CHAPTER - VI

CREDIT POLICY AND ATTEMPTS AT CREDIT PLANNING

INTRODUCTION:

The commercial banks in India have been playing the role of a catalyst in the post nationalisation period. They have been providing finance to the priority sectors on a much greater scale and the bank credit is now spread more evenly among various regions in our country. Under the new banking policy, they have been following the integrated rural approach with a view to bringing about economic development of the backward areas. The significant role played by the banks has been well recognised; and as remarked by one of the distinguished members of the Banking Commission:
"There is now a closer co-operation between banker and the planning authority. The need for information about the end-use of bank funds, for establishing inventory norms, for a close supervision of the bank financed production process, have all come to the forefront. India is now better equipped with standards and statistics than she was seven years ago."

Clearly, the banks have been giving greater attention to the end-use of credit. They see to it that the credit is provided in alignment with the plan priorities and that it is used by the borrowers for productive purposes.

**SUPERVISION AND FOLLOW-UP OF BANK CREDIT**

In order to ensure proper end-use of credit, banks exercise a complete vigilance over the borrowal account. Post-sanction care occupies, in fact, an important place in the practice of bank lending. Through constant visits and spot inspections bankers take care to see that the money is used for the authorised purpose. As soon as they discover the borrower to be guilty of diverting funds to an unauthorised purpose, they immediately recall advances. The bank officers

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* Bhabatosh Datta: Role of Nationalised Banks in a Planned Economy. Capital - 24.2.1977 P.68
who are charged with the responsibility of inspection, are thus required to be vigilant throughout the period of the advance. They are required to report immediately to the higher management of any irregularity which they might notice in the conduct of the account. Those who fail to report are often charged with negligence. A serious note of his negligence is taken by the management and the officer concerned is punished accordingly. The banks have thus been exercising enough care to ensure that the credit is used for productive purposes, and that there is no misuse of credit.

SOME LEAKAGES:

Nevertheless, some leakages are likely to occur so far as the use of bank credit is concerned. In other words, bank funds are likely to be misused by the borrowers notwithstanding the fact that banks exercise enough care in the conduct of borrowal accounts. It is quite possible, for example, for a corporate client to divert the working capital to the fixed assets or to the holding of excessive inventories. A part of the working capital may also be diverted to the associate concerns. In fact, inter-corporate investments made by the big business houses in India pose a serious problem in the proper use of bank credit by corporate clients. The misuse of bank credit by clients is well explained by Sampat P. Singh -
"The borrower knows more realistically how much money he is likely to need over a period and for what use. But he would be reluctant to share all this information. He knows policies and procedures of the bank. He can say frankly - I need Rs. 50/- lacs and that Rs. 20/- lacs I will use for purpose X and Rs. 30/- lacs for working capital. But he knows, his bank would not sanction those Rs. 20/- lacs. He adjusts his figure to justify Rs. 50/- lacs on working capital basis and the way bank wants to see it reckoned."

Possibility of misuse of bank credit is also present in the case of agricultural finance. Over the past few years banks have been providing direct finance to the agriculturists. Now, some of the affluent farmers whose main activity is to carry on commercialized agriculture, are also engaged in a trading activity. Thus an advance which is initially granted in the form of a crop loan is likely to be used for trading in tyres and spare parts of automobiles. Such an advance might be included by the bank in the priority sector, though it is used for a commercial purpose.

Misuse of bank credit is perhaps associated to a greater degree with the trading community. The wholesale dealers in agricultural commodities, such as paddy, rice, food-grains, vanaspati, oil seeds etc., often engage themselves in speculative activities. The supply of such commodities being short in relation to the demand, the prices of such commodities are subject to heavy and frequent fluctuations. Credit facilities which these traders have been availing in the form of cash credit are, therefore, likely to be misused for stock piling and speculative hoarding. Bank credit is also likely to be misused by the small farmers, who are tempted to spend the borrowed money either on consumption or on repayment of their private debts.

It is evident, therefore, that the misuse of bank credit may adversely affect production and raise the prices of various commodities. Bank lending in that case would generate an inflationary spiral and may jeopardise the very purpose for which banks have been lending money. Inspite of strict supervision, control and follow up of bank credit, the bankers may not be able to check completely the misuse of credit. It is against this background, that the need for credit control comes into its own.
CONTROL OF BANK CREDIT:

The responsibility of credit control rests in India with the Reserve Bank of India, as the central banking institution. Over all these years it has been trying to regulate the quantity and quality of bank credit in the light of the economic policy followed by the government. An attempt should, therefore, be made in the forthcoming paragraphs, to review the credit policy followed by the Reserve Bank of India, in the last twentyfive years.

CREDIT POLICY IN THE PLANNED ERA:

Credit policy of the Reserve Bank of India should be reviewed in the light of the doctrines and programmes which the country has accepted in the past twentyfive years. In 1951, India embarked upon economic planning and all the five year plans have laid emphasis on the development of various sectors and regions to a differing degree. As the central bank of the country, the Reserve Bank had therefore, to frame its monetary and credit policy in such a manner that it would easily fit into the overall requirements of economic planning. In the initial stages, the Reserve Bank of India was required to play a dominant role in the reorganisation and development of the Indian Money Market. It was charged with the responsibility of regulating the organised as well as unorganised sector of the money market, and of
promoting various institutions of long term finance. The promotional role played by the Reserve Bank of India in the process of economic development of the country, has been in fact a deciding factor in the formulation of the monetary and credit policy of the Reserve Bank of India in the past twentyfive years.

GOALS OF CREDIT POLICY:

Broadly, the monetary policy followed by the Reserve Bank of India during the planned era has been expansionary. During this period, it was required to increase the supply of money according to the needs of a developing economy. Expansionary monetary policy has, however, increased the credit creation capacity of commercial banks. The role of the Reserve Bank as the controller of credit, therefore, became much more significant during this period. The Reserve Bank of India was required to ensure that every increase in bank credit resulted in production and that it was sanctioned and utilised in accordance with the plan priorities. Here, the role of the Reserve Bank was very delicate. On the one hand it had to allow the commercial banks to sanction advances for productive purposes and at the same time, it had to ensure that the bank credit so sanctioned, was not misused for unauthorised purposes which would generate inflationary pressures in the economy. In other words, while expansion of monetary resources and bank credit was essential,
there was at the same time an urgent need to control the quantity and quality of bank credit. Credit policy of the Reserve Bank of India, therefore, aimed at growth with stability i.e. it aimed at bringing about economic development of various sectors and regions, without generating inflationary pressures in the economy.

AIMS OF CREDIT CONTROL :

The Reserve Bank of India thus aims at controlling the volume of credit in alignment with the plan priorities. It regulates the magnitude of credit in such a manner that it is compatible with the needs of a developing economy. The various measures of quantitative credit control have, therefore, been designed in such a manner that they ensure a smooth flow of bank credit for genuine productive purposes. The Reserve Bank of India has always allowed the genuine needs of production to be met out of commercial bank credit.

At the same time, the bank has tried to curb advances which are likely to be used for speculative and hoarding purposes. Advances sanctioned to the wholesalers in essential commodities are therefore, rigidly controlled under the selective credit control measures. It is worthwhile to bring out the important measures through which the Reserve Bank of India controls the quantity and quality of commercial bank credit.
MEASURES OF QUANTITATIVE CREDIT CONTROL:

The measures which aim at controlling the magnitude of bank credit have generally been traditional. Through these measures the Reserve Bank of India hopes to restrain the credit expansion. Briefly, these measures take the following forms:

1. CHANGING RESERVE REQUIREMENTS:

With a view to curbing the credit creation capacity of banks, the percentage of statutory reserves which the banks are required to keep with Reserve Bank of India under Section 42 (1) of Reserve Bank of India Act is increased.

By raising the statutory reserve requirements, the Reserve Bank of India thus exercises an effective control over the magnitude of bank credit.

The Reserve Bank of India made use of the instrument of variable reserve ratios for the first time on March 1, 1960 by a notification issued to the banks on this date. It impounded 25% of the increase in deposits mobilised by the banks. On May 6, 1960 it impounded further 25% of the incremental deposits. Thus about 50% of the incremental deposits were impounded lowering thereby the credit creation capacity of the banks. This instrument was not used much by
the Bank in 1960s, but it has been used most frequently during the 1970s. In 1973-1974 busy season, the percentage of statutory deposits which the banks are required to keep with the Reserve Bank of India was thus raised to 7% of the aggregate demand and time liabilities. These measures have enabled the Reserve Bank of India to regulate the volume of credit from time to time.

2. BANK RATE

Another weapon through which the Reserve Bank of India controls credit is the Bank Rate. By raising the Bank Rate, the credit is made costlier both to the commercial banks and their borrowers. The Reserve Bank of India has used this measure on a number of occasions in the last 25 years. The Bank Rate which was fixed at 3% in 1935 was raised for the first time to 3.5% in 1951. Thereafter, it has been progressively stepped up and at present it stands at 9%. While one of the purposes of the Bank Rate is to increase the rates of interest on deposits, it is also used as a weapon of making the credit costlier to the commercial banks and their borrowers.

3. COST OF REDISCOUNTING

Another measure through which control is exercised is that recourse to the central bank for refinance or rediscounting
is restricted to a ceiling stipulated for each bank. The ceiling or the quota is fixed in terms of percentage of the aggregate deposits of a bank. Sometimes, rediscounting is allowed on a discretionary basis.

4. PENAL RATES :

In order to reduce the dependence of banks on the Reserve Bank of India the system of penal rates of interest is scrupulously followed. The penal rates are linked to the Net Liquidity Ratio. For every fall of 1% in the Net Liquidity Ratio, the borrowing bank has to pay 1% more than the Bank Rate.

QUALITATIVE CREDIT CONTROL :

With a view to eliminating the misuse of bank credit, the Reserve Bank of India has introduced the system of Selective Credit Controls. The essential commodities such as gur, sugar, vanaspati, foo-grains, oil seeds etc., which are subject to wide price fluctuations on account of the speculative actions of the tradesmen have been covered by the Selective Credit Controls. This is done through requirements of (a) margins and (b) ceiling limits. Prescription of margin specifies the drawing power in a cash credit account. Thus the margin of 40% on advances against oilseeds would mean that the credit, to be allowed against the stocks of
the value of Rs. 100/- should not exceed Rs. 60/-. When the margin is raised, the drawing power of a borrower is, therefore, reduced. The prescription of ceilings means that a borrower should not be allowed to draw in excess of a limit, even though the value of the security offered is greater.

Selective Credit Controls have been in operation for almost two decades. Control over credit against selective commodities was first introduced by the Reserve Bank of India in May 1956, when advances against foodgrains were covered by the controls. Banks were asked to raise the margin on advances against paddy and rice by 10%. At the same time a ceiling was fixed for each borrowal account and the advances to a single party were not to exceed Rs. 50,000/-. Varying importance of different areas producing rice was, however, taken into account. Thus, the ceiling in Madras was the lowest and concessions were given for Andhra Pradesh, Madhya Pradesh and Orissa for rice mills. The first cash crop which was brought under selective credit control in February 1959 was groundnut. Vanaspati and vegetable oils were covered in 1964; and the selective credit control was gradually extended to many more commodities. In March, 1969 restrictions were imposed on advances against shares and the margin on such advances was raised to 50%. Spot transactions in shares were totally prohibited.
The technique of Selective Credit Control was refined and tightened further in 70s. In addition to the margins and ceilings, a minimum lending rate was prescribed in 1970. Thus at present the selective credit control rate is 15% while the general minimum lending rate is 12%/2%.

The system of Selective Credit Control is operated by the Reserve Bank of India in a flexible manner; in that exemptions are granted to promotional, functional or regional factors. These exemptions are usually allowed to manufacturing units, and to the units engaged in export trade. For example, exemption was given in 1974 when export of 'Basumati Rice' to the Middle East countries gained some importance. Similarly, all agencies acting as agents for public food procurement and distribution are given complete exemptions from the Selective Credit Control on food-grains.

DIRECTIVES TO BANKS:

The aims and objects of Credit policy would be clear if we look to the general guidelines given to the banks in the matter of allocation of credit.

1. Requirements of public food procurement, exports and priority sectors are to be made on a priority basis.

2. Public Sector Enterprises are to receive prior conside-
ration for their working capital requirements.

3. Banks should ensure that the working capital provided to public enterprises is not used as a substitute for Budgetary Resources.

4. While financing industrial sector, priority is to be accorded to core sector industries.

5. Special consideration should be given (a) new units in which block assets have already been acquired, (b) Export oriented units, and (c) Units located in backward areas.

These guidelines issued to the commercial banks clearly indicate the basis of credit policy pursued by the Reserve Bank of India in the recent past. The policy aims at meeting the credit requirements of public enterprises and new manufacturing units. It also aims at bringing about economic development of backward areas.

The implications of various schemes which have been put into operation by Reserve Bank of India for quite some time, should now be clear. The Credit Authorisation scheme implemented in 1965 thus aims at ensuring the end-use of credit availed by big business houses. The recommendations of the
Danejia Committee Report (1969) and the Tandon Committee Report (1975) also aim at reducing the excessive dependence of big borrowers on the commercial banks. The New Bill Market Scheme evolved in November 1970 aims at converting the cash credit system into the system of bill finance. In theory, the advances granted under cash credit system are repayable on demand; but in practice such advances are never repaid and are always renewed with increased limits. In course of time, the borrowers, therefore, come to depend on banks permanently. Bigger the borrower, greater are the chances of misuse of bank credit. With a view to reducing such evils associated with the cash credit system, the Reserve Bank of India, therefore, expects the banks to replace the cash credit system by bill finance, which is short term and self liquidating in character.

Efficacy of the measures:

The credit policy pursued by Reserve Bank of India over all these years has been short-sighted in that it is confined to a single busy season. Before the commencement of each busy season, the Reserve Bank of India arrive at their own estimate of the credit expansion that ought to take place during the busy season. When the size of the credit expansion is determined the policy measures are framed, and these measures are then communicated to the bankers. At a meeting, the Governor of Reserve Bank of India impresses
upon the chief executives of banks that the total bank credit of the banking system should not exceed the size determined by the central bank, and that a serious view would be taken if the commercial banks expand the credit beyond the desired level.

Unfortunately, the policy measures yield a limited success because the actual credit expansion that takes place every year is much greater than is anticipated by the Reserve Bank of India. In practice, the measures which aim at raising the statutory reserve requirements under section 42(1) of the Reserve Bank of India Act yield some success. They do restrain the credit creation capacity of banks but the other measures such as an increase in the cost of borrowing do not create a significant impact on the volume of Bank Credit. It has been noticed that in a country suffering from scarcity of materials and of rising prices, the business community can afford to borrow even at a higher cost. The measures such as an increase in the cost of borrowing through an increase in the bank rate are, therefore, ineffective. The system of penal rates of interest on borrowing from Reserve Bank of India is also less effective, because banks have been borrowing sometimes at the maximum penal rate of 15%. The system of elective Credit Controls is also less effective and does not produce the necessary impact on the volume of credit granted against the stocks of essential commodities.
Credit policy pursued by the Reserve Bank of India suffers some major weaknesses namely, it is confined to a very short period. This policy is linked each year with the busy season and the credit expansion is determined by the Reserve Bank of India on the basis of the volume of agro-based production.

Now, the production being subject to the vagaries of monsoon, the plans and policies formulated by the Reserve Bank of India in regard to bank credit, get upset every year. In an agricultural country like India, prospects of agricultural production cannot be ascertained with a high degree of precision and this puts a serious drawback in the formulation and implementation of the credit policy.

Moreover, the policy measures framed for every busy season are not conveyed to the banks in a single package. The Reserve Bank of India issues a number of circulars to the banks within a period of four months. The flow of circulars is so diverse and complicated that it is difficult to ensure proper implementation of all the policy measures contained in the circulars. It is therefore, felt that the Reserve Bank of India should form the policy measures which are applicable over a fairly long period.
It would be worthwhile to explain the operation of the credit policy with reference to the Policy Measures, imposed by the Reserve Bank during the busy season of 1973-74. Before the commencement of this busy season, the Reserve Bank of India shed their tears, as usual on the continuing imbalance in the economy between aggregate supply and aggregate demand; and with a view to mitigating this imbalance, i.e. with a view to maintaining price stability in the economy, imposed the 'Credit Squeeze'. The policy measures, embodied in the squeeze were initially communicated to the banks by the Governor, in his letter dated 30th May, 1973.*

1. With effect from the close of business on May 30, 1973 the Bank Rate was raised from 6% to 7%.

2. Statutory Cash Reserves, required to be maintained with the Reserve Bank, under Section 42(1) of the Reserve Bank of India Act, were stepped up from 3% to 5% for a period of one year from June 29, 1973 to June 28, 1974. On this additional reserve of 2%, the banks were to be paid interest at the rate of 4.75% p.a.

*RBI Bulletin, May 1973 PP.772-773
3. With a view to imposing further discipline in the use of bank credit, the minimum lending rate was fixed at 10%. Certain priority sectors like the small-scale industries, exports, food procurement programme etc., were, however, exempted from this provision.

4. The Net Liquidity Ratio was raised from 37% to 39% with effect from Friday, June 29, 1973.

As a follow-up of these measures, the Reserve Bank introduced on August 14, 1973 a few other measures:

1. The reserve requirements under Section 42(1) were increased to 7% in two stages from September 8 and 22, 1973.

2. The Net Liquidity Ratio, relevant for determining the rate on borrowing from the Reserve Bank of India was increased from 39% to 40% with effect from September 8, 1973.

To this end, the Reserve Bank of India further tightened its credit restraint measures on November 16, 1973. The banks

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* RBI Bulletin, August 1973, P.1316

** RBI Bulletin, November 1973 PP 1852-58
were advised to keep in close check and minimize their lending. This was followed up with the indication of a quantitative ceiling on credit expansion. Banks were told that the total credit expansion in sectors other than Food Procurement was not to exceed 650 crores during the period September 1973 and April 1974. Further, it was indicated that recourse to refinance facilities from the Reserve Bank of India would not be automatic even within the net Liquidity Ratio, but on a discretionary basis. The maximum rate of interest on borrowings from the Reserve Bank of India was also stepped up from 12% to 15% with effect from November 16, 1973. The minimum lending rate to be charged by the banks to their clients for commodities covered by the Selective Credit Controls was also raised from 12% to 13% p.a.

These measures were supplemented by some other measures on November 30, 1973, to tighten the squeeze,

1. The statutory liquidity ratio (SLR), which the banks are required to maintain under Section 24 of the Banking Regulation Act, was raised from 30% to 32% with effect from December 8, 1973.

2. The Bank also stipulated a ceiling in respect of

*R.B.I. Bulletin, November 1973 PP. 1852,58*
individual bank's total borrowings from the Reserve Bank of India as follows:

a. For the period between 8 December 1973 to 11 January 1974 ... at 1%.

b. For the period between 12 January 1974 to April 5, 1974 .......... at 2%

c. 1% thereafter till 31 May 1974.

The banks could thus borrow according to the quota which was fixed in terms of percentage of the aggregate demand and time liabilities of the borrowing bank as on September 28, 1973.

3. The minimum lending rate on bank advances was stepped up from 10% to 11% from 1.12.1973.

4. The refinance facility for the Government's Food Procurement Programme was also discontinued. Only the Bills Rediscounting facility was left outside the borrowing limits.

EXEMPTED CATEGORIES - A DELIBERATE LOOP HOLE:

As usual, the Reserve Bank exempted the following categories from the purview of the Credit Squeeze 1973-74:
1. All advances granted by the banks for the Government's Food Procurement Programme were exempted, though in the last stage they were brought under the purview of the squeeze, on 30 November 1973.

2. The refinance facility for exports was also excluded from the Credit Squeeze with effect from January 1974. This was done in order to maximize our foreign exchange earnings and provide a means for meeting the greatly enhanced cost of oil and other imports.

3. Throughout the busy season, the bills rediscounting facility, available to banks under the New Bill Market Scheme 1971, was exempted from the purview of the Squeeze. The purpose was to popularize the use of a genuine bill which relates to a particular transaction, is limited in period and is self-liquidating in character. With a view to achieving this end the banks were told that:

"They should as far as possible, resort to the New Bill Market Scheme to augment their resources. The regulations of the Scheme have already been relaxed by dispensing with the requirement of actual lodgement of bills of the face value of Rs. 2/- lacs and below."
This is being further relaxed with the dispensation of the requirement of lodgement of bills not exceeding Rs. 10/-lacs.

Thus, the Governor himself asked them to 'augment their resources' not through additional deposit mobilisation, but through refinance obtained from the Reserve Bank of India under the Bills Rediscounting Scheme.

SQUEEZE BECOME BOOM

The effects of the Credit Squeeze were indeed alarming. Before the commencement of the busy season, the Reserve Bank of India had estimated that the credit expansion during the busy season would not exceed Rs. 600/- to Rs. 650/- crores. In practice however, it was far in excess of Rs. 1000/- crores. As the Annual Report** points out, the credit expansion including bills rediscounted during the busy season of 1973-74 amounted to Rs. 1281/- crores or 19.7% as against credit expansion of Rs. 916/- crores or 17.4% in the previous busy season. The credit-deposit ratio of the scheduled commercial banks was pushed upto 72.6% at the end of 1973-74 busy season, as against 70.3% at the end of the preceding busy season.

* R.B.I. Bulletin, November 1973 PP 1853-54

What is interesting to note is that a large chunk of this credit expansion was financed by the Reserve Bank itself. Inspite of the several quantitative curbs which reduced the banks' recourse to the monetary authority, the Reserve Bank of India provided an accommodation of Rs.253/- crores to the commercial banks. Besides, the commercial banks' borrowings under the Bills Rediscounting Scheme amounted to Rs.244/- crores. Thus, the Reserve Bank of India accommodation supported the credit expansion to the extent of Rs 497/- crores during the busy season of 1973-74.

EFFECTS ON PRICES AND PRODUCTION:

The effects of the credit squeeze on the prices and production were still more serious. It not only contributed for a decline in production but was also responsible for a sharp and sudden rise in the price level. During the year from June 1973 to June 1974, the wholesale price index recorded an increase of 27.6% and the increase was around 50% if the previous year is taken into account. Never before, in the history of Independent India, have prices risen at such an alarming rate. Although a large part of the spurt in prices was due to the heavy dose of deficit financing; the price-rise due account of the Credit Squeeze was nevertheless significant.

The consumer price index also went up by 42% in the two
years. Such a situation naturally led to labour unrest, and persistent demand for wage increases. In certain industries, where such demand was met, either wholly or partially, the cost of production and therefore, the prices rose sharply. In effect, this reduced the competitive capacity of various industries and affected in turn our export performance. While industrial output and exports showed a declining trend, our imports continued to grow on account of higher prices of oil and other goods. Ultimately, this widened the gap in the balance of payments and affected adversely the internal, as well as external stability of our currency.

The hazardous effects produced by the squeeze on prices, production, and exports were brought to the forefront by some of the Chief Ministers of States. Thus, Mr. C. Achutha Menon, the Chief Minister for Kerala, condemned the blanket squeeze as irrational and injurious to the balanced development of industry in his state. In a letter written to the Union Finance Minister in January 1974, Mr. Menon urged that the credit squeeze was indiscriminate and pointed out that the credit restriction should cover only speculative lending and that the credit extended for productive purpose should be excluded from the purview of the squeeze.

* Economic Times - January 2, 1974.*
The recurrent complaints against the Squeeze made by the State Governments, prompted two union ministries to express their concern in the press. Thus, the Union Ministry of Industry complained that the squeeze was impeding production; and the commerce ministry felt that it was affecting adversely the country's performance at exports. The official circles in New Delhi also felt that the stringent curbs on bank credit would be counter-productive and might result in recessionary trends. They were convinced that there was an urgent need to strike a balance between the aggregate money supply in circulation and genuine needs of the economy.

Even after a year or so, the Minister for Industry, Mr. T.A. Pai* complained about the credit squeeze. He is said to have recommended to the Finance Ministry, priority treatment for some industries in the matter of bank credit.

JUSTIFICATION OF FAILURE

Thus, once again, the Reserve Bank went wrong in assessing the credit expansion and in implementing its policy measures during the busy season of 1973-74. The reasons given by the Reserve Bank of India, towards justification of the failure are, however, still more interesting. According to the

Annual Report:

"Some of the assumptions on which original credit projections were based were invalidated by subsequent developments, and adjustments had, therefore, to be made in the implementation of the quantitative restrictions."

......The monetary situation was at this stage a composite one of decline in deposit growth, persistently rising demand for credit and a general threat of dislocation in the production and distribution systems on account of dislocation in railway and shipping services, power and fuel supply and in some states, even law and order ——

In this context, the monetary authority had two alternatives. One was to adhere to the originally stipulated quantitative ceiling, disregarding the above developments and accepting their adverse impact on production, export, distribution of essential goods or the functioning of the monetary structure. The second alternative was to implement the policy in flexible manner and permit selectively extension of credit.
Taking the totality of national and international factors, the Reserve Bank of India took the deliberate decision to follow the second one viz., allowing the credit ceiling to be surpassed in the interests of maintaining production, increased exports and greater facility for movement of goods.

.... In the process, it had to allow an increase in commercial banks' resort to Reserve Bank of India Refinance and Bill Rediscounting."

Thus by providing refinance under the Bills Rediscounting scheme, to the extent of ₹.244/- crores during the 1973-74 busy season, as against ₹.19/- crores in the previous busy season, the Reserve Bank of India helped the credit expansion; and certified that:

"While the volume of bills rediscounted continued to be quite large throughout the year, the scrutiny of bills adequately established by and large, that they were genuine ones, and maintained their self liquidating character."**

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* Annual Report and Trend and progress of Banking in India - 1974-74  PP 25.27
** Ibid
Notwithstanding this justification, the credit policy of the Reserve Bank happened to be a Blind Alley. In effect, the credit situation went out of hand, and the credit restraint measures which were originally termed as the credit squeeze turned out to be a credit boom.

CREDIT POLICY – A RITUAL:

An assessment of the credit expansion, and an announcement of the policy measures on the eve of every busy season etc., have now become so customary that the Reserve Bank of India's credit policy cannot be regarded as anything more than a ritual.

Occasionally, however, the Reserve Bank of India goes out of the track, and attempts to investigate the use and misuse of bank credit. Thus, on the recommendation of the Union Finance Minister, Mr. Subramaniam, it asked the banks in 1974 to investigate into the use or misuse of bank credit as made by the big borrowers. The banks were asked to scrutinise each account with a credit limit of Rs.1/- crore and over, and see whether the big business houses had misused the funds for an unauthorized purpose. The Governor of the Reserve Bank, therefore, impressed upon the banks now,

"It is of utmost importance that banks should exercise adequate supervision over the operation
of borrowal accounts in all sectors so as to ensure that the amounts drawn by borrowers are the minimum required for their immediate legitimate needs and that such amounts are used for the purposes for which they are drawn."

The results of such an inquiry were, however, formal, because the banks came out with a reply that the credit is being used properly for approved purposes. The Reserve Bank of India Governor then simply passed on this reply to the Finance Minister, so as to justify his measures at credit control.

INCORRECTED PUBLIC EXPENDITURE :

Failure of the credit policy is due to two factors. In the first place, it is due to the increased budgetary deficits of the Government; and the credit extended by the Reserve Bank of India to the Government sector. Being a Banker to the Government, the Reserve Bank undoubtedly owes a duty to the Government, of providing 'ways and means' advances.

There should, however, be some limit on the amount advanced by the Reserve Bank to the Government. In practice, however, there is no such limit, and the Reserve Bank provides any amount of credit to the state Governments, and the Union

Government, in order to enable them to meet the public expenditure. It is worthwhile to see how the net credit extended by the Reserve Bank of India to the Government sector has rapidly increased during the last six years:

Table 6.1

<table>
<thead>
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<th>Year</th>
<th>RBI’s Net Credit to Government Sector</th>
<th>Increase over the previous year.</th>
<th>(in crores)</th>
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<tbody>
<tr>
<td>March 1970*</td>
<td>3,500</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>March 1971*</td>
<td>3,918</td>
<td>318</td>
<td></td>
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<tr>
<td>March 1972 +</td>
<td>4,694</td>
<td>876</td>
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<td>March 1973 +</td>
<td>5,494</td>
<td>800</td>
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<td>March 1974**</td>
<td>6,240</td>
<td>754</td>
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<tr>
<td>March 1975°</td>
<td>6,907</td>
<td>667</td>
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<tr>
<td>March 1976°</td>
<td>6,712</td>
<td>- 195</td>
<td></td>
</tr>
</tbody>
</table>

The third column in the Table shows the extent to which the Reserve Bank of India enabled the Government to overspend.

* R.B.I. Bulletin: * April 1971 - Table 16A P.630
  + March 1973 - Table 17A P.466
  ** March 1974 - Table 17A P.552
  ° Report on Currency and Finance 1975-76 Volume I P.128
Secondly, instead of curtailing the credit extended to the Government sector, the Reserve Bank tries to check the expansion of the bank credit, granted to the commercial sector for production and distribution.

**Independence of the Central Bank**

As a matter of fact, the Monetary Authorities know the real cause of the inflation. They are quite clear in their mind that it is due to the mounting public expenditure and budgetary deficits incurred by the Government during the era of planning. The Reserve Bank of India has, however, no courage to tell the Government that the inflation is due to the folly of Government. If the Reserve Bank of India were an independent institution and the Monetary Authority in the real sense, it could have impressed upon the Government that it is really so. In practice however, the Reserve Bank of India is no more than a government department controlled by the Ministry of Finance.

The diminishing importance of the Reserve Bank of India in the monetary affairs of the country is amply borne out by facts. Thus, neither the then Reserve Bank of India Governor, nor the Finance Minister, Mr. Sachar Choudhari, was consulted when the Rupee was devalued on the morning of 6th June, 1966. The diminishing power of the Reserve Bank of India once again became evident when the major commercial banks were
The Reserve Bank of India has, therefore, got little voice in shaping the monetary affairs of the country. The position is well explained by the disciple of Sir Chintaman, in the commemoration volume which he brought out in honour of his Guru:

"The fact is that nearly all the Governors have been exceptionally able, with great integrity and devotion to work. But not all have displayed the necessary spirit of independence. This is largely owing to the fact that the Government has full and unfeathered discretion in the matter of appointment of Governor and Deputy Governors. The appointees could also be dismissed at the discretion of the Government. It has also happened that some of the Governors had earlier worked as Secretaries under the Finance Minister. This results in not producing that spirit of independence on the part of the Governor that is essential for the successful working of a Central Bank."

As the leading financial journal has remarked, "It is the Parliament Street rather than the Mint Road that rules the monetary world in India." It is therefore, necessary that enough independence is allowed to the central bank to ensure proper implementation of its credit policy.

**NEED FOR CREDIT PLANNING:**

Effectiveness of the monetary and credit policy of the central bank, particularly in an underdeveloped country like India depends upon the rational allocation of bank credit between various sectors and regions in the economy. To begin with, the central bank should, therefore, assess the credit needs of the economy and plan the available credit according to certain priorities.

An assessment of the credit needs of the economy, through the commercial banks, and planning the available bank credit between various regions and sectors, constitutes concept of credit planning. It is pointed out that the Reserve Bank of India's credit policy should emerge from a credit plan which it prepares for the country as a whole. To begin with, the Central Bank should ask the banks to prepare their plans on given lines. These plans, prepared bankwise, should then be consolidated into a single credit plan for the economy.

* See Appendix II : Performance Budgeting as a Tool for Credit Planning.

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The national credit plan which would emerge in this manner must be in conformity with the plans and policies of the Government.

MICRO AND MACRO LEVEL

Credit planning based on the micro level would be advantageous in a number of ways. Since it is done by each bank in consultation with its actual and potential borrowers, it would be more realistic.

When credit plans prepared by different banks at the micro level are received by the Central Bank, they should be examined in the broader context of the economic, fiscal and monetary policies of the country. It is apparent that the only authority who is competent to plan the credit at the macro level is the Reserve Bank of India. Being the monetary authority it is concerned with a wide range of activities, such as regulation of the banking system, supply of money, management of public debt, regulation of the corporate sector, and other financial institutions, balance of payments, internal and external stability of the currency and so on. The monetary authority, which has built considerable expertise over all these years should therefore, plan the credit at the macro level.
It is worthwhile at this stage, to outline the steps that are to be taken in planning the credit system in the country.

1. Credit Planning at the macro level, should take into account the overall expansion of credit, necessary to meet the requirements of the economy in the context of certain broad considerations. In particular, it should be based on the overall increase in the money supply and the trends in real output. This responsibility can be discharged by the Central Bank by preparing the Monetary Budget, for a specific period such as a calendar year or a five year period. The primary purpose of a monetary budget is to project the rate of increase in money supply in the context of expected increase in real output. Assumptions underlying the monetary budget should also be made clear i.e. whether it is based on assumption of price stability or on the assumption of steadily rising price level. Generally, it should provide for a higher rate of growth in money supply than that of real income, so as to provide for the increasing monetization of the economy and the community's requirement of higher cash balances.

2. Having taken a view of the overall increase in the money supply, the next step is to determine the deposit component
of the monetary resources. In other words how much proportion of the increased money supply would come to the banking system in the form of deposit would have to be assessed.

3. Once the growth of deposits with the banking system is estimated, the third step in the credit planning process is to allocate the resources of banks, among the various segments and territories. This is to be done in accordance with the priorities laid down by the government in the five year plans.

4. The next important step in credit planning is to assess the demand for bank credit in the various sectors of the economy and indicate a broad sectoral allocation. An assessment of the credit needs of various borrower groups can be made by having dialogues with the users of bank credit.

CREDIT PLANNING AT THE MICRO LEVEL:

Such an assessment can be made with a fair degree of accuracy by the commercial banks than the central bank. The commercial banks are in direct touch with their borrowers and they are in a better position to assess the credit needs of their clients. Each commercial bank should therefore, prefer its credit plan based on the following:

a. The credit plan of an individual bank, should take into
account the developments at the macro level i.e. it should take into account the growth in money supply, real output and the deposits of the banking system. The economic department of each commercial bank should therefore, work in close harmony with the credit planning cell of the Reserve Bank of India.

b. It should take into account the credit requirement of the borrowers representing different segments of the economy. The commercial banks may then allocate the available resources to various segments. Regard should be given to the broad guidelines given to the banks by the Reserve Bank of India. In other words, while preparing its credit plan a commercial bank should give priority to the provision of credit to the priority sectors and small borrowers.

AN IDEAL PLAN:

A credit plan, which is worked out both from a micro and macro angle, should, however, take into account the following considerations:

1. The bankwise credit plan should be based on the area approach. That is to say, each commercial bank should be allotted certain areas and responsibility of regional development should be entrusted to a particular bank which is playing a major role in a given area.
2. It may be suggested further, as has been done by the Chief Economist* of the State Bank of India, that the area approach should be based on a district, as a unit. It may even be limited to a smaller block area, covered by the Community Development Programme. A credit plan, covering a smaller area would alone facilitate an intensive study of the area.

3. What is more important is that the credit plan should take into account the varying importance of different sectors. Thus it should undoubtedly emphasize the supreme importance of agriculture and rural development.

4. The credit plan should not only be related to different sectors; but has to be bifurcated further according to sub-sectors. The plan for the industrial sector should thus take into account the large manufacturing and service industries. The relative weight to be attached to each industry in the credit plan, should, of course be in conformity with the overall priorities set by the Five Year Plan.

5. While preparing the credit plan at the micro level, each commercial bank should be asked to assess the credit needs of the borrowers, not only for a year but over a sufficiently longer period of 3 to 4 years. Taking into account the cost

* L. D'Mello : Credit Planning for Districts, Rethinking on Methodology. State Bank of India Monthly Review. February 1974, P.50
and the time involved in the surveys, and the very short time left in its implementation, a One Year Plan is not advisable. Instead, a long-range plan seems advisable. Providing financial assistance in one year may at the most be called a phase in the credit plan; and the entire plan may be completed in 3 to 4 phases.

6. A credit plan should aim at correcting regional imbalances in deployment of credit.

STABLE POLICY NECESSARY:

Successful implementation of the Credit Plan would, however, depend upon the stability of the monetary and fiscal policies. It should not be difficult for the government to have a stable policy for a period of 3 to 4 years. When the Credit Plan is spread over the next few years, the emerging credit policy of the Reserve Bank would also have to be stable. Such a stable credit policy would ensure sustained growth in the production and distribution of goods. If it is linked further with a stable taxation policy, it would indeed be appreciated by the business community. If the businessmen are assured that the Government would not exact additional taxes during the next three to four years, they would indeed be tempted to invest and produce more.
It is against this background that the efforts at credit planning should be reviewed. The first systematic attempt was made in this direction when the National Credit Council was set up in 1958. The main functions of the National Credit Council were to -

a. assess the demand for bank credit from various sectors.

b. determine priorities for grant of advances having regard to the availability of resources and requirements of priority sectors, viz., agriculture, small-scale industry and exports.

c. Co-ordinate lending and investment policies as between commercial and co-operative banks and specialised agencies to ensure the optimum and efficient use of the overall resources.

The National Credit Council was to consist of 25 members. The Minister of Finance was to be its Chairman and Governor of the Reserve Bank of India the Vice-Chairman. The members were also to be drawn from the Planning Commission, Agricultural Refinance Corporation and so on.

The National Credit Council was largely an outcome of the
social control that was imposed on banks in 1968. But with the nationalisation of 14 major banks in July, 1969 the importance of the National Credit Council was considerably undermined. The only thing which the National Credit Council did was, however, the appointment of a Study Group to recommend a concrete path towards credit planning. The Study Group came out with the Lead Bank scheme, which was given effect to, in the post-nationalisation period.

CREDIT PLAN FOR A DISTRICT

Under the Lead Bank Scheme, a list of 338 unbanked districts was prepared and each bank was assigned with the responsibility of developing certain districts.

Each bank was supposed to undertake an extensive survey of a district that was allotted to it. Statistical data regarding population, number of taluks and villages, major production in the district etc., was available from the Government departments. On the basis of this data and the actual field visits, the bank was required to arrive at its plan of financing the various crafts and occupations in that district; by opening new branches if necessary. The districtwise plans were then to be consolidated and the final plan of financing the Lead Districts was to be drawn up. A bankwise credit plan could thus emerge at the micro level. When the plans prepared by different banks are consolidated
at the macro level, a total plan of financing the Lead Districts was obvious.

**CREDIT PLAN FOR 31 BANKS**:

The total Credit Plan which emerged in this manner was, however, confined to the underdeveloped districts. From the point of view of the country it was, therefore, a Partial Plan. In order to make the credit planning more comprehensive, the Reserve Bank took further steps in 1971-72.

In this year, 31 major banks were involved in the experiment of credit planning. Each bank was asked to prepare its own credit plan not only in relation to the lead districts, but with reference to the total lending activity of that bank in the Indian Union. This plan was to be prepared in terms of future branch expansion, deposit growth, increase in the number of staff, and possible changes in the profitability. During the year 1971-72, the Commercial banks thus set on with the experiment of credit planning.

**DIALOGUE WITH THE BANKERS**:

Each bank that submitted the credit plan, was required to discuss it individually with the monetary authority. The Reserve Bank of India had also a dialogue with various Trade Associations and Chambers of Commerce. Thus, as the Annual Report points out, the Reserve Bank had discussions with
Jute Manufacturers' Association, Engineering Association and similar representatives of private and public sector in the country. The experiences of the comprehensive credit plan for 1971-72 were also discussed at a meeting of economists of commercial banks in April 1972. The economists were asked to explain to the Reserve Bank of India the methodology that they used while estimating the deposit growth and sectoral allocation of credit.

A further leap was taken in 1973 when the banks were asked to prepare their credit plans statewise, in addition to being sectorwise. This has made the concept of credit planning more precise. The early experiments in 1971-72 and 1973 have indeed provided an opportunity for the banks to make their projections regarding future lending; and by now each commercial bank has developed its own expertise in credit planning.

DIFFICULTIES IN IMPLEMENTATION:

Great care should, however, be exercised when each bank implements its credit plan. The main difficulty that is likely to arise is that, in practice various sectors are often overlapping, and that the bank credit is likely to be misused for

* Annual Report and Trend & Progress of Banking in India 1971-72, p. 26
some other purpose. Thus the landed gentry that has migrated to the nearby cities, may borrow for the development of agriculture; but the amount of the loan might be misused for some other business in the city. Such diversion of credit to an unauthorized purpose is not unlikely, and the banks would have to exercise close supervision and control over the use of credit.

Successful implementation of the Credit Plan would also depend upon the foresight with which the plan is prepared. In a dynamic world, where changes after changes are taking place in the sphere of production and distribution of goods; and where economic, monetary and fiscal policies of the Government are constantly changing a credit plan has to have enough flexibility. In other words, if certain assumptions underlying the plan, are invalidated on account of the development of unforeseen events, the bank should be able to introduce changes while implementing the plan.

**LONG RANGE PLANNING NECESSARY:**

But this is not all. Any attempt at credit planning must take into account the changes that are likely to take place in a sufficiently long period. The credit planning in other words, should be spread over a long range. It is heartening to note that the progressive banks have set up their specialised departments called the Long Range Planning Department.
As a result of the phenomenal increase in their business during the past few years, the Indian banks are undergoing a change in their organisational structures. Some of the larger banks have completed their reorganisation schemes, and a few more are yet in the process. In all these banks, the Department of Long Range Planning would indeed occupy a signal importance. Let us hope that the newly emerging Long Range Planning's work in close harmony with the credit planning cell of the Reserve Bank of India, so as to make the country's credit policy more effective.

CONCLUSION:

The success of credit planning thus depends on a number of factors, which are diverse and complex in their nature. As remarked by an eminent central banker:

"The national credit plan will become meaningful only to the extent that the credit disbursing agencies comprehend the objectives and plan their operations in line with the thinking of the credit planning authority. The formulation of a credit plan for an individual bank has to take into account its size, resources, geographical spread, functional coverage, organisational set-up, etc. Above all, it requires a proper management.
Information system and an efficient statistical base. The preparation of a credit plan by a bank will again be mainly dependant on the co-operation forthcoming from the borrowing constituents and the extent to which the borrowers are prepared to give realistic assessment of their credit demand and cash flow statements. There has to be a continuous dialogue between the banks and the borrowers and frequent review of the performance of the borrowers. For credit planning to be successful, equally important is the discipline which the borrowing constituents themselves will have to adopt so as to bring about an economy in the use of credit.

* A Raman : Credit Planning and Policy. Institute for Financial Management and Research, Madras. P. 12. 13