CHAPTER V
THE RESERVE BANK OF INDIA AND ECONOMIC DEVELOPMENT

A strong Central Bank is an important pre-requisite to the growth of financial institutions and of the economy as a whole. Central Banks today are no longer circumscribed within the limited objectives of maintaining a stable exchange rate or stability of prices. But they are acting in close co-operation with the Government in achieving economic growth. In an underdeveloped economy, in particular, the creative aspect of the Central Bank's activities is as important as its regulatory aspect. Not only is the Central Bank called upon to regulate the volume of currency and credit but it also seeks to fill up the institutional gaps in the financial structure.

The history of the Reserve Bank of India throughout the thirty years of its existence is a history of the evolution of this dual role. The Bank, which was set up as a shareholders' institution and was nationalised in 1949, had a limited role according to the original Act. Thus, its main function was 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." To this limited responsibility had been added, from the beginning, that of expanding rural credit facilities.

As the country has been proceeding along the course of rapid economic development, the objectives and range of functions of the Reserve Bank have been gradually expanding. Its regulatory activities have been acquiring new dimensions and significance. The weapons of control at its disposal are becoming more numerous and the scope of their influence is growing.
Apart from control of currency and credit, remedying the commercial banking structure of all its weaknesses and defects and setting it up on a sound basis have also become parts of the normal activities of the Reserve Bank of India.

In addition to all these expected functions, however, the Reserve Bank of India is performing other important promotional and developmental functions. In an underdeveloped economy setting up of suitable financial institutions is as vital a step as the laying out of public utilities. A sectoral imbalance in the growth of financial institutions is to a large extent responsible for the inadequate development of some sectors, particularly those of industry and agriculture. Moreover, wherever there is an inadequacy in the financial set-up, be it in the field of industrial finance or in the field of rural credit, the Reserve Bank is stepping out to fill it up. The progress it has achieved within a period of little more than a decade is indeed remarkable.

Control of Credit by the Reserve Bank of India

The Objectives and Difficulties of Credit
Control Policies in India

The effectiveness of monetary policy in an underdeveloped country is limited because of the unorganised nature of the money market. Yet, its role cannot be ignored because the destabilising effects of a change in the stock of money here are very great. There is usually an unwillingness to hold assets in the form of money due to the low levels of income, high marginal propensity to consume, usual tendency of the value of money to fall, preference for hoarding wealth in other forms such as precious metals,
real estate etc. In the absence of a developed capital market, the choice is not so much between money and bonds or other assets as between money and commodities. Money supply, therefore, closely affects prices. Neither is a change in the income velocity of money very much likely to counteract a change in the stock of money. An interesting finding in India has been the relative constancy of the velocity of circulation of money in the context of economic development.

Money supply, of course, is not the only or the most important influence on prices. Nor can monetary policy as such initiate economic growth. But once the decision and initiative to development are taken, monetary policy can be of very great significance. In a developing economy the supply of credit must be adequate so that economic growth is not impeded by a shortage of funds. Nor must it be so excessive as to cause inflation. There are, therefore, two things that the Central Bank can do. It can try to maintain reasonable price stability as that is an essential condition of balanced growth; secondly, it can manipulate the cost and availability of credit so as to maintain the volume of credit within desirable limits, as well as to encourage certain forms of credit and discourage others.

This is not to deny the existence of various factors which impede the effectiveness of monetary policy in underdeveloped countries. These are: a general lack of integrated and organised money and capital markets, the presence of a sizeable non-monetised sector, (35% at rough estimates

(1) David L. Grove - "Objectives and Potentialities of Monetary Policy in Underdeveloped Countries" - Chapter I of doctoral dissertation on "Central Banking in Underdeveloped Countries" (Harvard University, 1952) received by the courtesy of the author.

(2) Presidential address by Dr. S.K. Basu at the 46th Annual Conference of the Indian Economic Association, Bombay, December 1968.
in India), the much greater importance of currency than that of deposit money, lack of cohesion even within the organised sector and the organised commercial banks' practice of working normally with huge excess reserves etc.

In some respects the money market in India is quite developed. She has a well developed commercial banking system. The organised sector of the money market is expanding. The Central Banking Enquiry Committee (1930-31) estimated that 90% of the total internal trade was financed by the unorganised sector. According to a Governor of the Reserve Bank, 50% of the total internal trade is, at present, being financed by the organised financial institutions, including both commercial and co-operative banks. (1) Moreover, loose and dichotomous as the Indian money market is, almost all sections of the money market are indirectly amendable to the control of the Reserve Bank through their dependence on the State Bank of India.

There is, also a framework of organised financial institutions other than commercial banks, including the specialised financial institutions, the insurance companies, the co-operative banks, the postal savings banks etc.

Several important impediments to central banking control have lost their force in recent years. First, commercial banks have ceased to work with as high a cash reserve ratio as in the past. Consequently, their borrowings from the Reserve Bank have ceased to be distressed borrowing in the last resort and have become more frequent. The Reserve Bank’s control has correspondingly increased. However, the cash reserve ratio is as yet a fluctuating one. Secondly, since, nationalisation, the Imperial Bank has ceased to act as a rival to the Reserve Bank of India in influencing the money market. Moreover, formerly the commercial banks

(1) H.V.R. Iengar - Monetary Policy and Economic Growth (Vora & Co.) P.136
had a closer connection with the Imperial Bank of India than with the Reserve Bank but now a days commercial banks' connection with the Reserve Bank is gradually becoming closer. Even the foreign exchange banks have recently been depending to a greater extent upon the Reserve Bank of India. Finally, since the passing of the Banking Companies Act, 1949, law has added enormously to the powers of the Reserve Bank.

In spite of these favourable developments, credit control by the Reserve Bank is, as yet, obstructed by various circumstances. There is still, in the money market, a large unorganised sector whose connections with the Reserve Bank are loose and indirect. Even within the organised sector, there is considerable lack of co-ordination. There is the difference between the Indian joint stock banks and the exchange banks. Excepting a few big banks, there is a lack of co-operation and understanding among Indian joint stock banks too, and between the Reserve Bank and commercial banks. Seasonal factors are as yet so important in the Indian monetary scene that monetary policy must be quickly adjusted to meet seasonal requirements. This calls for a high degree of judgment and quick action.

The decades of economic development have given rise to some special problems in addition to those mentioned. A stringency of funds and a tendency towards inflation have been the simultaneous and persistent features of this period. The genuine credit requirements of a developing economy must be met. But excessive or indiscriminate credit expansion will have inflationary consequences, on the one hand; on the other, it puts too great a strain on the resources of the banking system. Credit policy in India should be and has attempted to be expansionary and contractionist at the same time. It is, according to the Reserve Bank
of India, a policy of "Controlled Expansion".

The powers of credit control of the Reserve Bank of India are derived from two sources; the Reserve Bank of India Act, 1934 and the Banking Companies Act, 1949, both with subsequent amendments. The former gives the Reserve Bank of India general powers of control and the latter gives specific powers. Together they form a formidable list of powers for the Reserve Bank.

CREDIT POLICY OF THE RESERVE BANK OF INDIA

Prior to 1951, the credit control operations of the Reserve Bank of India were not very significant. The only two weapons in its armoury were Bank Rate policy and Open Market Operations. The thirties and forties were not, however, periods of normal use of Bank Rate policy. As regards Open Market Operations, in India they have usually been only the means of meeting seasonal variations in the demand for money and credit.

The period of economic planning can be described as a period of the efforts of the Reserve Bank of India to adapt itself to the requirements of a growing economy. It has been using both general and selective instruments of control and trying to adjust them to swiftly changing circumstances.

Save for one or two exceptions, the problem of credit control during the First Five Year Plan period had been comparatively simple. This was a period of rising national income and reasonable price stability. During this quinquennium national income rose by 10% and total money supply including currency and demand deposits increased by 10%. Total bank credit created was, on the whole, sufficient to meet the growing requirements of trade and industry and yet, not excessive as to cause inflation. Credit
management did not raise very serious problems during most of the First Plan period.

The credit control measures of the Reserve Bank of India during this period consisted of: (1) A flexible use of discount rate policy, in order to curb inflationary tendencies and to correct balance of payments disequilibrium; (2) Change in the Reserve Bank's Open Market Operations, to prevent excessive credit expansion; (3) Some amount of selective credit control to prevent the flow of credit along particular avenues.

The problem of credit control was much more serious and complex during the Second Plan period. The gap between available savings and estimated investment was much larger than during the First Plan period. The planned level of investment was nearly double. The proposed scale of government expenditure and the need for increase in bank credit were both much larger. Accordingly, inflationary tendencies and the pressure of demand for funds took much more serious forms. The credit control measures adopted during this period, too, were more varied and complicated.

The objectives of credit control during the second Plan period were: first, prevention of excessive credit creation in some directions without affecting genuine productive requirements; secondly to secure a greater degree of credit elasticity in the market in the face of a recurring shortage of funds. The credit control measures adopted therefore consisted of combination of a variety of measures - including a tightening and more discriminatory use of general quantitative methods of control along with the use of selective and qualitative controls.

Inflationary tendencies formed the chief cause of concern during the major part of the Third Five Year Plan period, particularly since June 1962. Although deposit mobilisation has proceeded at a more satisfactory rate
than before and the resources position of banks has improved, yet the rate of credit expansion also has been quite high. In this context this period has mostly been characterised by a tightening of quantitative control measures side by side with the use of selective control measures.

**BANK RATE POLICY IN INDIA**

In the absence of a developed market in short term bills, Bank rate has come to mean primarily the rate on advances and not the rate on discounts.

The potentiality of Bank rate policy is believed to lie in two directions. First it aims at regulating internal economic activity. Secondly it serves as a regulator of international movements of short term funds and through them, of the balance of payments position. This second aspect of control is non-existent in India because of the absence of a developed international market for short term funds and because the character of imports is largely determined as a matter of government policy.

Internally, by regulating the cost and availability of credit, Bank rate is expected to affect the building up of inventories as well as investment in fixed capital. Even in advanced economies, however the effectiveness of Bank rate policy is felt to be circumscribed now a days due to the declining importance of rate of interest as a determinant of investment. In imperfectly developed money and capital markets the effectiveness of Bank rate policy is still more doubtful. Interest elasticity of investment in fixed capital is negligible in a country like India where institutional agencies supply a very small part of the finance for investment. Secondly, the co-ordination between short and long rates is almost nil. The efficacy of monetary policy, therefore, would depend
more upon controlling the building up of inventories. Much of the inventory accumulation, too, is interest inelastic in the present India context. When there is a continuous pressure of demand for essential commodities, it is very difficult to check speculative building up of inventories, however high the interest rate may be.

Money market conditions too limit the potentiality of Bank rate policy. Bank rate changes in India do not always cause sympathetic changes in other short money rates even in the organised banking sector. An attitude of close cooperation between the Reserve Bank of India and the joint stock banks is lacking. Normally joint stock banks have worked with excess cash reserves and recourse to Reserve Bank lending has been unimportant in the past. There are considerable inter-bank differences in lending and deposit rates. These rates have little correlation with the Bank rate. The unorganised sector is virtually independent of Bank rate changes. There is thus a variety of short money rates in the market. There are, again, differences between the two major financial centres, viz. Bombay and Calcutta. Due to structural rigidities in the economy there are also geographical and sectoral differences, e.g., between the rural and urban areas, or between the agricultural and industrial sectors. Finally, in making use of Bank rate policy, the undesirable effects of increased money rates on the huge and growing volume of public debt too cannot be neglected.

Since the fifties, however, in view of the changes in money market conditions previously mentioned, the potentiality of Bank rate policy has increased. Experience shows that, at least in an upward direction, changes in Bank rate have transmitted themselves fairly effectively to other parts of the money market in recent years. Joint stock banks, particularly, are showing a greater willingness to accommodate their lending rates to Bank
rate changes and to fix uniform deposit rates voluntarily. Since 1951, money market rates, including the lending rates of commercial banks, have adjusted themselves more or less automatically to changes in Bank rate.

Experience with Bank rate policy is comparatively recent in India. In the November of 1951, the very first year the Reserve Bank of India was established, Bank rate was lowered from 3% to 3% and continued at that level until November, 1951.

In November, 1951, the Reserve Bank of India's discount rate was raised from 3 to 3%. This was simultaneous with discount rate changes in many other countries following the Korean war boom and the deteriorating foreign exchange situation. In India there was an excessive credit creation which continued even during the slack season. The expansion of credit was believed to have encouraged speculative investment in inventories. Inflationary tendencies were evident.

Bank rate remained unchanged at the rate of 3% up to November, 1956. The structure of the Reserve Bank's lending rate was quite simple. Except for concessional lending provisions with regard to agricultural credit, there has been only one rate for advances and discounts. With the introduction of the Bill Market scheme, a concessional rate of 5% below Bank rate was granted to advances against the scheme. Since November, 1956 with encouraging response to the scheme this concession was removed and there has been only one rate for discounts and advances since.

From the point of view of its impact upon other money rates and upon the total supply of credit the Bank rate change in 1951 had immediate effect. The rise in Bank rate was followed by a hardening of other
important short money rates. The Imperial Bank of India's rates largely affect all other money rates in the economy both in the organised and in the unorganised sectors. Besides its hurdle rates, the Imperial Bank of India's call loan rate on advances of Rs 5 lakhs and above to scheduled banks rose from 2½ per cent to 3 per cent immediately, and a month later, to 3½ per cent. Even the exchange banks, which are comparatively free of the Reserve Bank's control, raised their lending rates by ½ per cent.

Inter-bank call money rates of larger banks rose immediately in Bombay and although somewhat later in Calcutta, yet the February-March levels in 1952 were much higher than those during the corresponding period in 1951.

Timing of the Bank rate so as to fall just at the beginning of the busy season, combination of change in Bank rate with a change in Open Market Operations, the Imperial Bank of India's accommodating its lending rates to the Bank rate—all these accounted for the effectiveness of Bank rate policy.

Banks willingly cooperated with the Reserve Bank in following a more cautious policy towards advances and restricting speculative lendings. As a result of these, the busy season expansion of bank credit at Rs 99.96 crores in 1951-52 was much lower than that at Rs 180.29 crores in the previous busy season.

Quantitative control of credit was also given a selective character at this time. With greater dependence upon the Reserve Bank on the part of joint stock banks, the Reserve Bank could follow a more discriminatory lending policy. There was a better screening of loan applications. Non-essential loans were discouraged while special lending facilities were granted for essential purposes.
The imposition of tighter controls was accompanied by a fall in prices in February - March, 1952. There was a decline in the speculative accumulation of inventories. Thus there was a fall in commercial advances during the busy season, but not in industrial advances. The fall in prices was, however, a compound of many other factors too such as a rise in the index of industrial production, contraction in money supply as a whole, the disinflationary impact of a heavy balance of payments deficit, the post Korean boom yielding place to a mild recession etc.

The contraction of credit in the context of a rise in industrial production intensified the fall in prices. Thus Bank rate policy succeeded in controlling credit, but not so much in creating credit elasticity. In view of the larger rise in agricultural production and the consequent shift of funds from the monetised to the non-monetised sector, the need for credit elasticity was all the greater.

Because of inflationary tendencies and the pressure of demand for funds during the Second Plan period, quantitative control was made more restrictive and discriminatory. In February and May, 1957, the effective borrowing rate against the Bill Market Scheme and the Bank rate respectively were raised to 4%. Thus between the years 1951 and 1957, Bank rate had varied only twice, once in November 1956 and then again in May 1957. This is in sharp contrast to a change in Bank rate of 9 times in the U.K., 10 times in the U.S.A., 9 times in Canada and 10 times in Belgium during the same period. The maximum height of Bank rate reached during this period was 7% in U.K. compared to 4% in India. Moreover, the change in Bank rate in 1957 signified changes in money rates that had already taken place in the market. The approach to Bank rate was thus rather
weak and cautious. This cautiousness of approach was necessary because a downright restriction in advances was not called for. A sharp rise in Bank rate would also have disastrous effects upon the gilt edged market and the volume of government borrowing.

Bank rate remained fixed at the rate of 4% upto January, 1963. The need for a large curtailment of credit was felt again in 1960. There was a considerable expansion of credit in the private sector accompanied by a sharp rise in prices. The rise in prices was more marked in the case of those commodities against which there had been a considerable expansion of credit. Such were industrial raw materials, manufactures and food grains. The rise in bank credit persisted inspite of a combination of other quantitative measures with selective methods of control.

The new Bank rate policy introduced in October, 1960 had two notable characteristics. It consisted of a system of slab rates. Borrowings upto a certain quota were to be made at Bank rate. The quarterly quota for each bank was to be equal to half the average amount of statutory reserves to be maintained by the bank during the previous quarter under the Reserve Bank of India Act. Borrowings above this quota upto 200% of the quota would be at 2% above Bank rate. Secondly, lending rates of banks were also controlled. From October 1, 1960, the Bank also directed all scheduled banks to enforce a minimum lending rate of 3% on all advances excluding inter bank advances. Banks were also required to raise their average lending rates by 5%. The higher lending rate was felt necessary because the penal rate would not affect a bank unless it borrowed from the Reserve Bank.

The slab system of rates continued until September, 1964, with modifications from time to time. In July, 1962, the quota was lowered to 25%, instead of 50% of the average amount of statutory reserves during the previous quarter. With the outbreak of hostilities with China and the
inflationary possibilities it portended, an important modification was introduced in the system in October, 1962. For the first time, a maximum limit was set on a bank's borrowings from the Reserve Bank. This limit would be equal to the average statutory reserves of the Bank during the previous quarter.

These new measures were intended to be used as selectively as possible. The maximum limit might be relaxed if the Reserve Bank was satisfied of the justification of granting such relaxation. Borrowings beyond the limit would be at a higher rate (6%). The slabs themselves would be varied to fit individual cases.

Additional permissible limits for borrowings were later granted to some banks on the basis of their past borrowings from the Reserve Bank, general character of their working, lending to essential industries and exports etc. Banks were already enjoying a relaxation of the limit in respect of lending to small scale industries and the cooperative sector. Thus Bank rate policy was sought to be used in a flexible and discriminatory manner. The objective was to restrict only excessive or inessential borrowings. This selective bias of Bank rate policy is in keeping with the needs of the economy.

In January, 1963, in order to keep in line with the prevailing market rates, the Bank rate was raised to 4% and the three-tier system was changed into a two-tier one by merging the first two slabs. Thus borrowings up to 50% of the quota would be at Bank rate, the other 50% at 6% and borrowings in excess of the limit would be at higher rates.

Bank rate policy, as it was used in India until September, 1964, had several characteristics. First it did not intend to be a penal rate except for borrowings beyond the quota. The increases in Bank rate followed, instead of initiating market rate changes. Bank rate changes have been
much less frequent than in many other countries. The official rate has risen to much lower heights too (varying mostly between 3% and 4%). Approach to Bank rate policy has thus been always weak and cautious.

We find in the Reserve Bank's policy a frank recognition of the fact that Bank rate changes cannot have the same significance in the Indian money market that they can have in, say, U.S. Bank rate changes in India have been introduced only to signify fundamental shifts in the pattern of interest rates. They were never intended to provide a shock to the money market. The emphasis has been more upon affecting the availability than the cost of credit.

Apart from the possible increase in the cost of borrowing to the Government, the huge predominance of Government securities in the securities market and the possibility of large capital losses to most institutional investors who invest largely in government securities, affected the Reserve Bank of India's decision. The monetary authorities also avoided a straight rise in Bank rate so as not to affect the expansion of credit for genuine productive purposes. The former Governor of the Reserve Bank of India pointed out that although Bank rate changes have been few yet the average lending rate increased from 3% in 1956 to 5% in 1961.(1) The whole structure of money rates has shown a tendency to increase following the slab rate changes.

The Reserve Bank of India's policy of maintaining a comparatively low and stable Bank rate has evoked considerable criticism. This policy

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(1) H.V.R. Iengar - Speech delivered at the Annual General Meeting of the Institute of Bankers, August 1961, Reserve Bank of India Bulletin
Also reprinted in Monetary Policy and Economic Growth (Vora Publishers) pp. 241-273
failed to secure its purpose. Rather it had some unhappy consequences. The Bank was guided by a desire to secure credit elasticity, not credit restriction as such. Yet it was not always possible to achieve the necessary degree of credit elasticity. As a result the monetary system has faced severe credit stringency from time to time.

But then credit elasticity is perhaps too much to expect from the use of Bank rate policy. A more serious charge is that a simultaneous desire to restrict member bank borrowings from the Reserve Bank and to maintain the price level of Government securities has had paradoxical results. A rise in the Reserve Bank of India’s lending rates and a higher rate of interest on advances than on Government securities has led banks to sell off these securities and to grant more advances. The Reserve Bank in its anxiety to support the price structure of Government securities, has been taking up all securities. The result has been encouraging bank advance at the cost of Government securities. (1)

It has further been pointed out that the cost of servicing the public debt is largely in the nature of a fictitious book debt since more than 50% of the Government securities are held by the Government of India and various Government departments. As regards the institutional investors, any risk of loss can be avoided if the loan is held till maturity. And since the size of the public debt in India is much smaller in relation to total national income than in other countries the burden of service charges should cause less concern. It is also argued that a low interest rate structure in a capital scarce country prevents economy in the use of capital and a rational allocation of resources. (2)

The policy of low and stable money rates loses most of its justification in a highly inflationary situation. A low Bank rate, instead of maintaining the price structure of Government securities, rather creates a preference for equities over such assets because of their larger yield and possibility of capital appreciation. It will also hinder the growth of savings and may mean a shift of savings away from bonds into real estate, commodities etc. (1)

The soaring rise in prices since the middle of 1962 was rendering the Bank rate policy of the Reserve Bank more and more inadequate. Whereas the price level had been almost continually increasing since the middle of the fifties, the rise in the level since July 1962 seemed to go beyond all control. Between 1961-62 and 1963-64 the price index of all commodities rose by 14% and that of foodgrains by 21%. The increase was particularly marked during 1963-64. Between July 1963 and July 1964 the consumer price index rose by 19%. The wholesale index of all commodities rose by 10.7% between September 1963 and August 1964. (2) The rise in prices was higher than in any year since the War and it reflected a maladjustment between increased monetary demand and the growth of real output. During the first two years of the Third Plan increase in production at the rate of 2.5% per annum was much lower than the planned target of more than 5%. At the same time money supply increased by 9.9% in 1962 and 13.6% in 1963.

Under the circumstances there was a clear case for dearer money policy. When inflation takes too severe a form, simultaneous reliance has to be placed on fiscal, budgetary and physical control devices. Among

(1) A.N.Khosro – The Effects of Inflation in India, The Statesman, October 6, 1964

(2) Reserve Bank of India Bulletin, September 1964.
monetary controls, in the absence of a tightening of general quantitative controls, the effectiveness of selective controls is largely circumscribed. Monetary policy, as it is being used since September, 1964, has had important new orientations. First, emphasis has been shifted from manipulating the availability of credit to manipulating its cost. The system of quotas and slabs was substituted by a higher Bank rate which increased progressively with increases in the volume of borrowing from the Reserve Bank. Secondly, the Bank rate is being changed more frequently, in contrast with the previous reluctance to vary the basic rate.

In September, 1964, the Bank rate was raised from 4% to 5%. In February, 1965, it was raised further to 6%. Thus Bank rate was increased twice within five months and, for the first time, by a full one per cent at a time. While Bank rate was raised in order to restrict credit, the system of quotas and slabs was abolished to secure the necessary degree of credit elasticity during the ensuing busy season. The availability of credit was to be manipulated through a differential interest rate system. The banks would have to pay a progressively higher rate for their borrowings from the Reserve Bank, the level of the rate depending upon the real impairment of the liquidity position of the borrowing bank. The net liquidity position of a bank will be determined by the difference between the total liquid assets of a bank less its total borrowings from the Reserve Bank and the State Bank of India. If this difference formed 28 per cent or more of aggregate time or demand liabilities, banks would pay interest to the Reserve Bank at the Bank rate. For every one per cent decrease in this ratio the rate charged on a bank's entire amount of borrowings from the Reserve Bank would be raised by ½ per cent. This ratio was raised to 30% in February 1965.
All concessional rates except those with regard to the Rupee Export Bills Scheme were withdrawn.

As a restrictive device, this system is more reasonable than the previous system of quotas and slabs. Previously, for borrowings beyond a limit banks would have to pay higher rates only on the additional borrowings, but borrowings within the previous slab or slabs would not be affected. Now the higher rate would be payable on the entire amount of borrowing. Secondly, the cost of borrowing would be related to the total volume of credit extended by a bank in relation to its liquid resources. Formerly, the quota was fixed with regard to the size of the bank’s statutory resources during the previous quarter. There was no reason why any particular sanctity should attach to the aggregate reserves of the previous quarter.

In order to ensure the maximum effectiveness for the differential lending rates, the maximum rate on overdrafts, advances and discounts that could be charged by banks was fixed at 9% in September 1964. This was raised to 10% in February, 1965.

Following the increase in bank rate in September, 1964, the banks which are signatories to the Inter-Bank Agreement on Minimum Advance Rate raised the minimum rate charged on advances under the Agreement to 7%. Since October 1, 1964, the State Bank also raised its advances rate by 1% to 6%.
In 1951 besides raising the Bank rate the Reserve Bank of India also modified its customary Open Market operations in order to stop the automatic expansion of liquidity through the monetisation of public debt by the banking system and thus to provide support to Bank rate policy.

The instrument of Open Market operations has been used fairly extensively in the past by the Reserve Bank of India, as compared to other instruments of credit control. The legal and institutional setup has been favourable for its use. There are no legal restrictions upon the quantity and maturities of the securities which the Reserve Bank can purchase. Under Section 17(3) of the Reserve Bank of India Act; the Reserve Bank is authorised to purchase and sell securities of the Central Government and State Governments and certain approved securities of local Governments. The Reserve Bank's possession of an adequate and diversified portfolio of securities has been facilitated by the substantial increase in public debt both during the war years and during the years of planned economic development. The marketing organisation is fairly well developed. There are a large number of brokers in the principal cities while institutional investors like the L.I.C., Commercial banks etc., are major holders of the Government securities. However, Open Market operations here imply operations in Government bonds, particularly those of the Central Government. They do not mean operations in Treasury Bills as in U.K., or in Commercial bills, (although the Reserve Bank is legally entitled to purchase, sell and rediscount commercial bills), because there is no market for such paper.
Success of Open Market Operations depends upon Commercial Bank’s maintaining low and stable cash reserve ratios. In the past banks in India had been in the habit of maintaining high and fluctuating cash reserve ratios. During the decade of the fifties this ratio has varied between 6.0 and 11%. Maintenance of this lower ratio and the fact that short-term variations, at least, have not been very marked, have rendered the Reserve Bank’s Open Market Operations more effective.

Although Open Market Operations have been in keeping with the general objectives of monetary policy, yet, in the past they were not used as an instrument of credit control. Open Market Operations in India have, to a large extent, been used to meet seasonal variations in the cash reserve position of commercial banks, the Reserve Bank of India buying securities in the busy season and selling them off in the slack season. It was the practice of scheduled banks to buy securities in the slack season and to sell them off in the busy season to meet seasonal demands for cash.

Before World War II the scope of Open Market Operations was extremely restricted. With the enormous increase in public debt during War Years, the Bank’s objective had been to assist the successful flotation of these securities. When, in the post War Years, with the emergence of alternative demands for credit, banks began to sell off securities, the Reserve Bank adopted a policy of purchasing them in order to maintain the stability of their prices. This led to monetisation of public debt and automatic expansion of liquidity in the hands of banks. As long as the demand for bonds fluctuated seasonally, this was a self-correcting mechanism for banks would buy back in the slack season securities they sold in the busy season. But this regular
seasonal ebb and flow had been disrupted. Thus bank credit increased substantially in the subsequent slack season. The result was a severe stringency of funds at the beginning of the subsequent busy season and large scale expansion of bank credit on the basis of monetisation of public debt. Hence, in November, 1931, simultaneously with an increase in bank rate, the Bank announced that save in exceptional circumstances, it would not buy securities for meeting seasonal requirements of banks, but would grant temporary accommodation to banks against the collateral of eligible assets. Thus open market operations emerged for the first time as the deliberate instrument of flexible monetary policy. Reserve

Between November 1951 and November 1956, the Reserve Bank made net sales of securities worth Rs 50 crores, in contrast to purchases amounting to about Rs 200 crores between 1943 and 1951. In contrast to the policy of not buying government securities, the Bank in November, 1956, began to give discriminatory support to Government securities. This was done partly, because of an acute stringency in the money market and partly to facilitate a large scale flotation of bonds by State Governments. Between 1957 and 1961, the Bank had again been mostly following a policy of selling securities. These were years of tightening of credit control measures, both quantitatively and selectively. Open market operations have been used to make Bank rate more effective.

The Reserve Bank has also undertaken such operations in a considerable measure in connection with switchover in recent years. Thus it has offset one set of securities against another, i.e., it has purchased one set of securities before maturity in order to facilitate redemption of the loans and to ensure the success of new flotations.
It is the expectation of Sir, R.V.R. Iengar, the former Governor of the Reserve Bank, that with a decline in importance of seasonal characteristics it would be possible to make a more flexible use of open market operations for monetary control.

The facts that there have been both sales and purchases of Government securities since 1952, instead of only purchases as before and investors other than banks and insurance companies have emerged quite important in some years prove that the market in gilt-edged securities is growing.\(^{(1)}\)

The Attempt to Establish a Bill Market

The restrictive measures of November 1951 were followed by an attempt to impart credit elasticity to the money market through the Bill Market Scheme. A developed money market must have specialised dealers in various types of assets. These provide the Central Bank with sufficient ammunition and a market through which Open Market Operations become effective. The supply of credit is thus smoothly adjusted to requirements. The growth of a genuine bill market also provides the commercial banks with a very desirable type of liquid asset.

The Indian Central Banking Enquiry Committee (1930-31) explored the possibilities of establishing a bill market in India. It found that there were two obstacles. First, the absence of a Central Bank and the spirit of competition between the Imperial Bank and other banks. Secondly, lending by cash credits had been felt more convenient by both the borrower and the banker. Inspite of the establishment of the Reserve Bank of India in 1935 and a reduction of the stamp duty on usance bills in 1940, the

bill habit did not grow up.

The only genuine trade bill available in India is the multani hundi. But discounting operations in such bills are confined to a very few big banks and the total value of such bills is not important. The bills which are dealt in by most banks are really darshani hundis, or, in the form of demand promissory notes. Besides these, inland trade is financed very seldom through the intervention of trade bills, being mostly financed through the system of cash credits and overdrafts. Neither is there a market worth the name in foreign trade bills, agricultural bills or treasury bills.

Thus a genuine bill market never grew up in India. The Indian money market has always lacked the necessary degree of flexibility and resiliency as a result. This defect was sharply pointed out during the busy season of 1951-52. The liquidity position of banks was too weak to meet the busy season demand for finance. This coincided with an excessively high demand for credit and the Reserve Bank's policy of not buying Government securities in the busy season as a part of its credit control measures. All these emphasised the necessity of basing seasonal expansions of currency on self liquidating bills as far as possible.

The bill market scheme was introduced at first as an experimental measure for the current busy season to be modified later in the light of experience. The idea was not altogether new since it corresponded to the system according to which the Imperial Bank of India borrowed funds from the Currency Department during the busy season (Sec. 14, Indian Currency Act, 1920) against genuine trade bills or by the conversion of advances for that purpose.
The main features of the Scheme were as following:

Under Section 17(d)(c) of the Reserve Bank of India Act, the Reserve Bank could grant advances against internal usance promissory notes of 90 days. From now on the Reserve Bank would grant advances against this subsection to scheduled banks on the execution by them of demand promissory notes supported by usance promissory notes of their constituents. This would be done by converting the demand promissory notes of the banks’ constituents into 90 days’ usance promissory notes. The existing accounts of the bank’s constituents would be divided into two parts; one part would be covered by demand promissory notes to facilitate withdrawal in the form of loans, cash credits and over drafts. The other part would be converted into 90 days’ usance bills.

The Bill Market Scheme intended to meet the bonafide requirements of trade and industry. As per Section 17(d)(c) the promissory note required to have arisen out of bonafide commercial or trade transactions. The scheduled banks were therefore required to scrutinise the purpose of the loan, obtain a certificate from the drawer or endorser of the bill and lodge it with the Reserve Bank. The bill should bear two or more good signatures, one of which should be that of a scheduled bank. The scheme intended to combine the advantages of a cash credit system with those of a bill market.

In order to encourage the use of the facilities offered under the scheme, it was decided to make advances to banks for the time being at \( \frac{1}{2} \) per cent below the Bank rate. As a further inducement, it was decided that half the cost of the stamp duty incurred in converting demand bills into time bills would be borne by the Reserve Bank, although the incidence of the stamp duty payable was already quite low.
The facilities were offered within certain limits. The minimum limit for an advance which a bank might take at a time from the Reserve Bank would provisionally be fixed at ₹25 lakhs. It was also decided that each individual bill tendered by scheduled banks to the Reserve Bank should not be of a value of less than ₹1 lakh. These limits automatically barred the smaller banks from availing of the facilities offered. The scheme was initially confined to scheduled banks with deposits of ₹10 crores and above. These limits were felt necessary because the scheme was adopted, first, on an experimental basis.

It was clear that the scheme could be successful only through active and voluntary co-operation from the scheduled banks. They must make adequate use of the facilities offered under the scheme. They should also make proper enquiries as to the purpose of the loan and help the Reserve Bank with all the necessary information about their constituents.

There were originally criticism about the cumbersome system of inspection and examination of a bank’s dealings with its constituents and limitation of the facilities to bigger banks only. But this caution was regarded necessary at the beginning. With the initial success achieved by the scheme, it was found possible to relax these restrictions later on.

By stages, the facilities were extended to all banks having a licence, irrespective of the size of its deposits. Moreover, the minimum limit of advances under the scheme was lowered from ₹25 lakhs to ₹10 lakhs, later to ₹5 lakhs and the minimum amount of each individual bill also was fixed lower at ₹50,000.

Access to the Reserve Bank under the Bill Market Scheme was continually increasing. By 1956, the Reserve Bank was of the opinion that "The Bill Market Scheme has become a permanent and useful part of the
central banking mechanism". (1) The demand for the use of the facilities came not only from the Indian banks, but also from the exchange banks who had hitherto depended mainly upon imports of short-term capital from abroad. The high demand for facilities granted under the scheme continued even during the slack season. The success achieved by the Scheme enabled the Reserve Bank to withdraw the concessional rate of interest (1/2% below Bank rate) hitherto granted under the scheme. This concession had subjected the Reserve Bank to the charge of introducing "Cheap Money" during a period of restrictive monetary policy. With the withdrawal of this concessional rate and also of the concession with regard to stamp duty in 1956, the borrowing rate under the Bill Market Scheme became 3%. Since February 1957, the effective borrowing rate rose further by 1/2% as a result of an increase in the stamp duty on usance bills. In May, 1957, Bank rate also was raised to 4% to bring it on a par. The rate of stamp duty on usance bills being one-fifth of 1 per cent, the effective borrowing rate under the Bill Market Scheme became 4.1/5% i.e. 1/5% higher than Bank rate.

Another extension in the scheme was made in October, 1953, when credit facilities under the scheme came to be extended to export bills. Originally introduced on an experimental basis only at Bombay and Calcutta, the facilities have later been extended to some other placed. From the beginning borrowings against such bills were granted special facilities. The amount that could be borrowed by an individual bank and the minimum value of a usance promissory note were fixed at Rs 2 lakhs and Rs 20,000 respectively, later being lowered to Rs 1 lakh and Rs 10,000 respectively i.e. much lower than the similar limits fixed for other bills under the Bill Market Scheme. With a tightening of Bank rate policy since September 1964, concessional lending or rediscounting facilities against all types of bills have been withdrawn excepting those with regard to export bills.

(1) Trend and Progress of Banking, 1956, P.15.
With the extension of facilities granted under the scheme, the number of eligible banks nearly doubled and stood at 51 in 1959. In that year advances under the scheme formed 68% of the total advances accepted by the scheduled banks from the Reserve Bank of India. Large scale borrowing under the scheme continued inspite of the removal of the original concessions or even inspite of the discriminatory higher rate of 1/3% since February, 1957. This by itself does not testify to the success in the creation of a bill market. For, in a market with a rapidly expanding demand for credit, banks would be eager to cease any opportunity of increasing their resources. Thus, scheduled bank borrowings under the scheme have been particularly high during years of greater credit stringency, e.g. the years 1956-57, 1960. These were also years of lower rate of deposit expansion as compared to the volume of credit creation, such borrowings formed the basis of large-scale credit creation by banks.

Secondly, the Bill Market Scheme was intended to meet the bonafide requirements of trade and industry. Detailed steps were taken to ensure the same. During some years, however, it was felt that there was an excessive lending with funds borrowed from the Reserve Bank, and not all of it was extended for essential purposes. The Reserve Bank, therefore, sought to restrict such borrowings within reasonable limits and to combine these restrictions with selective credit control measures.

As a result of such restrictive measures and also a larger rate of growth of deposits during 1959 and 1959, there was some fall in the volume of borrowings under this scheme during these years. With the introduction of the slab rate system in 1960 borrowings under section 17(A)(c) came to

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(1) Reserve Bank of India Bulletin, May 1959,
Article by Nadkarni - Bill Market Scheme in Operation, P.529-534
be affected as borrowings beyond a fixed quota should be made at higher than Bank rate. The quota was gradually lowered until in October 1962 a maximum limit was placed on borrowings from the Reserve Bank. Thus, in the context of the inflationary situation, the Reserve Bank's policy was completely changed. Moreover as the deposit trends became more satisfactory the Reserve Bank had the feeling that banks should rely more on their own resources than on borrowed funds.

The Bill Market Scheme, therefore, has failed to impart the necessary degree of credit elasticity to the Indian money market. It has not served in removing temporary and genuine shortages of funds, but has only served as the basis of continued expansion of credit, not always for desired purposes. The Scheme could at best be described as an arrangement whereby banks could obtain more funds from the Reserve Bank but all the other required elements of such a market are ignored. No arrangements have been made for the free purchase and sale of the securities concerned. The only use to be made of them is to rediscant them with the Reserve Bank. Such necessary constituents of a market as discount houses, acceptance houses are also lacking.

The scheme completely ignores the multani hundi which is the only genuine trade bill available and in which there is some semblance of a market.

**VARIATION IN RESERVE REQUIREMENTS**

Another quantitative instrument of credit control, used for a brief spell of time during the second Plan period has been Variation in Reserve Requirements. Under Section 42 (1) of the Reserve Bank of India Act, 1934, scheduled banks were required to maintain with the Reserve Bank of India a minimum cash reserve of 5 per cent against demand liabilities and 2 per cent against time liabilities. Section 13 of the Banking Companies Act, 1949, made these ratios compulsory for all banking companies. The Amendment of the
Reserve Bank of India Act in 1936, gave the Bank the power to vary reserve requirements between 5 and 20 per cent of the demand liabilities and between 2 and 3 per cent of time liabilities.

Many countries, particularly those with an underdeveloped money market, have found variations in Reserve Requirements a powerful instrument of credit control. The statute in India made, at first, a distinction between time and demand liabilities. With an Amendment of the relevant section of the Act in 1962, banks now have to maintain a minimum of 3% cash reserve against aggregate liabilities, the Reserve Bank being able to raise this ratio up to 15%.

Secondly, the system of Variable Reserve Requirements is intended to serve as an equitable device. Thus, the Amendment Act of 1956 empowered the Reserve Bank to require scheduled banks to maintain with the Reserve Bank additional cash reserves against the excess of demand and time liabilities over the level of liabilities existing on any particular date to be notified by the Reserve Bank, and not upon all deposits. One of the arguments used against the instrument of Variable Reserve Requirements is that it is discriminatory in its effect. It does not distinguish between banks with larger and smaller deposit resources and thus discriminated against the latter. But according to the proviso mentioned above, banks would be affected exactly in proportion to the increased deposits acquired by each after a particular date.

Thirdly, the Act makes provision for payment of interest by the Reserve Bank, at a rate to be fixed by it from time to time, on the amount of reserves which exceed the minimum reserves.

No use was made of this weapon by the Reserve Bank until March, 1960, because a large proportion of the increase in deposits was used to buy Government securities. Gradually, however, bank credit to the private
sector was becoming an important source of credit expansion. There was a rise in prices which was believed to be due to the pressure of monetary demand. The inflated Government securities portfolio strengthened the liquidity position of banks and increased their power to create credit. In this context selective controls which had been the most frequently used controls since 1956, were not felt to be sufficient. A more direct and general method of control was called for.

In a directive issued by the Reserve Bank on March 11, 1960 it was announced that scheduled banks were to maintain with the Reserve Bank additional reserves equivalent to 25 per cent of the increase in their deposit liabilities since March 11, 1960 over and above the minimum statutory reserves, viz. 5 per cent of demand liabilities and 2% of time liabilities. Interest was to be paid on the additional reserves, subject to a maximum equal to the Bank rate.

The restrictive measures no doubt led to some amount of slackening in the rate of credit expansion. The expansion of credit in April, 1960 was slightly lower than that in the April of the previous year, being Rs 16 crores and Rs 23 crores respectively.

More important was the fact that the liquidity of the banking system was appreciably reduced. Excluding the State Bank, the free reserves (i.e. cash plus excess reserves) of other scheduled banks declined from Rs 64 crores on March 10, 1960 to Rs 39.5 crores on September 16, 1960, the ratio of free reserves to deposit liabilities declining from 4.9 per cent to 2.9 per cent. (1)

However, from the point of view of their impact upon total bank credit, the achievement of these measures was positively disappointing. Throughout

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the slack season, the level of bank credit continued to remain high. The restrictive effect of this policy was largely neutralised by the scheduled banks' much larger borrowing from the Reserve Bank. There was also a decline in the securities holdings of banks other than the State Bank in contrast to a rise of Rs 60 crores in the previous year, i.e. banks were selling off securities in order to maintain their volume of advances.

The stipulations regarding the additional reserves to be maintained were changed from time to time to meet changed circumstances. Unlike in U.S.A. changes in reserve requirements have been quite frequent in this country.

The additional reserves requirements were revoked altogether with effect from January 13, 1961. The Bank had not the legal power to return any portion of the impounded reserves. So the directive had to become effective with retrospective effect on the increase in liabilities between March 11 and November 11, 1960. About half of the Reserves impounded till then were released, amounting to about Rs 13 crores. It is the contention of the Reserve Bank that inspite of these restrictive measures, the legitimate credit requirements of the economy were adequately met, for over the year 1960 as a whole, credit expansion was more than double that in 1959. But this also means that banks were working with sufficient excess reserves or that they were able to borrow quite easily from the Reserve Bank. So credit increased inspite of the steep reserve requirements provisions.

The way in which this weapon is used in India has been criticised because it does not try to mitigate the hardship of the banks concerned by giving them timely warnings or by increasing the ratios in a gradual and progressive manner. (1)

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The efficacy of the method of variable reserve requirements depends upon the extent to which commercial banks are in the habit of maintaining stable and not too much excess reserves. It cannot be said that cash reserve ratios of Indian commercial banks have been unstable on the whole or too much in excess of the required reserves.

SELECTIVE CREDIT CONTROL

The most important development in credit control policies during the Second Plan period was the introduction of selective methods of control. Selective instruments form a means of discriminating credit control, depending upon the particular objective in view. Because of the significant part that the Central Bank is expected to play in guiding economic development and because of the various factors inhibiting the suitability of general methods of control, the consensus of opinion is in favour of using selective methods in an underdeveloped economy.

The power of using selective credit control is derived from section 21 of the Indian Banking Companies Act, 1949. According to this section the Reserve Bank may determine the policy in relation to advances to be followed by banking companies. The Reserve Bank may also give directives to banking companies as to the purposes for which advances may or may not be made, the margins to be maintained in respect of secured advances, and the rates of interest to be charged on advances, and each banking company shall be bound to comply with any directions so given. An amendment of the Act in 1963 has given the Reserve Bank the further power to give directives to banks regarding the maximum amount of advances that may be granted to one party.
The aim of selective credit controls as a restrictive device is to strike at the most sensitive, strategic sectors of the economy. If selective credit controls become effective in particular sectors, the inflationary potential of bank credit would be diminished to a large extent, although aggregate bank lending might not have diminished. The anti-inflationary impact would be determined by the contribution made by this sector to inflation. The undeveloped nature of the money market obstructs the effectiveness of selective controls too. For the commercial banks cannot follow up credit once it is granted. Thus borrowers may borrow funds for ostensibly permissible purposes against approved types of securities, but, in practice, divert their expenditure to the types of investment which are subject to control. Moreover, if credit granted for one purpose is made more costly, it is likely to affect the total volume of credit. Selective controls, moreover, may be useful when there is an overexpansion of credit in any particular direction, which cannot be controlled effectively by general credit control measures. This method is also more effective in the restrictive direction than as a positive means of encouragement. Restrictive selective controls may take various forms such as fixation of ceilings, margin requirements, import predeposit requirements, screening of bank loans, regulation of consumer instalment credit, through the fixation of minimum down payments and maximum maturity periods etc. In U.S.A. selective credit control has taken the form of regulation of consumer credit, real estate credit and fixation of margin requirements for stock market credit.

The weapon of selective credit controls was first resorted to in India in May, 1956. The background for the introduction of selective credit controls during the first year of the Second Plan period was inventory accumulation in foodgrains with the help of bank credit, the tendency to speculate in foodgrains and, simultaneously, a sharp tendency of foodgrains prices to rise.
Hence on May 17, 1936, a directive was issued specifying the aggregate amount of advances to be maintained by banks against paddy and rice and fixing the margins against them. The directive method for regulating the volume of advances was not something new. It had been resorted to from time to time, on earlier occasions. But these were in the nature of general instructions. The prescription of higher margins and the efforts at restricting the aggregate level of advances against specific commodities was something new. From general measures, the directives became selective in character.

Since their first inception in May, 1936, directives have been issued quite frequently by the Reserve Bank of India to allocate credit more selectively. Selective credit controls in India, as indicated by these directives, reveal several characteristics. First, these measures have wholly been restrictive in character, regulating the flow of credit to particular channels, rather than encouraging it to others. The only passive encouragement given has been that of granting exemptions to certain specific types of advances from the control measures e.g., advances against documentary bills drawn in connection with the movement of goods, advances against exports, advances against warehouse receipts issued by the licensed warehouses established by the Central Warehousing Corporation. In many undeveloped or semi-developed countries, however, the promotional aspect of selective credit control has been no less important. Thus some Latin American countries use preferential discount rates and different eligibility requirements both as a regulatory measure and as a channelling instrument. In some other countries such as Mexico, again, loans for specified preferred purposes are included among reserve eligible assets. In others, including Israel, banks are granted exemptions from reserve requirements in so far as they grant preferred types of credits. In India the Bill Sarhet scheme
initially provided for differential rediscount facilities at differential rates of interest. The objective, however, was not to guide credit along particular channels, but to encourage the use of a particular type of credit instrument for granting the same types of loans as before.

Secondly, the aim of these controls has been to check the seasonal rise in the prices of essential articles by curtailing bank advances against them. So most of the directives were issued at the beginning of the busy season and with regard to advances against food-grains, including, on different occasions, paddy and rice, wheat and other food grains such as Jawar, bajra, maize, barley, ragi, gram, other grains and pulses or against other food articles such as sugar. Some were connected with advances against industrial raw materials and manufactured articles like jute and jute goods, groundnuts and other oil seeds. Advances against all these commodities had a seasonal character. Only on one instance was there a directive with regard to advances against cotton textiles and yarn. Very recently, since 1960 advances against stocks and shares have been subject to these directives. This reminds that in U.S.A. stock market credit credit has been the most important sphere of selective credit control.

Thirdly, some of the directives were mandatory in character while others were in the nature of a request. It was believed that banks would voluntarily adjust themselves to the requirements insisted upon in the directives. It was also mentioned on occasions that if the banks could not conform to the specified limits within the prescribed period of time, corrective action would be taken against them. It has not, however, been necessary to take such corrective action.

Fourthly, the directives have taken the form of prescribing maximum limits for advances in any particular direction or to any particular borrower as well as fixation of margin requirements. The ceilings for advances and
the margins to be maintained against them were fixed in the context of the volume of advances prevailing during the same period in the earlier years.

Fifthly, the control measures were definitely aimed at preventing inventory accumulation and speculative dealings in the commodities concerned. At the same time genuine marketing and processing activities were granted exemptions. In fixing the margins and limits for advances, account was also taken of regional imbalances.

At first the measures adopted were rather simple in character. But as time went on and experience was gained; they became more complicated and detailed. The measures have been sought to be imposed quite flexibly. Thus the restrictions have been relaxed or withdrawn whenever there was improvement in the price or supply position.

Effectiveness of Selective Credit Controls:

Selective credit controls in India have had a limited objective. They have sought to counteract the maladjustments (mostly seasonal) between the demand for and supply of certain essential articles by preventing speculative withholding of stocks with the help of bank credit. In view of this limited objective, we can assess the effectiveness of selective credit controls from two stand points; first their impact on bank credit - i.e. the manner in which and the extent to which bank advances responded to these directives; secondly, we can judge their effectiveness from their impact upon prices whose regulation is the ultimate objective of selective controls in India.

The former Governor of the Reserve Bank of India frankly admitted that selective credit controls in India have not been intended to correct the general inflationary pressures nor is their success to be judged precisely by the extent to which the prices of the relevant commodities have fallen.
Prices are determined by the demand and supply positions which are, again, determined by various other factors. "Hence the role of selective credit controls on prices have been of somewhat marginal significance".\(^{(1)}\)

The Reserve Bank has tried to affect price movements only indirectly through the volume of bank advances. Price movements too have not always shown a satisfactory response to the restrictions, even if bank credit has been curtailed. The only period during which price movements showed a satisfactory response to selective controls was in the latter half of June 1957 when food-grains prices declined following the curbs imposed upon advances against these commodities. But the fall in their prices during those months was a compound of various other factors including an imposition of general quantitative restrictions and a slackening of economic activity.

The efficacy of selective controls is therefore to be judged in the context where they are expected to be more effective viz., controlling the level of bank advances in any particular direction. This will depend upon the promptness with and the extent to which changes in bank advances correspond to the provisions of the directives. Secondly, it will also depend upon the possibility of evading these directives by lending more through other types of security to the same borrowers.

From these points of view we notice several distinct phases in the implementation of selective credit controls. We find that the earlier directives could either not be fully implemented or they were implemented only after a considerable time-lag. This is true of the period between May 1956 and June 1957. Even the June 1957 directive was not fully successful. Apart from such inadequate implementation there is the probability of large evasions having taken place through advances against other securities or in the...

\(^{(1)}\) "The Role of the Reserve Bank in the Planned Economy" - H.V.R. Iengar - Monetary Policy and Economic Growth (Vora Publishers) P. 234
form of clean advances. Since June 1957, however, the control provisions became more and more elaborate, covering wider fields and they came to be combined with quantitative credit limits. So the possibility of evasion became gradually lower. At first the major emphasis of the directives was on control of advances against foodgrains. In 1953, the emphasis changed to industrial raw materials like ground nuts, other oil seeds etc. Control on advances against shares too were imposed at this time. By 1959, we enter a phase of selective controls on foodgrains like paddy, rice and wheat being fully implemented. Since 1960, with tightening of quantitative restrictions, there was further increase in effectiveness of selective controls.

The directive of May, 17, 1956, required that no scheduled bank should extend the credit limit against the security of paddy and rice beyond Rs 50,000 and the existing margin against such goods should not be less than 10% of the value of the commodity. This part of the directive was mandatory in character. The optional part was that the aggregate advances against paddy and rice should be reduced to a level not more than 25% above that in the corresponding week of the previous year.

Scheduled Bank Advances Against Paddy and Rice

<table>
<thead>
<tr>
<th>Last Friday of</th>
<th>April</th>
<th>May</th>
<th>June</th>
<th>July</th>
<th>August</th>
<th>September</th>
<th>October</th>
</tr>
</thead>
<tbody>
<tr>
<td>1956</td>
<td>26.30</td>
<td>22.33</td>
<td>15.52</td>
<td>11.69</td>
<td>7.49</td>
<td>5.39</td>
<td>4.34</td>
</tr>
<tr>
<td>1955</td>
<td>11.15</td>
<td>10.81</td>
<td>10.21</td>
<td>7.74</td>
<td>5.76</td>
<td>4.20</td>
<td>3.84</td>
</tr>
<tr>
<td>Percentage increase in 1956 over previous year level</td>
<td>133.7</td>
<td>116.3</td>
<td>52.0</td>
<td>52.3</td>
<td>30.0</td>
<td>30.5</td>
<td>10.4</td>
</tr>
</tbody>
</table>

Source: Trend and Progress of Banking.

Thus even the optional part of the directive was effective but with a time-lag. During May and June the advances were reduced by 43% as against a fall of 9% each during the corresponding period of 1954 and 1955. The level of advances in June 1956 was 52.0 per cent higher than that in the corresponding period of the previous year, whereas, in April and May, it was 116.3 and 133.7 per cent higher respectively. The necessary adjustments were completed only in September. But that time the decline also came in the normal seasonal process. Some time lag is of course inevitable in reducing credit limits already granted to customers or in refusing accommodation to the bank’s old customers and in contacting distant branches.

More important was the charge raised that the provisions of the directives were evaded by giving advances apparently against other securities. This accounts for an unusual increase in advances against stocks and stores in May-June 1956 whereas such advances usually fall during this period. There was also an increase in clean advances.

The directive of May 1956 had no impact on prices of rice and paddy. Neither did it bring about any fall in the total volume of credit. That the underlying tendency was always towards lending for speculative hoardings of foodgrains is proved by the fact that immediately the restrictions were withdrawn in November 1956, there was an increase in lendings against foodgrains. Controls upon such advances had, therefore, to be reimposed in February 1957.

It is to be noted that the directive of September 14, 1956, with regard to advances against wheat and other grains, gram and other pulses, fixed a time limit (October, 1956) within which credit granted against such commodities was to be brought down to a level not substantially higher than
that in the same month of the previous year. The aim was nearly fulfilled only in December. Such time lags occurred in the implementation of subsequent directives in 1956 and 1957, irrespective of the rigidity or liberality of the provisions of the directives.

The Reserve Bank often showed a complacency of attitude which was not justified by facts. Such complacency was displaced by the hasty withdrawal of controls in November 1956.*

Banks did not comply fully with the provisions of a directive even if it was of a mandatory character and the situation was a generally restrictive one. Thus the directive of June 7, 1957, required that the existing margin maintained in respect of advances against foodgrains should be increased by an amount not less than 5% of the value of the goods and being not less than 40% of the value. The aggregate level of credit against foodgrains since 12th July 1957 shall be not more than 66.2% per cent in the case of paddy and rice and not more than 75% of other foodgrains over the level prevailing in the corresponding week of 1956.

### Advances of scheduled Banks against foodgrains

<table>
<thead>
<tr>
<th></th>
<th>July</th>
<th>August</th>
<th>September</th>
<th>October</th>
<th>November</th>
<th>December</th>
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<tbody>
<tr>
<td><strong>1956</strong></td>
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<tr>
<td>(Last Friday of)</td>
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<tr>
<td>Paddy &amp; Rice</td>
<td>11.69</td>
<td>7.49</td>
<td>5.33</td>
<td>4.34</td>
<td>6.35</td>
<td>9.61</td>
</tr>
<tr>
<td><strong>1957</strong></td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Paddy) Permitted &amp; levels</td>
<td>7.79</td>
<td>4.99</td>
<td>3.59</td>
<td>2.90</td>
<td>4.33</td>
<td>6.19</td>
</tr>
<tr>
<td>Rice ) Actual levels</td>
<td>11.09</td>
<td>6.44</td>
<td>3.95</td>
<td>4.21</td>
<td>4.96</td>
<td>6.16</td>
</tr>
</tbody>
</table>
We see that while there was better an adjustment between the permitted and adjusted levels in the case of paddy and rice the actual level was sizeably higher in the case of other foodgrains. The difference became particularly marked towards the end of the year. The rise in such advances during the last three months was unusual for the time of the year, and took place in the context of a hardening of money rates between February and May 1957.

Three new features were added to the directives since 1957. These added greatly to the authority and flexibility of selective credit controls in India. First, apart from maximum limits of credit to be granted to each borrower, each individual bank was ordered to maintain a maximum limit of advances against a particular type of security. Secondly, the initial response to the directives being somewhat faltering a warning was issued in July that the defaulting banks would be subject to corrective action. Thirdly, since 1957, state-wise and branch-wise discriminations are being made in fixing the maximum limit of advances because there was a greater tendency towards hoarding in the producing centres like Andhra Pradesh and Madhya Pradesh.

It is to be noticed that inspite of the inadequate implementation of the control measures in 1956-57 and the wide legal powers in the hands of the Reserve Bank, the Bank did not try to enforce action upon the scheduled banks. There is no long standing tradition of co-operation between the Reserve Bank and commercial banks in this country. The Reserve Bank wanted willing co-operation instead of imposing severe penalties. So it rather tried moral suasion. From time to time the Governor of the Reserve Bank of India issued circular letters asking banks to exercise the necessary degree of caution in the creation of credit against essential articles in
short supply. The Governor of the Bank also met leading bankers from 
time to time.

Upto 1958, the directives were mostly complied with in part. (The 
only exceptions were the two directives of December 1957, relating to sugar 
and foodgrains.) But these years may be regarded as an experimental stage 
in the imposition of selective controls. As the control provisions became 
tighter and more elaborate, there was better compliance with the directives.

In 1959, with a view to preventing the circumvention of selective 
controls through clean advances, the Reserve Bank discouraged the practice 
of discounting clean blindis drawn by parties affected by the selective 
credit controls. During this year, the operation of selective controls, 
with regard to paddy, rice and wheat, was much more effective than in 
earlier years. The actual level of advances kept below or equal to the 
permitted level. In March, 1959, advances against paddy and rice were 40% 
lower than the permitted level. Advances against wheat were 60% lower 
than the permitted level in July. This was not, however, true of advances 
against other foodgrains whose levels exceeded permitted levels all through 
the year. There had been a rise in agricultural production, particularly 
of foodgrains, this year. So the pressure of demand and speculative 
tendencies were reflected in the case of industrial raw materials like 
ground nuts and other oil seeds and non-cereal food articles like sugar, 
gur, tea and oil. On February 9, 1959, a directive was issued fixing the 
margins to be maintained against ground nuts at not less than 45%. The 
average aggregate level of credit against the security of ground nuts was 
not to exceed such level of credit in the corresponding month of 1957 or 
1958, whichever was higher. Except for March and April, advances against 
ground nuts each month were kept below or equal to the levels in the 
corresponding weeks of the two previous years. The difference in March and
April may be due to the problems of bringing about an immediate adjustment.

In 1959, in order to facilitate state purchasing programmes of foodgrains, credit limits in certain states were liberalised.

An extension of quantitative credit controls in 1960—with the imposition of variable reserve ratios and the introduction of the system of slab rates—rendered selective credit controls more effective. This year also saw the fixation of a ceiling in respect of clean advances so as to prevent circumvention of the selective restrictions. In response to representations from banks and industry, the Bank was, however, ready to increase limits for clean loans for a temporary period, in the interest of clients engaged in productive activities or exports; such concessions were also to be made in the interest of industry.

It can now safely be said that selective controls in India have reached a new phase since 1958. Whereas all the earlier directives were either not fulfilled, or fulfilled only in part, there has been almost perfect compliance with the directives with regard to foodgrains and industrial raw materials since 1958. Since these are main objects of control, we can say that selective controls have acquired a high degree of success in influencing bank advances.
Excess (+) or short fall (-) of permitted compared to adjusted levels (in lakhs of rupees)

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<tr>
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addy & Rice | -1.41 | -2.99 | -5.71 | -3.72 | -33 | -41 | -1.62 |
|Heat | -41 | -35 | -29 |
|Other foodgrains | 74 | -76 | -1.95 | -1.92 | -62 | -14 | -55 |
|Round Nuts | +17 | -2.05 | -2.62 | -3.26 | -2.00 | -1.06 | -1.02 |

Source: Trend & Progress of Banking.
We see that with a few exceptions there has been a high degree of co-ordination between permitted and adjusted levels of bank advances. The adjusted levels mostly remained below the permitted levels.

The impact of these control measures upon prices has not mostly been immediate or perceptible enough. Yet it has been pointed out that the restrictions imposed by these directives must have had a marginal significance in spite of the fact that bank advances formed only a minor proportion of the total funds used in financing movements of foodgrains. Secondly, such directives also exercise a psychological influence upon consumers and prevent them from hoarding shocks of foodgrains on their part in anticipation of a future rise in prices (1).

Thus the scope of selective credit controls in India is extremely limited, but within this limited sphere compliance with the directives has been increasing and they have largely succeeded in achieving their objective.

It has been suggested that selective controls should be imposed at the beginning of the agricultural season in order to be fully effective. The occurrence of the seasons however, is not timed with perfect accuracy, the seasons varying in length from year to year.

One important difficulty in implementing the selective controls is the administrative complexities involved owing to the large variety in the structure of assets and standards of management of the banks concerned. The large network of branches also interposes a time lag in the implementation of a directive. The directives also do not preclude the possibility of a switchover of borrowers from bank to non-bank sources or to indigenous bankers.

(1) S.N. Sen - Selective Credit Controls - the Indian Experiment, "Arthaniti" - Nov. 1953, P.34.
There is a suggestion that selective controls should be more positive in character instead of being purely restrictive. As in other underdeveloped countries, they should encourage the flow of credit to particular channels. While there are huge practical difficulties in implementing even a restrictive control device, the difficulties would be all the greater if selective controls are used as a positive encouraging device.

A survey of the credit control activities of the Reserve Bank shows that seasonal adjustments have, by far, formed their most important objective. In view of the tremendous influence of seasonal factors upon the monetary and price situation, their role cannot be overemphasised. Because of its inflationary possibilities, the efficacy of monetary policy in an expansive direction in India is necessarily limited. Correction of seasonal maladjustments in the demand for and supply of credit and the level of prices may therefore be regarded as quite significant achievement.

Monetary policy adjustments to seasonal variations, however, were not always suitably timed or of the extent desired. One important reason is that the timing of seasonal fluctuations cannot be correctly anticipated.

Apart from the usual quantitative and selective instruments of control, the Reserve Bank has also tried moral suasion with the banks. The Reserve Bank has issued directives from time to time regarding the volume of and the purpose for which credit may be expanded. It has also entered into voluntary agreements with banks. In view of the loosely integrated character of the money market and absence of a long-standing tradition of cooperation between the Reserve Bank and joint stock banks, such directives have not always been fully implemented. Yet, on the whole, the degree of compliance with the directives has been quite high.
It has been found that persuasion is more effective if other factors do not exercise an opposite influence and if it is used conjointly with other methods of control. With gradual increase in the authority and prestige of the Reserve Bank, its powers of moral suasion are becoming more important.

Growth in Powers of the Reserve Bank of India

One of the most important banking developments since the decade of the fifties is the growth in powers and prestige of the Reserve Bank of India. Before the advent of this decade, the Reserve Bank's authority was rather weak and limited. There has been a fundamental change since 1949. Several factors contributed to the growing authority of the Reserve Bank of India. First, the Banking Companies Act, 1949 and subsequent legislation made tremendous additions to the Reserve Bank's general powers of supervision, inspection and control. Among other things, this Act led to the emergence of a new weapon of control, viz. Selective Credit Control. In 1956 the Reserve Bank further obtained the right to vary Reserve Requirements of Banks. Secondly, steps have been taken to increase the efficacy of two old methods of control, viz. Bank rate policy and Open Market Operations. Thirdly several institutional factors have added to the authority of the Reserve Bank. These are: the nationalisation of the Imperial Bank of India, closer connection between the joint stock banks and the Reserve Bank of India, diminishing significance of the unorganised banking sector etc. The Reserve Bank was also granted greater discretionary authority over note-issue during 1956-57 when the legal reserve against note issue was changed into a minimum, instead of a proportional one.
The Reserve Bank's powers of inspection, examination, issuing directives etc., have been used very extensively. The Reserve Bank also takes various steps to strengthen weaker banks. Weaker banks are nurtured until they work normally. Unless they are able to improve their affairs, license is refused to them. Another method of strengthening weaker banks has been through merger and amalgamation, preferably on a voluntary basis. After the winding up of two scheduled banks in 1960, power was given to the Reserve Bank to enforce, with the approval of Government, schemes of reconstruction or compulsory amalgamation of weak units with strong ones. (Second Amendment of the Banking Companies Act, 1960). The Amendment Act also empowers the Bank to apply to the Central Government for an order of moratorium in respect of a banking company. The Bank publishes each year, detailed information about the findings of its inspections. The banks are also to provide the Reserve Bank periodic information about the extent to which the defects have been remedied.

In view of certain organisational lacunae in implementing schemes of merger and amalgamation quickly, the Banking Companies (Amendment) Act was passed in March, 1961. This Act provided the Reserve Bank with powers to prepare any scheme for the compulsory amalgamation of any banking company with the State Bank of India and its subsidiaries.

Another addition to the Reserve Bank's power came in the form of collection and furnishing of credit information. Since there is no exchange of information among banks in India, it is possible for one borrower to borrow an unduly large sum from several banks together. An amendment of the Reserve Bank of India Act, 1934 enabled the Reserve Bank to collect credit information from individual banks and financial institutions.
The Palai Bank incident in 1960 proved that mere legal powers become meaningless unless the Reserve Bank uses the proper degree of caution.

The Banking Law (Miscellaneous Provisions) Act, 1963, which amended the Reserve Bank of India Act, 1934 and the Banking Companies Act 1949 added significantly to the powers of the Reserve Bank. It gave the Reserve Bank powers of supervision and control over non-banking financial companies in addition to those exercised over banking companies. Secondly it gave the Bank authority to take penal action against persons belonging to the management of banking companies without going into legal proceedings against them.

**THE PROMOTIONAL ROLE OF THE RESERVE BANK OF INDIA**

The dynamic character of central banking in an underdeveloped country has found wide expression in the developmental activities of the Reserve Bank of India, particularly since the decade of the fifties. As a promotional agency, the Reserve Bank has been trying to mould and build up suitable financial institutions in those vital sectors of the economy whose development should form the basis of a richer and fuller existence, but where a dearth or inadequacy of appropriate financial institutions is a major obstacle to economic progress. Two such important areas are (i) agriculture, along with allied rural occupations and (ii) industry, both large-scale and small-scale. Organised banking business has mostly kept out of these fields due, partly, to the risky nature of such lending and partly, to the fact that loans to these sectors are for a comparatively longer duration. It has nowadays become almost a normal part of the Reserve Bank's functioning to try to fill up this institutional vacuum by all possible help and guidance and, where necessary, by direct participatio
To some extent, extension of organised banking facilities has an important bearing for the central bank’s regulatory activities too, since it widens the range of effectiveness of its credit control measures.

It is in the sphere of rural credit that the Reserve Bank had shown an interest from the beginning. In recent years, however, its developmental activities in the field of industrial finance have assumed no less significance. In both respects the years since the fifties have been years of very rapid progress.

The Reserve Bank of India and Rural Credit

As early as 1935, when the conception of central banking was very limited, the Reserve Bank of India Act made it clear that the field of agricultural credit would be a field of special interest for the Reserve Bank. The Reserve Bank, being the central bank, however, any financial assistance that could flow from it to the primary cooperative societies must pass through the State Cooperative Bank or the central cooperative bank. Such assistance could be availed of only provided the pyramidal structure of cooperative credit with the State Cooperative Bank at the apex, the central cooperative bank at the middle and the primary cooperative society at the base was well-developed. But up to the late forties, the cooperative movement in India would not come out of its formative stage.

The standard of working or the services rendered by cooperative institutions was as yet of a very poor order. So the Reserve Bank could do very little beyond giving advice and making reviews. Thus the Agricultural Credit Department of the Reserve Bank which had been set up under the Act, had two main functions:

(a) To maintain an expert staff to study all questions of agricultural credit and be available for consultation by the central Government, the State Governments, State Cooperative Banks and other organisations;
(b) To coordinate the operations of the Bank in connection with agricultural credit and its relations with State Cooperative Banks and any other banks or organisations engaged in the business of agricultural credit.

Secondly, whatever financial accommodation was provided was for short term and for helping agricultural operations only.

This was the total picture of the role of the Reserve Bank up to the late forties. Since then, however, this role has undergone complete transformation. This transformation has had two aspects. First, over and above financial assistance, the Reserve Bank has been taking active steps to reorganise the cooperative credit structure itself and to place it on a sound footing. Secondly, financial accommodation is being provided not only for short term but also for medium term and long-term purposes; moreover, the objective is to finance, besides agricultural operations, other rural activities too, such as marketing, processing, warehousing etc. The Reserve Bank has been emerging in this new role since the early fifties, particularly since the All India Rural Credit survey of 1951-52.

Ever since its inception, the Reserve Bank had caused various surveys and investigations to be conducted into the problem of rural credit. The findings of these recommendations were published in the Preliminary Report of 1936, Statutory Report of 1937, the Rural Banking Enquiry Committee Report 1950, the Rural Credit Survey Committee Report, 1954. All these surveys pointed out one fact: the most suitable organisation for rural credit was the cooperative one and any service that the Reserve Bank could render to the rural sector must come in the form of assisting, strengthening and expanding the cooperative framework. In view of the necessity to reach numerous small cultivators, it was necessary to establish a decentralised
financial structure and as the majority of cultivators, being illiterate and ignorant, did not want to undergo the rigid formalities insisted upon by joint stock banks there was no alternative to the cooperative institution. It was, therefore, the recommendation of the Committee of Direction, All India Rural Credit Survey, that cooperation had failed, but cooperation must succeed.

Important features of the "integrated scheme of rural credit" recommended by the All India Rural Credit Survey Committee were: (1) State partnership in the cooperative credit structure at all important levels; (2) development, along with credit, of marketing, processing, warehousing or storage facilities; (3) provision of training facilities for cooperative personnel.

All these suggestions have had important implications for the Reserve Bank of India's functioning. Apart from the short-term, long-term and medium-term financial accommodation which the Reserve Bank provides directly to cooperative institutions, the Reserve Bank of India works for State participation in the cooperative credit structure by providing various types of financial assistance to State Governments which, on their part, acquire shares in the cooperative credit institutions. According to the Constitution, the development of cooperative institutions is a responsibility of the State Governments. Such responsibility is carried out in close cooperation with the Reserve Bank of India in the following manner. The State Governments are to draw up phased programmes for the reorganisation of cooperative credit institutions at all levels. These programmes are to be drawn up in consultation with the Reserve Bank of India. The basis for such reorganisation would be major State partnership in the cooperative credit structure at all levels. Thus the State should be a major shareholder in
the State Cooperative Bank, through it in the Central Cooperative Bank at the district level and through the former two in the larger sized primary credit societies at the primary level. The Reserve Bank of India grants medium and long-term financial assistance to State Governments for such partnership. Since inadequate financial resources have formed the major hindrance to the growth of cooperative institutions the importance of a scheme of state assistance in the form of ownership of shares cannot be overstated.

In so far as the State Governments want to invest in the shares of marketing and processing cooperatives, they are to obtain funds from the National Cooperative Development Board and not the Reserve Bank of India. However, for the processing and marketing cooperatives the Reserve Bank of India's functioning becomes meaningful through the medium of the State Bank of India in which the Reserve Bank, in collaboration with the Government of India is a major shareholder.

The Reserve Bank of India and the Cooperative Credit Structure

Short-term assistance

Short-term assistance is granted by the Reserve Bank under the original Reserve Bank Act to the State Cooperative Bank. The procedure for granting such accommodation is similar to that under which the Reserve Bank grants accommodation to the scheduled banks. The Reserve Bank grants advances and/or rediscounting facilities against approved bills and securities under various sections of the Act. The approved papers are either Government and Trustee securities (17(1)(a), or promissory notes and bills arising out of bonafide commercial or trade transactions (17)(2)(a) or promissory notes and bills drawn for financing seasonal agricultural operations or the marketing of crops (17(2)(b), promissory notes and bills
drawn or issued for the purpose of financing the production or marketing activities of cottage and small scale industries (17(2)(bb)). Advances against section 17(4)(c) are equivalent to those granted to commercial banks under the Bill Market Scheme. In view of the long-drawn character of most agricultural operations many of the bills acceptable from cooperative banks are drawn for longer periods than they are in the case of bills acceptable from scheduled banks. Normally the bills have to be endorsed by two sound cooperative banks, including the apex bank. In states where the central cooperative banks are not sufficiently strong, however, bills have to be endorsed by the State Governments.

In view of the acute shortage of institutional facilities for rural credit such financial assistance from the Reserve Bank has great significance. The volume of accommodation required by the individual bank in the cooperative sector is also much larger than that required in the case of the individual scheduled banks. This is quite natural since the cooperative banks have no deposit resources of their own and the need for credit of the agricultural sector is also much larger. Naturally, also, the Reserve Bank insists upon some special standards of creditworthiness. The borrowing banks have to furnish the Reserve Bank with information about their latest financial position and the audited balance sheet for the last three years. The loan granted has a relation to the borrowing bank's own funds, credit limits granted ranging up to two/three times the own funds of the cooperative bank. Sound lending practices and timely recovery of the loan are also important considerations. For purposes of determining the credit limits available to individual banks, all banks are divided into three classes - A, B and C, on the basis of the audit reports. Not only are credit limits larger than those set for scheduled banks, the rate of interest charged is also mostly cheaper. Thus a concessional rate of 2 per cent below Bank rate
is allowed on all short and medium-term advances to State Cooperative Banks provided such finance is used for seasonal agricultural operations or marketing of crops in the case of short term loans and for agricultural purposes in the case of medium-term advances. The significance of such lending lies not only in its direct impact on the volume of credit, but also in its indirect impact on the interest rate structure. Such an expansion of organised banking facilities lowers down the disparity between interest rates in the organised and unorganised banking sectors and even areas beyond the immediate sphere of operations of the cooperative institutions are benefitted. (1) The volume of such short-term assistance to the cooperative sector has been continuously increasing. Thus the total amount of loans sanctioned by the Reserve Bank for financing seasonal agricultural operations and the marketing of crops was Rs 1240 lakhs in 1951-52 and amounted to Rs 6542.33 lakhs in 1958-59. The value of loans outstanding during the same years amounted to Rs 645.29 lakhs and Rs 5626.31 lakhs respectively. (2) Advances under section 17(4)(c) increased from Rs 4.4 lakhs in 1951-52 to Rs 257.76 lakhs in 1963-64 and advances outstanding increased from Rs 3.60 lakhs to Rs 113.94 lakhs. (3)

Medium and Long Term Assistance

In order that the cooperative banks do not remain permanently unsound units, the Reserve Bank, in addition to the short term accommodation mentioned above, grants medium and long term loans to cooperative banks directly or to State Governments to encourage State partnership. It may

(1) Reserve Bank of India - Functions and Working, P.31
(2) Reserve Bank of India Bulletin, January 1961, P.22, "The Role of the Reserve Bank of India in the Development of Credit Institutions", article by D. Venkatappiah
(3) Reserve Bank of India Bulletin, December 1964, P.1533
even purchase the debentures of Central Land Mortgage Banks. To meet such long term financing needs two funds - the National Agricultural Credit (Long Term Operations) Fund and the National Agricultural Credit (Stabilisation) Fund were set up in 1936 following the recommendations of the All India Rural Credit Survey Committee. The Reserve Bank of India credited an initial sum of 10 crores to the Long Term Operations Fund and was to make an annual contribution of not less than 5 crores for five years since 1936. This Fund is utilised for granting the following types of loans: (i) long-term loans and advances to State Governments for a maximum period of 20 years to enable them to subscribe directly or indirectly to the share capital of cooperative credit institutions; (ii) medium term loans between 15 months and 5 years to State Cooperative Banks for agricultural purposes. The Reserve Bank has been empowered to provide such medium term loans under section 17(4A) since an amendment of the Reserve Bank of India Act in 1933. Such loans too are made at 2% below Bank rate. In the year 1963-64, total advances and outstandings under this section amounted to 4.42 lakhs and 6.73 lakhs respectively, compared to 4.41 lakhs and 5.51 lakhs respectively in the year 1955-56 (1); (iii) long term loans and advances to central land mortgage banks up to a maximum period of 20 years; (iv) purchases of debentures of central land mortgage banks by the Reserve Bank of India. It may be mentioned that the Reserve Bank also facilitates the issue of such bonds by granting advances to State Cooperative Banks against debentures of land mortgage banks.

The National Agricultural Credit (Stabilisation) Fund was to be utilised for granting medium term loans to State Cooperative Banks to

enable them to convert their short term loans into medium term loans under circumstances where the Reserve Bank of India was satisfied that, on account of natural calamities like drought, famine etc., the short term loan could not be repaid without serious dislocation to the cooperative credit structure.

**Inspection**

The responsibility to provide financial assistance carries with it the necessity of making inspections. Since 1932 the Reserve Bank has introduced a scheme of voluntary inspection of cooperative banks. Such inspection is in addition to those conducted by the Registrars of Cooperative Societies under the State Governments for audit and administrative purposes. The Agricultural Credit Department of the Reserve Bank has been developing its own machinery of inspection which is divided into regional units covering the whole country. Moreover, the Deputy Governor and other senior officials of the Reserve Bank visit different states and have consultations with State Governments and their departments. The objective of these visits is to aid the State Governments in the formulation of schemes for planned reorganisation of the cooperative system. As a result of these joint consultations considerable progress has been achieved in setting up State Cooperative Banks where they did not exist and in reconstructing or rehabilitating the existing cooperative credit institutions that were either financially weak or being unsoundly managed. Another activity of the Reserve Bank is to conduct sample surveys in a selected number of districts in order to assess the extent and the worth of the success achieved by the scheme of integrated credit. Such surveys are done by the Rural Economics and Rural Statistics Divisions of the Research Department of the Reserve Bank. Since 1951 the Reserve Bank has also set up a Standing Advisory Committee on Agricultural Credit for advising on various
matters connected with the cooperative movement in the country. This committee lays down suitable standards with regard cooperative banking and administration.

**Training Facilities for Cooperative Personnel**

An important feature of the new scheme of integrated credit was the provision of training facilities. Financial weakness and lack of necessary training to handle its business have been the two rocks upon which the cooperative movement has floundered in this country. Arrangements for training cooperative personnel, therefore, are no less important than provision of financial assistance. An important part of the promotional activities of the Reserve Bank is, therefore, the making of arrangements for training facilities. The need for training up cooperative personnel was recognised as early as 1931. The first step taken in this connection was the reorganisation of the cooperative training college at Poona in conjunction with the Bombay Provincial Cooperative Institute. This All India Centre provides training facilities for personnel of senior and intermediate degrees. There are also five regional centres for training intermediate grade personnel. Training centres for other categories of staff were set up at various places by the State Governments. In 1953 a Central Committee for Cooperative Training was set up jointly by the Reserve Bank and Government of India. Its activities are organised by the Agricultural Credit Department of the Reserve Bank. Its objective is to formulate and implement a scheme for the training of cooperative personnel at the senior, intermediate and junior levels. The Reserve Bank takes up the financial responsibility for the training of higher and intermediate grade personnel. The Government of India also finances eight institutions set up to train officers to work in the Community Project areas and National Extension Service blocks. The whole network of training institutions is
co-ordinated through a system of grant-in-aid operated through the Central Committee.

The training programmes have been of great practical use in the structural reorganisation of the co-operative mechanism.

The State Bank of India

An integral part of the reorganised scheme of rural credit is the State Bank of India. While the State Governments and the Reserve Bank would try to strengthen the co-operative system in all possible ways, what was also needed was a countrywide network of joint-stock banking to assist the co-operative institutions with banking services of all kinds. Thus the Rural Credit Survey Committee envisaged "the creation of one strong, integrated, state-sponsored, state-partnered commercial banking institution with an effective machinery of branches spread over the whole country which by further expansion, can be put in a position to take over cash work from non-banking treasuries and sub-treasuries, provide vastly extended remittance facilities for co-operative and other banks, thus stimulating the further establishment of such banks". This vision was given practical shape in the form of the State Bank of India. In the evolution of the State Bank the Reserve Bank of India played a role no less creative than that it did in the case of the co-operative structure itself.

The State Bank of India's business is to assist not only credit institutions, but the whole co-operative mechanism. It provides assistance to co-operative credit institutions through remittance facilities and short-term accommodation in the form of loan/overdraft facilities. It also grants long-term assistance by subscribing to the debentures of land mortgage banks and granting advances against the security of such debentures. But besides credit, the State Bank is interested in other aspects of co-operative
development such as marketing, processing and warehousing. Thus it grants direct financial accommodation to co-operative marketing and processing societies in various ways. It has also been lending full support to the Government's scheme for the development of warehousing. It is represented in the Boards of National Co-operative Development and Warehousing Board, the Central Warehousing Corporation and the State Warehousing Corporation. It participates in the share capital of the Central Warehousing Corporation. The State Bank of India is expected to open a country-wide network of branches. In its branch expansion programme it tries to look as far as possible to the requirements of co-operative credit.

The Reserve Bank of India is closely associated with all these developments since it is the major shareholder. The Reserve Bank, jointly with the Government of India was required by statute to hold 55% of the shares of the State Bank of India. Actually their ownership is much larger. A majority of directors of the Central Board of the State Bank are also nominated by the Central Government and the Reserve Bank. Last but not least, the Reserve Bank has the responsibility of sharing the losses that may be incurred by the State Bank in its branch expansion programme. For this purpose the dividend on the shares held by the Government and the Reserve Bank, which should not exceed 5%, is credited to an "Integration and Development Fund". The State Bank has completed its first branch expansion programme and is now going ahead with the second and third.

The Agricultural Refinance Corporation

The Reserve Bank's interest in agricultural credit has recently found an important expression in the setting up of the Agricultural Refinance Corporation. Apart from the land mortgage banks, whose resources are
extremely limited, sources of long-term agricultural credit have been virtually nil. The Standing Advisory Committee on Agricultural Credit and the Land Mortgage Banks, therefore, had been urging the Reserve Bank of India for a number of years to take a lead in the setting up an institution providing finance for long-term agricultural development. Since the emphasis is now on increasing agricultural productivity rather than meeting the bare needs of subsistence, agricultural investment has assumed a new importance. It was in response to the need for an institution to invest in long-term agricultural development that the Agricultural Refinance Corporation was set up in 1963.

The Corporation is mainly a refinancing agency for financing major projects of agricultural development which cannot be financed adequately under the existing institutional set-up. Such requirements are those of irrigation, land reclamation, financing the development of special crops such as Areca nut, coconut, cashew nut, orchards etc. and introduction of mechanised farming. Institutions eligible for refinance are: central land mortgage banks, state co-operative banks, other co-operative societies and scheduled banks. The Reserve Bank has not only taken the lead in the establishment of the concern, but the Corporation is also to work in close collaboration with the Reserve Bank.

Of the issued share capital of Rs 5 crores of the Corporation half has been subscribed by the Reserve Bank. The Reserve Bank would also take up any shares that remain unallotted, which will later be disposed of in accordance with section 5(4) of the Agricultural Refinance Corporation Act. The Reserve Bank will further keep with the Corporation the dividend accruing on shares held by it as interest-free special deposit for a period of 15 years.
The Deputy Governor of the Reserve Bank of India, in charge of Agricultural Credit, is the Chairman of the Board of Directors of the Corporation. The Reserve Bank is represented by one other member on its Board.

**THE RESERVE BANK AND INDUSTRIAL FINANCE**

The Reserve Bank began to evince an interest in the field of industrial finance much later than in the field of rural credit, but the transition here has been no less significant. The basis of economic progress is a quick development of industries. But like rural credit, the availability of industrial finance is beset with many difficulties. A strong conscious desire for rapid industrialisation arose with Independence. Simultaneously the Reserve Bank began to show an active interest in the building up of suitable institutions for industrial finance. Institutional development in this sphere has been largely a handiwork of the Reserve Bank. The Reserve Bank has been performing this service in the field of finance for large scale industries in the following ways: (1) Ownership of shares of the specialised financial institutions; (2) Granting of long-term loans; (3) Providing managerial assistance. The facilities that stem from the institutions thus fostered are the following: (a) equity participation; (b) medium and long-term financing; (c) guaranteeing of loans; (d) underwriting of issues of shares, debentures; (e) indirect assistance provided by the Refinance Corporation in the form of refinance facilities to approved institutions; (f) advice and guidance on technical, managerial and financial issues.

So far as the large-scale industries are concerned, the first stepping stone in institutional development was laid down in 1948 with the
establishment of the Industrial Finance Corporation of India. The last in the series is the Industrial Development Bank of India. Of these, the Industrial Finance Corporation is owned jointly by the Government, the Reserve Bank of India and private institutions; the Industrial Credit and Investment Corporation of India is owned wholly by private interests; the National Industrial Development Corporation is owned wholly by the Government; the Refinance Corporation is owned jointly by the Reserve Bank of India, the State Bank of India, other scheduled banks and institutional investors; the Industrial Development Bank is owned fully by the Reserve Bank of India.

The Reserve Bank and Industrial Finance Corporation of India

The Industrial Finance Corporation of India finances public limited companies and co-operative societies engaged in the manufacture and processing of goods by guaranteeing loans raised by industrial concerns, underwriting the issues of stocks, shares, bonds or debentures, granting loans and advances for a maximum period of 25 years and subscribing directly to the shares and debentures of industrial concerns.

Of the paid-up capital of Rs 5 crores of the Corporation, one-fifth has been subscribed to by the Bank. Following a suggestion by the International Bank for Reconstruction and Development, the Bank as well as the Central Government have agreed to forego the dividends accruing on their shares to the Corporation. Such dividends are to be credited to a special reserve fund until the aggregate of sums so credited exceeds Rs 50 lakhs.

Secondly, with an amendment of the Reserve Bank of India Act in 1953, the Bank has been authorised to grant loans and advances, both short and medium-term, to the Corporation. Such loans are granted under section 17(4B), while no maximum limit has been laid down on the outstandings of
short-term accommodation (repayable within 90 days) granted against Government securities, the medium-term assistance (maturing within 18 months) should not on any date exceed 3 crores.

Thirdly, the Reserve Bank of India also subscribes to the bonds issued by the Corporation. The Industrial Finance Corporation of India can borrow from the Central Government and the Reserve Bank up to 5 times its paid-up capital and reserve fund (including medium-term loans from the Reserve Bank up to 3 crores).

By virtue of its participation in the share capital of the Corporation, the Bank is represented in the Board of Directors of the Corporation by two of its nominees who also have the opportunity to function on the Central Committee of the Corporation.

The Bank also helps the Corporation by advising it on important matters of policy. Moreover, it spares the services of its officers to man positions of responsibility in the Corporation, e.g. the position of Managing Director or General Manager.

**The Refinance Corporation for Industry and Term lending**

The Reserve Bank of India takes initiative not only in setting up new institutions for industrial finance, but also in encouraging existing institutions to adapt themselves to the changing requirements. The need for the taking up of term-lending business by joint stock banks has been appreciated by the Reserve Bank of India for some years. It was thus one of the recommendations of the Committee on Finance for the Private Sector (1954) set up by the Reserve Bank. It was with a view to encouraging such business that the Refinance Corporation for Industry was set up in 1959. Its business is to grant refinance facilities to its member banks in so far
as they lent to industrial units of medium-size for medium-term and in medium-sized amounts. Of the issued share capital of Rs 12.50 crores 10% was paid up. It was contributed by the Reserve Bank of India, the Life Insurance Corporation, the State Bank of India and other member scheduled banks. The Refinance Corporation has played a gradually expanding role in the field of industrial finance.

The Industrial Development Bank of India

Of all the institutions for industrial finance, the Industrial Development Bank of India is the most ambitious. The range of its operations cover the functions rendered by all the finance corporations taken together. It may grant medium and long-term loans, subscribe to or underwrite issues of stocks, shares, bonds, debentures, guarantee deferred payments due from industrial concerns or loans raised by them, provide refinance facilities. Apart from provision of finance, it can undertake promotional activities such as conducting research and surveys, providing technical or administrative assistance and even planning and developing new industries.

The interest of the Reserve Bank of India in this institution is the most extensive. This institution is a wholly owned subsidiary of the Reserve Bank of India. Its authorised capital is Rs 50 crores, which the Reserve Bank is empowered to raise to Rs 100 crores with the approval of the Central Government.

The Development Bank may also borrow from the Reserve Bank for short-term, medium-term (upto 5 years) and long-term. For such long-term lending, a fund has been established by the Reserve Bank - the National Industrial Credit (Long-Term Operations) Fund - similar to the National Agricultural
Credit (Long Term Operations) Fund. The Reserve Bank will initially credit ₹ 10 crores to the Fund with an annual contribution of ₹ 5 crores since June 1965. The Reserve Bank may also purchase bonds and debentures issued by the Development Bank.

The Central Board of Directors of the Reserve Bank is to constitute the Board of Directors of the Development Bank and the Governor and Deputy Governor are to be its Chairman and Vice Chairman respectively.

The Reserve Bank of India and Finance for Small Scale Industries

The interest of the Reserve Bank of India in the field of finance for small scale industries is no less keen than that in the other types of finance. Small scale industries occupy a position of special importance in our country both from the point of view of employment opportunities provided and from the range of their production. Yet they find it even more difficult to obtain finance than do large scale industries. The Reserve Bank assists institutional growth in this respect in the following ways: (1) by assistance to State Cooperative Banks (2) by its interest in the State Financial Corporations (3) functioning as the Guarantee Organisation for the Government of India's Credit Guarantee Scheme and (4) formulation of a Pilot Programme for financing small scale industries in collaboration with the State Bank of India.

Under Section 17(2)(bb) of the Reserve Bank of India Act the Bank gives short term financial assistance to State Cooperative Banks for rediscounting of promissory notes and bills maturing within 12 months and drawn or issued for the purpose of financing the production or marketing activities of cottage and small scale industries approved by the Bank provided the repayment of principal and payment of interest of such bills is fully guaranteed by the State Government.
The most important institutional development in this field has been the setting up of the State Financial Corporations. The Industrial Finance Corporation of India caters to the need of only larger undertakings. To meet the requirements of small and medium-sized concerns the Reserve Bank of India collaborated with State Governments in the setting up of State Financial Corporations. The State Financial Corporations Act was passed in 1951 and it was modelled closely on the lines of the Industrial Finance Corporation of India Act. The State Financial Corporations provide medium and long-term credit to small and medium-sized industries which fall outside the purview of the IFCI.

The Reserve Bank of India shows a manifold interest in the growth and functioning of the State Financial Corporations. Apart from collaborating in the setting up of these institutions, the Reserve Bank is also an important shareholder in all the State Financial Corporations. It is also represented in the Board of the Corporations. The Reserve Bank has got the legal right of inspecting the Corporations. It convenes annual conferences of the Corporations. The Reserve Bank of India tries to coordinate the activities of the State Financial Corporations with those of all other agencies purveying finance for small scale industries, e.g., the joint stock banks, the cooperative banks, the Industries Departments of the State Governments, the Small Industries Service Institutes and the National Small Industries Corporation. The extent of financing done by the Corporations has been increasing. During the year ended June 1964 loans sanctioned and disbursed amounted to Rs 15.04 crores and Rs 13.41 crores respectively. The Corporations have also been doing underwriting business in recent years.
Another important step taken by the Reserve Bank of India has been that of collaboration with the State Bank of India in working up a "Pilot" scheme for assisting small-scale industry. Under this scheme arrangements are made for meeting all types of credit requirements - short-term, medium-term or long-term through appropriate authorities. Other institutional agencies collaborating in the scheme are the co-operative banks, the Director of Industries and the State Financial Corporations, each agency performing a specific type of service.

Finally, the Reserve Bank's Credit Guarantee Scheme is an important development since it tries to remove some serious obstructions to the availability of small-scale industrial finance. At the seminar on Financing Small Scale Industries at Hyderabad in 1960, there was a consensus of opinion that the factors which were primarily responsible for deterring the supply of such finance were the considerations of liquidity and risk. A scheme of credit guarantee for finance granted to small-scale industries will be a valuable inducement to lenders. Accordingly, the Credit Guarantee Scheme was introduced in 1960, the Reserve Bank of India acting as the "Guarantee Organisation". The scope of the scheme is being gradually expanded. It has been of great use to the State Bank of India and other institutions granting finance to small-scale industries.

Thus the Reserve Bank has been showing a high degree of versatility and initiative as the central bank of a rapidly expanding economy. While it has been constantly experimenting with various weapons of credit control in order to manipulate the money supply so as to keep pace with the growth of national income, it has also been spreading out to areas unexplored hitherto, so that economic growth may not be retarded by non-availability of finance. The practical gains achieved in the latter respect have not yet been commensurate with requirements. Large chunks of the country's productive machinery still
face an acute shortage of finance. But the reorientation of outlook on the part of the Reserve Bank is itself significant. What is also significant is that the Bank has been trying simultaneously different possible remedies for filling up the institutional gaps and its activities provide various types of encouragement not only to new institutions but also to the existing institutions so that they may, in their turn, come out in the new fields of operation. All these factors are sure to have a great impact on the financial set up of the country.