-up of the USSR) envisaged a total trade turnover of ₹ 9,411 crore comprising ₹ 5,081 crore of exports to the USSR and ₹ 4,330 crore imports from the USSR. Against this target, a total trade turnover of ₹ 6,413 crore was actually realised during 1991. Consequent upon their separation, the countries of the erstwhile USSR formed the Commonwealth of Independent States (CIS), and efforts were made by the Government of India and the republics of the CIS to establish trade and economic links with each other. Such agreements were reached between India and six republics, *viz.*, Kazakhstan, Kyrgyzstan, Russian Federation, Turkmenistan, Ukraine and Uzbekistan. All the republics opted for payments in freely convertible currencies. The general form of agreement between India and the republics of the CIS was that they would accord to each other the most favoured nation (MFN) treatment in all matters of trade and commercial co-operation.

#### RUPEE DEBT OWED TO RUSSIA

After the collapse of the USSR, a new agreement was reached between India and Russia in January 1993 for the repayment of loans and credits extended by the USSR to India. The rupee debt converted from the roubles stood at around ₹ 31,000 crore, comprising principal debt of ₹ 19,000 crore and rescheduled debt of ₹ 12,000 crore.

As per the agreement, the outstanding debt in Russian roubles as on April 1, 1992 was converted into Indian rupees based on the rate of exchange prevailing on January 1, 1992 (one rouble equalled ₹ 19.9169) and termed as principal debt. The principal debt was to be repaid as per the original repayment schedule enshrined in the loan agreements. In terms of the protocol, the principal debt attracted an interest rate of 2.5 per cent.

However, the outstanding debt in roubles was also converted into Indian rupees at the exchange rate as on April 1, 1992, *i.e.*, one rouble equal to ₹ 31.7514 in terms of the new agreement. The difference between the principal debt and the amount based on April 1, 1992 rupee-rouble exchange rate was called rescheduled debt, which was to be repaid in 45

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15. Virmani (2001) *op. cit.*

years. The rescheduled debt attracted no interest. The last instalment of rescheduled debt would fall due in 2037, while that of principal debt was paid in 2007.

According to the agreement, both parts of the debt, *viz.*, the principal and the rescheduled were to be revalued as and when the rupee appreciated or depreciated against SDR by more than 3.0 per cent and accordingly the revaluation was done from time to time.

Apart from the rupee debt, a foreign currency loan was contracted on September 17, 1992, for an amount of ₹ 1,091.23 crore with a repayment period of around 14 years to supply defence equipment to India.

#### BoP MONITORING GROUP

A BoP monitoring group was constituted by the Government<sup>16</sup> and the Deputy Governor of the Reserve Bank was a special invitee. The high-powered group closely monitored the developments on issues related to monetary, fiscal, industry and trade (both domestic and foreign) with particular emphasis, *inter alia*, on export promotion, import liberalisation and industrial deregulation against the background of the prevailing BoP situation. The BoP monitoring group in its meeting on May 6, 1991 considered a note from the commerce ministry entitled Impact on Exports of RBI Restrictions and concluded that the commerce ministry and the finance ministry should hold further discussions with the Reserve Bank on the proposed relaxations. It was recognised that some steps were needed to protect export performance, but the meeting remained inconclusive. Subsequently, on May 16, 1991, the commerce ministry forwarded certain proposals termed as minimal package of modifications to the existing import compression measures in respect of export-related imports to the Reserve Bank. Some of the important proposals were as under:

- (i) The Reserve Bank should issue clear instructions that LCs for all export-related imports such as advance licences, special imprest licences and replenishment (REP) licences should have absolute priority not only for RBI clearances but also clearance by regional offices and head offices of commercial banks.
- (ii) In the case of all export-related imports, the existing limits should be relaxed.

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16. The group was chaired by Secretary (Economic Affairs), Ministry of Finance, Government of India.

- (iii) The cumulative limit for individual importers, beyond which all LCs would need centralised clearances by the Reserve Bank, could also be liberalised.
- (iv) Many exporters required access to imported materials, which were not imported against advance licences but against OGL or supplementary licences. These imports continued to attract margins. Such exporters should be allowed certain margin-free entitlement of imports.

These proposals were part of the full package of liberalisation in favour of exports, which were proposed in the commerce ministry's note forwarded earlier to the Reserve Bank through the BoP monitoring group. The Reserve Bank promptly announced a number of relaxations through a press note released on June 4, 1991.<sup>17</sup> After consultations with the Reserve Bank, the Government announced the new trade policy in July 1991, which introduced the system of Exim scrip as a major export-related import measure for the benefit of exporters.

#### COMMITTEE ON BALANCE OF PAYMENTS: SETTING THE WAY FORWARD

The high level committee on BoP<sup>18</sup> constituted by the Government under the chairmanship of Dr C. Rangarajan submitted its interim report in February 1992 and its final report in April 1993. The committee made wide-ranging recommendations on various aspects of India's BoP and a number of its recommendations formed inputs for the policy decisions during that period.

Favouring a realistic exchange rate, the committee recommended the unification of exchange rates as an important step towards full convertibility. In pursuance, the unified exchange rate system was introduced with effect from March 1, 1993. The committee also recommended that a reserve target range should be fixed from time to time, taking into account the need to accommodate three months of imports and other payment obligations. In the committee's view, the reserves should not be allowed to fall below the floor level. Further, the option of the Reserve Bank converting gold into foreign currency resources should be constantly reviewed, although the immediate case for exercising such an option was not established. In

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17. For details, refer to Appendix 12.1.

18. Reserve Bank of India, *Annual Report, 1992-93*.

addition, the committee recommended that a part of the gold reserves should be available for conversion at a short notice into currency resources to meet any contingencies.

With regard to external assistance, the committee recommended that 100.0 per cent of external assistance should be passed on to the states for all sectors. It considered that commercial borrowings with a maturity period of less than five years should not be encouraged, and favoured a cautious approach to sovereign guarantees on external borrowings. It suggested an annual limit of US\$ 2.5 billion in the case of disbursements of ECBs. Further, the committee concluded that debt-equity conversion was not a desirable option for debt management in India. The committee recommended launching the gold bonds as an experiment.

To reduce the volatility and cost of NRI borrowings, the committee advocated a minimum maturity period of one year in the case of FCNR deposits and a gradual reduction in the difference between international interest rates and FCNR rates. The committee also favoured the development of markets for NRI bonds to attract medium-term investment by NRIs.

The committee observed that short-term debt should be permitted only for trade-related purposes. The committee further proposed setting-up a monitoring system for short-term debt to ascertain the extent of outstanding short-term debt at any point of time. With a view to attracting foreign investment, the committee favoured a national investment law to codify the existing policy and practices relating to dividend repatriation, disinvestment and employment of foreign nationals.

For the medium term, the committee considered it necessary to achieve an annual growth in exports of at least 15.0 per cent in dollar terms. Further, it felt that a CAD of 1.6 per cent of GDP could be maintained through a sustained level of net capital receipts.

### CONCLUDING OBSERVATIONS

The process of liberalisation of the Indian economy and the financial sector reforms had begun before the crisis of 1991. During the 1980s, the early reform measures and the process of liberalisation was undertaken in a limited way. These steps, though encompassing several sectors, lacked a coherent approach. The reforms helped the country lift its growth in the late 1980s, breaking away from the long-term rate of growth of around 3.5 per cent. However, an inconsistent framework of the process of reforms increased the vulnerabilities of the economic system and the efforts were

thwarted by pressures on public finances and the external sector. It was only when the country faced the threat of a default in its external payments that the 20-month IMF programme of stabilisation and structural adjustment was initiated during 1990–91 to 1992–93, which paved the way for wide-ranging reforms. The Government and the Reserve Bank were both involved in executing the measures needed to bring about macroeconomic stabilisation and structural adjustment from late 1989 and through 1990. Political uncertainty and change of governments delayed official action in approaching the multilateral institutions, despite the Reserve Bank signalling the need for the same to the Government since the late 1989.

Incipient signs of the BoP crisis were evident in the second half of 1990–91 when the gulf war led to a sharp increase in oil prices. Foreign exchange reserves began to decline from September 1990 due to a sharp rise in the imports of oil and petroleum products. The effect of the rise in oil prices was aggravated by the events that followed. Indian workers employed in Kuwait had to be airlifted back to India and their remittances ceased to flow in. Other adverse developments, reflecting the loss of confidence in the Government's ability to manage the situation, exacerbated the crisis further. Short-term credit began to dry up, imposing a severe strain on the BoP position. In addition, the outflow from NRI deposits was substantial. The import cover of reserves declined to three weeks of import value by the end of December 1990.

The overvaluation of the Indian rupee in the latter half of the 1980s *vis-à-vis* its Asian counterparts, and subsequently from October 1990 to March 1991, witnessed an appreciation of the REER of the Indian rupee by about 2.0 per cent as a consequence of the widening inflation differentials between India and the major industrialised countries, thereby eroding the international competitiveness of India's exports. To stem the loss of competitiveness and on account of the dwindling foreign exchange reserves, India resorted to devaluation of the rupee. The Reserve Bank effected an exchange rate adjustment in two stages: on July 1, 1991 and another adjustment on July 3, 1991. The two-step downward adjustment of the Indian rupee in terms of pound sterling worked out to 17.38 per cent and in terms of the US dollar about 18.7 per cent.

As part of the crisis management measures undertaken during 1990–91 to 1992–93, the Reserve Bank in consultation with the Government changed the method of valuation of gold held as foreign exchange reserves. It was felt that revaluation of the gold holding from time to time in accordance with international price movement could present a more realistic picture

of India's foreign exchange reserves. To meet the unprecedented BoP crisis, and to avoid risking a default in its external payments, India chose to sell 20 MT of government gold with a re-purchase option to the UBS through the SBI, yielding a little more than US\$ 200.0 million. Later, as a part of the reserves management policy and as a means of raising resources, the Reserve Bank in July 1991 pledged 47 tonnes of gold with the BoE and BoJ and raised a loan of US\$ 405.0 million.

The Government that took office in June 1991 acted quickly to address the deteriorating economic situation. From July 1991, the authorities (both the Government and the Reserve Bank) addressed with utmost speed and determination the issues of stabilisation and structural reforms, fiscal correction, exchange rate adjustment and reform, monetary targets and inflation control for the overall macroeconomic stability. These measures were supported by structural reforms in the form of industrial deregulation, liberalisation of FDI, trade liberalisation and financial sector reforms.

The crisis management and its successful resolution paved the way for liberalisation and led to economic and financial sector reforms. The reforms process comprised the following: industrial licensing for all except 18 industries was abolished; investment caps on large industrial houses were removed; only 6 industries remained exclusively in the public sector; access to foreign technology was liberalised; import licensing was virtually abolished; import duties were sharply reduced; and exporters could open foreign currency accounts.

To attract foreign exchange resources from NRIs, two new schemes were introduced in the second half of 1991–92. On October 1, 1991, the SBI launched the IDBs for NRIs and OCBs. The second scheme for mobilising additional foreign exchange resources provided immunity to NRIs, exempting them from scrutiny of the source of funds, purpose and nature of remittance under the exchange control regulations and direct tax laws.

A high-powered committee (Chairman: Dr C. Rangarajan) made several recommendations that set the tone for policies in managing the external sector during the years of reform following the crisis. A BoP monitoring group was constituted by the Government to closely observe developments in monetary, fiscal, industry and trade (both domestic and foreign) with particular emphasis on export promotion, import liberalisation and industrial deregulation against the background of the prevailing BoP situation.

The policy with regard to the exchange rate of the rupee was to counter the destabilising market expectations and undertake longer-term reforms to ensure the development of a deep and vibrant exchange market. The new trade policy of July 1991 introduced a system of Exim scrips, which faced several operational problems. The high level committee on BoP was of the view that for linking imports with exports and motivating exporters, the new system should avoid the need for issuing licences and should preferably operate through the banking system. After extensive discussions on several concepts with the Ministry of Finance, the Reserve Bank prepared a paper titled LERA, which was renamed as LERMS subsequently. LERMS effectively brought in a dual exchange rate system. LERMS was a system in transition and it subsumed the declared objective of movement towards full convertibility on the current account later in 1994.



# 13

## External Sector Liberalisation

### INTRODUCTION

#### INTEGRATION INTO THE GLOBAL ECONOMY

As brought out in detail in the previous chapter, the unprecedented payments crisis of 1991 was overcome by the concerted policy reforms initiated by the Government and the Reserve Bank in July 1991 onwards, including the depreciation of the Indian rupee by 18.7 per cent against the US dollar. The reforms implemented from 1991 resulted in the opening up of the Indian economy to the global economy. As a result of the policy reforms and successful mobilisation of exceptional financing, there was a marked improvement in the external payments situation and debt indicators. The increase in reserves combined with stabilisation and structural reforms restored international confidence, providing the basis for further liberalisation of trade, tariff, export credit and foreign investment policies during the subsequent period.

Against the backdrop of the policy objective of promoting exports and simplifying import procedures, several measures were introduced during the period. With the initiation of these measures, the trade policy focussed on providing both the institutional and infrastructural back-up to promote exports. The export volume responded to the reforms in trade and balance of payments (BoP) policies. The much needed recovery in export growth commenced from 1993–94 and remained strong during the subsequent two years until 1995–96 though it moderated in 1996–97. The size and quality of foreign exchange reserves also improved significantly.

A new regime of exchange rate management was introduced with the unification of dual exchange rates and the floating of the rupee was

announced in the budget of 1993–94. The Reserve Bank set up an expert group (Chairman: Shri O.P. Sodhani) in November 1994 to recommend measures for the growth of an active, efficient and orderly foreign exchange market and to suggest new derivative products. The group made wide-ranging recommendations concerning the removal of market constraints; development of derivative products with suggestions for short-term and long-term measures; risk management; and accounting and disclosure standards. It also dealt with aspects such as information systems and clearing mechanisms relating to the market. The implementation of these measures was expected to create a vibrant but well-regulated foreign exchange market in India that could withstand external shocks successfully. Exchange controls were further liberalised through the amendment of Foreign Exchange Regulation Act (FERA) and other laws.

With industrial recovery strongly under way, imports rose continuously, resulting in the widening of the trade deficit. Growth in invisibles, however, came to the rescue to a considerable extent. Debt-service payments continued to be high, but the debt-service ratio declined with the significant improvement in current receipts. In the medium term, India's BoP situation continued to depend crucially on the export performance. Success in sustaining strong export growth mainly depended on maintaining a competitive exchange rate, overall macroeconomic stability, relative profitability of exports and the competitiveness of the economy.

On account of the positive developments mentioned above, India remained much less vulnerable than most of the East Asian economies when the South-East Asian crisis broke out in 1997. The current account deficit (CAD) had declined to a sustainable 1.25 per cent of the gross domestic product (GDP) in 1996–97. External debt as a proportion of GDP (24.5% in 1996–97) was lower as compared with that of Indonesia (61.3%), the Philippines (59.3%) and Thailand (62.0%). Short-term debt was 7.2 per cent of the total debt in 1996–97. The debt-service ratio fell by 12.3 percentage points from 35.3 per cent in 1990–91 to 23.0 per cent in 1996–97, and the share of concessional credit remained at around 40.0 per cent. The banking sector — of which about 80.0 per cent was state-owned — was also in a better position, with non-performing loans (NPLs) only 8.0 per cent of total loans. The fiscal deficit, although high at 6.4 per cent of GDP in 1996–97, had declined since the early 1990s. All these aspects signified strengthening of the economy further.

## CHAPTER OUTLINE

Against the above backdrop, this chapter traces developments in the external sector, including changes in direction of policy in relevant areas, post the BoP crisis between 1992–93 and 1996–97.<sup>1</sup> The broad areas covered are the BoP and its different components, the external debt situation, the reserves position, tapping of gold for external adjustments and exchange rate management.

## BALANCE OF PAYMENTS

After the resolution of the BoP crisis of 1991; it was felt that the best way to put BoP on a long-term sustainable path was through comprehensive liberalisation of international trade/finance, capital flows and exchange regime, which was effected during the 1990s. The approach, however, remained cautious. Not only were the reforms sequenced and phased out but the policy also encouraged enduring non-debt-creating inflows as compared with short-term, volatile and debt-creating flows. While foreign direct investment (FDI) and equity flows found favour, capital controls continued on debt flows. Similarly, while capital account was opened to foreign entities, in particular institutional investors, controls continued on residents' investments abroad. Further, any implicit exchange guarantee to borrowers or investors, including through special schemes for non-resident Indians (NRIs), was withdrawn in a phased manner. This paved the way for integration of the foreign exchange market with the money and credit markets.

The process of stabilisation of the BoP was carried forward during 1992–93. The self-balancing mechanism embodied in the liberalised exchange rate management system (LERMS), a dual exchange rate system, and exceptional financing from bilateral and multilateral sources enabled an accretion of US\$ 612.0 million to the country's stock of foreign exchange reserves in 1992–93. By the end of March 1993, the Bank's foreign currency assets (FCA) recorded a rise of 14.2 per cent over the previous year. The response of the real sector to the supply-augmenting initiatives of structural reforms was weaker than anticipated, despite the strong recovery in agriculture.

Social disturbances in the country, particularly in Bombay (now Mumbai), which accounted for roughly 60.0 per cent of transportation

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1. The critical measures taken as part of crisis resolution immediately following the crisis are covered in chapter 12: Management and Resolution of the 1991 Crisis.

services related to foreign trade, stifled the seasonal upturn in both exports and imports, which usually occurred in the second half of the financial year. The uncertainty surrounding the external transactions with the constituents of the Commonwealth of Independent States (CIS) and the impediments to trade diversification in the context of the continuing recession in industrialised countries were the adverse exogenous factors that had a bearing on the external sector.

During 1993–94, there was a remarkable improvement in the BoP position, reflected in an unprecedented accretion to foreign exchange reserves. A steady build-up of FCA in the first half of 1993–94 was followed by a massive surge from November 1993 onwards. With an increase of 134.2 per cent in 1993–94, FCA reached a historic peak (US\$ 15,068.0 million) by the end of March 1994, equivalent to nearly nine months of imports.<sup>2</sup>

The external sector exhibited strength and resilience during 1994–95, consolidating four years of stabilisation and structural adjustment. There was a continued accumulation of reserves, reflecting sustained improvement in the current account balance and strong capital inflows. The CAD in 1994–95, although estimated to be larger than in the preceding year, was clearly justified and sustainable. The export performance during 1994–95 benefited from the recovery in world trade, favourable policy environment and a stable exchange rate. While the exchange rate of the rupee against the US dollar remained steady for the greater part of the year, the weakness of the US dollar against other international currencies offset the adverse inflation differentials between India and the rest of the world.

The large capital inflows witnessed in the second half of 1993–94 continued in the first half of 1994–95. Injection of external liquidity posed problems for the conduct of monetary management. As in the preceding year, the capital flows were dominated by inflows of foreign investment, direct and portfolio, that exceeded the net inflows recorded in 1993–94. Although the capital flows moderated in the second half of 1994–95 in response to the introduction of various policy measures, the absence of an external financing need resulted in a large accretion to the reserves.

Reflecting the strong real output performance, the external trade account showed a larger deficit in 1995–96, with imports recording an increase of 30.0 per cent (in dollar terms) against an export growth of 20.9 per cent. With the invisibles surplus being significantly higher than

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2. For details, refer to Table 13.5.

in 1994–95, the external current account showed a deficit of about 1.7 per cent of GDP. The enlarged external financing requirement of the economy coincided with a moderation in external capital flows, resulting in a drawdown of international reserves. As the developments in the external sector signalled easing of the nominal exchange rate, speculative tendencies appeared in the spot and forward segments of the foreign exchange market and the short end of the money market during the period from October 1995 to February 1996.

The Reserve Bank engaged in tactical interventions consistent with the fundamentals. When the rupee weakened sharply against the US dollar in the first week of February 1996, the Reserve Bank announced decisive measures to accelerate the repatriation of export proceeds and moderated the acceleration of import payments. This helped to bring about stability in the market almost immediately and by March 1996; the rupee regained much of its lost ground, achieving in real terms a level consistent with the fundamentals.

The FCA of the Reserve Bank, which were drawn down by 23.4 per cent at the end of February 1996 over that of March 1995 showed a turnaround thereafter and by the end of March 1996, the assets had reached a level equivalent to about five months of imports. At the end of June 1996, the FCA rose further by 2.8 per cent over the previous quarter.

The external sector exhibited distinct signs of stability during the year 1996–97, unlike the turbulence in the foreign exchange market witnessed in the second half of 1995–96. The moderation in the growth of industrial output restrained import demand and, in conjunction with the sluggishness in world trade had the effect of dampening export growth. A surge in net invisibles earnings and a strong resumption of capital flows, after the brief interruption between October 1995 and February 1996, resulted in a large overall surplus in the BoP. Reflecting these developments, surplus conditions prevailed in the foreign exchange market throughout the year. While the spot market saw excess supplies of foreign exchange, premia in the forward market declined significantly, reflecting easing of downside expectations of the future exchange rate of the rupee as well as a narrowing of short-term interest rate differentials *vis-à-vis* the rest of the world. The nominal exchange rate faced considerable upward pressures, which were mitigated by passive interventions by the Reserve Bank. Despite the interventions, the appreciation of the US dollar *vis-à-vis* other international currencies, as well as a continued inflation differential, translated into a

large appreciation of the real effective exchange rate (REER) of the rupee by 9.6 per cent by March 1997 over the base period set at March 1993.

TABLE 13.1  
*Key Components of India's BoP*

(US\$ million)

	1992–93	1993–94	1994–95	1995–96	1996–97
I. Current Account					
(i) Exports	18,869 (3.3)	22,683 (20.2)	26,855 (18.4)	32,310 (20.3)	34,133 (5.6)
(ii) Imports	24,316 (15.4)	26,739 (10.0)	35,904 (34.3)	43,670 (21.6)	48,948 (12.1)
(iii) Trade Balance	-5,447	-4,056	-9,049	-11,359	-14,815
(iv) Current Account Balance	-3,526	-1,159	-3,369	-5,912	-4,619
II. Total Capital Account @	2,936	9,694	9,156	4,690	11,412
IMF, SDR Allocation	1,288	188	-1,143	-1,715	-975
III. Reserve and Monetary Gold, Increase-/Decrease+	-698	-8,723	-4,644	2,937	-5,818

*Notes:* @ Capital Account includes errors & omissions.

Figures in parentheses indicate percentage increase over the previous year.

*Source:* Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008–09*.

#### FOREIGN TRADE

As described in the previous chapter, the stabilisation measures introduced during 1991–92 in response to the crisis indicated that both the Government and the Reserve Bank had recognised the need for extensive decontrol and delicensing measures to enhance the productive potential of Indian entrepreneurs and raise the underlying growth potential of the economy. Liberalisation was introduced in sectors like exports, imports and customs tariffs for ensuring growth in domestic production and maintaining price competitiveness of Indian goods in the international market.

#### EXPORTS

The import control measures for exports were primarily directed at providing duty-free access to imported inputs like intermediate goods and reduced duty access to capital goods used in export production. The primary objective of the reform process was to simplify the system while making it as comprehensive as possible. In the trade policy of April 1993, the system of export-oriented units (EOUs) and export processing zones (EPZs) was extended to agriculture and allied exports, with 50.0 per cent

domestic tariff area (DTA) sales allowed. Under the export promotion capital goods (EPCG) scheme, the concessional duty on capital goods was reduced to 25.0 per cent and 15.0 per cent, respectively, subject to certain conditions. In April 1994, an electronic hardware technology park scheme was introduced on par with EPZs. The concept of a free trade zone was evolved and finally accepted at the end of the 1990s.

During 1992–93, subdued export performance and a moderate rise in import demand yielded a merchandise trade deficit of US\$ 5,447.0 million. This reflected the compressed level of imports during 1991–92. The modest recovery in exports during the first half of 1992–93 was largely offset in the second half of the year on account of dislocation of trade following disturbances in Bombay and weak world demand. These negative factors resulted in very low export growth at 3.3 per cent. Imports, on the other hand, grew by 15.4 per cent during the year (Table 13.1).

Exports to the general currency area (GCA), having a direct bearing on foreign exchange reserves, exhibited resilience. The growth in GCA exports was evident from the beginning of the year up to October 1992; it decelerated in the following two months and veered away from the seasonal pattern (measured in terms of monthly averages of those exports over the preceding three years). By January 1993, however, GCA exports resumed the seasonal uptrend, which reached a peak in the closing month of the year. Given the continued sluggishness in the international prices of tradeables, the volume growth of GCA exports during 1992–93 was placed in the range of 7.0–8.0 per cent.

During 1992–93, exports to the rupee payment area fell over the year by 62.2 per cent in US dollar terms and continued to be a drag on overall export growth. The deterioration in these exports was evident for a third year in succession. The collapse of trade with the erstwhile USSR, one of India's principal markets, led to a marked shift in the destination of exports and sources of imports between the GCA and the RPA. During the subsequent three years between 1993–94 and 1995–96, export performance was robust and recorded a growth in US dollar terms of 20.2 per cent, 18.4 per cent and 20.3 per cent, respectively, over the previous years.

The robust export growth could not be sustained during 1996–97. Exports during 1996–97 registered a modest growth of 5.6 per cent as compared with the very high average growth rate of 19.7 per cent during the three-year period ending 1995–96. The slowdown in export growth during 1996–97 could be attributed, *inter alia*, to the decline in world trade coupled with sluggishness in prices of manufactured goods in the

global market, variations in cross-currency exchange rates and a slowdown in domestic industrial activities. The deceleration in exports was spread across major commodity groups. Export growth of agriculture and allied products decelerated (in US dollar terms) to 11.1 per cent in 1996–97 from the 44.6 per cent recorded during the preceding year; items such as tea, coffee and rice even witnessed absolute declines. The export growth of manufactured goods also slid down sharply to 3.6 per cent from 16.3 per cent in 1995–96.

At the disaggregated level, India's major export items that showed considerable deceleration during 1996–97 included gems and jewellery, leather and leather products and readymade garments. These three commodities together accounted for around 25.0 per cent of India's total incremental exports during 1995–96. In 1996–97, however, the export earnings (in US dollar terms) for the first two categories showed absolute declines, while those of readymade garments increased only marginally.

#### IMPORTS

The import control regime was extremely complex till 1990–91. Significant efforts were made to simplify this complex regime during the 1990s. The existing cash compensatory system was abolished. Quantitative restrictions were gradually eased by moving items from the limited permissible category list to the open general licence (OGL) category. A proactive policy of customs tariff reforms was pursued through the 1990s. The objective was to ease overall protection by reducing the arbitrary distribution of protection among industries through a reduction in the dispersion of tariffs. The peak customs tariff rate at around 300.0 per cent in 1990–91 was gradually reduced to 50.0 per cent in 1995–96 and further to 40.0 per cent in 1997–98.

Following the liberalisation in baggage rules for people of Indian nationality or origin returning from abroad, which was effected in the Union Budget 1992–93, there was an estimated inflow of about 132 tonnes of gold valued at approximately US\$ 1.4 billion during 1992–93. In February 1993, similar liberalisation was extended to the import of silver, as a result of which about 650 kg of silver was brought into the country during 1992–93. However, this inflow of bullion was not reflected either under imports or under private transfer receipts in the BoP data for 1992–93.<sup>3</sup>

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3. Reserve Bank of India, *Annual Report, 1992–93*.

The rebound in imports from the compression of 1990–91 and 1991–92 was strong in the first half of the year 1992–93, with import growth at 22.3 per cent in US dollar terms during April–September 1992; in the second half of the year, there was a perceptible slowdown in imports. As a result, the import growth for the year as a whole was only 15.4 per cent in US dollar terms, considerably lower than the expected increase from the retrenched level of imports in 1991–92. Non-petroleum, oil and lubricants (non-POL) imports rose by 11.2 per cent in US dollar terms after declining by 22.2 per cent in the preceding year. The impact of extraneous developments and the postponement of some imports in the latter half of the year due to expectations about changes in tariffs altered the seasonal pattern of non-POL imports during the year and resulted in a contra-seasonal downward drift between September 1992 and January 1993.

During 1993–94, import demand remained weak due to the interplay of various factors. With the ongoing liberalisation in trade policy, the need for imports to build up large inventories diminished. The stability of the exchange rate further reduced the anticipatory demand for imports. Sluggish industrial growth as evidenced by decelerating non-oil imports contributed to the weak import demand. Non-oil imports, according to Director General of Commercial Intelligence and Statistics (DGCI&S) data, included aircrafts acquired by Air India and those leased by Indian Airlines and air-taxi operators. If the value of the aircrafts was excluded, non-oil imports would have grown by 5.3 per cent during 1993–94 and overall imports by 9.9 per cent over the previous year.

The significant expansion of imports during 1994–95 and 1995–96 at 34.3 per cent and 21.6 per cent, respectively could be attributed to marked buoyancy in the industrial sector. Both oil and non-oil imports contributed to the high import growth. Reflecting in part the hardening of crude oil prices in the international markets, imports of POL registered a rise of 27.3 per cent during 1995–96. Non-oil imports, on the other hand, increased by 26.8 per cent as against 29.5 per cent during 1994–95. The surge in capital goods imports reflected the buoyancy in investment climate and industrial production during the year. Further, the increase in export-oriented imports, especially for manufactured goods exports, such as chemicals, pearls, precious and semi-precious stones, and iron and steel was also high, reflecting the buoyancy in export growth during the year 1995–96.

Imports rose by 12.1 per cent during 1996–97 compared with the average growth rate of about 27.9 per cent during the previous two years.

Despite the sharp rise in POL imports, the growth in aggregate imports remained subdued during the year 1996-97 on account of an absolute decline in non-oil imports. Non-oil imports were sluggish throughout the year, decreasing by 2.3 per cent during 1996-97 in contrast with a sharp rise of 28.3 per cent during the preceding year. The deceleration in domestic industrial activity and in exports could have, in part, contributed to a decline in non-oil imports. POL imports recorded a large increase of 33.8 per cent during 1996-97 compared with 27.0 per cent during the corresponding period of the preceding year, reflecting shortfalls in domestic production and refinery throughput, coupled with a firming up of international prices.

#### STRUCTURAL SHIFTS IN MERCHANDISE TRADE

India's exports exhibited substantial structural changes in a longer time horizon. The striking feature that emerged was the declining share of primary products, while manufactured goods exports assumed increasing importance in India's export basket. This was evident from the fact that the share of primary products in total exports declined from around 36.8 per cent in 1980-81 to around 23.8 per cent in 1990-91. In contrast, manufactured goods exports showed a persistent rise from 55.8 per cent in 1980-81 to more than 70.0 per cent by 1990-91. This structural shift in the composition of India's exports continued during the 1990s as well.

Within the primary goods sector, the fall in the relative share emanated primarily from the declining importance of traditional agricultural export categories, such as tea, tobacco, cashew kernels, spices and oilcakes. The decline would have been sharper but for the emergence of non-traditional export items, such as rice, fish and fish preparations, meat and meat preparations, vegetables, fruits, floricultural products and processed items from the 1980s.

A similar trend was discernible in the manufactured goods sector with traditional exports such as cotton fabrics and jute manufactures being overtaken by non-traditional items such as chemicals, engineering goods, readymade garments, gems and jewellery, and leather and manufactures.

The shift in the structure of merchandise imports, on the other hand, was not as perceptible as in the case of exports. Imports of fibres, iron and steel, non-ferrous metals, fertilisers, pulp and waste paper, and paper and paperboards registered a steady decline, with their combined share in total imports shrinking from 19.8 per cent in 1980-81 to 13.2 per cent in the early 1990s. On the other hand, the share of pearls, precious and semi-

precious stones registered a continuous increase to 8.5 per cent during the 1990s. The share of capital goods improved from 15.2 per cent in 1980–81 to 24.2 per cent during the early 1990s. The share of POL indicated a sharp rise to 41.9 per cent in 1980–81. Since the 1990s, however, their share had remained at around 24.0 per cent.

#### INVISIBLES

During 1992–93, the invisibles account recorded deterioration. There was a decline in the rate of growth of tourist arrivals (including nationals of Pakistan and Bangladesh) by 2.2 per cent, reflecting the impact of the disturbances that occurred at the beginning of the tourist season. The rising trend in interest payments decelerated, although outward remittances on account of royalty and technical fees continued to increase. Private transfer receipts, mainly comprising remittances from NRIs, remained broadly at the level of the preceding years, although there were indications of some diversion of remittances to the capital account to avail of the benefit of the full applicability of the market rate of exchange to such transfers which would otherwise have been converted at a composite of official and market rates in the ratio of 40:60. The invisibles account, inclusive of official transfers, yielded a net outflow of US\$ 815.0 million. Distinct shifts in inflows under various non-resident deposit schemes<sup>4</sup> occurred as a result of concerted policy efforts undertaken during the year 1993–94. Interest rates prescribed for various maturities under the FCNR (B) and the FCNR (A) schemes were adjusted periodically during the year, keeping in view the movements in the international interest rates. Under the NR(E)RA Scheme, the cap rate of interest for term deposits was revised downwards from 12.0 per cent to 11.0 per cent with effect from October 12, 1993, and further to 10.0 per cent effective May 16, 1994. To mobilise deposits under the NR(NR)RD and FCON schemes, it was, as in the past, left to commercial banks to decide the interest rate structure for different maturities.

The treatment to be accorded to the FCNR (A) scheme as part of the country's external debt statistics was subjected to critical review during 1992–93. Up to the year 1991–92, outstanding balances under

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4. FCNR (A): Foreign Currency Non-Resident (Account); FCNR (B): Foreign Currency Non-Resident (Bank) Account; NR(E)RA: Non-Resident (External) Rupee Account; FCON: Foreign Currency Ordinary Non-repatriable Account; FC (B&O) D: Foreign Currency (Bank and Others) Deposit; NR(NR)RD: Non-Resident (Non-repatriable) Rupee Deposits.

the FCNR (A) scheme were included in the debt statistics exclusive of accrued interest, primarily due to the accounting procedure adopted for transactions under the scheme. Interest accruing on FCNR (A) deposits and credited to the accounts, however, impacted on the debt statistics only when it was reinvested as a fresh deposit (inflow) or when it fell due and was paid out (outflow). Interest credited to the accounts but not specifically re-deposited was not placed under debt because it did not involve any immediate purchase or sale of foreign currency. Since it constituted a liability, the statistics relating to the FCNR (A) scheme were recast to add the interest amounts credited to the accounts to the principal amounts to derive the outstanding FCNR (A) liabilities, in line with the recommendations of the policy group/task force on external debt statistics of India (1992) set up by the Government. As a result of the concerted efforts to collect actual information on accrued interest credited to the accounts from the records of transactions between the Reserve Bank and deposit-taking banks, outstanding balances under the FCNR (A) as at end-March 1994 were estimated at US\$ 9,300.0 million.

Since the institution of structural reforms, there was an appreciable improvement in the performance of invisibles receipts, which offset the invariant trend in invisibles payments. Since 1991-92, surplus on the invisibles account was financing, to a considerable extent, the deficits on the merchandise account and, as a result, the CAD remained comfortable. In assessing the sustainability of the current account, it was, therefore, necessary to encompass invisibles transactions along with merchandise trade. The ratio of current receipts (excluding official transfers) to current payments moved up appreciably over the three years from 1992-93 to 1994-95. Current receipts financed as much as 94.3 per cent of current payments during 1994-95.

During 1995-96, invisibles receipts maintained a rising trend, spurred by a revival of tourist interest in India and supported by buoyant private transfer receipts as the depreciation in the nominal exchange rate induced switching to repatriation through formal channels. Despite the sharp rise in investment income payments, the net surplus under the invisibles account helped moderate the impact of the expansion in the merchandise trade deficit on the BoP.

The buoyancy imparted to net invisibles earnings with the institution of the market-determined exchange rate system and the introduction of current account convertibility was sustained during 1996-97. A surge

in the surplus on the invisibles account was led by burgeoning private transfers, partly reflecting the conversion of India development bonds (IDBs) and a noteworthy improvement in software and other technology-related exports. There was an estimated increase of about 46.0 per cent in exports of software in 1996–97 over the previous year. The increase in gross invisibles receipts more than offset the increase in net investment income payments. Underlying the growing surplus under net invisibles was the relatively stable growth in outflows under travel payments, as well as profits and dividends, contrary to expectations in the aftermath of current account convertibility. The net surplus under invisibles estimated in 1996–97 was significantly higher by 59.0 per cent than that in 1995–96. As a result, net invisibles receipts financed nearly 70.0 per cent of the trade balance compared with 48.0 per cent in 1995–96.

#### CURRENT ACCOUNT

The CAD for 1992–93 worked out to 2.1 per cent of GDP; it declined to 0.5 per cent of GDP during 1993–94, increased to 0.9 per cent during 1994–95 and went up further to 1.7 per cent of GDP in 1995–96. The CAD during 1995–96 underscored its inherent link with the rate of growth of the economy. CAD financed by capital inflows resulted in an accretion to the country's external liabilities, which required servicing. Accordingly, the size of the CAD needed to be kept at a level that was easily financeable. Traditionally, the debt-service ratio, *i.e.*, the ratio of interest and amortisation payments to current receipts, had been used as a measure of soundness. This ratio declined over the year, underscoring the fact that further slide in this ratio could occur only with a sharper increase in current receipts, especially export earnings. During 1995–96, the widening of the CAD was accompanied by a greater degree of openness of the economy as measured by the ratio of exports and imports to GDP, which rose from 19.5 per cent in 1994–95 to 22.8 per cent. Underlying the increasing global integration of the Indian economy was an improvement in the export to GDP ratio, which rose from 8.9 per cent in 1994–95 to 10.0 per cent in 1995–96. Current receipts were higher by 21.1 per cent over the preceding year. The import dependence also rose as evident from the sharp increase in imports during the year, causing deterioration in the ratio of current receipts to current payments to 89.1 per cent.

Drawing lessons from the crisis of 1991, the high level committee on BoP (Chairman: Dr C. Rangarajan) recommended that the CAD should

be contained at 1.6 per cent of GDP, which could be financed with normal capital flows. Structural reforms launched in the wake of the 1991 crisis helped on two fronts. First, there had been a deliberate policy shift towards encouraging non-debt-creating flows to finance the CAD. Second, the current receipts — both merchandise and invisibles — had shown robust performance since 1990–91, largely as a result of the reforms process. The ratio of current receipts to GDP saw a perceptible rise from 8.5 per cent in 1990–91 to 15.6 per cent in 1996–97. The combined outcome of these two factors was reflected in the decline in the debt-service ratio from 35.3 per cent in 1990–91 to 25.4 per cent in 1996–97, despite the fact that 1996–97 was marked by one time repayment of the IDBs. With the downtrend trend in the International Monetary Fund (IMF) repayment obligations, the debt-service ratio was expected to record a steep decline from 1997–98 onwards.

#### CAPITAL ACCOUNT

During 1992–93, in the capital account, the net inflow of external assistance declined by 38.8 per cent from that in the preceding year, despite the mobilisation of exceptional financing from donors. Access to commercial markets was not attempted in view of the country's rating. Disbursements of commercial borrowings largely took the form of trade-related credits. There was a turnaround in the trend of net outflows under the FCNR (A) scheme and net inflows began to occur from October 1992 onwards. Draws under the stand-by arrangement negotiated with the IMF were in the form of purchases of US\$ 663.0 million in July 1992, US\$ 643.0 million in December 1992 (of which US\$ 295.0 million or SDR 212 million was held in the reserve position in the Fund as India's quota subscription towards the increase in quotas under the ninth general review of quotas), US\$ 319.0 million in February 1993 and US\$ 325.0 million in June 1993. Net purchases from the IMF amounted to US\$ 1,288.0 million in 1992–93 as against US\$ 781.0 million in the preceding year.

Net external assistance declined steadily from a level of US\$ 775.0 million during 1992–93 to US\$ 52.0 million during 1996–97 (Table 13.2). This was attributable to the slower pace of utilisation and a steady increase in repayments. India had refrained from seeking access to markets in Japan and the US since 1990–91 due to its low credit ratings. The Euro market had, however, been accessed by corporate entities, both for bonds and equity. Mobilisation of commercial borrowings had mainly been in the form of trade-related credits, with a small component of bank loans.

TABLE 13.2  
*External Assistance*

(US\$ million)

<i>Year</i>	<i>Authorisation Loans and Grants</i>	<i>Utilisation Loans and Grants</i>	<i>Debt Service Payments</i>	<i>Net Inflow of Aid</i>
	(1)	(2)	(3)	(2-3)
1992-93	4,606	3,589	2,814	775
1993-94	4,490	3,769	3,055	714
1994-95	4,302	3,478	3,315	163
1995-96	3,649	3,307	3,699	-393
1996-97	4,826	3,372	3,320	52

*Note:* Figures of authorisation have been arrived at by applying the average exchange rate of the rupee with individual donor currencies. Figures of utilisation are at current rates applicable at the date of transaction. Figures of authorisation and utilisation include loans and grants on both government and non-government accounts.

*Source:* Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008-09*.

TABLE 13.3  
*Foreign Investment Inflows*

(US\$ million)

<i>Year</i>	<i>Direct Investment</i>	<i>Portfolio Investment</i>	<i>Total</i>
1992-93	315	244	559
1993-94	586 (86.0)	3,567 (1361.9)	4,153 (642.9)
1994-95	1,314 (124.2)	3,824 (7.2)	5,138 (23.7)
1995-96	2,144 (63.2)	2,748 (-28.1)	4,892 (-4.8)
1996-97	2,821 (31.6)	3,312 (20.5)	6,133 (25.4)

*Notes:* 1. Data from 1995-96 onwards include acquisition of shares of Indian companies by non-residents under Section 6 of FEMA, 1999.

2. Figures in parentheses represent percentage of increase or decrease over the previous year.

*Source:* Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2008-09*.

#### FOREIGN DIRECT INVESTMENT

In India's traditional policy framework, FDI was treated more as a source of transfer of technology. In the post-reform approach, its many other advantages such as infrastructure financing, trade and investment were

fully recognised. After the crisis, FDI policy reforms formed part of a package of industrial reforms. The attempt to decontrol FDI took the form of an automatic route that was monitored and implemented through the Reserve Bank. FDI with up to 51.0 per cent foreign equity was allowed for 34 priority industries and international trading companies. The newly created Foreign Investment Promotion Board (FIPB) in 1992 ensured the speedy approval of FDI proposals outside the ambit of the automatic route. The scope of 51.0 per cent FDI was widened to cover other industries during the 1990s. A study by a private international consultancy organisation showed that both the FDI policy and its implementation through the Reserve Bank automatic route and the FIPB were comparable with those in South-East Asia and China.<sup>5</sup>

The capital account was dominated by foreign investment inflows that met more than half the financing needs. A welcome development was the spurt in direct foreign investment from 1995–96. During 1995–96 and 1996–97, it nearly equalled the net inflows of portfolio investment for the first time since 1992–93 and emerged as an important item in the capital account. There was a steady improvement in inflows arising from investment proposals by NRIs. The US continued to be the largest direct investor, followed by the UK. Industry-wise, financial companies accounted for the largest share of FDI flows, followed by engineering, electronics and electrical equipment.

#### PORTFOLIO INVESTMENT

Among emerging economies, India was one of early openers of the equity market to foreign portfolio investments.<sup>6</sup> In addition to the general objective of raising equity flows, there were two other considerations. Though the domestic saving rate was relatively high, the availability of risk capital in the equity market was low. It was envisaged that the flow of foreign equity would help develop the domestic equity market by bringing in the world's best practices and stimulating competition. Second, foreign equity investors were expected to come to India quickly to assess and disseminate the opportunities available in India, which would bode well for FDI.

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5. Virmani, Arvind (2003). "India's External Reforms: Modest Globalisation Significant Gains", *Economic and Political Weekly* 37(32): 3373-3390. August 9-15.

6. The World Bank (2001). *A Review of Financial Sector Issues*.

Portfolio investment inflows, which were placed at US\$ 244.0 million during 1992–93, increased during the next five years and the inflow averaged US\$ 3,056.0 million (Table 13.3). During 1995–96, the inflow of portfolio investment was adversely affected by a slump due to global depository receipts (GDRs) of Indian corporate in the Euro markets. The bearish domestic market conditions coupled with the restrictions on utilisation and placement of the proceeds of Euro issues, which remained in force up to November 1995, had a dampening influence on corporate that were accessing funds from overseas markets.

With effect from November 25, 1995, however, companies were allowed to bring issue proceeds into the country in anticipation of end-use, while ceilings on the use of funds for corporate restructuring, including working capital, were raised from 15.0 per cent to 25.0 per cent of the GDR issue. Further, the condition relating to the approval of GDR issue of a track record of good performance for a minimum of three years was relaxed in the case of companies in the infrastructure sector. In response to these policy shifts, several Indian companies launched GDR issues. The total amount repatriated to the country against GDR issues, however, was only US\$ 149 million during 1995–96. Monetary tightening and rising interest rates in the US, beginning in February 1994, the Mexican crisis in December 1994 and bullish stock markets in the Organisation for Economic Cooperation and Development (OECD) countries, particularly the US, had the effect of lowering the flows to emerging markets. Among the emerging markets in Asia, a tendency to rotate funds away from the markets of Hong Kong and Singapore was driven by an appetite for higher risk-adjusted returns. In India, however, low stock prices tended to dampen foreign institutional investors' (FIIs') investment. FII investments surged on the perceptions of overcorrection in the stock and foreign exchange markets.

### INDIA'S EXTERNAL DEBT

A cautious policy towards debt flows was outlined in 1992–93. This included tight control on short-term borrowings and a cap on total external commercial borrowings (ECBs). Until 1992–93, ECBs had a minimum maturity period of five years and could only be used to purchase capital goods abroad. Priority was given to infrastructure, exports and small and medium enterprises (SMEs). The policy was gradually liberalised through the 1990s. The stringent short-term debt policy resulted in the closing of the FC(B&O)D scheme in July 1992, the FCNR scheme of less than

one year in May 1993 and the FCNR account scheme of less than two years in October 1993. As a result of this policy, short-term debt declined from 6.1 per cent of the total external debt at the beginning of the 1990s to 3.5 per cent at the end of March 2001. Other elements of this policy were eliminating ECBs, rigorous scrutiny of borrowings by public sector companies and increasing the share of private sector in ECBs. This resulted in a gradual decline in the share of the Government in external debt, while external private debt increased over the years (Table 13.4).

TABLE 13.4  
*India's External Debt (End-March)*

	(US\$ million)				
	1993	1994	1995	1996	1997
Total Long-term Debt	83,683	89,068	94,739	88,696	86,744
Short-term Debt	6,340	3,627	4,269	5,034	6,726
Total External Debt	90,023	92,695	99,008	93,730	93,470
Concessional Debt as % of Total Debt	44.5	44.4	45.3	44.7	42.2
Short-Term Debt as % of Total Debt	7.0	3.9	4.3	5.4	7.2
Debt Stock-GDP Ratio %	37.5	33.8	30.8	27.0	24.5
Debt-Service Ratio %	27.5	25.4	25.9	26.2	23.0

- Notes: 1. Short-term debt does not include suppliers' credit of up to 180 days from 1994 to 1997.  
 2. Debt-service is calculated on cash payment basis except for NRI deposits for which accrual method is used. The estimates, therefore, differ from BoP data compilation methodology.  
 3. Debt to GDP ratio derived from ₹ figures.

Source: Government of India, *India's External Debt: A Status Report, 2001*.

#### OVERALL POSITION

The highlights of India's external debt position were:

- (i) India's external debt recorded moderate growth of 3.0 per cent and 6.8 per cent during end-March 1994 and end-March 1995, respectively over the previous years. However, the external debt slowed subsequently, with negative growth of 5.3 per cent during 1996 and 0.3 per cent during 1997, compared with that of the respective earlier years.
- (ii) As per cent of GDP at current market prices, India's external debt declined from the peak of 37.5 per cent in 1993 to 33.8 per cent in 1994, 30.8 per cent in 1995, 27.0 per cent in 1996 and 24.5 per cent in 1997.

- (iii) Short-term debt (of maturity within one year) as a proportion of total external debt declined from 7.0 per cent at end-March 1993 to 4.3 per cent at end-March 1995, and thereafter increased to 5.4 per cent during 1996 and 7.2 per cent at end-March 1997.
- (iv) A large part of the external debt, especially debt to multilateral (excluding the IMF) and bilateral agencies had a high degree of concessionality, *i.e.*, grant element of at least 25.0 per cent. The share of concessional debt in total debt varied from 44.5 per cent at end-March 1993 to 42.2 per cent in 1997.
- (v) Debt in rupee terms owed to the former Soviet Union, rupee-denominated non-resident deposits and debt in the form of foreign currency convertible bonds (FCCBs) moderated the degree of concern about the level of external debt because of their special characteristics. The relatively high grant element in India's external debt translated into downsizing the nominal value of the debt by about one-third in present value terms.
- (vi) The debt-service ratio stood at 27.5 per cent in 1992–93, 25.4 per cent in 1993–94, 25.9 per cent in 1994–95 and 26.2 per cent in 1995–96, and declined to 23.0 per cent during 1996–97.

#### THE POLICY GROUP

The policy group and task force on external debt statistics of India recommended a new definition and classification of external debt. The new classification was exhaustive and included, in addition to the components already covered, the interest credited to the accounts under the FCNR (A) scheme, convertible debentures, revalued balances under the International Bank for Reconstruction and Development (IBRD) pooled loans and exchange adjustments in respect of pre-1971 International Development Association (IDA) credits.<sup>7</sup> It would exclude lease transactions and rupee-rouble credits from the main debt statistics (the latter appear as memo items). Under the short-term debt, all credits up to six-month maturity were excluded. The group also recommended that the data on non-civilian debt be disclosed in view of the need for greater transparency of the debt statistics.

In relation to GDP at current market prices, the total debt excluding under memo items rose from 28.7 per cent at end-March 1991 to 35.7 per

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7. IBRD pooled loans were excluded due to technical problems.

cent at end-March 1993. The debt-service ratio (*i.e.*, ratio of debt-service payments exclusive of defence-related debt-service payments to export of goods and services excluding official transfers) was estimated to have declined fractionally, from 35.3 per cent in 1991-92 to 27.5 per cent in 1992-93.

#### CONSOLIDATION

During 1993-1996, significant developments in the country's external transactions enabled a consolidation of external debt. As a result, at end-March 1996, the total debt recorded a decline of 5.3 per cent over the previous year and continued at the same level till end-March 1997. However, the reduction in external indebtedness during 1995-96 mainly reflected the appreciation of the US dollar *vis-à-vis* other major international currencies during the year, which more than offset the accretions in various important components of the debt stock.

The extent of indebtedness needed to be assessed, keeping in view the concessional element in the total debt. Bilateral debt and debt owed to multilateral institutions, both with a large element of concessionality, ranged between 42.0-44.0 per cent during 1993-1997. The share of ECBs comprising trade credits, bank loans and various types of securitised borrowings though remained range-bound between 13.0 and 18.0 per cent of the total debt between 1993 and 1997, there was a decline in the absolute level of bank loans as well as in their share in the total stock of debt. There was a perceptible decline both in terms of share and absolute level of short-term debt. Short-term debt declined from 7.0 per cent of total debt at end-March 1993 to 5.4 per cent at end-March 1997. This reflected the abolition of the short-term maturity slab under the FCNR (A) in May 1993 and the liquidation of liabilities due on account of public sector undertakings (PSUs).

Interestingly, according to the Global Development Finance 1997, India ranked sixth among the developing countries in terms of the magnitude of debt stock, which showed an improvement as compared with its fourth position in 1991.

#### RUPEE-ROUBLE DEBT

According to the agreement reached in the beginning of 1993, the amount of debt outstanding in Russian roubles as on April 1, 1992 was to be converted into Indian rupees and repaid in rupees as set out below:

- (i) The outstanding debt expressed in roubles as on April 1, 1992 would be converted into rupees as per the rupee-rouble rate of exchange (in accordance with the provisions of the protocol dated November 25, 1978) prevailing on January 1, 1990 (₹ 19.9 per rouble).
- (ii) The same rouble debt-stock would be converted into rupees at the exchange rate prevailing on April 1, 1992 (₹ 31.8 per rouble).

The difference between the two amounts, called rescheduled debt, would be repaid with no interest in equal annual instalments over a period of 45 years starting from April 1, 1993. There was no protection against any fluctuation in the value of the rupee for five years from April 1, 1992. Thereafter, this would be reviewed once every five years and, if there was more than 3.0 per cent depreciation of the rupee per year on an annual average basis *vis-à-vis* the SDR, the payment due on this account could be indexed to the rupee value of the SDR for the next five-year period. The debt, converted at the rate of exchange prevailing on January 1, 1990 (rupee equivalent of rouble debt as at (i) above), was called principal debt and would be repaid with interest in accordance with the payment schedule in force for each loan agreement. In case the value of the rupee *vis-à-vis* the SDR changed on any day after April 1, 1992 by more than 3.0 per cent either way compared with the base value of the rupee (which was ₹ 35.3637 on April 1, 1992), the amount of principal and interest to be paid would be readjusted proportionately to the change.

With this agreement, the advantage derived was that the increase in debt between January 1, 1990 and April 1, 1992 due to variation in the exchange rate of the rupee *vis-à-vis* the rouble as per the protocol would be repaid in 45 years without any interest.

#### FOREIGN EXCHANGE RESERVES

India's foreign exchange reserves as at end-March 1993 recorded an increase of 6.6 per cent over the previous year, *i.e.*, end-March 1992 (Table 13.5). Exclusive of gold revaluation and transactions with the IMF, the foreign exchange reserves declined by 5.3 per cent during 1992-93 against an increase of 30.3 per cent during 1991-92.

The international reserves increased significantly by 95.8 per cent as at end-March 1994. Excluding gold revaluation and transactions with the IMF, the foreign exchange reserves increased by 4.5 per cent as against a decline of 5.3 per cent during 1992-93. The reserves further rose by

30.8 per cent as at end-March 1995. Exclusive of gold revaluation and transactions with the IMF, the foreign exchange reserves increased by 18.3 per cent during 1994–95.

India's foreign exchange reserves stood lower by 13.8 per cent at the end of March 1996. By the end of June 1996, however, there was a modest build-up in the reserves. The movement in the reserves closely reflected the developments in the BoP and external sector policies pursued during the year. The reserves rose by 21.8 per cent during 1996–97, despite large payments on account of redemption of the IDBs and net outflows under the FCNR (A) scheme.

TABLE 13.5  
*Foreign Exchange Reserves*

<i>End of Financial Year</i>	<i>SDRs</i>	<i>Gold</i>	<i>FCA</i>	<i>Total</i>	<i>(US\$ million)</i>
					<i>No. of Months' Import Requirement</i>
1992–93	18	3,380	6,434	9,832	4.9
1993–94	108	4,078	15,068	19,254	8.6
1994–95	7	4,370	20,809	25,186	8.4
1995–96	82	4,561	17,044	21,687	6.0
1996–97	2	4,054	22,367	26,423	6.5

*Source:* Reserve Bank of India, *Handbook of Statistics on the Indian Economy, 2009–10.*

#### FOREIGN CURRENCY ASSETS

The Reserve Bank's FCA rose by 14.3 per cent as at end-March 1993 over the previous year. The balancing mechanism of the dual exchange rate system under LERMS was evident in the broad correspondence between foreign currency purchases from and sales to authorised dealers (ADs). A sharp decline in aid receipts and large debt-service payments resulted in a net outflow from the stock of foreign currency assets. The foreign currency assets were bolstered by an inflow of exceptional financing (in the form of aid receipts) and net accruals from the IMF drawals. There was a turnaround in the net outflows under the FCNR (A) scheme. Large inflows under the FC(B&O)D scheme in the first four months of 1992–93 were counterbalanced by withdrawals in succeeding months, so that the year ended with a net inflow of FCA.

The Reserve Bank's FCA rose by a substantial 134.0 per cent at the end of March 1994 over the previous year, reflecting an excess supply of foreign exchange in the inter-bank foreign exchange market. The Bank's gross purchases of foreign currencies amounted to US\$ 13,940.0 million during 1993–94. As a result of the cost-effective accretions to the FCA through purchases from the market, liabilities in the form of swaps that had been incurred during 1991–1993 could be completely settled. There were outflows under the FCNR (A) scheme and under the FC(B&O)D scheme (which was discontinued). In addition, aid receipts net of debt-service payments and transactions with the IMF yielded outflows resulting in a reduction in medium-term debt obligations. Further, there was a liquidation of the overhang of short-term liabilities incurred on behalf of PSUs during the payments crisis of 1991.

The increase in the reserves during 1994–95 was largely in terms of the Bank's FCA, which rose by 38.9 per cent at the end of March 1995 over that of March 1994. Unlike in 1993–94, the accretion to the FCA was uneven. Reflecting the surge in capital flows, FCA rose sharply between May and October 1994. In November and December 1994, moderation set in as several measures were taken to stem the inflow of elements of foreign capital that were responding to interest rate differentials aided by a stable exchange rate. In January 1995, FCA began to rise again as large purchases of foreign currency were undertaken from the market. While the Bank's purchases of foreign currency fell sharply in February and March 1995, the sharp rise in the FCA in these two months was propelled by the inflow of aid receipts. Despite augmented demand in relation to the preceding year, the inter-bank foreign exchange market faced conditions of excess supply of foreign exchange. The Reserve Bank had to resort to gross purchases of foreign currencies amounting to US\$ 10,304.0 million during 1994–95. As in the preceding year, accretions to the FCA were utilised to reorganise the reserves by divesting them of costly liabilities. Liabilities under the FC(B&O)D scheme were completely paid-off during the year. There were also large outflows under the FCNR (A). In addition, debt-service payments of US\$ 2,868.0 million and repurchases of US\$ 1,146.0 million from the IMF yielded outflows, resulting in a reduction in medium-term debt obligations.

The increase in the foreign exchange reserves during 1996–97 was primarily in the form of accretion to FCA. If the effect of valuation loss resulting from the depreciation of non-dollar currencies *vis-à-vis* the US

dollar was excluded, the increase in the FCA would be still higher. The perverse demand conditions and the leads and lags prevailing in the exchange market during 1995–96 completely reversed in 1996–97 under the impact of the strong policy response and market-driven corrections in the exchange rate. Excess supplies of foreign exchange, however, imposed pressure on the rupee to appreciate. Apart from the Reserve Bank's purchases of US\$ 7,801.0 million, aid receipts of about US\$ 1,705.0 million were the other important source leading to accretion to FCA. There were several large payments obligations to be met directly from the reserves during 1996–97. Under repayment of the IDBs, the actual depletion in the FCA was US\$ 1,234.0 million. Besides, withdrawal of deposits under the FCNR (A) scheme of US\$ 2,276.0 million and purchase of SDRs through the IMF for an amount of US\$ 1,019.0 million for effecting various payments to the IMF also constituted major outflows from the reserves.

Following the decision in July 1995 in respect of routing debt-service payments on government account increasingly through the market (the Government's aid receipts continued to accrue to the account of the FCA of the Reserve Bank), the outflows from the reserves under debt-service payments remained low during the year. The FCA at the end of the year were sufficient to cover around six months of imports. A large stock of volatile/short-term foreign exchange liabilities, however, necessitated the holding of reserves higher than what is conventionally suggested in terms of months of import cover. It was perceived that in the Indian context, the need for a higher level of FCA than the conventional rule of thumb of three months' import cover was justified in the face of large short-term debt and portfolio investment by the FIIs.

#### RESERVES ADEQUACY

From the standpoint of achieving the goal of ensuring orderly conditions in the foreign exchange market as also to deal with situations arising on account of unanticipated and sudden reversals of capital flows, a level of reserve assets that could be considered as adequate needed to take into consideration a host of factors, such as the cover for sufficient months of current payments, the stock of short-term and volatile external liabilities, a shift in the pattern of leads and lags in payments/receipts during exchange market uncertainties along with the conventional norm of cover for sufficient months of imports. The gross foreign exchange reserves stood at US\$ 26.4 billion at end-March 1997, equivalent to more than six months

of imports. Even after taking into account short-term debt of US\$ 5.0 billion, FII investment of US\$ 8.5 billion and GDRs of US\$ 6.0 billion, this level of reserves was considered adequate to deal with any external imbalances arising from fluctuations in capital flows. Though there was no specific policy on the quantum of reserves to be built up, the Reserve Bank, through various measures, accumulated a comfortable level of reserves by the end of the 1990s.

TABLE 13.6  
*Movement of SDR Transactions*

*(SDR million)*

<i>Year</i>	<i>Nature of Transactions</i>	<i>Receipts</i>	<i>Payments</i>	<i>Balance (3-4)</i>
<i>(1)</i>	<i>(2)</i>	<i>(3)</i>	<i>(4)</i>	<i>(5)</i>
1992-93	Net acquisition	225	--	--
	IMF drawal	446	--	--
	Repurchase	54	--	--
	Payment of charges/interest	--	227	--
	Sale of SDRs	--	231	--
	Payment to IMF towards increase in India's Quota	--	212	55
1993-94	Acquisition	263	209	255
	IMF drawals	105	--	--
	Repurchase	96	--	--
	Payment of charges/interest to IMF			
1994-95	Payment of charges to IMF	--	7	-7
1995-96 (June 1995)	Acquisition of SDR	95	--	95
1996-97	Payment to IMF (charges and valuation effects)	--	764.59	--
	Acquisition from IMF	651	--	-112.23
	Interest received	1.36	--	--

*Note:* --: Not applicable/not available.

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

Besides the size of reserves, their quality also assumed importance. Unencumbered reserve assets<sup>8</sup> must be available at any point of time to the authorities for fulfilling various objectives assigned to reserves. In India, the only encumbrance is forward sales net of purchases. The Reserve Bank's accumulated forward liabilities, which were US\$ 40.0 million at the end of August 1997, rose to a peak of US\$ 3,190.0 million or the equivalent of 13.0 per cent of the corresponding gross reserves by the end of January 1998. As a matter of prudent management of external liabilities, the Reserve Bank's policy was to keep forward liabilities at a relatively low level as a proportion of gross reserves.

#### SPECIAL DRAWING RIGHTS

Holdings of SDRs remained small and showed two-way movements between 1992–93 and 1996–97. However, at the end of March 1997, they fell to a level of around SDR 1 million. The details of transactions are given in Table 13.6.

#### TAPPING GOLD FOR EXTERNAL ADJUSTMENT

As part of resolving external payments problems and shoring-up reserves, at various stages, the Reserve Bank considered tapping its gold resources and earning some income from gold holdings.

#### VALUE OF GOLD RESERVES

The Reserve Bank, in its letter (from the Governor, Shri R.N. Malhotra) to the Finance Minister dated August 16, 1990, had suggested, *inter alia*, revaluation of the gold assets held by the Reserve Bank closer to international prices by amending the Reserve Bank of India (RBI) Act, 1934, to increase the flexibility in the use of gold reserves, and to keep 15.0 per cent of these reserves outside India as already permitted under the Act. In about two months' time, the Government initiated action on the suggestion.

The holdings by the Reserve Bank of gold coin and gold bullion were being valued at 0.118489 grams of fine gold per rupee; accordingly, prior to October 1990, these holdings were valued at ₹ 280.67 crore in terms of section 33(4) of the RBI Act, 1934. The Government, by formulating an

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8. The unencumbered reserve assets are reserve assets net of encumbrances, such as forward commitments, lines of credit to domestic entities, guarantees and other contingent liabilities.

ordinance dated October 15, 1990, amended the provisions of this section. Consequently, the Reserve Bank revalued its gold holding as on October 17, 1990 at the average of London market prices during the three-month period ended September 30, 1990, reduced by 10.0 per cent and the gold holdings stood at ₹ 6,623.44 crore. Further, the Reserve Bank decided to revalue the gold holdings at the end of each month based on the average daily London market prices during the month, keeping a margin of 10.0 per cent. This change to market-based valuation of gold helped over time to reflect the appropriate value of gold reserves. The details of the gold holdings (monetary gold) during the period 1992–93 to 1996–97 are given in Table 13.7.

TABLE 13.7  
*Movement in India's Gold Holdings*

	1992–93	1993–94	1994–95	1995–96	1996–97
I. Stock of Gold (end-March)					
(i) Qty. (tonnes)	354	367	396	398	398
(ii) Value (US\$ mn.)	3,380	4,078	4,370	4,561	4,054
II. Addition					
a) Interest on gold holdings kept abroad					
(i) Qty. (tonnes)	0.2	0.1	0.03	–	–
(ii) Value (US \$ mn.)	2.5	1.4	0.3	–	–
b) Purchases from Central Government					
(i) Qty. (tonnes)	3.1	12.6	28.9	1.6	–
(ii) Value (US\$ mn.)	29.4	139.3	315.0	17.9	–

Notes: '–': Not available.

mn.: million.

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

#### PROPOSAL TO ISSUE GOLD BONDS TO NRIs

In December 1990, the Finance Minister received several suggestions from NRIs to augment the foreign exchange reserves, one of which was to issue gold bonds to NRIs (and residents) with tax benefits and, in the case of residents, no questions were to be asked about the source of the gold. The bonds were repayable in gold or at the bidder's option in rupees at the prevailing domestic price of gold and to cover the gold price risk; the Government was to buy 10-year gold options in the international markets that might turn out to be cheaper than the best terms which any

Government could get in the international markets. The Reserve Bank was not much impressed with the proposal (as indicated to the Government in a letter dated December 17, 1990). The 'option' price suggested was seen as uneconomical since sizeable upfront premium was immediately payable in foreign currency. However, NRIs could be permitted to import or send out gold subject to the payment of a special customs duty of 30.0 per cent of the value of gold at international prices even though ultimately it might not result in any additional inflow of foreign exchange from the NRIs. This was because what they would have otherwise sent in the form of foreign currency remittances would in part come in the form of gold and thus diminish the inflow of forex remittances. Nevertheless, the Reserve Bank was prepared to allow the import of gold by NRIs for a limited period and the response was expected to be good.

In that connection, the Reserve Bank worked out two schemes, one for residents and the other for NRIs. For residents, gold bonds would be issued at the international price of gold converted into rupees at the prevailing exchange rate at an attractive interest rate consistent with immunity from disclosing the source of gold and tax concessions. These could be redeemed in rupees at the international price of gold and the rupee exchange rate then ruling, thus offering the investor the benefit of possible rupee depreciation and gold appreciation. On the other hand, NRIs were allowed to import gold for subscribing to the gold bond, by paying a special rate of 30.0 per cent customs duty, which would be added to the rupee value of the bond, thus making it attractive for them. The bonds were repayable only in non-convertible rupees and on the same terms as those for resident investors. Compared to deposits in an FCNR account, NRIs would get the added advantage of possible appreciation in the dollar price of gold with the tax benefits of the FCNR scheme, but at a somewhat lower rate of interest and without repatriation rights.

#### SETTING-UP OF A NATIONAL GOLD BANK

As part of economic restructuring after the 1991 crisis, a proposal to mobilise gold deposits from residents as well as NRIs for productive use at the hands of the Government was internally examined by the Reserve Bank. The total private gold holdings in the country were estimated at 7,000 tonnes (as against the monetary gold holdings of 350 tonnes). Besides, the estimated substantial gold holdings with NRIs, especially those living in the Middle East and African countries, were also kept in view. It was expected

that efforts to mobilise gold through a gold bank from both residents and NRIs could generate wider support for three reasons:

- (i) Chastened by the gulf war experience and seeking protection from the undercurrents of tensions in countries like South Africa, NRIs were showing interest in such a proposal.
- (ii) A gold bank scheme that could provide liquidity against idle stocks of gold at a reasonable cost was expected to receive support within the country from the business community against the background of the credit squeeze and high interest rates.
- (iii) The successful honouring of gold delivery commitments under the last scheme (issue of gold bonds by the Government at the time of the external aggression in the early 1970s) and, more importantly, the well-publicised sale and redemption of government gold in the recent past, were seen to have lent considerable credibility to any proposal from the Government involving gold.

In the aftermath of the crisis, a gold bank scheme was viewed as an arrangement to source external funds at low cost and as an off-balance sheet borrowing for the country. It was considered a safety net for procuring external resources at short notice to bridge any unforeseen gap arising from trade liberalisation. The scheme would substitute for a stand-by loan facility that many countries, like Indonesia, that were undertaking structural reforms, lined up with the international banks to safeguard against uncertainties in movements in the BoP.

It was proposed by the Reserve Bank that the gold bank would be a newly created entity under the Companies Act, jointly owned by the Reserve Bank and a few public sector banks (PSBs) that had overseas operations. The essential charter of the company would be to seek and obtain deposits in the form of gold or its equivalent value in dollars from residents and NRIs with a view to pledging such stocks with external agencies to raise funds and on-lend to the owners of the institution. It could seek and obtain the sovereign guarantee to the extent necessary in furtherance of the above objectives.

The Reserve Bank would issue gold certificates against the deposits, which would be redeemable at the end of five years by physical delivery of gold of international purity. Meanwhile, depositors would receive interest at 2.5 per cent per annum payable annually in dollars (or equivalent rupees for domestic residents). The Bank would be at liberty to pledge the gold abroad. On the then-quoted terms in the London market, a 5-year gold

deposit with the international banks would fetch a return of about 1.3 per cent per annum. The depository would have the right of usage of the gold until redemption. The Reserve Bank would raise loans and lend to Indian banks at a matching cost.

Borrowings against gold were available at extremely fine rates. A 5-year loan against the pledge of gold stocks could be raised at LIBOR less 60.0 basis points per annum. Lenders normally lent up to 80.0–85.0 per cent of the gold value. They returned physical gold of the same purity at the end of the period of the loan. There was thus no price risk in the account of the borrower.

The gold certificates would be honoured either by delivery of gold abroad or, at the option of the subscriber, delivery of an equivalent quantity to a resident within the country. The local restrictions, if any, at major overseas centres to market such gold certificates would need to be examined. Besides, a mechanism to provide liquidity to such bonds by way of loans within and outside the country would need to be drawn.

In view of the likely larger measure of support from NRIs to the gold certificates than domestic residents and the likelihood of NRIs opting to direct gold delivery on maturity to residents in the country, a probable criticism against the scheme could be that it would amount to backdoor import of pure gold without any tariff. However, such a criticism needed to be viewed against the mandatory lock-in (maturity) period of five years during which the country made full use of the gold. There would be no prepayment or early redemption option under the gold certificates.

To sum up, it was considered viable to constitute a gold bank and issue gold certificates to residents and NRIs with a view to raising low-cost funds against the pledge of gold to support the economic restructuring. Besides providing a safety net for BoP requirements, such a scheme would help monetise a modest portion of the private gold holdings within the country and provide a cost-effective avenue to raise external funds away from traditional funding sources.

Accordingly, the Governor, Shri S. Venkitaramanan, in his letter dated February 9, 1991, suggested to the Finance Ministry to set up a gold bank to mobilise the idle gold holdings of the public and to raise foreign exchange resources against long-term deposits. The National Gold Bank was to mobilise gold from the public in the form of 5 to 7-year deposits, repayable either in gold or dollars at the international prices ruling at the time of maturity. Under an amnesty scheme drawn for the purpose,

no questions were to be asked about the sources of gold so deposited. A token interest of 2.5 per cent was payable at the time of maturity of the bond on the value of the deposited gold. The national gold certificates issued against such deposits could be gifted without attracting gift tax and were exempt from wealth tax. The gold so mobilised was to be converted into foreign exchange through a variety of mechanisms to be utilised for providing foreign currency loans to Indian entities and would thus play a useful role in putting to effective use an asset that was remaining idle in the hands of the public, while ensuring a safe haven of investment to the holders of gold.

The Finance Secretary responded (letter dated April 16, 1991) that since the regular budget had been postponed and only the interim budget was to be presented, no new proposals involving the amendment to the tax laws could be finalised and that this proposal might be taken up afresh when the regular budget was presented.

Subsequently, the Government introduced only a gold bond scheme in 1993 that opened for subscription on March 15, 1993 and closed on June 14, 1993. The scheme mobilised 41.12 tonnes of gold from the public. At the domestic market prices (as on June 29, 1993), it was valued at about ₹ 1,807 crore (or ₹ 1,558 crore at international prices).

#### SUGGESTION TO EARN INCOME FROM GOLD RESERVES

In January 1994, the gold reserves of the Reserve Bank were 356 tonnes, valued at about US\$ 4.45 billion at international prices. Further accretion of about 40 tonnes of gold was expected under the gold bond scheme, 1993 of the Government in terms of the arrangement to sell back the gold to the Government on maturity of the gold bonds. Thus, the Reserve Bank's gold holdings were expected to be close to 400 tonnes, equivalent to about one-third of the aggregate gold and foreign exchange reserves. Of this, about 65 tonnes of gold were being held abroad.

The Reserve Bank, in a letter dated January 11, 1994 to the Finance Secretary, proposed that it would be desirable to earn some income on at least a part of its gold holdings. For this purpose, the Reserve Bank of India Act had to be amended to authorise the Reserve Bank to have a reasonable degree of flexibility in its gold operations so as to enhance the returns without undue undertaking risks. The draft bill to amend the Reserve Bank of India Act prepared by the Legal Department was: (i) to authorise the Reserve Bank to place deposits with commercial banks and financial

institutions (FIs) abroad; (ii) to provide gold loans to the institutions that were approved by the Central Board of Directors for promoting jewellery exports; and (iii) to deal in derivatives in respect of assets in which the Reserve Bank was permitted to invest under the Act. Investments in derivatives were envisaged since the Reserve Bank had been deploying its foreign exchange reserves in a range of foreign currencies in the form of high-quality money market instruments and bonds, which were in the nature of cash instruments, and a foray into new derivative transactions would enable the Reserve Bank to optimise returns without increasing the element of risk.

### EXCHANGE RATE MANAGEMENT

The dual exchange rate arrangement instituted on March 1, 1992 under LERMS enabled an orderly transition from a managed float regime to a market-determined system. During the 12-month period of the operation of LERMS, the officially determined exchange rate held steady except for a downward adjustment of 1.12 per cent effected on December 4, 1992. The official exchange rate equilibrated between 40.0 per cent of current receipts surrendered to ADs and in turn to the Reserve Bank and payments for purposes designated under LERMS. An even volume of transactions passed through market operators and, as a result, the market-determined exchange rate was stable (Table 13.8). The spread between the official and the market rate moved in a narrow range, except in the month of February 1993, when speculative activity resulted in some turbulence in the inter-bank exchange market.

With the introduction of unified market-determined exchange rate system in March 1993, the Reserve Bank's obligation to sell foreign exchange at the official rate for essential purposes, such as oil, food and fertiliser and defence imports, was discontinued and purchases of foreign currency for such transactions were made at the market rate. A part of the Government's debt-service payments were also being put through the market. In consonance with the ongoing efforts to reform the exchange markets in India so as to better reflect the demand and supply position of foreign exchange, the process was carried forward and the debt-service payments of the Government were increasingly routed through the exchange market. The repurchase obligation to the IMF, however, continued to be met through the Reserve Bank.

TABLE 13.8  
*Spread between Official and Market Exchange Rates*

(₹ per US\$)

<i>Month</i>	<i>Official Rate</i>	<i>Market Rate</i>	<i>Spread</i>	<i>Weighted Rate</i>
(1)	(2)	(3)	(4)	(5)
March 1992	25.8901	29.4551	13.77	28.0291
April 1992	25.8900	30.9253	19.45	28.9112
May 1992	25.8900	30.3407	17.19	28.5604
June 1992	25.8900	30.2361	16.79	28.4977
July 1992	25.8900	30.2524	16.85	28.5074
August 1992	25.8900	30.0885	16.22	28.4091
September 1992	25.8900	30.0584	16.10	28.3910
October 1992	25.8900	30.0471	16.06	28.3843
November 1992	25.8900	30.0824	16.19	28.4054
December 1992	26.1540	30.7005	17.38	28.8819
January 1993	26.1986	30.8833	17.88	29.0094
February 1993	26.1986	32.6456	24.61	30.0668

*Source:* Reserve Bank of India, *Annual Report, 1992–93*.

LERMS as a system in transition performed well in terms of creating conditions for transferring an augmented volume of foreign exchange transactions on to the market. It imparted stability, resulted in a significant deceleration in the rate of inflation and a healthy build-up in the level of foreign exchange reserves. At this point, the Reserve Bank evaluated three options for modifying LERMS: (i) to maintain the status quo; (ii) to change over to a 80:20 ratio; and (iii) to have a unified exchange rate regime with one or more purposes for the official rate and no requirement for ADs to surrender any part of their foreign exchange receipts to the Reserve Bank. The implications of these options are detailed below:

*Option I : Status Quo*

- (i) The Government would have to allocate the total foreign exchange that would be sold by the Reserve Bank in 1993–94 at the official rate for various purposes for which it was considered necessary.
- (ii) Any change in the list of purposes would require a suitable order to be issued by the Government.
- (iii) The Reserve Bank needed to change its instructions to ADs only if there was a change in the list.

*Option II : 80:20 Scheme*

- (i) The list of purposes would have to be modified, specifying the purposes for which foreign exchange would be sold by the Reserve Bank at the official rate, since only 20.0 per cent of the current receipts would be pre-empted by the Reserve Bank.
- (ii) Instructions to ADs would have to be issued regarding the modifications in LERMS.

*Option III : Unified Exchange Rate*

The Reserve Bank was in favour of a market rate-based official rate with the following clarifications:

- (i) The Government would have to specify at least one purpose for the sale of foreign exchange at the official rate under section 40, as per the opinion of the Reserve Bank's Legal Department.
- (ii) The market-based reference rate would be used for all transactions with the IMF, Asian Clearing Union (ACU), international credit and aid agencies, revaluation of Russian debt, revaluation of rupee balances of some of the banks in the former bilateral group, valuation of foreign exchange reserves, making provisions for balances held under various exchange protection schemes, debt-service payments and aid receipts on behalf of Government.
- (iii) Since the holders of Exim scrip, advance/imprest licences and other special licences would be deprived of the benefit of a favourable exchange rate, they would have to be advised by means of a press release by the Reserve Bank that arrangements would be made to compensate them at the rate of 20.0 per cent of the value of the licence eligible for foreign exchange at the official rate. For this purpose, consultations between the Reserve Bank and Ministry of Commerce would be necessary.

## UNIFIED EXCHANGE RATE SYSTEM

LERMS comprised a dual exchange rate system. It imposed tax on exports and resulted in rationing the subsidised foreign exchange among certain imports, which distorted resource allocation. As current and capital transactions were subject to different exchange rates, the diversion of remittances (current account) to certain non-resident rupee deposit schemes (capital account) became unavoidable. Therefore, eventually the merger of dual rates was effected on March 1, 1993.

The unified exchange rate arrangement operated within the overall framework of the exchange control. All foreign exchange transactions were put through ADs who had no obligation of surrender to the Reserve Bank. While foreign exchange transactions were effected at market rates, the Reserve Bank's own rate of exchange reflected market conditions and could move within a margin of 5.0 per cent on either side of the market rate. It could, at its discretion, buy US dollars spot and sell the currency for approved purposes and, as such, the Reserve Bank was no longer required to buy or sell foreign exchange; it could undertake, at its discretion, intervention purchases/sales of foreign currencies in the market. Besides its buying and selling rates for transactions with ADs, the Reserve Bank announced its reference rate on a daily basis, which was based on noon rates of a few select banks in Bombay. The Reserve Bank also entered into swap transactions in dollars with ADs for periods ranging from 2 to 6 months.

The market-based Reserve Bank official rate enabled a smooth transition to a regime under which the external value of the rupee was determined by market forces. The unification of the dual rate system into a single, floating exchange rate imparted a significant degree of flexibility in monetary management. The experience with the freely floating market-determined exchange rate system was satisfactory. Contrary to the expectations, there was remarkable stability in the exchange rate of the rupee. The rupee, in fact, strengthened on several occasions after the unification of exchange rates on March 1, 1993 (Table 13.9).

The unification of the exchange rate and the floating of the rupee, besides paving the way for current account convertibility, facilitated the foreign exchange market to develop and mature. The Reserve Bank permitted banks to deploy funds held in the foreign currency accounts of their customers in certain types of overseas investments. Banks were allowed to rediscount export bills abroad without the prior approval of the Reserve Bank with certain interest rate ceilings. Banks were also given permission to write cross-currency options for their customers by resorting to arrangements with their overseas branches or other banks abroad.

TABLE 13.9  
*Exchange Rate of the Rupee: Monthly Average*

(₹ per US \$)

<i>Month Ended</i>	<i>RBI Reference Rate</i>	<i>FEDAI Rate</i>
(1)	(2)	(3)
1993		
February	-*	32.9244
March	31.5833	31.5858
April	31.2940	31.2921
May	31.3255	31.3253
June	31.4065	31.4105
July	31.3702	31.3689
August	31.3723	31.3720
September	31.3712	31.3722
October	31.3700	31.3713
November	31.3700	31.3706
December	31.3704	31.3704
1994		
January	31.3700	31.3705
February	31.3700	31.3700
March	31.3731	31.3728
April	31.3704	31.3709
May	31.3700	31.3705
June	31.3705	31.3705

*Note:* \* Introduced on March 1, 1993.

*Source:* Reserve Bank of India, *Annual Report, 1993–94* (compiled from weekly average exchange rate); Foreign Exchange Dealers' Association of India (FEDAI).

#### EXCHANGE RATE MANAGEMENT: SOME ISSUES

Large capital inflows in the wake of the introduction of a market-based exchange rate system in 1993 far exceeded the CAD and resulted in excess supply conditions in the foreign exchange market.<sup>9</sup> This turn of events posed challenges for the monetary authority in the conduct of both monetary and exchange rate policies. In this scenario, the Reserve

9. For details refer to chapter 16: Financial Markets.

Bank took the opportunity to dwell on the serious dilemmas faced by policymakers in adopting an appropriate strategy.<sup>10</sup>

Under a flexible exchange rate regime, *i.e.*, letting the nominal rate to appreciate in the face of large capital inflows, the Bank propounded, had the virtue of insulating the domestic economy from such inflows and containing inflation on account of a favourable pass-through from exchange rate to domestic prices. These benefits, however, had to be weighed against the cost of deterioration of external competitiveness, reflecting let go of the external balance objective.

Alternatively, if the objective was to prevent the real appreciation of the exchange rate and preserve external competitiveness, the following four options or a combination thereof were envisaged.

- (i) The central bank could intervene in the foreign exchange market and sterilise the incremental liquidity thus generated, thereby keeping the monetary expansion under check. This process, however, carried quasi-fiscal costs associated with it and imposed the danger of raising real interest rates, which could induce further capital inflows.
- (ii) Trade restrictions could be relaxed to enable capital flows to finance additional imports. These resource flows generally supplemented domestic saving and as such had the potential to foster economic growth. Caution, however, had to be exercised to ensure that investment increased and not the consumption. Otherwise debt servicing would become unsustainable.
- (iii) Relax restrictions on capital inflows, which had the advantage of better portfolio diversification for domestic residents as well as improvement in the efficiency of the financial system. Sometimes, it could enhance the international confidence, thereby inducing larger inflows.
- (iv) Restrictions could be reintroduced to moderate the pace of inflows, such as, increasing reserve requirements on non-resident deposits, tightening the norms for entities accessing international markets for private capital, higher withholding taxes on interest payments abroad, tightening prudential standards on external borrowing and introducing end-use clauses.

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10. Reserve Bank of India, *Annual Report*, various issues; Extracts from the speeches of Governors.

The Reserve Bank was conscious of the fact that an open capital account would not only limit the authorities' independence in the conduct of exchange rate policy, but would also expose the economy to international shocks. More significantly, the Reserve Bank in its Annual Report (1993–94) observed:

Any strategy of targeting an exchange rate or the money stock may be offset by unexpected inflows which affect the nominal exchange rate as well. Again, free floating of exchange rate may increase volatility and lead to persistent misalignments which could destabilise the financial system, thereby eroding the credibility of an independent monetary policy. To be consistent with the economic fundamentals, it may be imperative to allow short-term nominal appreciation during periods of excess supply, but the authorities would have to be prepared for aggressive intervention supported more often by equally aggressive sterilisation so as to defend the monetary objective. Longer-term measures for preventing deterioration in external competitiveness such as increasing fiscal concessions, softer export credit, etc., should be weighed against the likely amount of losses on account of higher debt servicing burden in the event of depreciation.

The Reserve Bank summed up its exposition by stating that the exchange rate regime, thus characterised, would involve an “activism” in the conduct of exchange rate policy.

#### CURRENT ACCOUNT CONVERTIBILITY

Current account transactions refer to external transactions in goods and services. In August 1994, India accepted the IMF's Article VIII and thus the rupee officially became convertible on the current account. Further liberalisation of the exchange purchase rules for current account transactions took place in 1995–96. Restrictions relating to the non-trade elements of the current account were also addressed subsequently. The provisions of current account convertibility envisaged:

- (i) Indian exporters exporting to ACU countries and receiving the export proceeds in rupees or in Asian monetary units or in the currency of the participating country were permitted to receive payments in any permitted currency through banking channels, provided it was offered by the overseas buyer in the ACU countries.

- (ii) ADs were empowered to release exchange without prior approval of the Reserve Bank in certain types of foreign travel, even in excess of the indicative limit, provided they were satisfied about the bonafide of the applicant and the need to release exchange in excess of the prescribed scale.
- (iii) Interest income on NR(NR)RDs, which were not eligible for renewal, could be renewed along with the principal for deposit accounts opened on or after October 1, 1994.
- (iv) ADs were empowered to allow remittances by a family unit of resident Indian nationals to close relatives residing abroad for their maintenance expenses up to US\$ 5000.0 in a calendar year per beneficiary, subject to certain conditions.
- (v) ADs were permitted to allow exchange earners' foreign currency (EEFC) account holders to use funds in such accounts to make remittances in foreign exchange connected with their trade and business transactions that were of a current account nature.
- (vi) ADs were permitted to export their surplus stocks of foreign currency notes and coins for realisation of proceeds to private money changers abroad, in addition to their overseas branches or correspondents.

#### DEVELOPMENTS IN THE FOREIGN EXCHANGE MARKET

A detailed account of the developments in the foreign exchange market in India subsequent to the introduction of the market-based exchange rate system in March 1993 is given in the chapter titled: Financial Markets. Nevertheless, certain important aspects relating to the movements in the foreign exchange market are narrated briefly.

Up to 1994–95, there was remarkable stability of the rupee *vis-à-vis* the US dollar even though the Indian currency depreciated sharply against other major currencies and the SDR. Meanwhile, the Reserve Bank intervened in the foreign exchange market whenever there was upward pressure on the rupee or to protect the export competitiveness by preventing appreciation in the value of the rupee. Beginning from August 1995, the rupee came under downward pressure mainly due to widening CAD and pronounced appreciation of the US dollar against major international currencies. This trend was intensified in October 1995 on account of speculative tendencies. The Reserve Bank, in response, intervened in the foreign exchange market and initially tightened the liquidity in the money

market. Subsequently, however, the Bank had to lend support to the money market when the rates went up substantially. The foreign exchange market returned to normal conditions after February 1996. Following large capital inflows in 1996-97, the Bank undertook sizeable purchases of the US dollar to protect international competitiveness of the exports.

### CONCLUDING OBSERVATIONS

In response to the BoP crisis, concerted policy reforms initiated by the Government and the Reserve Bank in July 1991 onwards resulted in successful mobilisation of exceptional financing and led to a marked improvement in the external payments situation. The increase in reserves combined with stabilisation and structural reforms restored the international confidence in the Indian economy and provided the basis for further liberalisation of trade, tariff, export credit and foreign investment policies during the subsequent period from 1992-93 to 1996-97.

After a subdued performance in 1992-93, India's exports recorded robust growth during the three-year period from 1993-94 to 1995-96. The collapse of trade with the erstwhile USSR, one of India's principal markets, led to a marked shift in the destination of exports. A striking structural change in exports that emerged was the declining share of primary products, while manufactured goods exports assumed increasing importance in India's export basket. This compositional shift in India's exports continued during the 1990s.

Rebound in imports from the compression of 1990-91 and 1991-92 was strong in the year 1992-93. The significant expansion of imports during 1994-95 and 1995-96 could be attributed to marked buoyancy in the industrial sector. The shift in the structure of merchandise imports was not as perceptible as in the case of exports.

Owing to structural reforms, there was an appreciable improvement in the performance of invisibles receipts, which offset the adverse trend in invisibles payments. From 1991-92, surpluses on the invisibles account financed, to a considerable extent, the deficits on the merchandise account and, as a result, the CAD remained comfortable at 1.7 per cent of GDP in 1995-96. Drawing lessons from the crisis of 1991, the high level committee on BoP recommended that the CAD should be contained at 1.6 per cent of GDP, which was financeable with normal capital flows.

The capital account was dominated by foreign investment inflows that met more than half of the external financing needs. A welcome

development was the spurt in the FDI from 1995–96. During 1995–96 and 1996–97, it nearly equalled the net inflows of portfolio investment for the first time since 1992–93 and emerged as an important item in the capital account. There was a steady improvement in inflows arising from investment proposals made by NRIs. The US continued to be the largest direct investor, followed by the UK.

The growth of India's external debt slowed substantially to an average annual increase of only US\$ 2.2 billion between March 31, 1994 and March 31, 1997. As per cent of GDP at current market prices, India's external debt declined from the peak of 38.7 per cent in 1991–92 to 24.5 per cent in 1996–97. The debt-service ratio also moved favourably during the period.

Foreign exchange reserves expressed in terms of number of months of import requirement showed an uneven trend. From a level of 4.9 months' import requirements at end-March 1993, the reserves sharply rose to more than 8 months' import requirements at end-March 1995. The reserves marginally declined to cover around 6.5 months' import requirements at end-March 1997 and were considered to be comfortable to meet any unforeseen eventualities. Of the three components of foreign exchange reserves, the FCA showed a steady increase over the years from 1992–93 to 1996–97.

The dual exchange rate arrangement instituted on March 1, 1992 under LERMS enabled an orderly transition from a managed floating regime to a market-determined system. The spread between the official and market rates moved in a narrow range, except in the month of February 1993 when the speculative activity resulted in some turbulence in the inter-bank exchange market. LERMS, as a system in transition, performed well in terms of creating the conditions for transferring an augmented volume of foreign exchange transactions to the market. It imparted stability and helped in a significant deceleration in the rate of inflation besides facilitating a healthy build-up of foreign exchange reserves. At that point, the Reserve Bank evaluated three options for modifying LERMS: (i) to maintain the status quo; (ii) to change to a 80:20 ratio; and (iii) to have a unified exchange rate regime.

The unified exchange rate system, which came into force from March 1, 1993, stipulated that all foreign exchange transactions (receipts/payments), both under current and capital accounts of BoP would be put through by ADs at market-determined rates of exchange. The foreign exchange receipts/payments would, however, be subject to exchange

control regulations. Foreign exchange receipts should be surrendered by residents to ADs except where residents were permitted to retain them either with banks in India or abroad. Foreign exchange was sold by ADs for permissible transactions. The Reserve Bank's sale of foreign exchange to ADs was only for purposes approved by the Government. ADs were free to retain the entire foreign exchange receipts surrendered to them for being sold for permissible transactions and were not required to surrender to the Reserve Bank any portion of such receipts. The rates of exchange for transactions with countries belonging to the ACU were at rates announced by the Reserve Bank. Such rates were to be determined based on prevailing market rates. The Reserve Bank might also undertake market intervention at its discretion for purchases/sales of foreign exchange in the market. Besides its buying and selling rates for transactions with ADs, the Reserve Bank announced its reference rate on a daily basis, which was based on noon rates of a few select banks in Bombay. The market rate-based Reserve Bank official rate enabled a smooth changeover to a regime under which the external value of the rupee was determined by market forces. The unification of the dual rate system into a single, floating exchange rate imparted a significant degree of flexibility to the exchange rate regime in BoP adjustment.

After the crisis of 1991, the foreign exchange market in India was at an important stage of evolution as it was liberalised from a regime of exchange control to fulfil its principal function of price determination in its various segments. Quantitative controls and barriers to entry were progressively dismantled to allow a greater volume and diversity of transactions to be cleared by the market. The regulations relating to the provision of forward exchange cover by ADs were relaxed. Following the success of the unified market-determined exchange rate system introduced in 1993 and the large accumulation of foreign exchange reserves, it was possible for the Reserve Bank to further simplify the procedures and delegate greater autonomy to ADs in respect of a number of current account transactions. While the linkage between the money market and foreign exchange market was weak in the pre-LERMS period, the introduction of a market-determined exchange rate and the growing importance of the forward market for foreign exchange transactions strengthened the conduits of transmission of impulses between the short end of the money market and the foreign exchange market. Several measures were taken by the Reserve Bank to deepen the foreign exchange market in India. From March 1992, banks

were allowed to offer forward cover not merely for trade transactions but also for all genuine transactions as long as the amounts and the maturity dates were identifiable. In order to create liquidity in the foreign exchange market and to give market participants operational freedom and manoeuvrability, the corporate were permitted to cancel and rebook forward contracts.



# 14

## Monetary Management

### INTRODUCTION

For the most part of the 1980s, credit policy and monetary management by the Reserve Bank had to contend with the task of neutralising the inflationary impact of persistently rising deficit in the Government's budgetary operations. A significant part of the widening fiscal deficit following expansionary fiscal policy, especially in the later part of the decade had to be monetised automatically by the Reserve Bank through issuance of *ad hoc* Treasury Bills. This resulted in high inflation rates and culminated in the acute balance of payments (BoP) crisis of 1991. In such a milieu, the two main objectives of credit and monetary policy of the Reserve Bank were to maintain a reasonable degree of price stability by moderating money supply ( $M_3$ ) growth and to ensure adequate credit flow to the productive sectors of the economy by using essentially direct instruments such as the cash reserve ratio (CRR), administered interest rates and directed credit with stringent use of refinance facilities. A defining event that had a far-reaching impact on the conduct of monetary policy for years to come was the implementation of wide-ranging recommendations of the committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty). The later part of the 1980s was also marked by early measures for liberalisation of the money market and the introduction of new instruments. The Reserve Bank experimented with interest rate deregulation in April 1985 by giving banks freedom to fix short-term deposit rates, but the move had to be reversed quickly since it failed to evoke the expected competitive response from the banking system. These developments have been chronicled at length in chapter titled: Monetary and Credit Policy.

The early economic liberalisation measures pursued in the 1980s were carried forward more vigorously as a cohesive and detailed framework of economic reforms from about the middle of 1991–92. The trigger, as discussed elsewhere in this volume, came from the critical BoP crisis of 1991. The liberalisation measures were comprehensive and meant to bring about stabilisation and structural changes in the economy. Initially, the focus was on real, external and fiscal sector reforms, with monetary and financial sector reforms following in relatively quick succession. The focus of monetary policy as a result was transformed in the 1990s, with emphasis accorded to progressive and prudential regulation in the banking operations.

The main objectives of the monetary policy of the Reserve Bank during this eventful period (beginning in 1992) continued to be multi-dimensional, with emphasis being placed as much on growth as on price stability. Towards this end, the perception within the Reserve Bank was that monetary growth had to be consistent with the expected growth in output and a tolerable rate of inflation. In pursuit of the given objectives, monetary policy was rendered flexible enough to make strategic adjustments to any market disequilibria as also the surge in foreign capital inflows. Consequently, monetary management was also vested with the additional responsibility of maintaining orderly conditions in the money, credit, securities and foreign exchange markets.

Growth with moderate or tolerable level of inflation continued to be the primary goal of monetary policy in India. Broad money ( $M_3$ ), also referred to as the aggregate monetary resources (AMR), was adopted as an intermediate target, with the level of bank reserves serving as the operating target. What was more important was the progressive rationalisation and deregulation of the interest rate structure as an integral part of financial liberalisation. The flexibility that it provided in policy formulation was expected to improve the functioning of the financial markets as well. In the process, interest rates would eventually be closely aligned and markets progressively got integrated. As a corollary, this required a marked shift in emphasis from direct to indirect instruments of credit control. Open market operations (OMOs) and its derivative, namely, repurchase agreements or repos, were actively utilised from 1993–94 to influence the level of reserves with commercial banks and thereby the liquidity in the economy. This mechanism also helped to bring about discreet changes in the volume of primary liquidity in the system and served to communicate

to market participants in a subtle manner the perceptions of the monetary authority about the conditions in the money and financial markets.

The year 1991–92 was a landmark in terms of expeditiously overcoming the BoP crisis through fiscal correction, exchange rate adjustment and reform, industrial delicensing and reaffirmation of the need for introducing flexibility in monetary policy with a view to fostering inflation control together with growth sustainability. Framing monetary policy that would be in sync with the economic and fiscal policies took the form of a consultative process through dialogues between the Reserve Bank and the Government, taking the fiscal outlook into account. This co-ordination strengthened over the years, and was formalised with the signing of the historic agreement in September 1994 to phase out automatic monetisation of the budget deficit, which gave the Reserve Bank a relatively high degree of manoeuvrability in monetary management as well as in public debt management.

The Reserve Bank pursued financial sector reforms (including the strengthening of the banking sector) to enable smooth and orderly functioning of markets even while deepening the financial sector to give support to real sector growth. The report of the committee on the financial system (Chairman: Shri M. Narasimham) came in handy to bring about changes in the monetary policy framework and processes. However, this did not totally eliminate the challenges that the Reserve Bank had to face in addressing the economic uncertainties often associated with unpredictable international economic and financial developments and weaknesses in the transmission channels of domestic economic policies.

This chapter unfolds the developments in and challenges to monetary management from 1989–90 to 1996–97 with a focus on monetary and credit policy responses. The chart that accompanies the chapter summarises the policy measures in the context of the relevant macroeconomic backdrop, objectives and stance of monetary policy.<sup>1</sup>

#### MONETARY POLICY RESPONSES DURING THE RUN-UP TO THE BALANCE OF PAYMENTS CRISIS

By the beginning of the year 1989–90, there were distinct signs of several macroeconomic imbalances that caused concern to policymakers

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1. The other inter-related policy areas, namely, public debt management and financial market developments are covered in separate chapters (15 and 16) in this volume, as their functions attained much significance in the post-reform period.

in the Reserve Bank as well as the Ministry of Finance. These were the deterioration in budget deficits and the widening of the current account deficit (CAD) in the BoP leading to excess liquidity in the economy and pressure on the price level. Inflation as measured by the wholesale price index (WPI) showed unmistakable signs of hardening. The inflation rate in 1988–89 at 5.7 per cent, which was already unacceptably high, had begun to move upwards in 1989–90. Inflation turned out to be a generalised phenomenon mainly due to sectoral demand-supply mismatches in some essential commodities, additional budgetary imposts, escalation in import costs and, above all, high liquidity growth caused by fiscal imbalances.

At the time the Reserve Bank took up the exercise of framing credit policy for the first half of 1989–90, it was against the backdrop of the encouraging performance of the economy in 1988–89 and the prospect of growth in real national income of about 9.0 per cent in 1989–90. However, there were other disconcerting developments. Expansion in  $M_3$  up to March 10, 1989 was 18.3 per cent as against 15.1 per cent in the previous year. There was a larger increase in net RBI credit to the Central Government as also in reserve money, which forewarned a large expansion in liquidity. Under the circumstances, the basic feature of credit policy for the first half of 1989–90 (announced on March 27, 1989) was one of caution. The package of measures was designed to moderate growth in liquidity, rationalise reserve requirement prescriptions, and realign the maturity structure of term deposits. The policy also attempted to promote more efficient operations in the financial system by bringing about structural changes and introducing new instruments such as certificates of deposit (CDs) and commercial paper (CP).

The CRR structure as it had evolved was characterised by multiple prescriptions. Banks were required to maintain with the Reserve Bank a CRR of: (i) 11.0 per cent of their deposits (excluding foreign currency non-resident (FCNR) and non-resident (external) rupee [NR(E)R] deposits); (ii) an additional 10.0 per cent of their incremental domestic deposits; (iii) 10.0 per cent of FCNR deposits; and (iv) 3.0 per cent of NRE deposits. All these limits were subject to an overall statutory ceiling of 15.0 per cent. The Reserve Bank simplified the structure by stipulating a CRR of 15.0 per cent on the entire deposit liabilities of commercial banks from July 1, 1989.

The interest rate on term deposits of 46 days to 90 days was raised from 4.0 per cent to 6.0 per cent, and simultaneously the category of term deposits of 15 days to 45 days (at an interest rate of 3.0 per cent)

was abolished with a view to aligning short-term interest rates with other interest rates and improving the rate of return on short-term surplus funds.

In July 1989, the Reserve Bank, concerned about the buoyant growth in primary liquidity and the continued build-up of inflationary pressures, which presaged 'loss of monetary control' and the banks overextending themselves, contemplated taking tough counter-measures. These included reduction in export finance limits, withdrawal of the stand-by refinance against the collateral of government securities, reduction in interest payable on eligible cash balances maintained by commercial banks with the Reserve Bank and the prescription of incremental non-food credit-deposit ratio.<sup>2</sup> There are, however, no official papers to show why the Reserve Bank did not take the contemplated measures. One may have to, therefore, surmise that it preferred to wait for the scheduled busy season credit policy due in October 1989, instead of fostering market expectations that might not be in line with the aim of promoting balanced financial development.

The above surmise appears to be justified since the economic and financial situation did not show any improvement in the subsequent months. By August/September 1989, the Reserve Bank came around to the view that the rate of expansion of non-food credit had been excessive in the context of developments in the real sector. Increases in  $M_3$  and net bank credit to the Central Government were above the projected paths and, even though the growth in reserve money was somewhat lower, there was an overhang of large monetary expansion. Similarly, the build-up in aggregate deposits and non-food credit was above the anticipated levels. For the Reserve Bank, these disquieting trends underscored the need for further tightening of credit policy.

Against this background, the overriding consideration of the credit policy measures for the second half of 1989–90 (announced on October 9, 1989) was one of containing inflationary pressures without jeopardising the growth potential of the economy. The Reserve Bank's perception was that while banks should necessarily extend 'appropriate' credit support for all productive activities, the extent of 'additional' support need not be as large as in the previous year. Further, it was envisaged that large-sized companies would moderate their dependence on the banking system since they already enjoyed large recourse to the capital market.

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2. Reserve Bank of India, Credit Planning Cell (CPC), office notes dated July 4 and 6, 1989.

From November 4, 1989, the Reserve Bank reduced the proportion of export refinance entitlement from 100.0 per cent to 75.0 per cent of the increase in export credit over the monthly average for 1987 so that banks could finance a larger proportion of exports out of their own resources rather than from the Reserve Bank. Banks were at the same time advised that this should not be viewed as a disincentive to extending credit to the export sector and not lead to curtailing overall export credit as exports continued to enjoy preferred status. It was pointed out (in the credit policy circular) that the policy mix of concessional refinance, subsidy, attractive exchange margins, and a lower degree of bad debts in export credit ensured that export credit provided a reasonable yield to banks. However, this decision had to be reversed on December 31, 1990 on the grounds that the growth of export credit was not commensurate with the overall growth rate in net bank credit. Moreover, in view of the developments in the Gulf region and the consequent pressure on the BoP, it was considered that more efforts were needed to support exports.

To improve the return on short-term deposits, the rate for the period of 46 days to 90 days was hiked from 6.0 per cent to 8.0 per cent from October 11, 1990 which, in effect, meant that the rate for deposits for 46 days to less than one year became 8.0 per cent. To impart further flexibility to the administered structure of interest rates and also to promote efficiency in the use of term loans, all term loans which carried a rate of interest of 15.0 per cent 'fixed' were to carry a 'minimum' of 15.0 per cent, thereby doing away with the prescription of a ceiling. Banks were asked to use this discretion to charge differential rates judiciously so that the interest charged remained within reasonable levels. The *Economic Times* dated October 10, 1989, in its editorial: *Fighting the Wrong Fire* bemoaned that the focus of credit policy was invariably on bank credit to the non-government sector. It pointed out that the real culprit was the unrestrained budget deficit, but trade and industry were called on to help control inflation even though the expansion in non-food credit to this sector was proportionately no larger than that in the previous year.

Another area where the Reserve Bank took pre-emptive action was on window dressing by banks. The data on monetary aggregates for the end of each financial year (*i.e.*, March 31) got distorted since banks regularly resorted to window dressing. Therefore, the Reserve Bank announced that the facility of discretionary refinance without its prior sanction stood temporarily withdrawn during the fortnight beginning from March 24 to April 6, 1990.

To counter the tendency of banks to draw refinance from the Reserve Bank and simultaneously lend it in the call money market (*i.e.*, overnight call money and short notice money for periods up to and including 14 days), the Reserve Bank decreed that on any day when banks had outstanding borrowing from it under the stand-by and/or discretionary refinance entitlements and a lending position in the call money market, an additional interest charge would be levied on such borrowings. Banks were also cautioned that in case of flagrant violation of this stipulation, refinance facilities to the errant banks could even be withdrawn.

#### INCREMENTAL NON-FOOD CREDIT-DEPOSIT RATIO

Recognising that with large reserve money expansion there could not only be substantial growth in bank deposits but also excessive credit expansion, the Reserve Bank considered it necessary for banks to adhere to the stipulation of 60.0 per cent incremental non-food credit-deposit ratio (INFCDR) for the year 1989–90. This was different from the ‘guidelines’ for expansion in overall credit that were in vogue until 1981–82, in as much as any increase in credit over the stipulated level entailed an escalation in the cost of refinance from the Reserve Bank, namely, an additional interest charge of 3 percentage points on the refinance drawn by the concerned bank under all facilities to the extent of net non-food credit over the stipulated ratio or the refinance drawn, whichever was lower. The rationale was that given the statutory reserve pre-emptions as they stood, banks would be able to achieve an incremental non-food credit-deposit ratio of only 40.0 per cent on the strength of their own deposit resources, and that even after availing of any refinance from the Reserve Bank, term-lending institutions and money market borrowings, they would find it extremely difficult to reach the 60.0 per cent limit in the course of the remaining months of 1989–90. Thus, the measure operated on the cost of refinance linked to actual credit expansion by a bank. According to the Annual Report of the Reserve Bank for 1989–90, the stipulation essentially ensured that credit expansion was commensurate with deposit growth and available refinance facilities and that the individual banks did not over-extend themselves.

The imposition of INFCDR was, however, not taken kindly by the industrial sector. In an attempt to allay the misgivings of the industry, the Deputy Governor, Dr C. Rangarajan, clarified<sup>3</sup> that since the non-food

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3. Rangarajan, C. (1989). *Recent Credit Policy Measures*. Address at Gujarat Chamber of Commerce and Industry. Ahmedabad. December 9.

credit-deposit ratio of banks in the first half of 1989-90 was only 35.0 per cent, the stipulation of 60.0 per cent for the whole year in fact implied that in the second half of the year, the banks could go to the extent of providing 85.0 per cent of the increase in deposits as credit and there was no ground to fear that the working capital requirements of industry would not be met adequately. He drove home the point that monetary and credit expansion that was excessive could only result in further increase in prices without any benefit to industry.

What was interesting was that the Ministry of Industry in the Government too represented against the new prescription of the Reserve Bank. In its letter dated October 26, 1989 to the Finance Secretary, the Ministry expressed apprehension that this method of checking inflation through a 'credit squeeze' on industry and trade might further aggravate stagnation in industrial production and thereby adversely affect the growth of industry, impact the price level of manufactured products and thus defeat the very purpose of controlling inflation through selective credit control. Further, it feared that reduction in export finance could result in lower off-take by exporters and higher inventory levels in industry. The Governor, in his letter dated November 23, 1989 to the Finance Secretary, responded that taking into account the prevailing statutory liquidity ratio (SLR) and CRR prescriptions, the INFCDR could not in any case be 100.0 per cent and that this ratio was only 35.0 per cent in the first half of the year. The letter concluded that banks were under no restriction to provide non-food credit beyond 60.0 per cent of their incremental deposits, but that only in case the ratio was breached, refinance and its costs would become important considerations for banks and industry.

The policy measures taken during the year could be broadly classified under three heads. The first were the measures aimed at imparting greater discipline and prudence in the functioning of banks. These included imposition of additional charge in the event of banks lending in the call money market simultaneously when they had a borrowed position with the Reserve Bank; prescription of a shut-out period for discretionary refinance facility; strict observance of the instructions for use of the bill mechanism in order to inculcate a bill culture; reduction in interest rate on cash balances maintained with the Reserve Bank; revisions in the scheme of graduated penalties for CRR shortfalls (effective December 29, 1990); and an increase in interest rate charged on 182-day Treasury Bill refinance. Under the second category, several measures that were already in place were carried forward with a view to imparting greater flexibility and

reducing rigidities in general, and promoting a competitive environment in the money and financial markets. Third, the functioning of financial markets was strengthened by allowing a larger number of participants as lenders in the money market and liberalising the existing guidelines for issue of CDs and CP with a view to broad-basing the primary market and giving a fillip to development of secondary markets for these instruments. Besides, changes were made in selective credit control (*i.e.*, modifications in minimum margin levels and ceilings on bank advances against select commodities) in response to price-output developments relating to sensitive commodities.

Reflecting the Bank's concerns towards monetary stability, the Annual Report of the Reserve Bank for the year 1989–90 postulated that if the Centre's overall budget deficit in 1990–91 was kept within the budgeted figure (which implied that the ratio of deficit to gross domestic product (GDP) at current market prices would fall from 2.4 per cent in 1989–90 to about 1.5 per cent in 1990–91), the aim of monetary management would be to bring about a reduction in the expansion of  $M_3$  in 1990–91 by about 4.0 percentage points over that in 1989–90.

The year 1990–91, however, turned out to be an exceptionally difficult one for the Indian economy. All the components of  $M_3$  recorded lower growth rates compared to the previous year, mainly due to a large and unplanned drawdown of external reserves. A memorandum to the Central Board of Directors of the Reserve Bank (dated January 8, 1990) stated that the central bank would continue to explore ways of controlling liquidity and that a more consistent framework of monetary projections would have to be evolved taking into account the trends in net RBI credit to the Government and the borrowing programme of the Government. The memorandum envisioned an active role for internal debt management if monetary policy was to play its assigned role, which again depended on the initiative of the Government to place the entire debt-raising on the market and eliminate the automatic monetisation of budget deficit.

#### MACROECONOMIC CRISIS OF 1990–91 AND ITS IMPACT ON MONETARY MANAGEMENT

The main thrust of the credit policy of 1990–91 was to bring about a sharp break in inflationary expectations by initiating measures to achieve a sizeable reduction in overall monetary expansion, which was backed by the Government's declaration to effect a cut-back in the overall level of budgetary deficit. However, a sudden turn of events — both external

and internal — set in motion a further set-back to the already fragile macroeconomic situation. The high external CAD owing to the sharp spurt in crude oil prices exerted the maximum adverse impact on the economy. Notwithstanding a fairly satisfactory performance in the real sector, inflationary pressures did not slacken and instead took a turn for the worse in the early part of 1990–91. The immediate concern of both the authorities in the Reserve Bank and the finance ministry was to arrest the precipitous flight of foreign reserves and to restore the confidence of investors abroad in creditworthiness of the country. In the absence of a regular budget for the year 1991–92 and a credible medium-term stabilisation programme for correcting the macroeconomic imbalances, the immediate burden of economic management fell considerably on the monetary and credit policy of the Reserve Bank, particularly from July 1991. The Governor, Shri S. Venkitaramanan, initiated several contractionary demand management measures. At the peak level, a cash margin of 200.0 per cent was imposed on the import of goods under the open general licence (OGL) and 150.0 per cent under specific import licences.

As an integral part of overall demand management, on one hand the deposit rates were raised to boost deposit mobilisation and, on the other, lending rates were increased to restrain and dampen demand for credit. Within a restrictive policy environment, credit for exports was protected from the rigour of credit control and interest on post-shipment credit beyond certain maturities was raised to encourage faster realisation of export proceeds. Other instances were the relaxation made in the Reserve Bank's export credit finance entitlement and also exclusion of export credit from computation of the INFCDR prescription for banks during 1991–92.

The credit policy formulation for the first half of 1990–91 was accordingly influenced by the need to address the large expansion in reserve money, its impact on the economy and the attendant pressure on the price level. This was because over the five-year period ended 1989–90, overall liquidity increased by 17.6 per cent per annum, while the annual average growth of real GDP was recorded at 5.6 per cent. However, with strong deposit growth, despite heavy statutory pre-emptions, the resources of banks to meet credit demand from industry were adequate. The Government, on its part, made known its intention to cut back the overall budget deficit in 1990–91 to ₹ 7,206 crore as against ₹ 11,750 crore (RE) in 1989–90. Taking all these factors into account as well as the resurgence of inflationary tendencies in 1989–90, the Reserve Bank decided that the objective of monetary management was to bring about a sharp reduction

in the pace of overall monetary expansion ( $M_3$ ) in 1990–91 by about 4.0 percentage points below the figure of 19.9 per cent.

The gulf crisis of August 1990 dramatically altered the underlying macroeconomic fundamentals and induced far-reaching changes in the economic and monetary policies. The need for immediate measures to stave off from default in repayment of maturing external obligations, which needed current account adjustment in the BoP, took centre-stage and became the priority for policymakers in the Government and the Reserve Bank in the early stages of the crisis. However, carefully designed plans of long-term macroeconomic adjustment were announced only in July 1991.

#### RESTRUCTURING OF CRR FOR EFFECTIVE CREDIT CONTROL

One proposal considered was that of restructuring CRR, which had served well as an important and flexible instrument of monetary control until it reached its operational statutory ceiling of 15.0 per cent on July 1, 1989. There was also the requirement on the part of the Reserve Bank to pay interest to commercial banks on the reserves maintained with it in excess of the minimum of 3.0 per cent. This had the unintended effect of augmenting the stock of reserve money and thereby diluting the effectiveness of CRR as a monetary policy tool. Since the Government took time to initiate steps to raise CRR ceiling, the Reserve Bank, in March 1990 explored the possibility of restoring this initiative by restructuring CRR in combination with changes in other credit control instruments. The office note dated March 10, 1990 called for two-pronged action. The Reserve Bank was not to pay any interest on the eligible balances of banks from a cut-off date (say, end of March 1990) but instead, the interest rate to be paid on balances prior to the cut-off date was to be increased from 10.5 per cent to 12.0 per cent. Under the arrangement, banks were expected to benefit overall in the first year after the change, but lose heavily in subsequent years. For the Reserve Bank, the outgo on interest payments on cash balances could be maintained at a reasonable level. The Deputy Governor, Dr C. Rangarajan, however, envisioned that this could evolve into a complex structure if interest rates had to be lowered later for some reason.

Another novel but complex proposal was a reduction in CRR to be offset by either reducing the entitlement of export credit refinance or by an increase in SLR. The intention was to slowdown the accretion of non-interest bearing cash balances and thereby give banks the much needed time for adjustment to the interest income foregone and correspondingly

reduce access to export credit refinance from the Reserve Bank or even eliminate it completely. The Reserve Bank's Executive Director reasoned in his office note dated March 10, 1990 that a CRR reduction accompanied by a reduction in the existing export credit refinance limit was a somewhat difficult proposition as it presupposed an unchanged export base, even though for an effective monetary policy, it was highly desirable to totally abolish the export refinance facility. He also had reservations about the possible adverse implications in the event of its sudden withdrawal and therefore favoured an increase in SLR with a corresponding reduction in CRR, provided there was no change in the Government's borrowing programme. The Deputy Governor saw merit in the second option as it offered the Reserve Bank manoeuvrability in regulating monetary expansion in future. The matter was referred to the Governor, Shri R.N. Malhotra for a decision, who in turn passed the following order on March 28, 1990:

Considering the strain on bank profitability, it will not be feasible to deny them [banks] interest altogether on their future cash reserve deposits. Raising the rate of interest for a year would not be the signal. At a time when liquidity is ruling high, dropping the CRR by 2 per cent even if it were feasible, and to raise the SLR by 2 per cent without at the same time agreeing to increase Government's borrowing from the market is not desirable.

A *via media* would be to reduce the rate of interest on future accretions to deposits under CRR to, say, 8 per cent. SLR could perhaps be raised by 1/2 per cent to accommodate the large borrowing of Rs. 1,100 crore to which we agreed at the time of budget preparation. This could be supplemented by an increase in SLR on NRI deposits from 25 per cent to 30 per cent.

#### REFINANCE FACILITIES

In March 1990, the policy on refinance facility was reviewed, keeping in view the need to restrain monetary expansion. The review suggested that: (i) the base for determining the export credit refinance could be shifted from the monthly average level of export credit for the calendar year 1987 to the monthly average for the financial year 1988-89, thus reducing the overall limits by about ₹ 1,000 crore; (ii) the less-used discretionary stand-by refinance be abolished; and (iii) refinance against holdings of

Treasury Bills by banks be introduced. As regards food credit refinance, even though no bank was eligible to draw refinance (at the limits it stood then), the thinking in official circles was that it would not be advisable tactically to withdraw this facility at a time when food credit was expected to rise sharply. Another proposal was to bring forward the base year for discretionary refinance to 1988–89. This would have resulted in an increase in such refinance limits, but it did not find favour for several reasons. First, it would run counter to the Reserve Bank's long-term objective of encouraging banks to do more business with the Discount and Finance House of India Ltd (DFHI), for which they had to hold eligible money market assets. Second, the Reserve Bank contemplated offering the market in the near term about ₹ 1,000 crore securities through DFHI. Third, as in the past, the Reserve Bank could increase the discretionary limit in individual cases based on merit. Last, the Reserve Bank was seriously contemplating an increase in the rate of interest on the 182-day Treasury Bill Refinance facility from 10.75 per cent to 11.25 per cent, since the cut-off yield on this instrument had risen from 9.42 per cent at the end of March 1989 to 9.93 per cent by early March 1990. These suggestions were approved by the Governor, except for the one relating to stand-by refinance against excess holding of liquid assets.

#### CONTINUATION OF THE INCREMENTAL NON-FOOD CREDIT-DEPOSIT RATIO

In yet another review done in March 1990, the staff proposed that due to the prevailing difficult money and credit situation, the INFCDR might be continued during the first half of 1990–91 at a reduced ratio of 40.0 per cent with a penalty for infringement, so that credit expansion in the first half did not turn out to be so excessive as to make any correction in the second half difficult. The Governor, however, opted to continue the 60.0 per cent ratio for the entire duration of the year.

#### INCREASE IN SLR ON NON-RESIDENT DEPOSITS

The Reserve Bank felt that SLR on FCNR (A) and NR(E)R deposits should be raised from 25.0 per cent to 30.0 per cent, which would, in turn, require banks to invest an additional ₹ 900 crore in government securities. A drawback was that it might have an uneven impact on banks due to concentration of such accounts in the deposit portfolio of some banks. Therefore, to give the affected banks time to adjust to this change and taking into account the likely bulge in food credit requirement that might

surface during the first quarter of 1990–91, it was proposed in March 1990 that it might be made effective four months later, *i.e.*, towards the end of July 1990. The Executive Director, Shri S.S. Tarapore, in his note dated March 22, 1990, advocated the increase on the following grounds:

The external payments position and the fact that interest rates on non-resident deposits vary from domestic deposit rates have been factors which have been taken into account while continuing to prescribe lower reserve requirements on non-resident deposits. With the blunting of the cash reserve requirements, it is necessary to use some other instrument to immobilise liquidity. Although the SLR increase implies a shift in lending from the commercial sector to the government sector, with an unchanged borrowing programme it results in a reduction in net RBI credit to Government. There has to be a trade-off between external balance of payments concerns and domestic monetary concerns and to the extent that these are inter-related, it would appear desirable to undertake this measure.

However, the Deputy Governor was in favour of a cautious approach and effecting the change at a later date to avoid an adverse impact on the attractiveness of these deposits to non-resident Indian (NRI) account holders. Moreover, with the interest rates ruling at a high level in the international financial markets, even though the rates of interest paid on FCNR deposits were equal to or higher than the domestic rates — particularly in the case of dollar-denominated deposits — any increase in SLR could lead to erosion in the attractiveness of these deposits. The Governor indicated that ‘tentatively’ he would like to raise SLR to 30.0 per cent on non-resident deposits, which was given effect to in the credit policy announcement of April 12, 1990.

#### RATIONALISATION OF INTEREST RATE STRUCTURE OF NRE DEPOSITS

The Reserve Bank tried to remove the anomaly between the interest rate on short-term NRE deposits and domestic deposits for corresponding periods by abolishing the maturity range of 15 days to 45 days in respect of NRE term deposits (which carried an interest rate of 3.0 per cent), introducing a new maturity of 46 days to 1 year at a uniform rate of 8.5 per cent and abolishing the facility for withdrawal or early repayment after a notice period (as in the case of domestic deposit maturities). The proposal was approved.

## SALIENT CREDIT POLICY MEASURES

The credit policy for the first half of the year 1990–91 reflected the above-mentioned internally formulated suggestions, *viz.*, continuation of the INFCDR at 60.0 per cent, an increase in SLR from 38.0 per cent to 38.5 per cent and an increase in SLR in the case of NRE and FCNR deposits from 25.0 per cent to 30.0 per cent effective July 28, 1990.

The eligibility conditions for export credit refinance were modified. From August 25, 1990 banks were provided refinance equivalent to 75.0 per cent of the increase in export credit (instead of 100.0 per cent). It was to be over the monthly average level for the calendar year 1987. Although the banks' access to export credit refinance was reduced, it was expected to be quickly recouped as they expanded export credit in the busy season. The interest rate on refinance against 182-day Treasury Bills was enhanced from 10.75 per cent to 11.25 per cent per annum, in line with the rise in cut-off yields on these bills in regular auctions. The maturity range of 15 days to 45 days was abolished in the case of NRE accounts and a uniform rate of 8.5 per cent was made applicable on term deposits of maturities of 46 days to less than one year from April 16, 1990.

For payment of interest on banks' cash balances with the Reserve Bank, a two-tier formula was introduced. On the eligible cash balances held as on March 23, 1990, interest was paid at 10.5 per cent and on the increase in deposits after March 23, 1990 interest was paid at 8.0 per cent. As a corollary, modifications were made under the scheme of graduated penalties for shortfalls in the maintenance of CRR.

## LENDING RATE REFORM OF SEPTEMBER 1990

Over the years the lending rate structure had become complex and was characterised by a multiplicity of rates. The element of concessionality in interest rates depended on disparate criteria, such as the size of the loan, the priority status of the beneficiary, the location of economic activity, the nature of the lending programme and the level of income of the borrower. For the Reserve Bank, administering such a complex rate structure, turned out to be difficult and cumbersome. Therefore, a rationalisation of the interest rate structure was overdue. At the same time, it was accepted that some element of cross-subsidy within the interest rate structure was inescapable, since societal considerations warranted continuation of concessions in the case of small borrowers and weaker sections. In the proposed structure, all sector-specific and programme-specific lending rate

prescriptions were discontinued except for the differential rate of interest (DRI) scheme and export credit. Moreover, the distinction between short and long-term credit was abolished, except in the case of term loans for agriculture, small scale industry and road transport operators owning up to two vehicles. Banks were asked to use 'judiciously' the discretion given to them to determine the rate of interest for advances over ₹ 2 lakh. In the case of public sector procurement/distribution agencies, the new lending rates involved an increase in the cost of interest on their bank borrowings. This presaged the interest rate reform subsequently recommended by the Narasimham Committee.

#### CREDIT POLICY FOR THE SECOND HALF OF 1990–91

The Reserve Bank announced the credit policy measures for the second half of 1990–91 on October 8, 1990. A new category of deposits of three years and above at a rate of 11.0 per cent was introduced from October 10, 1990, thus raising the maximum rate on term deposits by one percentage point. The objective was to assist banks in their deposit mobilisation efforts by offering attractive rates on longer-term deposits. To prevent unwarranted increases in deposits and non-food credit of commercial banks during the last few days at the end of March (which in fact turned out to be dependent on refinance from the Reserve Bank), the facility to draw discretionary refinance without the Reserve Bank's prior sanction was not made available from March 9, 1991 to April 19, 1991. Moreover, banks were asked to repay the amount outstanding under this facility before March 9, 1991 and they were to plan their operations well in advance on the basis that the discretionary refinance facility without prior sanction of the Reserve Bank would not be available during the shut-out period.

To encourage a bill culture, the Reserve Bank had prescribed in March 1987 that the credit limits sanctioned by a bank to borrowers under the credit authorisation scheme (CAS) against book debts should not be more than 75.0 per cent of the aggregate limits sanctioned to such borrowers for financing inland credit sales. On a review of its working, the Reserve Bank decided that in the case of fund-based working capital limits of ₹ 5 crore and above, from January 1, 1991 interest at 2.0 percentage points above the relevant cash credit interest rate should be levied on that portion of the book debt finance in excess of the prescribed norm of 75.0 per cent of the limits sanctioned to borrowers for financing inland credit sales.

It took some time for the Central Government to formulate short-term fiscal measures to achieve stability in its budgetary finances. For the full year 1989–90, the budgetary deficit, which was projected at ₹ 7,206 crore, had, by the middle of November 1990, deteriorated to ₹ 15,442 crore, but stood at ₹ 11,430 crore by the close of the year; this was nearly 60.0 per cent more than the original budgetary estimate. Despite the substantial growth in monetised deficit,  $M_3$  expanded at a slower pace, mainly due to massive decumulation of foreign reserves. The real sector of the economy also experienced some sluggishness on account of transport and other infrastructure bottlenecks. Bank deposit growth slackened as a result of lower real income caused by rise in prices and emergence of other attractive avenues of financial savings, such as mutual funds.

By the second half of 1990–91 and early 1991–92, with the precipitate and substantial decline in foreign exchange reserves, financing the CAD of the BoP became a serious problem, and more so because the short-term and long-term sources of commercial finance had practically dried up. Under these circumstances, the management of the BoP became the overriding and immediate preoccupation of the economic policy administration in the short run. To tide over the situation, exceptional methods of financing were sought and obtained from multilateral and bilateral agencies, especially the IMF. Gold transactions also provided an important source of bridge finance. The strains on the economy were compounded by the inability of the Central Government to present a regular budget in Parliament. In this grim situation, the responsibility for short-term economic management had to be borne by monetary and credit policy. The Reserve Bank deployed unconventional instruments of credit control, which helped ease the strains considerably within a short time.

INSIGHT INTO THE CREDIT POLICY FORMULATION  
FOR THE FIRST HALF OF 1991–92

In response to the instructions of the Governor, Shri S. Venkitaramanan, who assumed office on December 22, 1990, three analytical notes were prepared in February, March and April 1991 that outlined the policy measures that could be considered for inclusion in the April 1991 credit policy statement.

In an office note titled: Issues for Discussion (February 1991), the Executive Director, Shri S.S. Tarapore proposed that credit policy should continue to be tight in view of the major problems facing the economy

and the uncertain outlook for future, but with some rationalisation. He, therefore, suggested increasing SLR from 38.5 per cent to 40.0 per cent and gradually phasing out the export credit refinance facility. On the former proposal, the Governor took the view that such an increase in SLR would convey a contradictory signal to the 'reformers', and on the latter he felt that, while it was the best option operationally, export credit refinance would look 'optically' reduced.

An 'Exploratory' note (March 1991) also prepared by the Executive Director, forewarned that the economy might enter an extremely critical phase during April–June 1991 that might need to be addressed by unusual remedies. The first line of action was to curb the effective drawing power of large borrowers (*i.e.*, all non-food credit cash credit limits of ₹ 1 crore and over) for the period from April 9, 1991 to September 20, 1991 by limiting it to 60.0 per cent of the peak level of actual utilisation reached in the three-year period ending March 31, 1991. Any drawal in excess of the reduced drawing power but within the existing limit would attract an interest rate surcharge of 25.0 per cent. Moreover, on advances above ₹ 2 lakh for all non-priority sector personal loans, loans for purchase of consumer durables and loans to individuals against shares and debentures an interest rate surcharge at 25.0 per cent was to be made applicable on the entire amount of the advance.

Perhaps the most stringent proposal was an increase in the Bank Rate by 2.0 percentage points and no segment was to be spared from the impact. Carrying the analogy further, all interest rates (*i.e.*, deposit and lending rates, coupon rates on government securities, the rate on Treasury Bills and refinance rates on drawals from long-term operations [LTO] funds) were to be raised by 2.0 percentage points without any exception. All discretionary refinance limits sanctioned that exceeded the limits where prior sanction was not required were to be phased out by the end of April 1991. In the case of imports, the existing margin was to be raised from 50.0 per cent to 100.0 per cent, and all exemptions given in the immediate past were to be withdrawn. Last, there was to be no further allocations out of long-term operations [LTO] funds during 1991–92 and no drawals were to be permitted during the period April–September 1991. There were indications in the file notings that the Deputy Governor had perused this note and the Governor was apprised of its contents. It redounds to the credit of the official concerned that within three months (*i.e.*, July 1991) events so unfolded that the authorities were forced to implement some of the strong measures envisaged above, though with some modifications.

The third and final office note prepared in early April 1991 summed up the economic scene as it was evolving.  $M_3$  recorded subdued growth, which was attributable to factors, such as the slackening of deposit growth on the components' side, as also lower non-food credit and a decline in the foreign exchange assets of the banking sector on the side of sources. Competition from mutual funds as well as inflation impacted bank deposit growth. The macroeconomic fundamentals and the continuing uncomfortable BoP situation left the authorities with little option but to pursue a restrictive credit policy during 1991–92 too. However, the silver lining on the horizon was the prospect of success in fiscal correction, a factor that would provide considerable manoeuvrability to the Reserve Bank in formulating its monetary policy. Growth in  $M_3$  was expected to be fairly close to the projection of 15.5 per cent in 1990–91, much better than the sharp rise of 19.9 per cent in 1989–90.

Besides these principal policy notes, another subsidiary note considered the implications if there was a hike in the maximum bank lending and deposit rates, including the rates on overdrafts to state governments. Concurrently, there was a proposal that if the lending rates were to be raised by 1.5 percentage points, no interest needed be paid to banks on their incremental cash balances beyond March 1991. The rationale was that the package would not entail a loss to banks, while for the Reserve Bank, the effectiveness of CRR as an instrument of monetary policy would stand enhanced.

The hard posturing, however, concealed the fact that while the Reserve Bank was overtly committed to promoting exports through provision of export credit refinance on favourable terms to banks, it was rather uneasy about its impact on reserve money creation. The Bank contemplated three options: (i) bringing forward the base for determining export credit refinance entitlement from the year 1988–89 to 1989–90; (ii) provision of refinance to the extent of only 50.0 per cent outstanding export credit; and (iii) introduction of a two-tier refinance formula, namely, 50.0 per cent on 1988–89 base and 100.0 per cent on 1989–90 base level. The first option, although perceived to be best suited for restraining reserve money growth, did not find favour because it was construed to adversely affect export promotion. The second course of action was expected to impart an element of rigidity since the authorities could find it difficult to reduce the limits in future when needed and, more importantly, it could result in enhancing the prevailing export finance limit to banks, an outcome that the Reserve Bank was trying to avoid. The last option of a two-tier

formula on balance found favour, since it combined a partial relaxation of the existing practice of bringing forward the base year with the absence of any difficulty if it had to be withdrawn in future. The dilemma facing the Reserve Bank was clearly brought out by the Deputy Governor in his noting dated March 24, 1991.

The feasibility of withdrawing export credit limits conjointly with some reduction in CRR was examined internally in the above context. But it was felt that such a measure would have varying effects on the concerned banks. To elaborate, banks that had a relatively higher share in export refinance limits than in their deposits (*i.e.*, the base for CRR) would stand to lose and *vice versa*. The Governor's perceptive comment that banks, which did more for exports; a national priority, should be helped, consciously settled the issue. Notwithstanding the differences in these internal perceptions, the Reserve Bank was clear that it should continue to explore avenues for rationalisation to the point where CRR could be brought down to a lower level, thus doing away with the payment of interest on impounded CRR balances and, in the process, adapting it as an effective instrument of credit control. As a first step in this direction, the Reserve Bank decided to partially reduce the existing export finance level together with an appropriate reduction in CRR. The Deputy Governor recommended a CRR reduction of 1.5 per cent and simultaneously bringing forward the base year for determining export refinance entitlement from 1988-89 to 1989-90. This would augment the resource position of banks on one hand and exporters would get 100.0 per cent refinance over the new base year on the other. The Deputy Governor, Dr C. Rangarajan summed up the proposition in a subtle manner: "We need to present the case as a rationalisation of CRR and not a signal for further credit expansion." The Governor assented.

#### TIGHTENING OF CREDIT POLICY FOR THE FIRST HALF OF 1991-92

The credit policy measures for the first half of 1991-92, which the Governor announced on April 12, 1991, were formulated more in the context of the precarious BoP position than the emerging macro trends in growth in  $M_3$ , prices and output. Its overriding objective was to conserve the country's foreign exchange by slowing the pace of imports and aiding export promotion efforts and, therefore, its stance was one of caution. Banks were advised in the circular that although there were several imponderables in making a forecast of the real rate of growth of the economy for the year 1991-92, they should ensure that their incremental non-food credit (excluding export credit)-deposit ratio did not exceed 45.0 per cent.

To help export promotion efforts, export credit was excluded from the computation of the non-food credit-deposit ratio. From April 20, 1991, for defaults in maintaining the prescribed ratio, the errant banks were to be charged additional interest of 3.0 percentage points on the refinance drawn from the Reserve Bank under all facilities on the amount of excess credit over the stipulated level or the refinance drawn, whichever was lower. Banks that chronically breached the ratio faced the prospect of total withdrawal of all refinance facilities.

Recognising the need to provide continued support to the export sector without unduly resulting in a large increase in created money, a two-tier refinance formula was introduced. From July 27, 1991, banks were provided export refinance to the extent of 50.0 per cent of the increase in export credit over the monthly average level of export credit in 1989–90. To restrain monetary expansion, the lending rate on limits of over ₹ 2 lakh was raised from April 13, 1991 by one percentage point to 17.0 per cent (minimum). Term deposit rates for three years and over were raised by one percentage point, from 11.0 per cent to 12.0 per cent to achieve better alignment between the maximum deposit rate and the yield on alternative saving instruments and to reflect the prevailing inflation rate. Rates of interest on NR(E)R deposits of maturities of three years and above were enhanced by one percentage point.

The foreign exchange position continued to cause serious concern to the authorities, and, therefore, it became necessary to further contain overall demand pressures by moderating monetary expansion. The Reserve Bank tightened further its credit policy by imposing an incremental CRR of 10.0 per cent of the increase in deposits over the level on May 3, 1991. To mitigate its effect on banks, the Reserve Bank decided to pay interest at the rate of 8.0 per cent on these additional cash balances. This measure was considered essential to meet the short-term exigencies of the situation and was a prelude to activating the monetary policy measures in July 1991.

#### NEED FOR REGULATION OVER PORTFOLIO MANAGEMENT SERVICES OFFERED BY BANKS

The Credit Planning Cell (CPC), in an office note dated March 22, 1991, made a strong case for imposing strict control over portfolio/funds management services provided by banks on the rationale that these activities undermined monetary and credit discipline. These were treated as off-balance sheet items and hence did not strictly form part of the liabilities of banks. Even though a Reserve Bank circular dated January

18, 1991 had advised banks that the funds deployed under their clients' portfolio account would attract CRR and SLR, policymakers surmised that banks might manipulate these funds to circumvent the reserve requirements. The office note suggested that the minimum period for funds involved under portfolio/funds management services should be three years and subject to reserve requirements. However, in the case of funds handled by subsidiaries of banks for these purposes, the reserve prescription was to apply for a temporary period. The Executive Director felt that instead of imposing conventional reserve requirements, some kind of quasi-reserve rule could be devised to achieve the objective of prudent management of these funds by banks and their subsidiaries. Under this proposal, banks would hold 25.0 per cent of the funds in government and other approved securities, and to avoid the volatile churning of funds and venturing into the call money market by errant means on days other than reporting Fridays, investment in any single instrument was to be for a minimum period of six months and such investments purchased must be transferred in the name of the client for whom the portfolio management services were being provided. With a touch of humour, the Executive Director, Shri S.S. Tarapore, remarked: "To have to impose such curbs soon after the pioneering portfolio management is indeed distressing... That economists have been awarded Nobel Prize for Economics [for doing pioneering research on this topic] is a painful reminder of the harshness of the realities of the Indian financial system."

However, the Deputy Governor preferred a pragmatic approach to this issue, which was approved by the Governor. He reasoned that the Reserve Bank had 'wrestled' with this problem for the past two years since it was widely believed that the basic motivation of the scheme was to earn a rate of return well above the prevailing interest rate on bank deposits, and portfolio management was only a 'facade' to provide a higher rate of return on short-term funds. According to him, the existing regulations over these transactions were adequate, that it was only a matter of ensuring that banks — particularly the foreign banks — abided by the regulations, and adding further conditions would not take the Reserve Bank far. Finally, he suggested that a mechanism should be devised to ensure strict compliance with the existing regulations in the form of submission of quarterly returns by banks relating to these activities.

## SWIFT RECOVERY AND ON THE ROAD TO GROWTH

## THE NEW ECONOMIC POLICY OF JULY 1991

As discussed earlier, the overriding consideration in the policy actions of the Reserve Bank in the second half of 1990–91 and the first quarter of 1991–92 was to contain aggregate demand and, in particular, the demand for imports. The terms of export credit were adjusted in order to accelerate realisation of export proceeds. The efforts at reducing the overall monetary demand and inflation in the economy had over time led to an improvement in the BoP. As the foreign exchange situation improved and the rate of inflation showed signs of slackening, there was gradual withdrawal of the stipulation relating to cash margins on imports and some moderate lowering of lending rates applicable to large borrowers (October 1991).

The strategy for correcting serious imbalances in the internal and external sectors of the economy was two-pronged, namely, strong macroeconomic stabilisation on one hand and structural reforms on the other. The former included fiscal correction, monetary tightening, inflation control, exchange rate adjustment and strengthening the competitiveness of India's exports. These were supported by long-term structural reforms, such as, industrial deregulation, liberalisation of foreign direct investment (FDI), trade liberalisation, overhauling of public sector enterprises and financial sector reforms. The determined efforts made by the Government and supported by the Reserve Bank to bring the external liquidity crisis under control and restore the confidence of foreign creditors succeeded. The country's foreign exchange assets (FCA) recorded a remarkable turnaround from less than US\$ 1.0 billion in the middle of July 1991 to US\$ 5.6 billion by the end of March 1992. Nonetheless, the Reserve Bank in its Annual Report for the year 1991–92 sounded a note of caution that immediate stabilisation measures and the long-term structural reforms could pose problems of prioritisation of measures, such as between the goals of fiscal correction and fiscal consolidation and between monetary control measures and financial sector reforms.

## SYNCHRONISED APPROACH

In the very first year of the reform, the conduct of monetary policy underwent transformation concurrently with the presentation of the reform-oriented Central Government budget in July 1991. The key macroeconomic assumptions underlying monetary targets for 1991–92, namely, real GDP growth of 3.0 to 3.5 per cent, inflation of around 9.0 per

cent and a significant slowdown in  $M_3$  expansion to about 13.0 per cent, became irrelevant by the first half of 1991–92, since building up foreign exchange reserves emerged as an overriding objective by the middle of 1991. Severe import compression, credit curtailment and fiscal adjustment measures adversely impacted the industrial sector and thus the overall growth rate of the economy. Expansion in  $M_3$  accelerated to a high of 18.5 per cent in 1991–92, mainly due to a sharp increase in primary liquidity. In response to these developments, the Reserve Bank took a series of measures in co-ordination with the finance ministry to restore macroeconomic stability and bring in structural adjustment.

The foremost measure was a two-step downward adjustment in the exchange rate of the rupee by 17.38 per cent in terms of pound sterling and about 18.7 per cent in US dollar terms, which was effected by the Reserve Bank with the objective of promoting competitiveness in exports, reducing inessential imports, minimising incentives for flight of capital, stabilising the current account of BoP and restoring the viability to the country's BoP. To ensure that the gains of exchange rate adjustment were not dissipated by inflation, the Reserve Bank tightened monetary policy with sharp increases in the Bank Rate and lending and refinance rates. These measures were in accord with the Government's adjustments in fiscal, trade, industrial licensing and foreign investment policies, and formed part of a radical shift in the economic policy regime.

#### ACTIVATING THE MONETARY POLICY FOR CRISIS MANAGEMENT AND ECONOMIC RECOVERY

The Union Budget for 1991–92 launched the programme of fiscal adjustment for rapid macroeconomic stabilisation. It was to be followed up with fiscal consolidation over a medium-term perspective of about three years. Hence, the budget proposed concrete measures to reduce the gross fiscal deficit (GFD) from about 8.4 per cent of GDP in 1990–91 to 6.5 per cent in 1991–92 and to contain the revenue deficit and monetised deficit at relatively low levels. The budget also included several non-fiscal reform measures related to the financial sector, such as, an increase in interest rates on small savings, granting freedom to financial institutions to charge interest in accordance with their perception of the creditworthiness of their borrowers subject to a floor rate of 15.0 per cent, removal of restrictions on the interest rate offered on debentures, strengthening the capital market, transfer of control over capital issues to the Securities and Exchange Board of India (SEBI) and permitting mutual funds activity in the private sector.

Finally, the Government announced its intention of strengthening the role of the financial sector as an essential adjunct to promoting economic growth and competitive efficiency, as well as improving the health of the financial institutions.

To ensure adjustment of the imbalance in external payments, the Bank raised the Bank Rate by one percentage point, *i.e.*, from 10.0 per cent to 11.0 per cent, from the close of business on July 3, 1991, as well as other rates on accommodation from the Reserve Bank specifically linked to the Bank Rate (by one percentage point). Simultaneously, the Reserve Bank realigned refinance rates with the enhanced Bank Rate. Discretionary refinance rate was raised by 3.0 percentage points, food credit refinance by 2.5 percentage points, stand-by refinance by 1.0 percentage point and export credit refinance by 0.5 percentage points. The decision to raise the Bank Rate was taken by the Governor based on the statutory powers derived under section 7(3) of the Reserve Bank of India (RBI) Act, 1934, without going through the normal course of obtaining the prior approval of the Central Board of Directors or its Committee.<sup>4</sup>

Interest rates on term deposits (excluding FCNR/NRE accounts) were enhanced across the board by one percentage point; this was, however, made applicable only to fresh deposits and on renewals of maturing deposits. To curtail aggregate demand and following the change made in deposit rates, the lending rate on limits over ₹ 2 lakh was marked-up by 1.5 percentage points from 17.0 per cent (minimum) to 18.5 per cent (minimum). The effective interest rate on discounting bills of exchange for this category of borrowers was one percentage point below the corresponding lending rate charged to borrowers in this category. There was no change in the existing rates in the case of term loans to agriculture, small scale industry and transport operators owning up to two vehicles.

The measures announced by the Bank attracted interesting reactions from the media. For example, under the caption A Deflationary Policy, the Economic Times in its editorial dated July 8, 1991 postulated that given the devaluation of the rupee, it was only natural that the Reserve Bank followed it up with the announcement of new measures to prevent monetary overheating of the economy and to dampen inflationary pressures and that the logic and the need for these steps were understandable. It added that

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4. This action was based on earlier precedents of raising the Bank Rate during the tenures of the Governor, Shri S. Jagannathan (on July 22, 1974) and the Governor, Dr I.G. Patel (on July 11, 1981).

the proximate compulsion behind the changes in the interest rates was the fear that the rupee devaluation might fuel inflation. However, it sounded a note of caution that attempts to curb the growth in  $M_3$  and credit might lead to a resource crunch and push up costs in the manufacturing sector and that the prime engine behind the monetary expansion in the economy was the Central Government, given its heavy dependence on the Reserve Bank credit.

CONTINUANCE OF TIGHT CREDIT POLICY  
IN THE SECOND HALF OF 1991-92

With inflation still hovering around double-digit figures by the second quarter of 1991-92 and given the need to comply with the performance criteria under the IMF stand-by arrangement, the Reserve Bank was left with no choice but to further tighten credit control. The Executive Director, in his note dated September 25, 1991, advocated the withdrawal of refinance facilities — in particular the discretionary refinance — which was expected to have a strong announcement effect and serve as a pre-emptive strike on larger drawal by banks.

A sharp rise in short-term deposit rates within the existing ceiling of 13.0 per cent was also envisaged, because with the high rate of inflation (*i.e.*, around 15.0 per cent), deposit rates turned out to be negative. In addition, changes in the lending rate structure became necessary for three reasons. First, the rates being charged by the Small Industries Development Bank of India (SIDBI) had to be placed on par with those of banks, by raising the rate from 14.0 per cent (fixed) to 15.0 per cent (minimum) in the case of term loans to agriculture, small scale industries and transport operators owning up to two vehicles. Second, an increase in lending rates at the lower end of the structure was seen as an 'ineluctable' necessity, because the co-operative banks were confronted with the anomaly of paying 13.0 per cent for deposits and charging 10.0 per cent for loans. Third, enhancing the lending rate for limits over ₹ 2 lakh was seen as an appropriate response to the rising inflationary trend. All lending rates up to ₹ 2 lakh were proposed to be enhanced by 1.5 percentage points, and term loans for agriculture, small scale industries and transport operators owning up to two vehicles for loans between ₹ 25,000 and up to ₹ 2 lakh were to be raised by one percentage point. For loans over ₹ 2 lakh, the rate was to be 15.0 per cent (minimum) as in the case of term-lending institutions. Policymakers placed faith in banks' monitoring the incremental non-food credit (excluding

export credit)-deposit ratio, and favoured the imposition of stiff penalties for any infringement of the rules in this regard.

A post-shipment export credit facility denominated in foreign currencies at the prevailing international interest rates was proposed to be introduced. The Reserve Bank decided that all mutual funds, including the Unit Trust of India (UTI), should be asked to maintain in a phased manner 10.0 per cent liquidity requirement in government and other approved securities related to their asset value. However, this measure was to be implemented through issuance of guidelines and kept distinct from the October 1991 credit policy. During the last week of September 1991, these proposals were discussed by the Governor at a meeting with the Finance Minister, Finance Secretary and the Chief Economic Adviser to the Government of India. For obvious reasons, the hike in the Bank Rate, which formed the nodal feature of the credit policy announcement of October 8, 1991, was kept a well-guarded secret.

In the context of the proposals considered separately for raising the bank interest rates, a need arose to further reduce the payment of interest on eligible cash balances of banks with the Reserve Bank. From April 21, 1990, the Reserve Bank had been paying interest under a two-tier formula, *i.e.*, at 10.5 per cent on balances as on March 23, 1990 and at 8.0 per cent on balances maintained on increased deposits after March 23, 1990 (*i.e.*, incremental CRR). The option of non-payment of interest on the 10.0 per cent incremental deposits from March 1990 as well as on the incremental CRR balances after May 3, 1991 did not appeal to policymakers because of the comparatively larger loss in income to banks compared to the alternative, namely, a reduction in interest on eligible cash balances from 8.0 per cent to 6.0 per cent after March 1990 (*i.e.*, balances relating to the average as well as incremental prescription). The second method had the drawback that if at some stage the Reserve Bank decided to merge the average and incremental CRR, it might face the problem of determining the rate of interest to be paid on eligible cash balances after March 1990.

The Reserve Bank, however, was not unduly concerned about the loss of interest income to banks, as such income was in any case expected to rise very sharply because of other measures and there was a pressing need to reduce the created money in the system. As things stood at that time, there was a distinct possibility that if no corrective measures were taken, one-fourth of the cash balances impounded would return to banks as interest (on these balances) in 1992–93. Taking all factors into account, the Reserve Bank concluded that some reduction in interest paid on CRR

balances was 'justified'. The Governor approved of the second proposition with the proviso that the rate of interest paid to banks should be 5.0 per cent instead of 6.0 per cent, thus making the prescription even more stringent.

SECOND INCREASE IN THE BANK RATE IN THREE MONTHS AND  
OTHER RESTRICTIVE MEASURES OF OCTOBER 1991

As internally envisaged, the October 8, 1991 credit policy announcement contained several restrictive measures. Table 14.1 provides the gist of these measures and their rationale.

TABLE 14.1

*Important Credit Policy Measures Announced on October 8, 1991*

<i>Credit Policy measure</i>	<i>Rationale</i>
Bank Rate revised from 11.0 to 12.0 per cent.	The inflationary pressures warranted a restrictive stance of credit policy. Consequent to the increase in the Bank Rate, all other rates on credit from the Reserve Bank that were specifically linked to the Bank Rate were correspondingly raised by one percentage point unless otherwise specified.
Lending rates of scheduled commercial banks (SCBs) raised across the board by 1.5 percentage points, which ranged from 11.5 per cent to 20.0 per cent (minimum) as against 10.0 per cent to 18.5 per cent (minimum). In the case of term loans to agriculture, small scale industries and transport operators owning up to 2 vehicles, however, the lending rate for loans between ₹ 25,000 and up to ₹ 2 lakh was raised by one percentage point.	In the context of the current inflation rate, several lending rates had become negative in real terms.
The rate on term deposits with a maturity of 46 days to less than one year was increased from 9.0 per cent to 11.0 per cent. For better alignment of the return on short-term deposits, the term deposit rate with a maturity of one year to less than two years was raised from 10.0 per cent to 12.0 per cent.	With high inflation rates, deposit rates at the short end had become unattractive. The rates were increased to ensure the competitiveness of bank deposits and to provide a better rate of return on short-term surplus funds.
Interest rates on pre-shipment and post-shipment export credit were raised.	To provide greater incentive to banks and to enable them to provide credit support to the export drive.

*contd...*

*contd...*

The export credit refinance formula was modified. Commercial banks would be provided export credit refinance to the extent of 60.0 per cent of the increase in outstanding export credit over the monthly average level of 1988–89 up to the monthly average level of 1989–90 plus 125.0 per cent of the increase over the monthly average level of outstanding export credit in 1989–90. The modified two-tier formula was implemented in two stages.

Cash margins on imports:

The cash margin on OGL imports (at the time of opening of letters of credit or placement of order on overseas suppliers for import of other than capital goods) at a rate of 200.0 per cent was reduced to 150.0 per cent.

From October 9, 1991, refinance facilities to SCBs were withdrawn for the remaining duration of the year. These included food credit refinance, stand-by refinance, 182-day Treasury Bills refinance and discretionary refinance.

Banks that exceeded their incremental net non-food credit (excluding export credit)-deposit ratio of 45.0 per cent for 1991–92 for two successive fortnights faced the prospect of an automatic reduction in refinance limits for the next four fortnights and any excess credit in each subsequent fortnight would result in reduction in refinance limits for the following two fortnights.

From October 19, 1991: (i) on the eligible cash balances based on deposits (*i.e.*, net demand and time liabilities) as of March 23, 1990, interest was continued to be paid at a rate of 10.5 per cent; and (ii) on the increase in eligible cash balances based on deposits maintained after March 23, 1990 under the average 15.0 per cent CRR as well as eligible cash balances under the 10.0 per cent incremental CRR, interest was to be paid at a reduced rate of 5.0 per cent.

Major incentive to banks to extend export credit.

The imperative need to contain reserve money expansion in the context of the severe inflationary pressures in the economy.

To ensure strict compliance with the stipulated ratio.

To curtail the increase in reserve money, the total interest payments made by the Reserve Bank to banks had to be moderated.

*contd...*

*concl.*

Selective credit controls were reintroduced on bank advances against stocks of cotton and *kapas*, the minimum margins on advances against pulses raised and the level of credit ceiling on advances against wheat reduced.

On a review of the recent price-output developments in the respective commodities.

Banks were to ensure that there was no increase in the credit outstanding: (i) for purchases of consumer durables; (ii) to individuals against shares and debentures/ bonds; (iii) other non-priority sector personal loans; and (iv) real estate loans.

In the context of inflationary pressures and pressure on banks' resources.

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*Source:* Reserve Bank of India, CPC circular.

#### POST-CRISIS RELAXATION IN MONETARY POLICY (FEBRUARY 1992)

The payments crisis was overcome within a short period. The Reserve Bank, therefore, decided to resume efforts at correcting the fundamental macroeconomic imbalances afflicting the economy.

An important mid-course policy announcement was made by the Reserve Bank on February 29, 1992, coinciding with the presentation of the Union Budget by the Finance Minister in Parliament for the year 1992-93. From the available records it appears that unlike in the past, there was no internal review note to suggest possible changes in credit policy measures. Apparently, there were close and frequent consultations between the Reserve Bank and the Government in order to integrate and harmonise the content of credit policy with the budget proposals. The measures announced related to lending rates, SLR and introduction of a new NRI rupee deposit scheme.

#### REDUCTION IN LENDING RATES

In view of the decline in the headline inflation from the peak of 16.7 per cent in the week ended August 24, 1991 to 11.8 per cent in the week ended February 8, 1992, the Reserve Bank reduced the lending rate on credit limits of over ₹ 2 lakh by one percentage point, *i.e.*, from 20.0 per cent (minimum) to 19.0 per cent (minimum). Banks were advised to reduce the rates for all borrowers under this category by a minimum of one percentage point over the rates being charged to them. The effective rate of interest on rediscounting of bills of exchange for this category of borrowers was reduced to 18.0 per cent (minimum) and the actual rate charged was one percentage point below the corresponding lending rate

charged to borrowers in this category. The Reserve Bank impressed upon banks that while they were free to determine the actual lending rates, they should adopt objective and rational criteria to decide the range of rates between the minimum lending rate as stipulated by the Reserve Bank and the actual rates charged to different borrowers. Borrowers with the highest credit rating were normally to be provided credit at the minimum rate stipulated by the Reserve Bank and, depending on the credit risk, higher rates could be charged. However, banks were cautioned that it would be prudent to avoid an excessively large spread in rates. *Inter alia*, the lending rate for commodities within the purview of selective credit controls was reduced from 20.0 per cent (minimum) to 19.0 per cent (minimum).

#### LOWERING OF SLR

In the context of the fiscal adjustment and macroeconomic stabilisation undertaken by the Government, the Reserve Bank considered it feasible to moderate the existing levels of statutory pre-emptions. The Narasimham Committee had recommended in its report submitted in November 1991 that the SLR might be brought down in a phased manner. Considering the expected decline in the GFD of the Centre and keeping in view the recommendation of the Narasimham Committee, the Reserve Bank reduced SLR from its existing level of 38.5 per cent without disrupting the market borrowing programme of the Central Government. SLR remained 'frozen' at 38.5 per cent up to the level of outstanding deposits as on April 3, 1992 (excluding non-resident liabilities), and for any increase in deposits above the April 3, 1992 level, the applicable SLR was 30.0 per cent.

#### A NEW NON-RESIDENT (ORDINARY NON-REPATRIABLE) RUPEE DEPOSIT SCHEME

To provide further incentives and wider options to non-residents, including the overseas corporate bodies, a new non-resident (non-repatriable) rupee deposit scheme [NR(NR)RD] was introduced in June 1992. The scheme contained several attractive features to enable banks to mobilise substantial deposits and attract foreign exchange on a non-repatriable basis without any foreign exchange risk. Banks that were authorised to deal in foreign exchange could accept deposits under the scheme by way of transfer of foreign exchange funds from outside India or from the existing NRE/FCNR accounts, which would be converted into rupees at the prevailing exchange rate; these funds, were not repatriable. The deposits under the new scheme could be accepted for maturities of six months to three years and were not

deemed as part of net bank credit for purposes of determining priority sector lending. These deposits (and the advances against such deposits) were exempt from interest rate stipulations and, thus, banks were free to fix the deposit and lending rates under this scheme.

#### SUSTAINED PROGRESS IN THE REFORM ERA

The first phase of crisis management was completed by the close of 1991–92. The Government at the Centre, which assumed office in June 1991, inherited a grave and deepening economic crisis. The BoP situation was precarious, with the foreign exchange reserves barely enough to meet two weeks of import payments. International confidence in the creditworthiness of India had collapsed so much that access to commercial borrowings was closed and non-resident deposits were being withdrawn at an alarming pace. Industrial growth had turned negative due to severe import squeeze, and inflation was on the rise. The new Government moved quickly to restore macroeconomic stability and, at the same time, initiated structural reforms that were designed to strengthen the growth capability of the economy in the medium-term. Although full results of the Government's adjustment policies took time to materialise, substantial progress was achieved even in the first nine months. By April 1992 international confidence in the Indian economy had been restored and the cushion of foreign exchange reserves had been rebuilt. Inflation was on a downtrend from a peak of about 17.0 per cent in August 1991 to less than 13.0 per cent by March 1992, which, however, was not adequate to meet the target.

Reforms in the area of fiscal correction formed the centre-piece of the wide-ranging reform measures.<sup>5</sup> The fiscal policy initiatives introduced in July 1991 greatly helped to reduce the GFD of the Central Government in relation to GDP, from 8.3 per cent in 1990–91 to 5.9 per cent in 1991–92 and further to 5.7 per cent in 1992–93. However, the revenue deficit of the Centre as a percentage of GFD continued to remain high at around 45.5 per cent. Unfortunately, the resource gap on revenue account was bridged by high-cost borrowed funds. As a result, interest payments accounted for 41.5 per cent of revenue receipts in 1992–93. However, progress in other areas was highly satisfactory. The macroeconomic outcomes from 1990–91 to 1996–97 are captured in Table 14.2.

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5. Refer to chapter 15: Public Debt Management for a review of fiscal consolidation

TABLE 14.2  
*Indian Economy in the Post-Reform Period*  
*(1991–92 to 1996–97):*  
*Key Macroeconomic Growth Indicators*

*(Per cent unless otherwise indicated)*

	1990–91	1991–92	1992–93	1993–94	1994–95	1995–96	1996–97
Real GDP Growth <sup>@</sup>	5.4	0.8	5.3	6.2	7.8	7.2	7.5
Inflation (average of weeks) <sup>#</sup>	10.3	13.7	10.1	8.4	10.9	7.7	6.4
Broad Money (M <sub>3</sub> ) growth	15.1	19.3	14.8	18.4	22.4	13.6	16.2
Reserve Money Growth	13.1	13.4	11.3	25.2	22.1	14.9	2.8
Net RBI Credit to Central Government	20.5	6.3	4.6	0.3	2.2	20.1	1.6
Net Domestic Assets (NDA) of RBI	1.1	9.5	9.3	-1.0	8.4	27.3	-12.6
Gross Fiscal Deficit (GFD/GDP)	8.3	5.9	5.7	6.9	5.6	4.9	4.7
Monetised Deficit as percentage of GDP <sup>+</sup>	2.7	0.9	0.6	0.03	0.2	1.6	0.1
External CAD/GDP	-3.2	-0.4	-1.8	-0.4	-1.0	-1.6	-1.2
Official Foreign Exchange Reserves (US\$ billion) (end-March)	58.34	92.20	98.32	192.54	251.86	216.87	264.23
Gross Official Reserves (in months of imports) <sup>&amp;</sup>	2.7	5.6	5.1	8.6	8.5	6.1	8.1

*Notes:* @: Real GDP growth rate at constant prices. GDP at factor cost (base = 1980–81).

#: Wholesale Price Index (WPI) (base = 1981–82).

+ : In 1989–90, Monetised Deficit as percentage of GDP was 3.02, the highest on record.

&: According to the IMF definition and including SDR holdings and gold valued at SDR 35 per ounce.

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

#### FINANCIAL SECTOR REFORMS

The favourable outcomes of the strong and purposive policy measures in 1991–92 provided the launch pad for further financial sector reforms, which can be classified into three categories, namely: (i) removing the external constraints operating on the profitability of banks; (ii) improving the financial health of banks and introducing greater transparency in their balance sheets; and (iii) injecting a greater element of transparency in the financial system. The first category formed the plank of monetary management, given the fiscal dependence on the banking system's

support and the need to ensure that the banks' ability to create credit was modulated to suit the economic circumstances of the time.<sup>6</sup> The external constraints in the form of high levels of SLR were required to be relaxed and the structure of interest rates to be simplified. The Economic Survey for 1992–93 stressed the need to phase out the distortion present in the financial system due to the very high levels of SLR and CRR, and suggested that CRR might be reduced over a five-year period to a level below 10.0 per cent. The Narasimham Committee had also, *inter alia*, recommended a phased reduction in SLR. The Government decided to reduce SLR to 25.0 per cent over the next three years and reduce CRR to 10.0 per cent over four years (Table 14.3).

TABLE 14.3  
*Phased Reductions in SLR and Changes in CRR*  
I. *Reductions in SLR*

<i>Announcement date</i>	<i>Effective date on domestic deposits of commercial banks</i>
February 29, 1992	30.00 per cent of the increase in deposits over April 3, 1992 level. However, 38.50 per cent of deposits up to April 3, 1992 level was frozen.
October 8, 1992	38.25 per cent, 38.00 per cent and 37.75 per cent as on April 3, 1992, with effect from January 9, 1993, February 6, 1993 and March 6, 1993, respectively.
April 7, 1993	37.50 per cent and 37.25 per cent as on April 3, 1992 from August 21, 1993 and September 18, 1993.
October 11, 1993	34.75 per cent as on September 17, 1993 and 25.00 per cent on increase in deposits over the level as on September 17, 1993.
May 14, 1994	34.25 per cent and 33.75 per cent as on September 17, 1993 with effect from August 20, 1994 and September 17, 1994.
October 29, 1994	31.50 per cent as on September 30, 1994 and 25.00 per cent on increase in deposits over the level as on September 30, 1994.
April 15, 1997	Inter-bank liabilities were exempted from maintenance of SLR from April 26, 1997.

*contd...*

6. The last two categories do not strictly form part of monetary management; so they are discussed in the chapter 17: Reforms in Banking and Financial Institutions.

*concl.*

## *II. Changes in CRR*

<i>Effective date</i>	<i>Changes in domestic deposits (per cent)</i>	<i>On incremental deposits</i>
May 4, 1991	15.00	10.00 per cent of the increase in deposits over the level as on May 3, 1991.
January 11, 1992		[The rupee equivalent of the funds mobilised under the India Development Bonds exempted.]
April 21, 1992 (announcement date)		(i) 10.00 per cent of the increase up to the level as on April 17, 1992 exempted. (ii) Increase in deposits over the level as on April 17, 1992 exempted.
October 8, 1992		One-third of impounded balances under incremental CRR based on deposit level as on April 17, 1992 was released in three equal instalments beginning from October 17, 1992, November 14, 1992 and December 12, 1992.
April 17, 1993	14.50	
May 15, 1993	14.00	
June 11, 1994	14.50	
July 9, 1994	14.75	
August 6, 1994	15.00	
November 11, 1995	14.50	
December 9, 1995	14.00	
April 27, 1996	13.50	
May 11, 1996	13.00	
July 6, 1996	12.00	
October 26, 1996	11.50	
November 9, 1996	11.00	
January 4, 1997	10.50	
January 18, 1997	10.00	

*Source:* Reserve Bank of India, CPC circulars.

Incidentally, the phased reduction of SLR to 25.0 per cent over a three-year period was part of the strategy to phase out the automatic monetisation of budget deficit in a three-year time frame (which, again, would help to reduce CRR over the medium term).<sup>7</sup> In effect, as the GFD came down and there was a move away from automatic monetisation of fiscal deficit,

7. The topic of phasing out automatic monetisation of budget deficit is discussed in chapter 15: Public Debt Management.

monetary policy came into its own. Thus the regulation of money and credit was determined by the overall perception of the country's monetary authority on what the appropriate level of expansion of money and credit should be, depending on how real factors in the economy evolved.

#### THE RESERVE BANK'S DILEMMAS IN REDUCING RESERVE REQUIREMENTS

The medium-term plan was to reduce CRR to 10.0 per cent by March 1997. However, the Reserve Bank was cognisant that temporary deviations might be necessary to restrain growth in excess liquidity. To counter the expansionary impact of the large fiscal deficit in 1993–94, CRR had to be raised by one percentage point, from 14.0 per cent to 15.0 per cent, in three phases between June 11, 1994 and August 6, 1994. Subsequently, the Reserve Bank, while reducing CRR, tried to counterbalance the consequent excess liquidity in the system by trimming export credit refinance.

By March 1993, the Reserve Bank noted that SLR for banks had reached such high proportions that they tended to be 'counterproductive' (office note dated March 17, 1993). This implied that the Bank recognised the need for a basic shift from reserve requirements to more flexible and active OMOs. In the case of CRR, the reduction had to be gradual, as a rapid pace of adjustment could aggravate the problem of excess liquidity. CRR reduction to a more realistic level could be considered only when there were clear signals of an enduring abatement of inflationary pressures as also containment of the fiscal deficit of the Central Government. The acute predicament faced by policymakers in this regard was well captured in the office note recorded (dated February 16, 1994) by the Deputy Governor, Shri S.S. Tarapore, "If we are to effectively move from direct monetary control to indirect monetary control, we need to move away from high CRR limits. The present time offers an opportunity for rationalisation under which the CRR and the refinance limits can both be reduced."

However, the Governor was not persuaded by this reasoning and instead remarked that lowering CRR simultaneously with a reduction in export credit refinance might send the wrong signal and, therefore, instructed that CRR might be raised by one percentage point to contain liquidity.

In the case of SLR, as an integral part of the financial sector reform, its reduction in a phased manner was envisaged to 25.0 per cent over a three-year period ending March 1996. Here again, the policy decision was contingent on a reduction in the GFD of the Central Government.

Unlike CRR, the need for a high level of SLR diminished perceptibly with the progressive move towards market-related interest rates on government borrowing after 1993–94. Although the quantum of SLR that banks were required to maintain was being progressively lowered, the demand from banks for holding government securities did not wane since their rate of return was very attractive and they carried zero risk weight under the capital adequacy norms for commercial banks. In other words, SLR as a statutory prescription became redundant as far as the Central Government was concerned. But the continued reliance of the state governments on SLR led to the pursuit of a cautious approach towards rapid declines in SLR.

Several policy measures were taken to usher in fundamental changes in the financial system. In particular, commercial banks underwent a time-bound structural transformation. The thrust of the reform was to improve the operational and allocative efficiency of the financial system as a whole. This was achieved by correcting several external and structural factors that were affecting its performance. Banks and financial institutions were encouraged to function as autonomous business units that were fully accountable for their performance. The structural reforms in the financial sector focused on easing external constraints, prescribing requisite prudential norms relating to provisioning against loan losses and capital adequacy, introducing transparency in accounting and reporting procedures, restructuring and recapitalising banks, and increasing the competitive element in the market through the entry of private participants. Legislative changes were made to strengthen the legal framework supporting the financial sector.

#### MONETARY MANAGEMENT IN THE FIRST FULL YEAR OF REFORM (1992–93)

During 1992–93, there was a sharp and welcome deceleration in the price level. Also, the pressure on the external sector eased, allowing for a build-up of the FCA of the Reserve Bank. Besides, the Government decided to reduce the GFD-to-GDP ratio from 6.5 per cent in 1991–92 to 5.0 per cent in 1992–93.

The major objective of monetary policy as usual was on containing inflation by limiting monetary expansion, while at the same time ensuring adequate availability of bank credit for revival of economic activity. Accordingly, the Reserve Bank planned a sharp reduction in  $M_3$  from 18.6 per cent in 1991–92 to less than 11.0 per cent in 1992–93.

## CHART 14.1

*I. Monetary Policy Announcement for the First Half of 1992–93  
(on April 21, 1992)*

<i>Endogenous factors</i>	<i>Exogenous factors</i>	<i>Fiscal developments</i>
The large build-up of foreign exchange reserves resulted in acceleration of monetary aggregates. Growth in $M_3$ in 1991–92 was estimated at around 18.6 per cent as against 14.9 per cent in 1990–91. The process of implementing the recommendations of the Narasimham Committee on the financial system was taken up.	Growth in select macro-economic variables had to conform to the conditions attached to the draws under the IMF stand-by loan.	The Central Government decided to reduce GFD from 6.5 per cent of GDP in 1991–92 to 5.0 per cent in 1992–93.

*II. Monetary Policy Announcement for the Second Half of 1992–93  
(on October 8, 1992)*

By the second half of 1992–93, there were distinct signs of economic recovery. Real GDP was expected to grow by about 3.5 per cent as against about 2.0 per cent in 1991–92. There was strong expansion in $M_3$ in the first half of the year. The inflation rate by August 1, 1992 touched a single-digit level — after two years of double-digit inflation. This was made possible by a reduction in the GFD/GDP ratio and an improvement in the supply position of essential commodities of mass consumption.	The increase in net RBI credit to the Central Government up to September 18, 1992 was 6.0 per cent against 10.2 per cent in the previous year.
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*Source:* Reserve Bank of India, CPC circulars.

The key elements of monetary and credit policy for the first half of 1992–93 were rationalisation of deposit and lending rates, reduction in the average level of CRR and discontinuation of the incremental net non-food credit (excluding export credit)–deposit ratio, which was prescribed in October 1989. Emphasis was placed on encouraging exports in order

to alleviate the deficit in external payments. At the same time, the Reserve Bank was aware that the export refinance arrangement attenuated the effectiveness of monetary control, since it accounted for very large refinance limits to commercial banks, which could draw upon the facility as and when required.

Coming to details, the Reserve Bank made conscious efforts to not only gradually reduce the level of interest rates in the banking system, but also rationalise the rate structure as the inflation rate slowed and the macroeconomic situation improved. The lending rate structure of commercial banks was reduced from six to four, according to the size of limit, from April 22, 1992. The lowest category of credit limit, *i.e.*, up to and inclusive of ₹ 7,500 and the interest thereon, was, however, kept unchanged. The second slab was over ₹ 7,500 and up to and inclusive of ₹ 25,000 and the third slab was over ₹ 25,000 and up to ₹ 2 lakh. As a step towards further rationalisation of deposit rates, the number of prescribed rates was reduced. As against fixed rates of interest prescribed for term deposits for three maturity periods in the range of 11.0 per cent to 13.0 per cent, from April 22, 1992, the deposit rate for maturity of 46 days to 3 years and above became a single prescription of 'not exceeding 13.0 per cent per annum'. Moreover, as the economic crisis receded, an early move towards maintenance of lower reserve requirements was felt to be an appropriate policy response.

Banks were exempted from the maintenance of the 10.0 per cent incremental CRR for increase in net demand and time liabilities (NDTL) (*i.e.*, deposits) over the level as on April 17, 1992. However, the 10.0 per cent incremental CRR continued to be operative up to the level of deposits as on April 17, 1992. With the reduction in the effective CRR as a result of the discontinuation of the incremental CRR, the Reserve Bank decided that from May 2, 1992: (i) on the eligible cash balances based on deposits as on March 23, 1990, interest would continue to be paid at 10.5 per cent; and (ii) on the increase in eligible cash balances based on deposits after March 23, 1990 — under the average 15.0 per cent CRR as well as the 10.0 per cent incremental CRR — interest would be paid at 3.0 per cent (earlier, the first category was paid interest at 10.5 per cent and the second category at 5.0 per cent). Measures were introduced to allow a more liberal flow of refinance to banks and institutions and augment their lendable resources. Further, credit policy measures sought to improve the flow of credit to sectors such as exports, the priority sector including agriculture and small scale industry, and medium and large industry.

Perhaps the most striking aspect of the credit policy, which marked a break from the past, was that it initiated a multi-pronged strategy. For example, the Reserve Bank took steps to develop an institutional framework for financial markets by facilitating the emergence of an active secondary market in government securities. The Reserve Bank broadened the gilt-edged market, which, in the long run, decreased the dependence of the Government on borrowings from it and the banks. The credit policy circular dated April 21, 1992 averred that this was an important element of monetary and credit policy for 1992–93 and that once credit to the Government did not pre-empt the resources of the banking sector, it should be possible to augment credit availability to support the revival of private sector activity in the economy. In pursuance of this approach, one of the major steps was the introduction of 364-day Treasury Bills, the first auction of which was held on April 28, 1992. Under the scheme of money market mutual funds (MMMFs), banks were allowed to raise resources to the extent of 2.0 per cent of the sponsoring bank's fortnightly average deposits during 1991–92.

In the first half of 1992–93, there was a strong growth in time deposits, which was attributable to the telescoping of the maturity structure of term deposits, the flexibility given to banks to pay interest on term deposits within the cap of 13.0 per cent, the increase in interest rate on savings deposits, the increase in the limits for the issue of CDs and inflow of funds from abroad. Interestingly, the uncertainty arising from the irregularities in the transactions in the securities market during this period seemed to have contributed to the spurt in term deposits.

Before moving to the developments in the second half of the year, it is worth recording an instance of policy undercurrents and dilemmas. As a prelude to the finalisation of the credit policy for the first half of 1992–93, at the meeting held with the Finance Minister in April 1992, the Government sought clarifications on some of the proposals. At the meeting, the Reserve Bank officials shared the Government's concern in respect of rationalisation of short-term deposit rates and that the April/May 1985 episode<sup>8</sup> should be avoided with rigorous follow-up. As regards changes in CRR, the Reserve Bank showed a distinct preference for reducing the average CRR rather than merely abolishing incremental CRR, because the former had the advantage of inducing benefit at the time of change and reducing interest payments at the same time, while abolishing

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8. Refer to chapter 4: Monetary and Credit Policy and chapter 6: Banking and Finance for details of this event.

the incremental CRR provided benefits only over time. The third proposal — which, however, did not find a place in the final policy measures for the first half of 1992–93 — related to changing the base for determining export credit refinance with the intent of better monetary control, as severe difficulties were foreseen in putting through adjustments in CRR. The Reserve Bank was reconciled to the fact that if the status quo on the rupee export credit base was to be maintained, it was better not to reduce CRR at that stage.

The measures introduced in the credit policy for the second half of 1992–93 (announced on October 8, 1992) carried forward the emphasis on the development objective that had been initiated at the beginning of the year. The changes mainly related to minimum lending rates, deposit rates and reserve requirements. The rationale for the proposed changes, as evidenced from the internal notings at the time of formulating the policy, gives an insight into the progressive evolution of monetary policy. These are dealt with in the following paragraphs.

#### MINIMUM LENDING RATES

The high lending rates for certain sectors were necessitated by the pre-emption of resources at subsidised rates for the Government, as well as the priority sector (as per the mandate) and the slackness in recovery of advances by banks. The official perception was that high interest rates could be brought down only when pre-emption at subsidised rates came down and the overall interest rate structure was rationalised. In October 1992, there was a perceived fall in the inflation rate to a single digit which meant the emergence of relatively high real rates of interest. This development induced the Reserve Bank to reduce the lending rate of SCBs on credit limits of over ₹ 2 lakh by one percentage point, from the minimum of 19.0 per cent to the minimum of 18.0 per cent from October 9, 1992.

#### RESERVE REQUIREMENTS

The aggregate pre-emptions of the banking system on account of SLR and CRR declined from 63.5 per cent in 1991–92 to 45.0 per cent in the first half of 1992–93. Following the moderation in the GFD, SLR (which was being computed against the outstanding deposits as on April 3, 1992 at 38.50 per cent) was reduced from 38.50 per cent to 37.75 per cent in three steps of 0.25 percentage points each from the fortnights beginning January 9, 1993, February 6, 1993 and March 6, 1993, respectively. SLR of 30.0 per cent on the increase in deposits above the April 3 level was retained.

As discussed earlier, from April 17, 1992, the incremental CRR of 10.0 per cent was discontinued. Again, of the impounded cash balances of ₹ 3,848 crore maintained under the 10.0 per cent incremental CRR between May 3, 1991 and up to the level of April 17, 1992, one-third (₹ 1,280 crore) was released in three equal instalments in the fortnights beginning October 17, 1992, November 14, 1992 and December 12, 1992, respectively. This, in effect, implied a reduction in the effective CRR by about 0.6 percentage points. Further, CRR base of commercial banks (excluding RRBs), which had remained unchanged since July 1989, was reduced by one percentage point from 15.0 per cent to 14.0 per cent in two equal steps from the fortnights beginning April 17, 1993 and May 15, 1993.

In order to minimise the fragmentation of CRR, the concession granted to banks of exempting a part of the CDs was withdrawn by April 1993. However, the reduction in CRR by augmenting the lendable resources of banks also strengthened their profitability. From May 2, 1992, the Reserve Bank reduced the interest payable on eligible cash balances on the basis of increase in deposits (that is, the NDTL of SCBs) over the level as on March 23, 1991 from 5.0 per cent to 3.0 per cent. On the eligible balances as of March 23, 1990, interest was continued to be paid at 10.5 per cent. To make three non-resident deposit schemes, namely, the NR(NR)RD, foreign currency (ordinary non-repatriable) deposit scheme (FCON) and foreign currency (banks and others) [FC(B&O)] scheme more attractive, they were made fully exempt from reserve requirements.

An area of disquiet shared with the banks (in the credit policy circular dated October 8, 1992) was that, while recognising the paramount need for continued support to the external sector, the unlimited export credit refinance turned out to be counterproductive as it resulted in loss of monetary control. The Reserve Bank's strong misgivings in this regard were articulated by the Deputy Governor, Shri S.S. Tarapore, in his office note dated October 1, 1992 as follows:

We are riding a dangerous tiger in terms of export refinance facility. This facility was expected to provide some incentive to banks to provide export credit and between 1982 and 1987, the proportion of refinance to export credit ranged between 7 per cent and 27 per cent. Since then, there has been an insidious increase in the proportion of export refinance and the CPC estimate is that on the present formula, by March 1993 the export refinance will be equivalent to 75 per cent of total export credit. The rise in the proportion of refinance has emboldened the export lobby to cry

foul unless export refinance covers 100 per cent of export credit and that too at a very low rate of interest.

In accord with the above perception, the Reserve Bank made certain modifications in this refinance facility. Export credit (rupee) refinance would be provided to the extent of 60.0 per cent of the increase in outstanding export credit over the monthly average level of 1988–89 up to the monthly average level of 1989–90 plus 110.0 per cent of the increase over the monthly average level of outstanding export credit in 1989–90, as against 125.0 per cent hitherto. Under the post-shipment export credit denominated in US dollars (PSCFC)<sup>9</sup> refinance facility, banks were eligible for export credit refinance limits equivalent to 120.0 per cent of such credit provided by them as against 133.3 per cent earlier. Both the changes were effected from October 31, 1992.

#### RELEASE OF IMPOUNDED INCREMENTAL CRR

The main intention of the authorities was that the pace of reduction of the impounded CRR balance should be carefully worked out, as faster reduction might aggravate the excess liquidity in the economy. In the wake of the slowdown of the inflation rate and the Central Government's renewed commitment to reduce the GFD, the Reserve Bank decided towards the end of 1992 that one-half of additional cash balances that remained impounded with it under the 10.0 per cent incremental reserve ratio between May 3, 1991 and April 17, 1992 could be released in three equal instalments spread over the period from October 17, 1992 to December 12, 1992. The office note dated September 28, 1992 observed that the expansionary impact of the release of CRR balances on  $M_3$  should be borne in mind and ways of mopping-up the excess liquidity through OMOs be explored.

#### RATIONALISATION OF DEPOSIT RATE STRUCTURE

The deceleration in the rate of inflation during 1992–93 encouraged the Reserve Bank to explore the feasibility of rationalising the structure of deposit interest rates. A reduction in the banks' maximum deposit rate was effected in two stages so that the banks could maintain their economic viability. Rates on domestic deposits of 46 days and above were reduced by one percentage point each from October 9, 1992 (from not exceeding 13.0 per cent to not exceeding 12.0 per cent) and again from March 1, 1993 (to

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9. Post Shipment Credit in Foreign Currency.

not exceeding 11.0 per cent). The rate on domestic saving deposits which had been raised from 5.0 per cent to 6.0 per cent from April 24, 1992 was lowered to 5.0 per cent from July 1, 1993. Thus, the maximum deposit rate, the saving deposit rate and the lending rate for limits over ₹ 2 lakh was reduced to the level which ruled before interest rates were raised on April 13, 1991. The interest rate on savings account under the NR(E)R deposits scheme was raised by one percentage point to 6.0 per cent from October 8, 1992. Term deposits on these accounts were rationalised to be in broad consonance with the domestic deposit rates. At the same time, the rates for NR(E)R accounts for maturity of 46 days to three years and above were made subject to a single prescription of not exceeding 13.0 per cent and this was further reduced from April 8, 1993 to not exceeding 12.0 per cent.

#### TRANSFORMATION OF THE ECONOMY (1993–94 TO 1996–97)

As the year 1992–93 drew to a close, the transition of the Indian economy — which had been afflicted with fiscal dominance and extensive regulation over the functioning of banks and other financial institutions (FIs) — to a more liberalised and market-driven structure gained momentum. Also, the country moved away from the spectre of the BoP crisis to that of convertibility under Article VIII of the International Monetary Fund (IMF).

Fiscal deficits and the automatic monetisation of the budget deficit by issue of *ad hoc* Treasury Bills to the Reserve Bank had been reined in as a result of fiscal consolidation and the Government meeting its temporary budgetary needs by sale of securities in the gilt-edged market. In the period from 1993–94 to 1996–97, huge inflows of foreign capital and the consequent surplus in the BoP, welcome as they were for several reasons, opened new and unforeseen challenges for domestic monetary management. The Reserve Bank's responsibilities, as a result, extended beyond monetary and credit management to promoting financial stability and growth of financial markets with the ultimate objective of achieving more efficient and quick transmission of monetary policy impulses. In the course of implementing the financial sector reforms, the Reserve Bank forged close rapport and understanding with the Ministry of Finance. This was, for instance, reflected in the two agreements with the Central Government in September 1994 and March 1997 to phase out automatic (and unlimited) monetisation of budget deficit in order to reinforce the process of macroeconomic management by the Reserve Bank, on one

hand, and impose greater fiscal discipline on the Central Government on the other.<sup>10</sup>

The underlying theme of the narrative covering the years beyond 1993–94 is the manner in which the Reserve Bank tackled the problems arising out of huge capital inflows, given the consequential sharp increases in primary money creation and the impact on other macroeconomic variables. It could also be hypothesised that there was no diversity in these challenges. In fact, what emerged was a ‘blended’ pursuit of short-term fine tuning and long-term objectives of monetary policy.<sup>11</sup> In the final analysis, in an increasingly open economic environment, the pressure of developments emanating from the external sector was instantly felt in the conduct of monetary policy.

Inflation control, however, remained the cornerstone of the objectives of monetary policy during this period, with varying degrees of emphasis accorded to other subsidiary goals.<sup>12</sup> The latter category included revival of economic growth (1993–94), meeting genuine credit requirements, including that of exports, agriculture, small scale industry and weaker sections (1994–95), necessary credit support for production and investment (1995–96), and support for productive activity by easing resources available to banks without jeopardising the main objectives of monetary and exchange rate stability (1996–97).

Before moving on to narrate the important developments in monetary management during these four years, the accompanying two charts (Chart 14.2 and Chart 14.3) present an overview of monetary policy operating procedures and its strategy, *viz.*:

- (i) Major macroeconomic developments that influenced formulation of monetary policy during the period 1993–94 and 1996–97.
- (ii) Monetary policy responses during 1993–94 and 1996–97.

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10. Refer to chapter 15: Public Debt Management for details.

11. Reserve Bank of India, *Annual Report, 1996–97*.

12. That monetary policy had been anchored to inflation control all along would be evident from the two policy statements appearing in the Annual Reports of the Reserve Bank of India for the years 1991–92 and 1996–97. The former averred that while there were always multiple objectives, ultimately the mission of the Reserve Bank had been to steer monetary policy with its sights set firmly on inflation control. Five years later, in the *Annual Report 1996–97*, the Reserve Bank elaborated (in the context of the conduct of monetary policy having been criticised by a few as being obsessed with achieving a lower inflation rate) that emphasis on inflation control was not meant to lower the importance of the growth objective and that, on the other hand, it was the sustained reduction in the inflation rate which would pave the way for attaining all the broad macroeconomic objectives including higher economic growth.

These charts are intended not to supplant the historical narration that follows but only to serve as reference points for the study.

## CHART 14.2

*Major Macroeconomic Developments which Influenced Formulation of Monetary Policy (1993–94 to 1996–97)*

Explanatory note:

The periodic internal exercise for framing monetary and credit policy took into account several macroeconomic fundamentals and developments. The more important of these were: (i) trends in macroeconomic variables in the previous year/half-year and the outcome of credit control and other policy measures of the past; (ii) current economic developments, trends in monetary and financial aggregates and the broad monetary policy objectives proposed to be achieved; and (iii) an assessment of the likely performance of the economy and its key components in the short-term.

<i>Monetary Policy (Year and announcement date)</i>	<i>Endogenous factors</i>	<i>Exogenous factors</i>	<i>Fiscal developments</i>
(1)	(2)	(3)	(4)
1993–94 (first half) April 7, 1993	Real GDP growth in 1992–93 recovered remarkably to about 4.0 per cent from a low of 1.2 per cent in 1991–92. There was some moderation in monetary expansion, <i>i.e.</i> , 14.2 per cent in 1992–93 instead of 19.4 per cent in 1991–92.	Due to large foreign capital inflows, the current account of BoP recorded a sharp improvement in 1992–93. To sterilise the primary money creation, the Reserve Bank resorted to OMOs.	Monetised deficit ( <i>i.e.</i> , net RBI credit to Central Government) was contained at 4.6 per cent in 1992–93 as against 6.3 and 20.5 per cent in 1991–92 and 1990–91, respectively.
June 23, 1993 September 1, 1993	Price situation showed improvement and inflationary pressures weakened. Inflation stood at 6.2 per cent on August 14, 1993 as against 9.3 per cent the year before.		
1993–94 (second half) October 11, 1993	Real GDP was estimated to grow at around 5.0 per cent in 1993–94. WPI as on September 25, 1993 expanded by 7.3 per cent (10.2 per cent the year before). Monetary expansion ( $M_3$ ) for the full year 1993–94 was projected to exceed 12.0 per cent estimated at the beginning of the year to record 14.0 per cent.	The opening up of the external sector and the strong accretion to foreign exchange reserves created pressures on the domestic economy. Also, the transmission processes of the impulses from the domestic sector to the external sector and vice versa became powerful.	There was some slippage in the GFD target for the year due to pressures on expenditure on both the Plan and non-Plan accounts. But its impact could be contained through sizeable open market sales of government securities by the Reserve Bank.

*contd...*

*contd...*

(1)	(2)	(3)	(4)
1994-95 (first half) May 14, 1994	A sea change took place in 1993-94 in the factors operating behind monetary expansion. Reserve money expanded by 25.1 per cent compared to 11.3 per cent in 1992-93. $M_3$ grew by 18.2 per cent in 1993-94 as against 15.7 per cent in the previous year. Inflation at 11.2 per cent as on April 23, 1994 was higher than 7.0 per cent the year before, which caused concern to the Reserve Bank. Increase in net RBI credit to Government in 1993-94 was a nominal ₹ 260 crore, whereas in the past this item accounted for a predominant share of reserve money growth.	The quantum jump in foreign exchange reserves, although welcome for a number of reasons, contributed to large expansion in primary money and thus overall monetary growth.	The Government announced in the Union Budget for 1994-95 its decision to phase out automatic monetisation of the budget deficit through recourse to <i>ad hoc</i> Treasury Bills. The agreement of September 9, 1994 between the Reserve Bank and the Central Government formalised this arrangement.
1994-95 (second half) October 17, 1994	In the immediate past, the rate of inflation showed signs of decline. The source of reserve money growth turned out to be the strong expansion in net foreign assets (NFA) of the Reserve Bank. $M_3$ expanded in 1993-94 (up to September 30, 1994) by 9.7 per cent as against 7.8 per cent in the corresponding period in the previous year, propelled by overhang of primary liquidity from the last quarter of 1993-94 and the continued inflow of foreign funds in the second half of 1994-95. Net RBI credit to the		The reduction in the Central Government's reliance on the Reserve Bank was reflected in a decline in the issue of <i>ad hoc</i> Treasury Bills as compared with an increase in the previous year. Monetised deficit of the Central Government remained well below the budget level despite some slippage in GFD.

*contd...*

contd...

(1)	(2)	(3)	(4)
1995-96 (first half) April 17, 1995	<p>Central Government and NFA of the Reserve Bank moved in opposite directions for the most part of the year.</p> <p>In 1994-95, GDP growth picked up to 6.4 per cent and in 1995-96 was expected to perform better at 7.0 per cent. The major sources of <math>M_3</math> increase in 1994-95 were the growth in NFA of the Reserve Bank and a sharp pick-up in RBI credit to commercial banks. Strong inflationary pressures at the beginning of 1994-95 weakened by the third quarter but picked up during the fourth quarter. <math>M_3</math> up to March 17, 1995 grew by 22.2 per cent (18.4 per cent in 1993-94). The Reserve Bank perceived this as well beyond what could be considered desirable after taking into account the expected increase in real output. Incidentally, the high growth of <math>M_3</math> exceeded the 20.0 per cent mark for the third time, the earlier occasions being 1976-77 and 1978-79.</p>	<p>The volume of capital inflows turned out to be higher than anticipated. The phenomenal increases in capital inflows in the second half of 1993-94 and the first half of 1994-95 had a pronounced effect on monetary expansion in 1994-95.</p>	<p>For the first time in two decades, <math>M_3</math> expansion was not due to monetisation of the budget deficit. The Central Government did not have recourse to <i>ad hoc</i> Treasury Bills for the greater part of the year. However, towards the close of the year, the strains on Government finances surfaced and the Government experienced some difficulty in putting through its borrowing programme.</p>

contd...

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(1)	(2)	(3)	(4)
1995–96 (second half) September 29, 1995	Unlike in the previous year when much of the created money emanated from an increase in NFA, in 1995–96 the growth was due to larger net RBI credit to the Central Government. The run of normal monsoons continued for the eighth successive year with prospects of good agricultural output.	In spite of the volatility in the foreign exchange market, the Reserve Bank felt that the economic fundamentals were strong and the causes for volatility reflected the sharp changes that were taking place in the international currency markets.	Net RBI credit to the Central Government spurred by ₹ 13,225 crore from March 31 to September 15, in contrast to a decline of ₹ 640 crore in the corresponding period of the previous year.
November 11, 1995 and December 9, 1995	The Reserve Bank provided large support to the money market to counter the escalation in call money rates to very high levels till November 10, 1995. However, with the moderation of this support and taking into account the monetary and credit developments, the Reserve Bank decided to reduce CRR from 15.0 to 14.5 per cent from November 11, 1995 and further to 14.0 per cent from December 9, 1995.		
1996–97 (first half) April 3, 1996	The commercial sector had articulated its concerns about shortage of resources. Conditions in the foreign exchange market displayed considerable volatility. Macroeconomic fundamentals in 1995–96 recorded robust growth, especially in real GDP. After two years of double-digit inflation,	The resumption of capital inflows together with the narrowing of the CAD in the BoP helped augment the external reserves of the country.	

*contd...*

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	(1)	(2)	(3)	(4)
		<p>its growth eased to 4.7 per cent by March 16, 1996. This turn of events called for active Reserve Bank intervention in the areas of monetary policy and exchange rate management. The Reserve Bank recognised that the high level of interest rates that prevailed during 1995–96 needed to be reduced to facilitate credit off-take during 1996–97.</p>		
<p>1996–97 (second half) October 19, 1996</p>		<p>The real sector of the economy, after posting strong growth in the past few years, showed signs of slackening, particularly in the industrial sector. However, agriculture was expected to perform much better. Monetary growth was on the targeted course of 15.5 – 16.0 per cent for the year. Inflation (WPI) stood at 6.3 per cent during the week ended September 28, 1996 as against 8.8 per cent during the corresponding week of the previous year.</p>	<p>The automatic monetisation of budget deficit was finally phased out from April 1, 1997, following the supplemental agreement dated March 26, 1997. The financial position of the Government was not comfortable as there was large deceleration in revenue growth together with a sharp rise in expenditure commitments. Despite the fiscal pressures, favourable conditions in the securities market and improved liquidity conditions facilitated Central Government in raising the needed resources without much support from the Reserve Bank.</p>	

*Source:* Reserve Bank of India, Credit Policy circulars issued by Credit Planning Cell/Monetary Policy Department; *Annual Report*, various issues.

## CHART 14.3

*Main Credit Policy Responses during 1993–94 to 1996–97*

(A period of financial sector reforms and inflow of foreign funds)

<i>Year</i>	<i>Instrument</i>	<i>Changes</i>	<i>Reason/objective/in response to</i>
(1)	(2)	(3)	(4)
1993–94	<i>CRR</i> (on domestic deposits)	Reduced from 15.0 to 14.0 per cent in two stages (April 17, 1993 and May 15, 1993).	Reductions in monetisation of fiscal deficit, and in inflation rate and carrying forward of financial sector reform.
	<i>SLR</i> (on domestic deposits)	Reduced from 37.75 to 34.75 per cent on deposits as on April 3, 1992/September 17, 1993 (August 21, 1993 – October 16, 1993); however, SLR above the September 17, 1993 level remained unchanged at 25.00 per cent.	– do –
	<i>Lending Rates</i>	Four categories of lending rates reduced to three categories (April 8, 1993). Minimum lending rates for term loans of over ₹ 2 lakh brought down from 17.0 per cent to 16.0 per cent (June 24, 1993) and to 15.0 per cent (September 2, 1993). Minimum lending rate on term loans of three years and above lowered from 15.0 per cent to 14.0 per cent (March 1, 1994). Fixed interest rates on term loans over ₹ 25,000 and up to ₹ 2 lakh reduced from 16.5 per cent to 16.0 per cent (June 24, 1993) to 15.0 per cent (September 2, 1993) and to 14.0 per cent (March 1, 1994).	To rationalise the lending rates of commercial banks. Abatement in inflationary pressures.
	<i>Deposit Rates</i>	Rate on savings deposit reduced from 6.0 per cent to 5.0 per cent (July 1, 1993). Deposit rates for maturity of 46 days to 3 years and above revised to 'not exceeding' 10.0 per cent per annum (September 2, 1993).	To provide stimulus to investment. Consequent upon reduction in maximum term deposit rate. Reduction in inflation rate.
1994–95	<i>CRR</i>	Raised to 15.0 per cent from 14.0 per cent in three stages ( <i>i.e.</i> , June 11, 1994, July 9, 1994 and August 6, 1994).	To counter the strong inflationary impact of the increase in NAF.
	<i>SLR</i>	SLR (up to September 17, 1993 level) lowered from 34.75 to 33.75 per cent in two phases (August 20 and September 17, 1994).	With the progressive move to market-related rates of interest on government borrowing, the need for high SLR was reduced.

*contd...*

*contd...*

(1)	(2)	(3)	(4)
		SLR (up to September 17, 1993 level) reduced to 31.50 per cent (October 29, 1994).	In furtherance of the objective of bringing down SLR to 25.00 per cent by March 1996.
	<i>Interest Rates</i>	Deregulation of lending rates:  Lending rates of commercial banks for credit limits over ₹ 2 lakh were freed; the prescription of a minimum lending rate for credit limits over ₹ 2 lakh was abolished; and banks were given the freedom to fix the lending rates for such borrowers (October 18, 1994).  For loans up to ₹ 2 lakh, protection to these borrowers (in lending rates) was continued.  Savings deposit rate reduced from 5.0 per cent to 4.5 per cent (November 1, 1994).  The maximum term deposit rate was revised from 'not exceeding' 11.0 per cent to 'not exceeding' 10.0 per cent (February 10, 1995).	The objective was to further reduce the element of prescription of interest rates by the Reserve Bank. With the reduction in inflationary pressures the lending rates should reflect lower interest rates and at the same time, the savers should get an adequate rate of return in real terms.  A large proportion of savings deposit accounts were being operated essentially as current accounts. Moreover, depositors were able to get interest rate as high as 7.0 per cent for 46-day term deposits. The reduction in rates was to reflect better the nature of savings deposits.  To evolve a more stable asset-liability balance and to ensure that deposit rates remained attractive in an environment of high inflation.
1995-96	<i>Interest Rates</i>	The maximum term deposit rate ( <i>i.e.</i> , 'not exceeding') was increased from 11.0 per cent to 12.0 per cent (April 18, 1995).  Banks were given the freedom to fix their own interest rates on domestic term deposits with a maturity of over 2 years (October 1, 1995).	To make banks' term deposits attractive in the context of the prevailing inflation level and to enable banks to mobilise more deposits.  To increase the resources of banks and to make the structure of interest rates on deposits more flexible.

*contd...*

*concl.d.*

(1)	(2)	(3)	(4)
	CRR	Reduced from 15.0 to 14.5 per cent (November 11, 1995).	This was done simultaneously with the moderation of money market support and to augment the resources of banks
1996-97	CRR	Further reduced to 14.0 per cent (December 9, 1995). Lowered in two stages to 13.0 per cent (April 27, 1996 and May 11, 1996).  Brought down to 12.0 per cent (July 6, 1996).  Reduced to 10.0 per cent in four stages of 0.5 percentage points each (October 26, 1996, November 9, 1996, January 4 and 18, 1997).	The prevailing monetary and credit situation To augment the lendable resources of banks, which would enable them to meet genuine productive requirements for credit. Rationalisation, <i>i.e.</i> , CRR reduction along with a reduction in refinance. Consistent with the medium-term objective of reduction of CRR over a three-year period.
	Interest Rates	Banks were given the freedom to fix their own interest rates on domestic term deposits with a maturity of over one year (July 2 1996). The minimum period of term deposits was shortened from 46 days to 30 days (July 2, 1996). Interest rates on domestic term deposits for maturity of 30 days and up to one year were reduced from 'not exceeding' 11.0 per cent to 10.0 per cent (October 21, 1996).	To provide banks with greater flexibility in determining their term deposit rates. To provide some outlet for management of short-term surplus funds of banks.

- Notes:* 1. Besides the frequently used credit control instruments (as detailed above), changes in refinance facility were also utilised to influence liquidity in the economy. OMOs were increasingly relied upon after the mid-1990s as an instrument (indirect) of monetary management as well as public debt management. In this connection, repo transactions shot into prominence. Moral suasion by the Reserve Bank, even though not apparent to the public at first sight, was a potent and trusted weapon in the armoury of the Reserve Bank.
2. The reserve requirements (CRR and SLR) as well as interest rate prescriptions were made applicable to non-resident deposit accounts albeit in less rigorous form and not necessarily simultaneously with the changes in reserve prescriptions on domestic deposits. Some of the reasons were to augment/reduce the lendable resources of banks, to bring all deposit liabilities of banks under reserve requirements, to rationalise the overall SLR prescription and make it attractive for banks to mobilise deposits from non-residents.
3. In the case of interest rate payable on various non-resident deposit accounts, the objectives included bringing about an alignment of the maturity structure with that of domestic term deposits, giving more flexibility to banks in mobilising deposits from non-residents, to bring about a better alignment with the maturity structure/interest rate pattern of term deposits under various schemes and the interest rates prevailing in international markets for comparative maturities.

Source: As in Chart 14.2.

From 1993–94, the conduct of monetary management and credit policy came to be determined strongly by the huge foreign capital inflows and their impact on creation of primary money. It became the dominant, if not the prime mover of monetary expansion. Moreover, with the gradual opening up of the economy, developments in the external payments position impinged on the behaviour of domestic macroeconomic variables. In a short time, the Reserve Bank came to focus sharply on a monetary policy that was consistent with the exchange rate and payments policy.

#### NEW THRUST TO MONETARY POLICY (1993–94)

During 1993–94, the BoP improved, especially in the second half of the year. However, this entailed substantial monetary expansion and acceleration in inflationary pressures. On the fiscal side, there was slippage in the fiscal deficit target due to large supplementary budgets on both Plan and non-Plan accounts. Even though the fiscal deficit during the year was much larger than the budgeted level, its monetary impact could be contained through sizeable open market sales of government securities by the Reserve Bank. Nevertheless,  $M_3$  growth was recorded at 18.0 per cent in 1993–94 as against 15.7 per cent in 1992–93. NFA of the Reserve Bank escalated sharply to ₹ 28,775 crore in 1993–94, an increase of ₹ 24,966 crore as against a modest increase of ₹ 3,809 crore in the previous year. While presenting the Union Budget for 1994–95, the Finance Minister announced a major financial reform under which the monetisation of *ad hoc* Treasury Bills for the year as a whole would not exceed ₹ 6,000 crore and ₹ 9,000 crore for more than 10 consecutive days at any time during the year. This arrangement was expected to strengthen financial and monetary management. Apart from continuing the reform process, the monetary policy for 1993–94 sought to enlarge the availability of credit for production purposes through further reductions in CRR and SLR.

#### MONETARY POLICY RESPONSES

Despite the major constraints on account of the developments in the fiscal sector, monetary policy measures sought to ensure that the banking system extended adequate credit support for revival of output by reducing the cost of money and increasing the availability of credit, particularly for key sectors like agriculture and small scale industry (SSI). Indirect instruments of monetary policy were deployed in the second half of the year. Notably, the Reserve Bank undertook large sales of securities from its portfolio to

counter fiscal expansion. The Annual Report for 1993–94 admitted that the effects of this measure were insufficient to reduce primary liquidity growth. The pressure of demand was reflected in double-digit inflation, *i.e.*, 10.8 per cent, at the end of March 1994. The main responses in credit policy measures were a reduction in the deposit and minimum lending rates of banks and reductions in SLR and CRR.

The removal of controls on interest rates formed an important aspect of the financial sector reform. Taking a cue from the Economic Survey for 1992–93, the Reserve Bank modified four categories of lending rates to three from April 8, 1993. Also, the minimum lending rate for term loans of over ₹ 2 lakh was brought down from 17.0 per cent to 16.0 per cent (June 24, 1993), and further to 15.0 per cent (September 2, 1993). The minimum lending rate on term loans of three years and above was lowered from 15.0 per cent to 14.0 per cent from March 1, 1994. The fixed interest rate on term loans over ₹ 25,000 and up to ₹ 2 lakh was reduced from 16.5 per cent to 16.0 per cent from June 24, 1993, to 15.0 per cent from September 2, 1993, and to 14.0 per cent from March 1, 1994. Correspondingly, the maximum deposit rate (applicable for maturity for 46 days to 3 years and above) was brought down from 13.0 per cent to 11.0 per cent, so that the viability of the banking system was not impaired. In September 1993, this rate was revised downwards to 10.0 per cent. The Reserve Bank's Annual Report for 1993–94 explained that in determining the deposit rate, one had to take into account the perceptions of depositors as well as the returns available on alternative financial assets and it was not the intention of the policy to keep real lending rates at very high levels over a long period. Finally, it expressed the view that interest rate policy must be deployed as a flexible instrument to raise and lower interest rates as the circumstances warranted.

In the context of the need for continued progress towards financial sector reform, reducing the GFD of the Central Government and moderating the inflation rate, the base level SLR to be maintained by commercial banks up to the level of outstanding NDTL (excluding non-resident liabilities) as on April 3, 1992 was lowered from 37.75 per cent to 36.75 per cent in four phases of 0.25 percentage points each from August 21, 1993, September 18, 1993, October 16, 1993 and November 13, 1993, respectively. Citing the same reasons as for SLR, CRR was reduced from 15.0 per cent to 14.0 per cent in two phases of 0.5 percentage points each from April 17, 1993 and May 15, 1993.

## AN EVENTFUL AND DEFINING YEAR (1994–95)

In several ways, the year 1994–95 was eventful and momentous for the conduct of monetary policy. For the first time in two decades, monetary expansion was not attributable to monetisation of the fiscal deficit of the Central Government. It took place due to sizeable and sustained capital inflows. The growth in net Reserve Bank foreign exchange assets constituted 76.0 per cent of the reserve money expansion in 1994–95. Although lower than the contribution of 103.0 per cent to the reserve money increase in the preceding year, it was still historically large. Second, a landmark development in fiscal policy was the decision of the Central Government to phase out and ultimately discontinue automatic monetisation of the budget deficit. The Union Budget for 1994–95 announced that there would be a limit on its recourse to the Reserve Bank for issue of *ad hoc* Treasury Bills. This was formalised by an agreement between the Government and the Reserve Bank, signed on September 9, 1994, in terms of which automatic monetisation of the budget deficit through the issue of Treasury Bills would be phased out over three years and completely eliminated from 1997–98.<sup>13</sup> In practice, the Central Government did not take recourse to *ad hoc* Treasury Bills during the greater part of 1994–95. At the end of 1994–95, the recourse to *ad hocs* was a modest ₹ 1,750 crore as against the budget estimate of ₹ 6,000 crore.

The monetised deficit of the Central Government in 1994–95 remained well within the budgeted level, despite minor slippage in the GFD. The Reserve Bank activated its OMOs in government securities to lessen the strong monetisation effect of large capital inflows and the consequent inflationary impact. It made special efforts to expand the financial sector by permitting entry of several financial entities that provided a wide range of services. The external sector exhibited strength and resilience during the year, thereby consolidating stabilisation and structural adjustment efforts that had been evident since June 1991. This development and the groundwork done by the Reserve Bank and the Government to move forward in liberalising the external sector enabled India to accept the obligations of Article VIII of the IMF in August 1994.

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13. Refer to chapter 15: Public Debt Management for further details on this development.

CHALLENGES TO MONETARY MANAGEMENT DUE TO  
MASSIVE CAPITAL INFLOWS

The continuous accretion to foreign currency reserves no doubt reflected a sustained improvement in the current account of the BoP and strong capital inflows, which included both foreign direct and portfolio investment. However, injections of large external liquidity posed problems for monetary management. Although capital inflows moderated somewhat in the second half of 1994–95, foreign reserves (including gold) touched an unprecedented level of US\$ 25.2 billion, equivalent to around 10 months of the country's imports. This was a far cry from the middle of 1991, when foreign reserves were adequate only to meet two weeks of import payments. As regards policy formulation, with the growing integration of the Indian financial system with international markets, the need to maintain internal consistency among the exchange rate, monetary and fiscal policies had become paramount.

The rise in the NFA of the Reserve Bank combined with a sizeable expansion in net domestic assets (NDA) in the last quarter of 1994–95 was responsible for a strong expansion in reserve money. However, the rising trend in the ratio of NFA to currency in circulation — an indicator of the quality of monetary management — was disquieting, because during a period of falling NFA, if domestic assets expanded rapidly, the pressure on international reserves might have been aggravated (Table 14.4).

TABLE 14.4  
*NFA/Currency Ratio*

<i>Year (end-March)</i>	<i>NFA/Currency in circulation</i>
1991	14.4
1992	29.6
1993	31.8
1994	60.2
1995	71.4

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

IMPACT OF CAPITAL INFLOWS ON MONETARY VARIABLES

In the Reserve Bank, policymakers were concerned about the impact of foreign capital inflows on monetary variables during the second half of 1994–95. An internal note in October 1994 expressed concern that based

on the prevailing trends; the increase in NFA that was estimated at the time of formulating the credit policy for the first half of the year might be surpassed by the end of the year. On the basis of the trends in reserve money expansion as on September 16, 1994, it was feared that if the NFA increased to US\$ 7.0 billion and the Centre utilised *ad hoc*s up to the ceiling of ₹ 6,000 crore, the expansion in reserve money could turn out to be ‘explosive’. In such an eventuality, the authorities contemplated taking recourse to huge OMOs equivalent to at least ₹ 7,000 crore. Moreover, the perception was that if the money multiplier turned out to be higher than it had been so far, open market on a substantially larger scale might be needed and for this purpose, 4.6 per cent non-marketable securities held by the Reserve Bank could be converted into marketable securities, such as, zero coupon bonds.

#### MONETARY POLICY RESPONSES

##### *Policy Framework*

The most crucial task for monetary management during 1994–95 was the mode of management of the strong surge in capital inflows. To elaborate, this came down to two issues: (i) how to frame policies to increase the productive use of foreign exchange; and (ii) the need to sterilise them to restrain inflationary pressures without raising real rates of interest. The first issue was not directly connected with monetary policy or central banking. The second one was more pertinent since the basic objective of policy was to bring about a reduction in the inflation rate while ensuring that the credit requirements of the economy, especially those of agriculture, small scale industry and weaker sections of society, were met. For the first time, monetary policy was ‘predicated’ on a specific 4.0 percentage points reduction in the inflation rate, which meant that the stance of policy was unequivocally one of tightening monetary control. The expansion in  $M_3$  was, therefore, proposed to be contained within the range of 14.0–15.0 per cent during 1994–95, as against 18.4 per cent in the previous year.

In his speech at the Bankers’ Club, Bangalore (now Bengaluru), on May 19, 1994, the Governor, Dr C. Rangarajan, articulated that a sea change had occurred in the factors operating behind monetary and credit expansion, and that the quantum jump in foreign exchange reserves, welcome as it was for several reasons, led to a subsequent expansion in primary money and monetary growth. He envisioned new responsibilities for the Reserve Bank in monetary management in the coming years as follows:

With the opening of the external sector, the transmission impulses from domestic to the external sector and vice versa are becoming powerful. Therefore, domestic monetary policy and policy relating to the external sector need to be harmonised. Stability of the real exchange rate depends crucially on the degrees of success achieved in holding down inflationary pressures. Thus, it is imperative that excessive monetary expansion should be avoided. The monetisation effect of large foreign capital inflows and the consequent inflationary impact on monetary expansion is a major concern. If the increase in net foreign exchange assets is large, it will be necessary to take various measures to offset their impact. In this context, active open market operations by the Reserve Bank in government securities would be an integral part of monetary policy endeavour to stabilise the inflows.

#### *Changes in Measures*

The credit policy responses to tackle the strong expansionary impact of the increase in the NFA took the form of a package of measures, which included an increase in CRR, a reduction in SLR, reduction in the export credit refinance limit and tightening of selective credit controls. More significantly, these instruments of control were supported by active OMOs to sterilise part of the capital inflow.

To contain the monetary consequences of a rapid rise in foreign exchange reserves from the second half of 1993–94, CRR was increased by 1.0 percentage point to 15.0 per cent that was spread over the period of June–August 1994. With the termination of the FCNR (A) scheme, there was a corresponding rise in deposits under other non-resident schemes that were subject to nil or low reserve prescriptions. This shift weakened the impact of the overall CRR. Therefore, from January 21, 1995, CRR under the FCNR (B) scheme was enhanced from 7.5 per cent to 15.0 per cent. Similarly, deposits under the NR(NR)RD scheme, which were exempt from reserve requirements, were subjected to a CRR of 7.5 per cent. Surprisingly, even after the imposition of these reserve requirements, the inflow under these schemes continued to be strong.

With the progressive movement towards market-related rates of interest on government borrowings, the justification for maintaining a high level of SLR lost its force. Therefore, while the incremental SLR was retained at 25.0 per cent, the base SLR was reduced in two equal instalments

from 34.75 per cent to 33.75 per cent on deposits as on September 17, 1993 (August and September 1994). Further, from October 29, 1994, SLR was fixed at 31.50 per cent up to the level of outstanding deposits as on September 30, 1994, and on the increase in deposits over that date SLR was prescribed at 25.0 per cent. In the pre-reform period, changes in SLR were invariably determined by the support needed to make the Government's annual market borrowing programme successful. However, this concept underwent a change as is evident from the notings of the Deputy Governor, Shri S.S. Tarapore, dated October 7, 1994:

We have long since crossed the Rubicon and the borrowing programme is no longer SLR-driven. Banks hold excess liquid assets of over Rs. 27,000 crore and bringing down SLR further does not affect the borrowing programme. Rather than large changes next year, we could effect a small change now. The shifting of the base year allows for a better presentation of the SLR prescription and is also more equitable between the older and newer banks.

The Governor went along with this exposition.

Deregulation of the minimum lending rate of banks was an important strategy of monetary system reform. There was a gradual but weakening trend in the inflation rate, which became pronounced by the first half of 1994-95. The Reserve Bank, therefore, considered that the time was opportune to deregulate the minimum lending rate for credit limits over ₹ 2 lakh from October 18, 1994. However, to shield the small borrowers with loans up to ₹ 2 lakh, the interest rates on the first two slabs continued to be administered. The lending rate for credit limits up to ₹ 25,000 was retained at 12.0 per cent and the rate for credit limits of over ₹ 25,000 and up to ₹ 2 lakh for all advances (including term loans) was fixed at 13.5 per cent. For credit limits above ₹ 2 lakh, banks were given the freedom to fix lending rates. Banks, with the approval of their board of directors, were required to declare their respective prime lending rates, which would be the minimum rate charged by them for credit limits of over ₹ 2 lakh uniformly at all branches. The deregulation of interest rate on the highest slab of bank advances was expected to stimulate healthy competition among banks and improve their operational efficiency.

The Reserve Bank discerned that a large proportion of savings deposit accounts were being operated essentially as current accounts and moreover the depositors were able to get rates of interest as high as 7.0 to 8.0 per cent for 46 days as in the case of term deposits. Therefore, the savings deposit

rate was reduced by 0.5 percentage points from 5.0 per cent to 4.5 per cent from November 1, 1994. The internal policy note prepared in the CPC in October 1994 envisioned that the abolition of the minimum lending rate and the eventual deregulation of the administered rate structure would give a fillip to the development of financial derivatives and also help evolve a 'reference rate' of interest.

While the minimum lending rate for advances over ₹ 2 lakh was deregulated in October 1994, the ceiling rate on term deposits continued to be administered. The Reserve Bank was conscious of this anomaly, but it preferred to deregulate deposit rates at the end of the deregulation process and after inflation was under firm control. In actual practice, in the absence of a 'reference rate' by the Reserve Bank, the maximum deposit rate prescribed by it served as an important signalling device for interest rate administration. On the other hand, the prevalence of a high inflation rate called for a positive real rate of return on bank deposits. The situation was compounded by the fact that bank credit expansion exceeded the increase in the resources of banks. Under these circumstances, the Reserve Bank devised a more stable asset-liability balance by raising the maximum term deposit rate by one percentage point from February 10, 1995, *i.e.*, from 'not exceeding' 10.0 per cent per annum to 'not exceeding' 11.0 per cent.

#### *Selective Credit Controls: A Review*

A critical assessment of the working of selective credit controls was done during 1994–95, which brought to the fore different viewpoints of the Government and the Reserve Bank.

In April 1993, the Ministry of Finance suggested that the Reserve Bank initiate a review by external experts of selective credit controls as a relevant credit policy instrument. However, the Reserve Bank was not keen on the proposal because this was an important instrument of monetary control available to it and had special relevance to developing countries like India that had to contend with growing fiscal deficits and the persistent overhang of liquidity, which generated inflationary pressures in the economy. Further, this measure restrained speculative hoarding of essential commodities, since any pressure on them would affect adversely the most vulnerable sections of society. The Reserve Bank in its reply concurred that the outstanding bank credit against sensitive commodities as a percentage of total outstanding bank advances was small and administrative measures played a small role in controlling price rise, but

countered that the ability of traders in these commodities to speculate with bank finance was not inconsiderable and that the impact of administrative measures supplemented by selective credit control would be greater in containing price rise. The letter added that in administering this tool, care had been taken that the legitimate production and distribution needs of the concerned sectors were not affected and that the complex nature of these measures had been greatly simplified since 1985. The Reserve Bank pointed out that a quick look at the policy responses in the past revealed several instances where the Government found that changes in selective credit controls provided support to its policy objectives. In particular, the Reserve Bank did not favour an in-depth study by outside experts because several such studies in the past had generally found that these controls had indeed been effective and had helped contain the price rise in sensitive commodities. Nevertheless, at the insistence of the Government, the Reserve Bank agreed in its letter dated April 5, 1994 to an external study.

The National Institute of Bank Management (NIBM), Pune, was entrusted with the study, which was completed in October 1994. Its main findings were: (i) during the 1960s and 1970s, in India, selective credit controls played a pivotal role and shouldered a major responsibility in containing inflationary pressures emanating mostly from speculation in sensitive commodities of agricultural origin; (ii) subsequently, the scope for speculative hoarding in these commodities diminished due to commercialisation of agriculture and existence of public sector agencies operating the distribution system; and (iii) the role of selective credit controls in credit policies was on the wane. The study, therefore, recommended a phased 'deregulation' of the structure of selective credit controls. A copy of the study was forwarded to the Ministry of Finance. The Economic Survey, 1994–95, nevertheless, took a favourable view of selective credit controls, *viz.*:

...a role in inflation control in a closed economy with short-run inelasticity of supply. By increasing the cost and reducing the availability of credit for stock accumulation, the build-up of inflationary expectations can be moderated. Delicensing of imports along with appropriate tariffs can, however, be more effective and also more efficient as it increases the supply.

## CONTINUATION OF RESTRICTIVE MONETARY POLICY (1995–96)

Monetary and financial developments during 1995–96 were dominated by the interface between external sector developments, especially the foreign exchange market, and the behaviour of the related domestic financial markets.

### DOMESTIC MACROECONOMIC ENVIRONMENT

The Reserve Bank continued its tight monetary policy during 1995–96, since the growth in  $M_3$  at 22.2 per cent (up to March 17, 1995) was higher than 18.4 per cent in 1993–94. This was viewed as well beyond what could be considered desirable after taking into account the expected increase in real output. The money multiplier had risen to 3.27 in the 1990s from 3.10 in the 1980s. Since the strong demand for funds from both the government and commercial sectors drove up interest rates, the Reserve Bank strove to achieve a delicate balance between money, output and prices. To a great extent, the Reserve Bank succeeded in bringing about a subdued increase in  $M_3$  of 13.2 per cent during the year, which was lower than the long-run annual average of about 17.0 per cent. The success in this regard should be viewed with caution. As pointed out by the Reserve Bank in its Annual Report for 1995–96, the lower growth in  $M_3$  was largely due to the unusually high base of March 31, 1995 caused by an unprecedented increase in the deposits of SCBs by as much as ₹ 20,161 crore as on the last Friday of March 1995. However, if one were to take the preceding reporting Friday, *i.e.*, March 17, 1995 as the base, the  $M_3$  growth worked out to only 17.9 per cent.

The continued buoyancy in economic activity was reflected in the performance of the economy during 1995–96 with an estimated GDP growth of about 7.0 per cent (6.4 per cent in 1994–95). A welcome feature was the reduction in the inflation rate to 7.7 per cent on the basis of movements in the WPI on average basis (or 5.0 per cent on point-to-point basis). The average rate of inflation measured in terms of changes in the WPI from 1990–91 to 1994–95 at 10.7 per cent exceeded the long-term average of 6.3 per cent for the period 1950–51 to 1989–90. In 1995–96, inflation on average basis abated to 7.7 per cent as against 10.9 per cent in 1994–95, which was made possible by prudent demand management as well as supply management of essential commodities. The substantial gains on the inflation front during 1995–96, juxtaposed against the slower

expansion in  $M_3$  and reduction in the fiscal deficit from 6.7 per cent of GDP in 1994–95 (RE) to 5.5 per cent in 1995–96 (BE) was a matter of satisfaction for the Reserve Bank. Its Annual Report for 1995–96 predicated that it was possible to target inflation without hurting real activity and that, in a more fundamental sense; inflation targeting had to be part of the known transmission mechanisms of monetary policy. The Economic Survey for 1995–96 took the view that the opening up of international trade in agricultural commodities had also contributed to the success of active supply management of essential agricultural products.

The year was exceptional due to the fact that the Government found it difficult to finance its borrowing needs despite a rise in interest rates on account of lower non-bank sources of financing. This resulted in large monetisation of fiscal deficit, and *ad hoc* Treasury Bills exceeded the within-the-year gap on net issues for extended periods of the year. Unlike the preceding year when much of the created money emanated from an increase in Reserve Bank's NFA, the increase in created money in 1995–96 was attributable to credit to the Government by the Reserve Bank. A reduction in NFA to ₹ 2,575 crore (till September 29, 1995) in contrast to a large increase of ₹ 12,688 crore in 1994–95 moderated the expansion in reserve money.

#### MONETARY POLICY RESPONSES

Monetary policy for 1995–96 was framed against the backdrop of double-digit inflation in the previous two years and robust growth in real GDP. The thrust of monetary policy was accordingly on moderating monetary expansion, consistent with the expected growth in real output and a relatively tolerable rate of inflation. Given the expected high growth, the financing needs of the economy were considered relatively large. To ensure that development needs were met, it was considered essential to provide incentives for deposit mobilisation. The Reserve Bank, therefore, increased the maximum deposit rate by one percentage point to 12.0 per cent from April 18, 1995 to enable banks to mobilise more term deposits to finance their growing loan operations. However, when an acute problem of volatility emerged in the foreign exchange market in the second half of the year, the Reserve Bank intervened in the market, which impinged on domestic liquidity. It was only after stabilising the foreign exchange market that the Bank could take measures to ease pressures in the money market and enable banks to meet the rising credit demands in the context of growth in real output. Liquidity injection mainly took the form of money market support

through reverse repo transaction arrangements with the Securities Trading Corporation of India Ltd (STCI) and the DFHI. Intervention, in turn, was supported by measures such as imposing an interest surcharge on import finance effective October 1995 and tightening of concessionality in export credit for longer periods. On November 11, 1995, CRR was reduced from 15.0 per cent to 14.5 per cent and further to 14.0 per cent from December 9, 1995, which augmented the resources of banks by about ₹ 4,000 crore. Several policy initiatives were taken in a phased manner to reduce CRR prescriptions for non-resident deposit schemes. These actions served the dual purpose of not only easing domestic liquidity but also encouraging the inflow of funds into the foreign exchange market by providing more incentives to banks to mobilise non-resident deposits.

The other measures introduced in the second half of the year were freeing interest rates on domestic term deposits with maturity of over 2 years, enhancing the limits for refinance to banks against government and other approved securities and raising the ceiling interest rate on term deposits in NR(E)R accounts by 2.0 percentage points.

#### A PROTRACTED DEBATE ON THE CREDIT CRUNCH

Monetary and banking trends exhibited some unusual features in 1995–96. Increase in  $M_3$  and growth in deposits were below past trends, while bank credit expanded sharply. This generated an animated discussion in banking and industrial circles, as the latter expressed the view that growth had been impeded by a restrictive monetary policy that emphasised price stability. With the base as March 31, 1995, non-food credit expanded by 22.1 per cent by March 31, 1996 and the increase in non-food credit in absolute terms between March 17, 1995 and March 31, 1996 was ₹ 54,684 crore compared with an increase of ₹ 45,777 crore in the corresponding period in the previous year. In fact, such a large credit expansion was partly facilitated by a series of monetary policy measures that augmented the lendable resources of banks through CRR reductions.

The Governor, Dr C. Rangarajan,<sup>14</sup> responded to the criticism. Terming the conduct of monetary policy in 1995–96 as having received more than ‘normal’ attention, the Governor stated that monetary policy had to be tight at certain points to prevent the flow of funds from the domestic money market to the foreign exchange market, which was exerting

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14. Rangarajan, C. (1997). “Dimensions of Monetary Policy”, *Anantharamakrishnan Memorial Lecture*. Chennai. February 7.

pressure on the rupee. However, as the situation changed, the policy direction also changed. He articulated that though the rate of monetary expansion had moderated, this was not true of bank credit expansion. Despite low deposit growth, credit expansion was large in 1995–96 because of successive lowering of CRR and the consequent augmentation of lendable resources of banks. The INFCDR was high at 96.0 per cent, while investments of commercial banks in government securities during the year were much less. As a result, the Reserve Bank had to contribute almost 33.0 per cent of the government's borrowing programme. The Governor rebutted complaints from the corporate entities about the liquidity crunch despite sizeable expansion in non-food credit in 1995–96. First, part of the liquidity crunch should be traced to the decline in funds that the corporate sector was able to raise from the domestic capital market and foreign issue of GDRs, which recorded a substantial decline in relation to both these sources compared with the previous year. Second, bank credit could not be a total substitute for these sources. The Governor also made a pointed reference to the fact that since November 1995, monetary policy measures had been in the direction of easing rather than tightening.

Earlier, in March 1996, the Deputy Governor, Shri S.S. Tarapore, at the meeting organised by the Confederation of Indian Industry (Western Region) had set out in a forthright manner the Reserve Bank's views on this vexatious issue of liquidity crunch. The address, aptly titled: *The Liquidity Crunch: Facts and Fiction*, termed this problem as a 'debate of unprecedented intensity'.<sup>15</sup> Referring to similar occasions in the past (*i.e.*, 1981–82 and 1991–92), he stated that in these two years the absolute level of credit from the banking sector was 'crushed' to lower absolute amount of increase than in the corresponding previous years. Regarding the argument that the total resource flow from bank and non-bank resources was the same in 1995–96 as in 1994–95, he answered that there was no substance in the argument that the potential of the economy had been stunted because of shortage of credit. On the question whether monetary policy was too tight and warranted relaxation, he pointed out that while  $M_3$  growth during the period from March 17, 1995 to February 6, 1996 was 13.0 per cent as against 15.8 per cent in the previous year, the latter growth was one of 'unbridled' expansion and it would not be prudent to take the previous year as a good indicator of the desired pace of monetary

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15. Tarapore, S.S. (1996). *The Liquidity Crunch: Facts and Fiction*. Address at the meeting organised by the Confederation of Indian Industry (Western Region): Mumbai. March 8.

expansion. He took pains to counter the demand from business circles that, since the real rates of interest were on the higher side, interest rates should be lowered, as follows:

Be as it may, it would be extremely imprudent to try and artificially reduce interest rates by increasing the flow of created money from the central bank as such a course of action will only cause a sharp resurgence of inflation and thereby merely flare up nominal rates of interest. There is, therefore, no easy way out. If created money could bring about a general reduction in real rates of interest and promote growth, surely all countries would use this panacea. A country following the path of pump-priming in such a situation would be taking recourse to a reckless policy which would eventually abort growth. Large injection of created money would result in a large monetary expansion and consequently inflation would accelerate and such creation of money can make no contribution to the real growth of the economy. While small adjustments in the form of policy responses can be considered depending on the evolving monetary and credit situation, it would be most imprudent on the part of the Reserve Bank to try and fill the gap between the availability of resources and the 'desired' level of resources by created money.

Continuing in the same vein, to the argument that a liquidity crunch brought about by escalating interest rates would damage industrial growth, the Deputy Governor commented that a permissive policy of monetary expansion would be detrimental to the interests of industrial growth, because an acceleration in inflation would force nominal interest rates to rise to even higher levels; and to finance inventories at higher levels, demand for credit would rise even faster and, in the process, aggravate the tight credit conditions.

In his summing up, Shri Tarapore reminded the audience that the pressure on liquidity was a symptom and not the cause of the ailment; the ailment was the problem of scarce means with alternative uses, and unless demand for resources was realistic and reflected the available resources, interest rates would remain high and liquidity continue to be tight. "Expanding money supply when the net foreign exchange assets are rising is one thing, but expanding money when the net foreign exchange assets are falling is quite another," he stressed. His final point was that the

relatively large expansion of domestic assets of the Reserve Bank in that financial year clearly pointed to the need for continuing caution. Focussing on the dilemma faced by the central bankers in developing economies, he averred:

While a cautious policy is often criticised as being an unrealistic ivory tower approach to practical problems, yielding to these pressures would be tantamount to an irresponsible monetary policy. This is the cross the monetary policy has to bear in the best interests of the economy.

Some press comments attributed the liquidity crunch in 1995–96 to the rigid monetarist stance followed by the Reserve Bank. Finally, the authoritative views of both the Reserve Bank and the Government on this topic could be gleaned from the Reserve Bank Annual Report and the Economic Survey for the year 1995–96. The Reserve Bank took the stand that while borrowers had voiced some concern regarding the insufficiency of credit, all indicators showed that the flow of credit to the productive sectors had been well maintained, credit drawals continued to be well below the credit limits and, therefore, there was very little substance in the argument that government borrowing had ‘crowded out’ credit for the private sector. It added that all sectors of the economy must recognise the need for a more efficient use of credit.

The Economic Survey, 1995–96 also reiterated that the facts did not support complaints regarding a liquidity crunch and crowding out by government borrowing. But the subsequent Economic Survey 1996–97 modified its stand with the comment that the Reserve Bank might have overreacted when it observed that the tightening of monetary policy in 1995–96 to counter the inflationary effect of the surge in capital inflows and the resulting faster monetary growth in the previous year might have been too ‘sharp’. Further, it added:

The policy has since been adjusted during 1996–97 to bring it in line with targets which are still valid. We must now be careful to avoid over-compensating in the opposite direction by easing money supply too far above the target level, and thus building up inflationary pressures in the next year. Any short-term temptation of depending solely on monetary policy to solve problems arising from other policy imperatives should be avoided.

The episode of the 1995–96 liquidity crunch remained a subject of debate for more than a year.

## MOMENTOUS YEAR FOR MONETARY MANAGEMENT (1996–97)

The year 1996–97 was significant for the conduct of monetary policy in India in a number of ways. For the first time, CRR was reduced sharply by 4.0 percentage points within a period of one year. The net sales of government securities under OMOs registered a record level of ₹ 10,435 crore. The contraction in the CAD and resurgence of capital inflows in 1996–97 culminated in substantial excess supplies of foreign exchange in the market. Hence, the Reserve Bank undertook regular purchases of US dollars amounting to US\$ 7,801.0 million (₹ 27,037 crore) during 1996–97 to prevent nominal appreciation of the rupee. The resultant improvement in liquidity together with CRR cuts was so strong at the short end of the market — particularly in the second half of 1996–97 — that the repo operations that had been discontinued since February 3, 1995 had to be revived in November 1996. The Reserve Bank made conscious efforts to reduce its reliance on direct instruments of monetary control, especially the administered structure of interest rates. OMOs, including repo transactions, emerged as the principal policy tool. The interest rate instrument was sought to be developed by reactivating the Bank Rate as a signalling device to the market, along with the provision of the general refinance facility. The operating procedures of monetary policy also necessitated close co-ordination between liquidity management and debt management, as well as between liquidity management and institutional developments, for it had become necessary to evolve and put in place appropriate risk management strategies for efficient functioning of the financial markets.

The Reserve Bank's task was greatly facilitated by the Government's recognition that the key to providing flexibility in the conduct of monetary policy depended on control over fiscal deficit. The signing of the first supplemental agreement between the Reserve Bank and the Central Government on September 9, 1994 to phase out the issue of *ad hoc* Treasury Bills by the end of fiscal year 1996–97 marked an important step in achieving this goal. The system of *ad hoc* Treasury Bills was discontinued from April 1, 1997 consequent upon the signing of the second supplemental agreement between the Government and the Reserve Bank on March 26, 1997.

## NEW STRATEGY OF MONETARY MANAGEMENT

The formulation of monetary policy during 1996–97 underscored a 'blended' pursuit of short-term fine-tuning and long-term objectives of monetary policy. The short-term policies attempted to address the immediate concerns that had arisen out of developments during the previous year and hence were specific to 1996–97. The long-term policies focused on institutional changes aimed at securing a greater degree of manoeuvrability in the management of liquidity in the economy and bringing about greater integration of the various financial markets. Accordingly, the Reserve Bank adopted a stance of cautious monetary policy in 1996–97, which in the main attempted to sustain the lower and stable level of inflation achieved during the previous year, while ensuring that the legitimate credit requirements of all sectors of the economy were met.

It is worth noting that the long-term policy affirmed the firm commitment of the central bank to pursuing a low and stable order of inflation by specifying the order of expansion in  $M_3$  that would be used as an intermediate target to realise the core policy objectives. The Reserve Bank's commitment to price stability was reiterated in its Annual Report for 1996–97 as follows:

In the case of India, both output expansion and price stability are important objectives, but depending on the specific circumstances of the year, emphasis is placed on either of the two. Increasingly, it is being recognised that central banks would have to target price stability since real growth itself would be in jeopardy if inflation rates go beyond the margin of tolerance.

To contain the rate of inflation at around 6.0 per cent during 1996–97, the Reserve Bank projected the rate of expansion in  $M_3$  during the year at 15.5–16.0 per cent. The policy for 1996–97 addressed two immediate concerns, *i.e.*, reducing high real interest rates and making available larger lendable resources to the system. Structural changes, aimed at improving and strengthening the efficacy of the instruments of monetary control were also simultaneously pursued.

## MONETARY POLICY RESPONSES

Monetary policy for the first half of 1996–97 (announced on April 3, 1996) contained a package of measures devised to support productive activity by easing the resource availability of banks without jeopardising

the objectives of monetary and exchange rate stability. The two immediate concerns of the authorities in the early part of the year were the high rates of interest and the declining trend in credit growth. The average CRR was reduced by one percentage point to 13.0 per cent in two phases of 0.5 percentage points each (April 27 and May 11, 1996), which augmented the lendable resources of banks by about ₹ 3,800 crore. Further, CRR on NRE deposits was reduced to zero, which released ₹ 1,400 crore. However, the rationalisation of export refinance initially resulted in reducing the limits which, however, was expected to be temporary. Interest rates on NRE term deposits of over 2 years were freed. Again, in order to rationalise CRR *vis-a-vis* the refinance facility against government and other approved securities (which, in any case, had not been utilised) and to impact favourably on banks' profitability, CRR was lowered from July 6, 1996 to 12.0 per cent.

As part of the rationalisation of CRR and refinance facilities from the Reserve Bank, sector-specific refinance facilities were either eliminated or curtailed considerably. The refinance facility against government securities was withdrawn from July 6, 1996. Export credit refinance to commercial banks under the first tier of the formula was diminished from 45.0 per cent to 20.0 per cent (effective April 13, 1996) of the total outstanding export credit eligible for refinance over the level of credit as on February 16, 1996. On an incremental basis, however, the export credit refinance to the extent of 100.0 per cent of the increase in outstanding export credit eligible for refinance over the level as on February 16, 1996 continued.

To provide banks with greater flexibility, banks were given the freedom to fix from July 2, 1996 their own interest rates on domestic term deposits of over one year as against the earlier stipulation of over two years applicable from October 1, 1995. The minimum maturity period of term deposits was shortened from 46 days to 30 days to offer some outlet for management of short-term funds with the progressive move away from the cash credit system to loan system.

As the year progressed, time deposits recorded strong growth, which substantially eased the liquidity situation. In the second half of the year, capital inflows resumed, but demand for credit from the corporate sector was relatively low mainly due to slack industrial production. These two contrasting developments contributed to a decline in nominal interest rates at the shorter end. Surprisingly, interest rates at the longer end displayed marked stickiness, partly because inflationary expectations had not yet weakened. The consequent increase in the term spread, particularly in the second half of 1996–97, impelled active liquidity management by

the Reserve Bank to ensure that the overall liquidity in the system did not build up inflationary pressures and the interest rate and exchange rate remained relatively stable.

Despite the softening of interest rates in May, the lending rates of banks continued to rule high. The Reserve Bank came round to the view that the interest rates charged by banks should be made sustainable and must reflect the lower cost of funds emanating from reduced levels of CRR and SLR prescriptions. Measures were taken in October 1996 to augment the lendable resources of banks without excessive monetary expansion and inflation, to improve the credit delivery system and to bring down the cost of credit. CRR was lowered by two percentage points to 10.0 per cent in four phases of 0.5 points each on October 26, 1996, November 9, 1996, January 4, 1997 and January 18, 1997, respectively. The credit policy circular to banks dated October 19, 1996 advised that the reduction in CRR should not be viewed only as a response to certain short-term developments, but as part of the plan to restructure CRR and refinance regime through a simultaneous reduction in reserve requirements and refinance entitlement. Export credit finance limits were rationalised.

An internal review carried out at the end of December 1996 evaluated that notwithstanding the prevailing comfortable monetary and price conditions, the last phase of reducing CRR envisaged for January 4, 1997 might be effected. The Deputy Governor, Dr Y.V. Reddy, agreed with the assessment and made his perceptions known. In his opinion, there was some risk in having larger-than-desired monetary expansion and excess liquidity, though it was 'manageable' through OMOs as and when warranted. He added that there was no question of going back on CRR increase as it would have a highly 'disruptive' influence by giving a jolt to market participants and, more importantly, convey the message that the monetary and price developments were not favourable.

#### ENDEAVOURS TO RE-ACTIVATE THE BANK RATE

The Reserve Bank attempted to re-activate the Bank Rate by linking the interest rates of significance to it, in terms of credit policy circular dated April 15, 1997. It also became the rate at which refinance to banks was granted. The Reserve Bank expressed the hope (in the Annual Report for 1996–97) that this would facilitate its emergence as the 'reference rate' for the entire financial system. Proceeding further in this direction, from April 16, 1997 the maximum deposit rate for maturity for 90 days and up to one year was linked to the Bank Rate by prescribing as 'not exceeding'

the Bank Rate minus two percentage points per annum, which implied that the applicable rate would be 9.0 per cent. Further, all interest rates on advances from the Reserve Bank — besides the penal rates on shortfalls in reserve requirements — were linked to the Bank Rate.<sup>16</sup>

While on this subject, it is useful to refer to two instances where the feasibility of a more active deployment of Bank Rate was contemplated by the authorities since the early 1990s. There was a memorandum submitted to the Committee of the Central Board of Directors of the Reserve Bank in March 1990 that arrived at the following important conclusions. First, in India, the Bank Rate had a limited significance as a policy instrument mainly because of an administered structure of interest rates and the absence of a direct link between the Bank Rate and several interest rates of significance, especially the refinance rates of the Reserve Bank. Second, changes in the Bank Rate did not induce ‘cost effect’ and ‘announcement effect’. Third, the Bank Rate had got increasingly distanced from the refinance rates because the latter were changed several times during the 1980s, while the Bank Rate had remained unchanged since July 1981. “The signals of change in policy has thus emanated not from the Bank Rate, but from the refinance rates”, the memorandum observed. Fourth, even where certain rates were linked to the Bank Rate, they had been either formally delinked or effectively delinked by altering the margins between the particular rates and the Bank Rate. But there were still some rates in the system linked to the Bank Rate, such as accommodation to the state governments, short-term accommodation to financial institutions and penalties on defaults in reserve requirements. Fifth, the fiscal-monetary relationship in the Indian context had worked to minimise the effectiveness of the Bank Rate by the budget deficit being the major constituent of reserve money creation. Nevertheless, the memorandum concluded on an optimistic note that if and when it was decided at some future date to move away from sector-specific refinance to general refinance, the Bank Rate could once again become a major instrument of policy.

An internal group on the Bank Rate (constituted by the Reserve Bank) in its report submitted in March 1997 expressed the view that certain pre-conditions had still to be met if the Bank Rate had to be used effectively as an instrument of monetary policy. The more important of them

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16. Incidentally, the Bank Rate was reduced to 11.0 per cent from the close of business on April 15, 1997, to 10.0 per cent from the close of business on June 25, 1997 and further to 9.0 per cent from the close of business on 21, October, 1997.

were moderation in the Central Government's GFD, discontinuation of automatic monetisation of budget deficit, move away from sector-specific refinance to general refinance, active conduct of OMOs, deregulation of interest rates and gradual reduction in reserve requirements. It noted that the process of moderation in fiscal deficit and phasing out automatic monetisation of the budget deficit through creation of *ad hoc* Treasury Bills had begun. The report contemplated several measures to improve the effectiveness of the Bank Rate, namely, doing away with all sector-specific loans and advances/ refinance facilities at different rates so that the Bank Rate would be the rate at which advances were provided to banks (instead of such interest rate being linked to the Bank Rate), and a movement away from both export credit refinance facility and concessional interest rate, with a simultaneous setting-up of a generalised refinance window/ liquidity adjustment facility (LAF) linked to the Bank Rate. Clearly the internal group's influence was manifest in the credit policy circular of April 15, 1997.

#### RELATIONS BETWEEN THE RESERVE BANK AND THE GOVERNMENT

The conduct of monetary management during the prelude to the BoP crisis and in the thick of the crisis from 1989–90 to 1991–92 proved to be somewhat stressful since fiscal restraint and containment of monetisation of government deficit had been elusive. Inflation control found paramount importance in the Reserve Bank's correspondence with the Government. The policy and operational framework, however, underwent some significant changes with the onset of a comprehensive package of economic and financial sector reforms since mid-1991 as an integral part of the overarching shift in the economic policy regime. The change implied that while the conventional objectives of price stability and promoting economic growth through appropriate credit flows should be pursued, the framework for the Reserve Bank in operating its various policy instruments needed to be attuned with the emerging liberalised environment in the financial sector without jeopardising monetary and financial stability. The shift in the economic regime also required that the Reserve Bank's policies be framed in tandem with those of the Government and other stakeholders in the system. This necessitated exchange of views and close consultation on a variety of issues — both relating to policy and operations — between the two authorities. The select interactions relating to shaping of monetary policy and related matters are briefly dealt with in this section.

## NEED TO CONTAIN FISCAL DEFICIT AND ITS MONETISATION

As early as in December 1988, the Reserve Bank appraised the Ministry of Finance of the unmistakable indications of imbalances building up in the components of the BoP of the country. An internal review in May 1989 confirmed that the situation continued to be perilous at the beginning of 1989–90, especially because the foreign exchange reserves were depleting at a rapid pace. This prompted Governor Malhotra, in his letter dated May 24, 1989 to the Finance Minister, Shri S.B. Chavan, to suggest, *inter alia*, that domestic inflation should be brought down from 8.0–9.0 per cent to less than 5.0 per cent and for this purpose, special attention needed be paid to containing fiscal deficit (during 1989–90) to the level actually achieved in 1988–89 by reducing unnecessary government expenditure, careful pruning of imports on government account and a review of the trade policy.<sup>17</sup>

The substantial liquidity growth and the attendant pressure on the price level were strongly in evidence in September 1989. Moreover, the Reserve Bank was constrained in the deployment of CRR as it had reached its statutory ceiling of 15.0 per cent. The Reserve Bank brought this disturbing situation to the notice of the Principal Secretary to the Prime Minister in September 1989. The main thrust of the letter was the need to supplement monetary by strong fiscal measures and for an effective anti-inflationary package.

During 1989–90, the expansion in  $M_3$  was 19.4 per cent, compared to 18.1 per cent in 1988–89. The rate of increase in  $M_3$  in 1989–90 was the highest since 1978–79, whereas the indicative monetary target for 1989–90 as set out in the note to the Cabinet Committee on Economic Affairs (CCEA) was 16.1 per cent. Governor Malhotra, in his letter to the Finance Minister, Prof Madhu Dandavate, dated April 28, 1990 conveyed his deep concern that the very large increase in overall liquidity would inevitably put pressure on prices which were already on the uptrend. Despite two good harvests in 1988–89 and 1989–90, the WPI rose by 8.4 per cent on a point-to-point basis in 1989–90 and the pressure on prices was expected to persist in 1990–91. The main factor that propelled this expansion was the net Reserve Bank credit to the Central Government.

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17. In the main, the letter to the Government stressed the need for the Government to take strong measures to check the deterioration in the CAD. Refer to chapter 5: Balance of Payments and Exchange Control for more details.

In order to contain this monetary variable within agreed limits, the Reserve Bank urged the Government to make concerted efforts from the early 1990–91 onwards to adhere to the budgeted deficit for the year. The Reserve Bank also emphasised that the budgeted deficit and the net RBI credit to the Central Government should not rise to very high levels during the major part of the year and then nominally attain the target at the end of the year; the average level of created money during the course of the year was even more important than the level at the end of the year; and, finally, specific targets should be set on a quarterly basis for the budget deficit and net RBI credit to the Central Government.

RESERVE BANK TO OVERSEE THE OPERATIONS OF FINANCIAL INSTITUTIONS  
AS AN ADJUNCT TO MONETARY MANAGEMENT

The Governor, Shri R.N. Malhotra, decided to expand the Reserve Bank's supervision to developmental financial institutions (DFIs) and other financial intermediaries in the early 1990 on the analogy of similar action by the Swiss National Bank, which extended banking supervision to financial intermediaries and investment banks. In the case of Switzerland, the main considerations were to ensure smooth functioning of credit and capital markets, complement the protective measures of capital market legislation *vis-a-vis* the investment banks and promote competitive neutrality between financial market institutions, both domestic and international.

*Queries Raised by the Ministry of Finance and  
Reserve Bank's Reply*

The Ministry of Finance raised several queries over this initiative. The Finance Secretary, in his letter dated October 1, 1990 to the Governor, advised that it had learnt from the news reports that the Reserve Bank had started to monitor the working of DFIs, which apart from collection of information from them, involved co-ordination of activities of the FIs and banks. The main issue raised by the Government was that the Reserve Bank's action would tantamount to a major 'shift' from the existing practice on three counts. First, under the Industrial Development Bank of India (IDBI) Act, the IDBI was the principal FI for co-ordinating in conformity with national priorities the working of institutions engaged in financing, promoting or developing industry. Second, the Reserve Bank under its Act could call for statements and particulars relating to their business from banking companies and it was not clear whether the monitoring of FIs and the assessment of the quality of assets and their activities needed legal

amendments. And, third, the IDBI and other FIs were expected to play an activist and developmental role with a measure of autonomy and for this reason, the IDBI had been separated from the Reserve Bank about a decade ago.

The Governor, in his reply dated October 10, 1990 to the Finance Secretary, clarified that he had in his earlier letter dated May 18, 1990 (to the Government) already spelt out the need for a comprehensive oversight over the entire financial system, the fact that the Reserve Bank already had legal backing for undertaking such a task and outlined the steps proposed to be taken in the immediate future. He added that in the Reserve Bank's Annual Report for 1989-90, there was a specific reference to the growth of non-bank financial institutions, the need for taking an integrated view of the financial system and what the Reserve Bank intended to do in this regard. It was also pointed out that this aspect had come up for discussion at the Central Board meeting (in which the Finance Secretary was present) wherein the approach indicated in the report was fully endorsed.

Further, the Reserve Bank averred that the RBI Act had been amended to include chapter III B to enable it to exercise a 'comprehensive oversight' of the entire financial system for the purpose of regulating the credit system to the country's advantage. The Reserve Bank was cognisant that different FIs had different roles to perform and the relevant sections of the RBI Act themselves had laid down that, in issuing any direction to any FI, the Reserve Bank should have 'due regard' to the conditions in which and the objects for which the institution had been established and its statutory responsibilities. The Governor assured the Government that in initiating measures for periodic monitoring of operations and assessment of the health of the FIs, there was no intention to detract from the role that had been assigned to the IDBI as the principal institution for co-ordinating the activities of all-India and state-level term-lending institutions in their respective areas.

The Reserve Bank also advised in this letter that the Governor had discussed the matter with the chairman of the IDBI and the latter had indicated that he would have no difficulty in furnishing the Reserve Bank with the requisite information or for the Reserve Bank looking at the health of the asset portfolio, but in doing so he wanted the role of the IDBI as a co-ordinating agency to be kept in view. Moreover, the Reserve Bank reasoned that FIs were already providing information to it in various formats and the intention of setting-up the financial institutions cell (FIC) in the Reserve Bank was to streamline the monitoring of information

it received and to have more structured discussions with the FIs. To strengthen the Reserve Bank's stand, the Governor astutely introduced the monetary policy angle:

Our objective is broadly to monitor and oversee, within the current legislative framework, the operations of financial institutions as an adjunct to monetary and credit policy. The role of the Reserve Bank in relation to financial institutions has to be seen essentially in terms of the need for a macro-perspective of monetary and credit policy, assessing the quality of assets of the financial system and improving co-ordination between banks and financial institutions.

#### *Government's Conditional Acquiescence*

The Government, in its letter dated October 18, 1990, opined that notwithstanding the clarifications offered by the Reserve Bank in the letter, it expected that before specific proposals were finalised, the latter would consult them. It was emphasised that a general discussion took place at the Board meeting pertained to the desirability of the Reserve Bank maintaining an oversight of the entire financial system but no specific decisions were taken. The Finance Secretary suggested that it was desirable to clearly identify the role of the FIC set up in the Reserve Bank. First, the cell would be concerned only with compiling and analysing the data received from FIs necessary for a macro perspective and credit policies and not develop into a cell for co-ordinating or supervising the activities of FIs. Second, the Reserve Bank could have periodic dialogues at the Governor's level with the top management of the FIs to discuss matters of mutual interest. Third, policy matters that called for joint action of banks and FIs, e.g., synchronisation of term loans and working capital loans, handling of sick units might be dealt with by the Reserve Bank. Fourth, the Reserve Bank could continue to take decisions in regard to the interest rate of FIs after appropriate consultations. Last, the market borrowings for FIs were within the purview of the Reserve Bank in consultation with the Government. More importantly, the Government indicated that: "in order to avoid duplication of functions and authority" the Reserve Bank should not get involved in operational matters of FIs without its 'concurrence', in individual cases or periodic assessment of the assets of the institutions.

The Governor, in his letter dated November 26, 1990 to the Finance Secretary, agreed with the responsibilities of the Reserve Bank as outlined

in the Government's letter, but still felt that it was essential for the central bank to assess broadly the quality of the assets of the FIs that had grown over the past decade and stood at about half the assets of commercial banks. Further, the Reserve Bank clarified that it proposed to make periodic assessments on the basis of data supplied by the FIs and not preceded by onsite inspections. Finally, the Reserve Bank urged that its intention was to: "establish a monitoring system which served its purpose without interfering with the functional autonomy of the institutions or with the co-ordinating roles of apex institutions."

Before the Government could take a view on the Governor's letter, the Governor, Shri R.N. Malhotra, tendered his resignation as of December 22, 1990, though he had not completed his extended term. While this event had no parallel with the earlier event of the resignation of the Governor, Sir B. Rama Rau in January 1957,<sup>18</sup> his successor, Shri S. Venkitaramanan, a former Finance Secretary, had to deal with this issue with the Government.

#### *Issue Resurfaces and its Resolution*

The Finance Secretary, Shri S.P. Shukla, in his letter dated March 19, 1991 to the Governor, Shri S. Venkitaramanan, reiterated that the Government would not be in favour of any 'examination' of the portfolios of FIs in so far as they related to individual companies, but the Reserve Bank could seek from them data of an aggregate nature that affected the recycling of credit by FIs and impinged on monetary and credit flows. This was in the context of the stand taken by the Reserve Bank that it would like to make periodic assessment of the quality of the assets of FIs without getting involved in operational matters.

The Governor in his letter dated May 6, 1991 affirmed that the Reserve Bank's response in the recent past had been towards developing a 'sharper' macro policy focus and a more 'efficient and purposeful monitoring' of FIs, and that the information obtained from the IDBI and other FIs would give it a useful feedback on macro aggregates and thereby enable formulation of a more effective monetary policy. Next, the Governor stated that while the Reserve Bank had already indicated to the FIs what it 'intended to do' as regards broad classification of assets according to their health, the Government's letter appeared to convey some anxiety regarding

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18. An absorbing account of the events leading to the resignation of the Governor, Sir B. Rama Rau in January 1957 is given in the second volume of the Reserve Bank of India history, *The Reserve Bank of India (1951-1967)*.

what the Reserve Bank 'should not do'. He emphasised that an assessment of the quality of financial assets of the institutions was an integral part of the monitoring mechanism, at the same time conceding that it was not its intention to focus primarily on individual companies. The letter also pointed out that in an increasingly sophisticated financial system the flow of funds was inevitably intertwined, and there could be occasions when the Reserve Bank had to take an integrated view in individual cases. The Governor's observation: "I am afraid that reluctance to allow RBI an oversight of the quality of financial assets of financial institutions is inconsistent with the expressed desire to have a better monitoring of the monetary and credit system through RBI" marked a hardening of the stance as compared with that of his predecessor. However, in the concluding part of the letter, the tone was conciliatory, *viz.*:

As you are aware, the existing provisions of the Reserve Bank of India Act give adequate powers to enable the Reserve Bank to undertake the kind of monitoring we intend to do and I hardly need stress that the Reserve Bank would always operate within the confines of the Act. In fact, in the context of the forthcoming negotiations with international agencies on financial sector reforms, it would be useful to stress the role the Reserve Bank can play in taking an integrated view of the operations of both banks and financial institutions. The powers of oversight over the credit system have increasingly been vested with the central banks in other countries and I urge that we move in the same direction. Fortunately, the powers already exist. I would, therefore, feel that any step we take should be in the context of these powers and not in the direction of their dilution.

RESIGNATION OF THE GOVERNOR, SHRI R.N. MALHOTRA  
(DECEMBER 22, 1990)

The sudden and abrupt resignation of the Governor, Shri R.N. Malhotra, and his being replaced by Shri S. Venkitaramanan on December 22, 1990 cast a shadow over relations with the Government. Even though this incident was not comparable with the resignation of the Governor, Sir B. Rama Rau, in January 1957, (referred to earlier) his graceful exit was the culmination of the growing differences between the finance ministry and the Reserve Bank on various issues.

Besides steadfastly maintaining a strong stance on controlling inflation by moderating fiscal deficits and trying to uphold the Reserve

Bank's responsibility as a monetary authority in an environment of fiscal profligacy, Governor Malhotra's reign of over six years was notable for successful efforts to make the financial system more flexible and competitive. He implemented in a dedicated manner the wide-ranging recommendations of the Chakravarty Committee, which set the platform for further reforms after the gulf crisis. Special mention may be made of Shri Malhotra's efforts at fostering disintermediation in the financial system. These included allowing banks manoeuvrability in their most profitable business areas, introducing new money market instruments and, above all, making attempts towards reform in the interest rate structure. In this task, among others, especially in the area of monetary and credit policy administration, he was ably supported by the Deputy Governor, Dr C. Rangarajan, with his sound economic background and analytical mindset.

The memorandum to the Central Board of Directors of the Reserve Bank of India, dated January 22, 1991, paid tributes to Shri Malhotra's administrative capabilities and achievements:

As Governor of the Reserve Bank of India, he strove to ensure that the Bank contributed effectively towards achieving the national goal of growth with stability, particularly through its monetary and credit policies and that the country's financial system remained sound. He provided the impetus for a more flexible, transparent and competitive financial system and more significant contributions in ensuring that the banking system adopted prudential norms and took particular interest in ensuring improved housekeeping by banks.

#### DISQUIETING TRENDS IN GOVERNMENT FINANCES AND DEPENDENCE ON RBI CREDIT

Although the concerted and structured reform measures were launched in July 1991 by the new Government, it took some time for the macroeconomic fundamentals to stabilise. Stabilisation required both monetary and fiscal discipline to go hand-in-hand. With this end in view the Governor, Shri S. Venkitaramanan, in his letter dated December 10, 1991 informed the Finance Minister, Dr Manmohan Singh, that he had been 'perturbed' for some time by the disquieting trends in the finances of the Government as also its dependence on Reserve Bank credit, *i.e.*, the data for December 6, 1991 revealed that the budget deficit and the related RBI credit to the Centre had reached 'historically' high levels even by December. The letter pointed out that even though the net market borrowing till then had been

lower than in the corresponding period of the previous year, this was compensated by larger accretions under the 182-day Treasury Bills. The none-too-comfortable situation had been made even more acute because the IMF performance criteria had to be complied with, and it had become a 'Herculean' task for the Reserve Bank to ensure that the NDA target on the previous 'test date' (November 1, 1991) was met.

The Reserve Bank's anxiety was not merely about the difficulties in adjusting these numbers on 'test dates'. There were several other concerns. First, the persistent increase in liquidity caused by fiscal deficits had serious implications for inflation, which was a cause for worry. Second, if monetised deficit persisted at high levels for major parts of the period and was sharply brought down to adhere to the 'test date' criterion; it might leave behind considerable monetary impulses that would not be entirely reversible. The letter added that it was partly for this reason that  $M_3$  growth was running at a rate faster than in the previous year and also faster than the implied annual growth of 13.0 per cent accepted for 1991-92. The third source of concern for the central bank was the prevailing credit situation for the commercial sector, which was feeling the adverse effects of unusually 'stiff' credit policy measures and, with the onset of the busy season, it was expected that demand for commercial credit would pick up. In such a prospect, refinance facilities for commercial banks could not be unduly compressed without further hurting the availability of bank credit for productive sectors in general and for export purposes in particular. It was against this background that the Governor stressed that the required burden of adjustment in NDA would have to be borne by the Centre's budgetary operations and that the Government should take measures of an enduring nature to contain the budget deficit and liquidity growth on a sustained basis. He expressed a desire to meet the Finance Minister before his meeting with the officials of the finance ministry on December 14, 1991. As events later unfolded, the subtlety of the letter was felt, with the fiscal authorities paying increasing attention to consolidating the fiscal position.

#### CO-ORDINATION BETWEEN DEBT MANAGEMENT AND MONETARY POLICY

The idea of having large-scale OMOs *ipso facto* called for closer co-ordination between debt management and monetary policy. In this connection, the views of the Reserve Bank on the method of co-ordination underwent a change between November 1992 and February, 1993,

which reflected the individual perceptions of the two Governors.<sup>19</sup> The Government took seriously the idea put forth by the Governor, Shri S. Venkitaramanan, in November 1992 that a co-ordination committee might be set up with participation from the Ministry of Finance and the Reserve Bank to co-ordinate debt management and monetary policy issues. When the Finance Secretary suggested that such a committee be set up immediately in February 1993, the Governor, Dr C. Rangarajan, gave a different viewpoint that was based on the premise that there had always been intense discussions on the topic with the Ministry of Finance both prior to and after the budget, and the Reserve Bank had taken co-ordinated action in this area. The central problem was the need to reduce the Government's heavy reliance on a captive market for government securities and move towards a genuine market-related interest rate structure.

The Reserve Bank conceded that while considerable reform had been managed, the authorities had still to 'bite the bullet'. The Governor remarked: "I am of the view that to the extent that co-ordination and consultation was the issue, we have plenty of it! I frankly do not see the central problem being resolved merely by setting-up a Co-ordination Committee." However, he left the door open by concluding the letter as follows:

My preference would be to continue with the present system of consultation. A formal Committee approach may add to the problems rather than improve co-ordination. If, however, the Ministry of Finance wishes to set up the Committee, the Reserve Bank will be glad to participate and endeavour to bring about greater co-ordination between public debt and monetary management.

The co-ordination committee, however, did not materialise and debt management was continued to be handled by the monetary authorities on behalf of the Government.

#### DENT IN RESERVE BANK'S BALANCE SHEET DUE TO MANAGEMENT OF LARGE ACCRETION TO FOREIGN EXCHANGE RESERVES

Quite early in his office, the Governor, Dr C. Rangarajan, was confronted with disturbing evidence about the profits of the Reserve Bank. The

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19. In the interim period, Dr C. Rangarajan took over as Governor from Shri S. Venkitaramanan on December 22, 1992.

evidence concerned the reimbursement made to the State Bank of India (SBI) at the Government's instance in respect of the premium paid by the SBI on purchase of Exim scrips, the depreciation in the value of dated government securities held in the investment portfolio of the Reserve Bank and the losses to the Reserve Bank due to its intervention operations in the foreign exchange market. The profit and loss account of the Reserve Bank was expected to show a net loss of ₹ 375 crore after making the necessary provisions. The Government was kept informed of the anticipated course of events so that the budget estimates for 1993–94 would be made on a realistic basis. The Governor's letter to the Finance Secretary of February 3, 1993 gave substantive reasoning behind each of the three factors, the main gist of which is worth recounting.

Due to the Government's budgetary constraints, the Reserve Bank had been asked to bear the premium of 20.0 per cent to be paid by the SBI on its purchase of Exim scrips, even though it was not its responsibility. The statutory auditors had initially raised objections to the payment on the ground that this was not an expenditure relating to the Reserve Bank's business and hence should not have been borne and recorded in its books. But after the relevant letter from the Government was placed before the auditors and after clarifying that the amount involved was not very large, they did not pursue the point. In February 1993, the amount reimbursable to the SBI worked out to ₹ 797 crore. But by February 28, 1993, which was the last date for the purchase of Exim scrips, the year's reimbursement to the SBI was estimated to go up to ₹ 1,000 crore. In addition, the depreciation in the value of dated government securities held in the investment portfolio of the Reserve Bank was placed at about ₹ 800 crore by June 1993.

The item involving current losses to the Reserve Bank was its intervention operations in the foreign exchange market. Ever since the introduction of partial convertibility in March 1992, the Reserve Bank had to buy surplus dollars in the Indian forex market so as to maintain the premium above 15.0 per cent. Until the end of January 1993, the Reserve Bank had made net purchases of US\$ 2,150.0 million at market rates. Since the Reserve Bank's books were being maintained at the official rate, the rupee losses booked till February 3, 1993 due to the intervention operations amounted to ₹ 818 crore and, based on this trend, the exchange loss figure was expected to go up to ₹ 1,200 crore by end-June 1993.

The Reserve Bank in its letter advised that according to the current estimates, there would be no profit to be passed on to the Government

as against the profit of ₹ 1,500 crore transferred for the preceding year and that the reduction in current receipts of this magnitude in the Government's budget would be difficult for the Government to handle. However, to alleviate the situation, the Governor outlined one possible way for the Government to consider. While provisions would be required as far as Exim scrip purchase and depreciation in government securities were concerned, it would be possible to handle the market intervention transactions without booking current losses by creating within the existing reserves a market operations fund to which would be transferred all the foreign currencies (at that time only the US dollar) purchased from the market under the stabilisation operations at the ruling market rates.

The dollar amounts would be valued at the prevailing market rate in the books of the Reserve Bank. When the US dollar was sold at market rates, this fund could be drawn upon. If this method was adopted, the exchange loss ranging from ₹ 850 crore to ₹ 1,000 crore could be avoided, but it would still be reflected in the higher rupee cost of the dollars held in the books of the fund. As far as published reserve figures were concerned, this proposal was not expected to make any difference. However, if the reserve fund came down drastically and the fund had to be drawn, the sales would have to be effected only at the market rate. In other words, the dollars held in the fund would be like any other foreign currency and would be subject to revaluation at the end of every month as in the case of other foreign currency holdings. The auditors who were sounded informally did not voice any objection to this course, provided that no transfer of the 'official rate' dollars was made to the market operations fund in order to boost the profits. If the proposal was acceptable, the Reserve Bank expected to be in a position to transfer a profit of ₹ 850 crore to ₹ 1,000 crore during the Government's financial year 1993–94. In actuality, the Bank's surplus profits that were transferred to the Government in 1993–94 (July–June) remained unchanged at ₹ 1,500 crore.

The Bank also took the opportunity to apprise the Central Government that, in the immediate past, several foreign currency borrowings/funding operations involving sizeable exchange risk had devolved on the Reserve Bank. These included deposits under the FCNR (A) and FC(B&O)D schemes, the parking facility extended to certain FIs (IDBI, ICICI and SCICI<sup>20</sup>), India Development Bonds (IDBs), the swap facility extended to

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20. Shipping Credit and Investment Company of India Ltd.

authorised dealers, intervention in the forex market, the compensation paid to Exim scrip holders by the SBI, the cost of cover given to the IDBI and ICICI in respect of certain IBRD credit lines and the foreign currency liabilities of the Indian Oil Corporation (IOC) and the SBI, which had been crystallised in rupee terms in 1985 for which IOC had been discharged from further liability. In a forthright assessment, the emerging scenario was depicted by the Governor thus:

These involve considerable exchange risk. An idea of the risk involved can be had from the fact that with the present liability on these counts amounting to \$ 15 billion less reserves of \$ 5 billion, every change of just one rupee in the rupee value of the US dollar led to a loss/gain of Rs. 1,000 crore in the books of the Reserve Bank. The exchange risk on this liability had to be provided for in full to the satisfaction of the auditors and till then, the Bank had been able to make necessary provisions from its internal reserves. The internal reserves have been depleted to just Rs. 2,900 crore. It will not, therefore, be possible for the Reserve Bank to take over the exchange risk in respect of any further foreign currency liabilities. Apart from this, if the value of the dollar goes up by more than, say, Rs. 2 per dollar, the reserves would not be adequate to make the required provision which may lead to a remark to that effect by the Statutory Auditors in the balance sheet of the Bank. I need hardly mention how undesirable such a remark would be. Unlike in the Bank, in the case of the Government of India, there is no need to make any provision for the corpus of the liability and the loss as and when arises at the time of repayment can be booked in the Government account. It is in view of this that we had earlier requested that the exchange risk in respect of FCNR deposits should be taken over by the Government. At that time it was not agreed to but the Government may have to think of this before any significant improvement of dollar-rupee rate materialises.

The views that the Bank offered were essentially to provide important inputs to the Government in its formulation of the budget for the subsequent year. As events unfolded, the surplus profits transferred to the Government in 1994–95 in fact rose to ₹ 3,558 crore compared with ₹ 1,500 crore in 1993–94.

## PHASED REDUCTION IN SLR

The issue of phased reduction in SLR was being discussed between the Government and the Reserve Bank since May 1993 when the Finance Secretary sought the Reserve Bank's views about the feasibility of bringing about a reduction of SLR to 25.0 per cent to be achieved by the end of 1995–96, keeping in view that any feasible plan must ensure adequate availability of SLR resources to the state governments and state government owned institutions. The letter also acknowledged that in identifying the resources for the Centre's borrowing programme (after reduction in SLR), the possibility that in future, several banks might still opt for government securities not only because of SLR prescription but also because of the zero risk attached to them should also be factored in. "In effect, capital adequacy ratio would operate in the opposite direction to the reduction in SLR by increasing the flow of finance to Government borrowing," was the observation made by the Finance Secretary.

The Reserve Bank's reaction was based on a detailed study. First, it would not be prudent to plan the borrowing programme on the basis of excess SLR holding by banks. Second, if the Central Government guaranteed institutions had to be provided resources under the market borrowing programme, there would have to be a *pro tanto* reduction in the Centre's borrowing programme. Third, as a result of the contemplated reduction in SLR, the market borrowing programme would be supported by commercial banks to a relatively small extent. Fourth, while there might be some excess investments in SLR securities over and above the stipulation, the assumption regarding investments by non-bank institutions could go awry if stipulations on their investments in government and other approved securities were lowered, which was a distinct possibility. While conveying these perceptions to the Government in the letter dated July 8, 1993, the following important suggestions were offered:

- (i) While the programme of SLR reduction to 25.0 per cent could be phased over a period of three years inclusive of 1993–94, it should be conditional on a satisfactory fiscal adjustment and the borrowing programme supported by 'captive' investors.
- (ii) The rate of interest on government bonds would require to be raised in order to attract investments consistent with the borrowing requirements. If the borrowing requirement was set at too high a level compared with the available resources from SLR stipulations, the rate of interest might have to be raised to levels that would make the task of containing the fiscal deficit difficult. This could

lead to a vicious spiral of rising interest rates and growing fiscal deficits. Therefore, borrowing requirements would have to be kept within limits.

- (iii) The system of automatic monetisation of the Central Government's budgetary deficit should be discontinued under a phased programme during this period. Accordingly, the phased reduction in SLR should be dovetailed into a programme to phase out automatic monetisation of the budget deficit over a three-year period. Thus, the proportion of auctioned bills in the total creation of 91-day Treasury Bills should be one-fourth in 1993–1994, one-half in 1994–95, and three-fourth in 1995–96, and from 1996–97 the system of *ad hoc* Treasury Bills should be totally discontinued. The Central Government could then be provided a ways and means (WMA) limit from the Reserve Bank to meet temporary requirements, which should be liquidated by the end of the year.

Under the multiple system of maintenance of SLR adopted since February 1992, SLR at the rate of 25.0 per cent was made applicable for any increase in domestic deposits over the level as on September 17, 1993. However, SLR on deposits up to the level as on September 17, 1993 was 34.75 per cent.

#### DILEMMA FACED BY THE RESERVE BANK IN ITS MONETARY MANAGEMENT IN THE CONTEXT OF LARGE ACCRETION TO FOREIGN RESERVES

With the rapid accumulation of foreign exchange reserves in 1994–95, the Reserve Bank's task of monetary management became more complex. The movements in foreign reserves and the consequent control over liquidity in the economy called for continuous monitoring by the Reserve Bank. The control tool of CRR was not expected to be effective, as interest had to be paid on banks' balances held with the Reserve Bank, thereby creating reserve money. The only option left, namely, OMOs, was no doubt handy, but the Reserve Bank had to surmount the problem of availability of government securities with suitable coupon rates and maturity composition.

The policy challenge for the Reserve Bank became more apparent when it undertook a review in May 1994. An increase in NFA, given the order of net RBI Credit to the Government, gave rise to two possible scenarios which, as the Governor, Dr C. Rangarajan, implied through his letter of May 5, 1994 to the Chief Economic Adviser to the Government, presented a dilemma for monetary authorities should the Government not act to bring about fiscal discipline or to discourage large capital inflows.

The first of the projections estimated  $M_3$  growth in 1994–95 at 16.0 per cent on the assumption of an increase in NFA by US\$ 3.0 billion, an increase in net RBI credit to Government of ₹ 6,000 crore, and an incremental money multiplier of 3.55. This order of increase in  $M_3$  combined with a rate of growth of 5.0 per cent in real terms was expected to bring down inflation to around 7.0 per cent. While terming this as an ‘acceptable scenario’, the Governor felt that it was advisable to prepare for other contingencies.

The second alternative envisaged that with an NFA increase of US\$ 5.0 billion, the increase in  $M_3$  would be about 21.4 per cent, which was termed as ‘totally unacceptable’. If the NFA exceeded US\$ 3.0 billion, the authorities would have to take necessary action. If the increase in NFA was US\$ 1.0 billion above the first alternative, it was still possible to keep  $M_3$  growth at 16.0 per cent by undertaking OMOs. Securities at market-related interest rates held by the Reserve Bank for OMOs were around ₹ 4,000 crore, which was felt to be inadequate. If the gross foreign currency reserves of the Reserve Bank increased beyond US\$ 18.0 billion, the authorities must be willing to take some other actions, all of which would be costly.

A step-up in CRR would seriously affect the profitability of banks. No doubt, the other course of converting part of the non-marketable securities with the Reserve Bank at a rate of 4.6 per cent into marketable securities at prevalent coupon rates would bolster OMOs. However, the cost of such conversion was estimated at ₹ 80 crore per annum for every ₹ 1,000 crore of securities. As the conversion cost was fairly high, the Reserve Bank advised that the immediate cost to the Government could be avoided by converting non-marketable securities into zero coupon bonds. Besides these measures, action would need to be taken on other fronts to prevent an increase in the NFA to unacceptable levels. The letter concluded that as it was not possible to predict how the NFA would move during the year, the authorities should be prepared to put into effect the various suggestions as and when circumstances demanded and that the overall objective should be to ensure that  $M_3$  did not increase beyond 16.0 per cent in 1994–95.

These projections, however, turned out to be much lower than the actual outcomes. By the end of October 1994, the NFA and  $M_3$  exceeded their respective projections. The Reserve Bank, therefore, had to revise its views on the policy options with a view to containing  $M_3$  growth in 1994–95 at 16.0 per cent.

A detailed letter from the Governor to the Finance Secretary, Shri Montek Singh Ahluwalia, dated October 31, 1994 recalled that at the time of the announcement of monetary policy for the first half of 1994–95, the NFA were projected to increase in the range of US\$ 3.0 billion to US\$ 5.0 billion, but in the financial year up to October 21, 1994, the NFA had increased by a little over US\$ 5.6 billion. The growth of reserve money up to that period was ₹ 16,869 crore, compared with an increase of ₹ 14,934 crore during the comparable period of the previous year and this growth was to some extent subdued due to a decline of ₹ 7,225 crore in *ad hoc* Treasury Bills. The rate of growth in  $M_3$  during the year up to October 14, 1994 at 11.1 per cent was considered to be much higher than the projected trajectory of 14.0–15.0 per cent for 1994–95 envisioned by the Reserve Bank and also the 16.0 per cent growth estimated at the time of the monetary policy announcement in April 1994. “Unless the reserve money growth is slowed down in the second half of the year, there could well be an explosive increase in  $M_3$  with adverse impact of acceleration of inflation,” the Governor postulated.

As regards NFA, the Reserve Bank opined that the increase during the full financial year 1994–95 could be a minimum of US\$ 7.0 billion or ₹ 22,400 crore. If the Centre used *ad hoc* Treasury Bills up to the predicted level of ₹ 6,000 crore, an ‘explosive’ growth of reserve money of the order of ₹ 32,400 crore (23.4 per cent) in 1994–95 was expected and the resultant growth of  $M_3$  was estimated at around 20.5 per cent, a figure even higher than the increase of 18.2 per cent in 1993–94. The Governor, therefore, reckoned that such a large monetary growth would be clearly ‘unacceptable’ and that given the paramount objective of achieving a significant reduction in the inflation rate, it was essential to contain  $M_3$  growth in 1994–95 to around 16.0 per cent.

The Reserve Bank came out with drastic measures to contain the pace of monetary expansion. A reduction in interest rates on non-resident deposit schemes and the imposition of CRR on the FCNR (B) scheme could be expected to moderate the inflows, but in any case the increase in NFA was unlikely to be less than US\$ 7.0 billion and the increase could be significantly larger. Therefore, to have a meaningful impact on reserve money growth, the Reserve Bank suggested very large OMOs, but in the prevailing situation, this posed serious logistical problems. The Reserve Bank held marketable dated securities of ₹ 4,000 crore (book value) of which only about ₹ 2,900 crore were with coupon rates of over 10.0 per cent and the balance carried low coupon rates, which would be difficult

to sell even if the prices were lowered to match the yield-to-maturity on recently floated securities by raising the current yield. To facilitate effective OMOs, the Reserve Bank was required to have in its portfolio an additional ₹ 7,000 crore worth of non-marketable 4.6 per cent securities from its own stock converted into marketable securities.

To tide over the situation, the Reserve Bank put forward two proposals. First, the non-marketable non-terminable securities were to be converted into marketable ones with a maturity of 5 years and the coupon rates left unchanged. But given the face value of these securities *vis-a-vis* the prevailing yield to maturity, the Reserve Bank would have had to incur a huge capital loss for raising the yield to at least 10.0 per cent (if not the desired 11.5 per cent) to make them marketable. Therefore, this option was ruled out. The remaining alternative was for the Government to issue to the Reserve Bank, zero coupon bonds of 5-year maturity in lieu of the redemption of special securities. This had the advantage that the financial burden of the Government would arise only at the time of maturity.

The Governor recommended: “We are of the view that this alternative is feasible and that the Government should bear this burden in the overall interest of macro-economic stability.” In the concluding paragraph of the letter to the Government, the Governor expressed the fear that the projected increase in NFA of US\$ 7.0 billion would itself be a ‘serious underestimate’ and the Reserve Bank might have to undertake OMOs of an order significantly more than ₹ 7,000 crore. He urged the Government to take early action to implement the main proposal to redeem ₹ 7,000 crore face-value of special securities and invest the corresponding sum in zero coupon bonds of 5-year maturity at an implicit yield-to-maturity of 11.5 per cent. The Governor felt that the additional cost of ₹ 483 crore in order to keep down the inflationary pressures was not that onerous and the cost need, in any case, not be borne immediately.

### CONCLUDING OBSERVATIONS

In contrast to the 1980s, when expansionary fiscal policy posed a continuous challenge in the conduct of monetary policy, the onset of financial sector reforms beginning in the mid-1991 also meant that monetary management would need to be broadly aligned with other macroeconomic and institutional policies. The agreements reached between the Reserve Bank and the Government to limit the net issue of *ad hoc* Treasury Bills from 1994–95 culminating in discontinuation of issuing these bills effective April 1997 meant the end of a four-decade old

practice of automatic monetisation of budget deficits. With market-based government borrowings through auctions, the co-ordination between monetary and public debt management was strengthened. Second, while the twin objectives of price stability and support to growth remained intact, monetary management turned to increasing use of market-based instruments, such as OMOs and interest rates. The interest rate structure, which was rigid and complex, was progressively rationalised and deregulated during the reform period to make it flexible and its rigours considerably reduced. Third, with market integration improving, in particular between the money, government securities and the foreign exchange markets, the financial stability consideration of maintaining orderly conditions in financial markets gained prominence as an additional responsibility of the Reserve Bank, particularly after the irregularities in the government securities market that pervaded all market segments in 1992. Fourth, monetary policy had to handle the impact of large capital flows into the economy that was increasingly becoming open, especially after current account convertibility in 1994 followed by significant opening of capital account to foreign institutional investors. All these resulted in testing the Reserve Bank in realising better control over inflation, while providing adequate support to growth impulses generated by economic reforms across sectors.

The decade of the 1990s opened with a serious BoP crisis and until about 1992, monetary management had to take the extra burden of bringing back macroeconomic stability and closely tracking the IMF-supported programme targets on  $M_3$  and credit. Both the reserve requirements and interest rates reached their peaks during these years. Thereafter, a process of gradual relaxation in terms of bringing down SLR and flexible use of CRR was set in motion. Monetary management also assumed the responsibility of ensuring stability in the foreign exchange market.

The year 1991–92 was a landmark in terms of quickly overcoming the severe BoP crisis through fiscal correction, exchange rate adjustment and reform. The overcoming of the payments crisis was followed by policy measures to stabilise the economy and to bring about more efficient allocation of resources. By 1992–93, substantial results were achieved in reducing the volume of fiscal deficit and keeping inflation under reasonable control, and the momentum was kept up in the following years. A cautious attempt was made to move away from direct to indirect instruments of monetary control. A beginning was made to develop OMOs as an effective

instrument of credit control, and it became the most potent tool in the subsequent years — in the form of repos — to modulate liquidity.

In 1993–94, a sea-change occurred in the factors contributing to reserve money expansion, shifting from domestic assets to FCA in the Reserve Bank's balance sheet. The quantum jump in foreign exchange reserves, although welcome for several reasons, led also to a substantial expansion in primary money and the overall  $M_3$ . With the opening up of the external sector, the transmission of impulses from the external sector to domestic markets became powerful. The stability of the exchange rate came to depend crucially on the degree of success in holding down the inflationary pressures. The monetisation effect of large foreign capital inflows and the consequent inflationary impact on monetary expansion became a major concern and preoccupation of the Reserve Bank in the mid-1990s. OMOs by the Reserve Bank in dated government securities formed an integral part of the monetary policy strategy to sterilise inflows. As a corollary, internal debt management policies were activated and integrated with monetary management.

In 1994–95, the conduct of monetary policy was influenced by the rise in capital inflows and consequent increase in the FCA of the Reserve Bank. Therefore, the Reserve Bank tried to impart a sharper focus on evolving internal consistency among monetary, fiscal and exchange rate policies. A far-reaching development was the initiative to delink budget deficit from monetisation. The Reserve Bank entered into an agreement with the Government to place a ceiling on its unlimited borrowing from the former through *ad hoc* Treasury Bills so as to curb automatic monetisation of the fiscal deficit and the resulting growth of reserve money. Another agreement paved the way for discontinuation of *ad hoc* Treasury Bills from April 1997. It provided greater flexibility in monetary management and strengthened the linkage between fiscal and monetary policies in achieving their respective goals more optimally.

Overall, during the 1990s, the Reserve Bank's monetary policy helped contain inflation and inflationary expectations. Towards the close of 1996–97, the Reserve Bank's various policy initiatives and responses made it also possible for the financial markets — especially the money and gilt-edged markets — to attain greater depth and strength. In the process, new financial instruments were deployed. Fiscal consolidation markedly scaled down the Central Government's dependence on Reserve Bank credit and also the draft of the Government on the resources of commercial

banks. The transmission channels of monetary policy apparently became operationally more effective. The Reserve Bank came to enjoy greater freedom in framing monetary policy compared to the 1980s, with the elimination of automatic monetisation of fiscal deficit.

The interconnected measures designed to develop financial markets, payment and settlement systems and other financial infrastructure, along with the development of banking regulation and supervision, contributed to the maintenance of financial stability in India and helped to meet successfully the challenges thrown up by the South-East Asian financial crisis that affected the global economy in the mid-1997.

ANNEX 14.1

*Evolution of Monetary and Credit Policy in India (1990–1997) – Part II*

1990–91

A TRAUMATIC YEAR: MACROECONOMIC IMBALANCES AND STRAINS ON  
BALANCE OF PAYMENTS AGGRAVATED BY THE GULF CRISIS

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

Shri S. Venkitaramanan (22.12.1990–21.12.1992)

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

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
<p>From the beginning of 1990–91, the economy faced several problems. These were the medium-term, large and continuing fiscal imbalances (mainly on the revenue account), the build-up of strong inflationary pressures in the economy, and strains on the BoP (<i>i.e.</i>, CAD).</p> <p>The fragile economic situation was abruptly aggravated by the eruption of the gulf crisis (August 1990). Consequently, the deterioration in the foreign exchange reserves position was on an alarming scale.</p> <p>The drying up of commercial loans from abroad and reduced access to international financial markets was exacerbated by a sharp outflow of NRI deposits starting from the last quarter of 1990 to practically the end of 1991.</p> <p>The uncertain political conditions came in the way of taking timely policy decisions. In particular, the unsustainable level of fiscal imbalances that had been building up for several years resulted in a large expansion in <math>M_3</math> and the build-up of inflationary pressures despite a satisfactory monsoon and good agricultural output for the third year in succession. These factors placed severe pressure on the BoP.</p>	<p>Taking into account the strong acceleration in primary money growth and its adverse impact on inflationary expectations, the main objective of the tight credit policy for the first half of 1990–91 was to reduce monetary expansion (<math>M_3</math>) by about 4.0 percentage points during the year.</p> <p>However, in the second half of the year, with the sudden eruption of the economic crisis, the short-term management of the BoP situation became the overriding concern of both economic and monetary policy, besides the continuing objective of price stability. The need to conserve as well as augment the slender foreign exchange reserves of the country became the dominant objective. These were sought to be achieved by import compression and export promotion.</p>	<p>The package of credit policy measures announced on April 12, 1990 sought to regulate growth in <math>M_3</math> and credit and thus moderate the growth of liquidity in the system.</p> <ul style="list-style-type: none"> <li>• SLR increased from 38.0 per cent to 38.5 per cent from September 22, 1990, excluding non-resident accounts.</li> <li>• Selective credit controls imposed on bank advances against price-sensitive commodities.</li> </ul> <p>In the second half of the year, due to the deterioration in the macroeconomic imbalances, credit policy measures became progressively stiffer to contain the overall demand for imports and culminated in the imposition of cash margins as high as 200.0 per cent on imports of goods under OGL and 150.0 per cent on specific import licences; this was termed “the use of monetary instrument in a non-discretionary manner to moderate the level of imports”. The other measures were:</p>

*contd...*

*contd..*

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
		<ul style="list-style-type: none"> <li>• Imposition of interest rate surcharge on export financing.</li> <li>• Raising interest rates on post-shipment export credit beyond certain maturities to encourage faster realisation of export proceeds.</li> </ul> <p>The lending rates of banks were re-structured (September 22, 1990). From April 23, 1991, banks were advised that every transaction of sale of foreign exchange or payment to any person resident outside India equivalent to or above ₹ 2.5 crore (other than for repayment of balances in FCNR and NRE accounts and inter-bank transactions) should be referred to the Reserve Bank for clearance before effecting the transaction.</p>

*contd...*

*concl.*

*Fiscal-monetary  
co-ordination*

*Financial sector  
reform*

The conduct of monetary policy was closely co-ordinated with fiscal policy. Measures to contain  $M_3$  growth were backed by associated measures to contain fiscal deficit.

The Government took recourse to borrowing from the IMF.

- India used its reserve tranche during July-September 1990 to obtain SDR 487.26 million (₹ 1,173 crore).
- In January 1991, ₹ 3,334 crore was availed of under the modified CCFE and the first credit tranche under a three month stand-by arrangement.

## 1991–92

UNPRECEDENTED AND ACUTE BALANCE OF PAYMENTS CRISIS  
AGENDA FOR ECONOMIC REFORM – THE NEW ECONOMIC POLICY (JULY 1991)  
TRANSFORMATION IN CONDUCT OF MONETARY AND CREDIT POLICY

Governor : Shri S. Venkitaramanan (22.12.1990 – 21.12.1992)

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

Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
<p>The year 1991–92 was exceptionally traumatic for the Indian economy. The BoP situation turned critical. Despite substantial financial aid from multilateral and bilateral agencies/governments, the foreign exchange reserves declined to about US\$ 1.0 billion by mid-June 1991. Both <math>M_3</math> and price level exhibited expansionary tendencies.</p> <p>The new Government under the Prime Minister, Shri P.V. Narasimha Rao initiated economic reforms in July 1991. These included short-term corrective measures aimed at crisis management as well as long-term measures of structural reform to improve the efficiency and productivity of the economy and put it on the path of sustainable growth with equity and social justice. These measures were piloted by the Finance Minister, Dr. Manmohan Singh.</p> <p>The regular budget for 1991–92 set in motion the process of fiscal adjustment as part of macroeconomic stabilisation efforts, with a promise to follow up with continued fiscal consolidation over three years.</p> <p>As a result of a series of crisis management measures, that is, stabilisation and structural adjustment programmes that included financial sector reform, the economy turned around.</p>	<p>The Reserve Bank continued to adopt a restrictive credit policy during the first half of 1991–92 to contain aggregate demand, particularly in the demand for imports.</p> <p>After July 1991, two considerations dominated the framing of credit policy. One was the need to align financial sector reforms with the macroeconomic adjustment process launched by the Central Government. The second was the need to contain inflation, which reached a high of 16.7 per cent by August 1991. Monetary and credit policy sought to achieve monetary stability by trying to attain a lower <math>M_3</math> expansion of about 13.0 per cent for the full year. Therefore, a restrictive credit policy was adopted.</p>	<p>The thrust of monetary and credit policy measures for the first half of 1991–92 was two-pronged. The first set of measures sought to contain aggregate demand (particularly of imports) and encourage acceleration of export receipts, while the second category enhanced the competitive position of banks in deposit mobilisation by increasing the rate of interest on deposits of three years and above. An incremental CRR was imposed from May 3, 1991.</p> <p>The Reserve Bank announced a package of policy measures effective from July 4, 1991 to curb imports and reduce aggregate demand in the economy, namely,</p> <ul style="list-style-type: none"> <li>• Bank Rate hiked from 10.0 to 11.0 per cent.</li> <li>• Rates of interest on advances from RBI specifically linked to the Bank Rate raised.</li> <li>• Interest rates on bank advances over ₹ 2 lakh raised.</li> </ul> <p>The GoI also announced major structural reforms in trade policy on July 4, 1991.</p>

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<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
The FCA of the RBI, which had plummeted to US\$ 975.0 million on July 12, 1991, spurred to US\$ 5.6 billion by the end of the year.		<p data-bbox="755 366 965 460">In the second half of the year, the important changes in credit policy were:</p> <ul data-bbox="755 495 988 822" style="list-style-type: none"> <li data-bbox="755 495 988 566">• Increase in the Bank Rate from 11.0 per cent to 12.0 per cent.</li> <li data-bbox="755 571 988 642">• Withdrawal of all RBI refinance facilities (except for exports).</li> <li data-bbox="755 647 988 742">• Reduction in the rate of interest paid on cash balances impounded with the RBI.</li> <li data-bbox="755 747 988 822">• Increase in the short-term interest rates on deposits.</li> </ul>

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*Fiscal-monetary  
co-ordination*

*Financial sector  
reform*

The measures of macroeconomic stability formulated by the Government in July 1991 related to fiscal consolidation, exchange rate adjustment and reform, fixation of monetary targets and inflation control. These were supported by structural reforms through industrial deregulation, overhauling of public sector enterprises and financial sector reforms.

To improve the international competitiveness of India's exports and restrain import demand, the Reserve Bank on July 1 and July 3, 1991 adjusted downwards the value of the Indian rupee, which in terms of GBP worked out to 17.38 per cent and in terms of US \$ about 18.7 per cent.

1992–93

## GOOD PROGRESS IN ECONOMIC STABILISATION – DEEPENING OF REFORM PROCESS

## INTRODUCTION OF FINANCIAL SECTOR REFORM

## UNION BUDGET FOR 1992–93 – CREDIT POLICY FOR 1992–93

Governors: Shri S. Venkitaramanan (22.12.1990 – 21.12.1992)

Dr C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of</i>	<i>Salient policy measures monetary and credit policy</i>
<p>Within 10 months, the Government not only overcame the BoP crisis and reduced macroeconomic imbalances, but also initiated the process of a major transformation of India's development strategy. Changes in industrial, trade and financial policy had liberalised one of the most regulated economies in the world.</p> <p>During 1992–93 progress was made in economic stabilisation and revival of economic activity. The high expansion in <math>M_3</math> was caused by the build-up of foreign exchange reserves; but the price level could be contained. The Central Government brought about a substantial budgetary reduction in GFD from 6.5 per cent in 1991–92, which had a favourable impact on other macro variables.</p>	<p>Monetary and credit policy for the year focussed on making adequate credit available for renewal of productive activity (especially in industry, agriculture and exports) and containing inflationary pressures. The Reserve Bank decided to effect a sharp reduction in the pace of monetary expansion (<math>M_3</math>) from 18.6 per cent in 1991–92 to less than 11.0 per cent in 1992–93 to supplement the anti-inflationary impact of the proposed reduction in the budget deficit. In effect, the stance of credit policy was restrictive, except for some relaxation to stimulate productive sectors of the economy.</p> <p>The Reserve Bank started implementing the major recommendations of the Narasimham Committee.</p>	<p>The important policy measures during the period were:</p> <ul style="list-style-type: none"> <li>• Gradual reduction in the bank lending rate, followed by a reduction in maximum deposit rates.</li> <li>• Rationalisation of the structure of lending rates.</li> <li>• SLR reduction in a phased manner (April 3, 1992).</li> <li>• Release of part of additional cash balances.</li> <li>• Reduction in effective CRR in a phased manner.</li> </ul> <p>There was a cautious attempt to move away from direct to indirect tools of monetary control and to develop OMOs as an active control instrument.</p>

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*Fiscal-monetary  
co-ordination*

Monetary policy was increasingly co-ordinated with internal debt management policy. The Reserve Bank accorded priority to activating public debt management by reorganising the gilt-edged market so that the Government gradually reduced its dependence on the Reserve Bank to meet its borrowing programme and the budgetary gap. To move towards conducting regular OMOs, the Reserve Bank conducted repo auctions for Central Government dated securities from December 10, 1992.

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*Financial sector  
reform*

Reforms in the financial sector included a reduction in incremental CRR and SLR on outstanding deposits. The Reserve Bank tried to reduce the role of reserve requirements as a tool of monetary control. The development of the government securities market impacted favourably on the conduct of monetary policy. The dual exchange rate arrangement instituted in March 1992 under LERMS enabled an orderly transition from a managed floating rate regime to a market-determined system in March 1993.

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1993–94

SPEEDING UP OF ECONOMIC REFORMS

Governor: Dr C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
<p>The Indian economy emerged stronger from the payments crisis of 1991. A sea-change occurred in the factors operating behind money and credit expansion. The quantum of foreign exchange reserves generated strong expansion in primary money growth. The monetised deficit, which used to be the predominant factor in reserve money creation, was significantly weak during the year.</p>	<p>Despite the success in reining in inflation in 1992–93 by monetary and fiscal discipline, the focus of monetary policy for 1993–94 was to be on guard against the resurgence of inflation. The Reserve Bank indicated its objective to bring about a 4.0 percentage points reduction in the annual inflation rate. Also, monetary policy was formulated against the broad framework of financial sector reforms.</p>	<p>To impart greater flexibility to monetary management, the following changes were made:</p> <ul style="list-style-type: none"> <li>• Both SLR and CRR reduced in a phased manner, thus increasing the lendable resources of banks at market rates.</li> <li>• Lending and deposit rates reduced in stages against the backdrop of overall improvement in the economic situation and softening of the inflation rate.</li> <li>• The minimum lending rate slashed by 3.0 percentage points (March, June and September 1993).</li> <li>• Deposit rates reduced (June and September 1993).</li> </ul>

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<i>Fiscal-monetary co-ordination</i>	<i>Financial sector reform</i>
<p>Monetary and exchange rate management became intertwined owing to large inflows of capital and their direct effects on money creation and liquidity expansion.</p>	<p>Monetary reform — as part of financial sector reform — continued the process of modernising the instruments of control to make them more suitable for the conduct of monetary policy in a market-oriented financial environment.</p> <p>The administered interest rates were made more flexible and less rigorous.</p>

1994–95

INDIAN ECONOMY ON GROWTH PATH  
NEW DIMENSIONS FOR MONETARY MANAGEMENT

Governor: Dr C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
<p>Macroeconomic management during 1994–95 encountered problems due to the high fiscal deficit of the Central Government and the large inflows of foreign capital. In the second half of the year, credit expansion was sharp. <math>M_3</math> growth of 22.2 per cent in 1994–95 was worrisome.</p> <p>For the first time in almost two decades, monetisation of the Centre's budget deficit was not the major factor accounting for monetary expansion.</p>	<p>Large capital inflows and injection of external liquidity posed problems for effective monetary management. Also, the Reserve Bank faced multiple challenges in having to: (i) increase the productive deployment of foreign exchange assets; and (ii) sterilise the build-up in liquidity and thus reduce the pressure on the price level without raising the real rates of interest.</p> <p>The <math>M_3</math> expansion during the year was targeted at 14.0-15.0 per cent. Price stability was the primary objective of monetary policy, to be achieved by bringing about a reduction in the inflation rate by about 4.0 percentage points.</p>	<p>Active OMOs continued to be the anchor of monetary policy in order to sterilise capital inflows.</p> <ul style="list-style-type: none"> <li>• CRR increased from 14.0 to 15.0 per cent (in three phases during May 1994).</li> <li>• Increase or imposition of CRR on non-resident accounts.</li> <li>• Tightening of guidelines on Euro issues.</li> <li>• SLR reduced in phases (October 1994).</li> </ul>

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*Fiscal-monetary co-ordination*

*Financial sector reform*

The historic agreement with the Central Government (September 9, 1994) strengthened the efficacy of monetary policy by eliminating the automatic monetisation of fiscal deficit phased over three years. Meanwhile, the access of the Central Government to borrowings from the Reserve Bank through the issue of *ad hoc* Treasury Bills was to be kept within the agreed annual limits. This removed one major source of instability in monetary management and helped control inflation.

1995–96

RESTRICTIVE MONETARY POLICY CONTINUED DESPITE DECLINE IN INFLATION RATE

Governor: Dr. C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governor: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
<p>Two significant developments during 1995–96 were a strong demand for bank credit generated by the good performance of the real sector (GDP growth of 6.0 per cent) and volatile conditions in the foreign exchange market, albeit temporary, that impacted the inter-connected domestic money market. The Reserve Bank was compelled to inject funds into the money market to restore normalcy.</p> <p>Even though capital inflows slackened during the second half of the year, tight liquidity position persisted due to strong expansion in non-food credit.</p>	<p>The Reserve Bank pursued a tight monetary and credit policy that helped moderate <math>M_3</math> growth to about 13.0 per cent compared to 22.3 per cent in 1994–95; however, the latter was mainly due to increased net RBI credit to Government.</p> <p>In view of the highly satisfactory position of their statutory reserves, commercial banks reduced their holdings of government and other approved securities. This necessitated Reserve Bank's support to market borrowings of the Central Government, which increased the growth of net RBI credit to Government.</p>	<p>The significant credit policy measures of 1995–96 were:</p> <ul style="list-style-type: none"> <li>• Increase in maximum term deposit rate (April 1995).</li> <li>• Moderation of export credit refinance limits.</li> <li>• Freeing of interest rates on term deposits of over 2 years.</li> <li>• Changes in interest rates and CRR levels for different categories of NRI accounts to counter the excess demand in the foreign exchange market (October 1995 – January 1996).</li> <li>• CRR reduced to 14.5 per cent (November 1995) and then to 13.5 per cent (December 1995).</li> </ul>

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<i>Fiscal-monetary co-ordination</i>	<i>Financial sector reform</i>
	<p>Domestic monetary management had to take into account the external pressures transmitted through the foreign exchange market, particularly when volatile conditions ruled in the market.</p> <p>The Reserve Bank intervened during October and November 1995 to stabilise the volatility in exchange rates, which resulted in a sharp rise in the call money rate. The Reserve Bank injected large sums in the short-term money market, which helped stabilise the two markets.</p>

1996–97

MOMENTOUS YEAR FOR MONETARY MANAGEMENT  
 CRR REDUCED BY FOUR PERCENTAGE POINTS  
 SUBSTANTIAL FOREIGN CAPITAL INFLOWS LED TO SIZEABLE LIQUIDITY GROWTH  
 INCREASED RELIANCE ON INDIRECT INSTRUMENTS OF CREDIT CONTROL  
 REACTIVATION OF INTEREST RATE  
 AGREEMENT OF MARCH 26, 1997 PHASED OUT MONETISATION OF GOVERNMENT DEFICIT  
 AND STRENGTHENED CONDUCT OF MONETARY POLICY

Governor: Dr C. Rangarajan (22.12.1992 – 22.11.1997)

Deputy Governors: Shri S.S. Tarapore (30.1.1992 – 30.9.1996)

Dr Y.V. Reddy (14.9.1996 – 31.7.2002)

<i>Macroeconomic backdrop</i>	<i>Objectives and stance of monetary and credit policy</i>	<i>Salient policy measures</i>
<p>There was considerable softening of interest rates with an improvement in the overall liquidity situation, inflation was under control despite some supply-side pressures and <math>M_3</math> growth was within the targeted range of 15.5–16.0 per cent. The reduction in external CAD coupled with large capital inflows translated into foreign exchange reserves scaling a new peak of US \$ 26.4 billion by end-March 1997. In fiscal consolidation, the GFD of the Central Government at around 5.0 per cent of GDP was considered to be satisfactory.</p> <p>However, the Reserve Bank was concerned that while the foreign exchange reserves swelled, there was some appreciation of the real effective exchange rate (REER), with a possible impact on export performance in an environment of depressed global demand.</p>	<p>The objective of monetary policy pursued during 1996–97 reflected a “blended” response to short-term and long-term concerns. While the immediate need was to reduce the high level of interest rates which prevailed in 1995–96, the long-term concern centred around building an appropriate environment to ensure a low and stable level of inflation (which was postulated at 6.0 per cent). The latter purpose was helped by phasing out the automatic monetisation of government deficit, which became a reality from April 1, 1997.</p> <p>Monetary policy sought to consolidate the gains against inflation achieved in 1995–96. However, its basic stance for the year was one of relative ease. It envisaged expanding the lendable resources of banks without fuelling excessive monetary expansion and the consequent pressure on the price level.</p>	<p>The monetary and credit policy measures announced were:</p> <ul style="list-style-type: none"> <li>• CRR reduced by one percentage point to 13.0 per cent (April 27 – May 11, 1996) and in the case of NRE deposits from 10.0 per cent to zero (April 13, 1996).</li> <li>• Export refinance rationalised.</li> <li>• CRR reduced to 12.0 per cent and simultaneously the refinance against collateral of Treasury Bills and government dated securities terminated (July 6, 1996).</li> <li>• CRR was further reduced to 10.0 per cent (in four stages from October 26, 1996 to January 18, 1997).</li> <li>• Banks granted freedom to fix their own interest rates on domestic deposits of over one year instead of two years (July 2, 1996).</li> <li>• The minimum maturity period of term deposits reduced from 46 days to 30 days.</li> </ul>

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*Fiscal-monetary  
co-ordination*

*Financial sector  
reform*

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The operating monetary policy procedures necessitated close co-ordination between liquidity and debt management.

The financial sector reforms were responsible for forging linkages between money, capital, gilt-edged and foreign exchange markets.

Even though there was pressure on Central Government finances, favourable market conditions and the improved liquidity position of banks helped raise the needed resources for the Government without placing much reliance on Reserve Bank support.

The elimination of automatic monetisation of fiscal deficit became the key to providing flexibility to the conduct of monetary policy.

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

