Chapter II

Monetary Policy and the Industrial Sector: Theory and Operation

In this chapter, we attempt to take up some of the more relevant literature analysing the impact of monetary policy on industry. The limitation of existing monetary theory is that it looks at the impact of monetary policy with a model of industry which is atomistic, so that all individual firms are affected in the same manner. In other words, there are a large number of firms in an economy, whose investment decisions are supposed to react to changes in a monetary parameter, e.g., the rate of interest, in an identical fashion. Investment in these models, is a decreasing function of the rate of interest. Hence, if the government wants to reduce the demand for funds, it can hike up the rate of interest. On the converse side, savings are also related to the rate of interest, whereby, when the rate of interest goes up, aggregate savings increases. Hence, with interest rates going up, investment comes down and savings goes up and these counter-forces restore the monetary balance in the economy.

In most standard policy literature, pumping of additional money by the government into the economy is the crucial focus area. Governments are advised to borrow from the central bank only till that point where the additional money supply that results from such spending, does not lead to an inflationary pressure on the economy. In case, such spending is unavoidable, standard monetary theory tells us that the interest rate mechanism will have to be adjusted so that it could restore the
balance between the demand and supply of money or in other words the excess demand for money could be brought down.\(^1\) But at times the interest rate may be sticky and there may have to be non-price controls or restrictions on lending by commercial banks. In such cases, the commercial banks would be asked to either not lend towards certain categories of borrowers or would have to ask for increased margin contributions from borrowers.\(^2\) The point that we come to now is how does this affect borrowing by firms.

Keynes' contribution to the relationship between the rate of interest and investment by firms in fixed capital came in the form of the theory of the marginal efficiency of capital. This he defined as "the expected rate of return from one more unit of capital". The marginal efficiency of capital is a declining function of investment and is given by the rate of discount which makes the present value of the flow of the expected income stream over the life of a machine, equal to the present cost of that machine. Investment will go on till the point where the rate of discount is equal to the rate of interest.\(^3\) Therefore, to curtail investment and spending, the policy direction for the monetary authorities is to hike up the rate of interest through appropriate monetary measures and this would equate the rate of discount with the rate of interest, earlier.

In the theory of the firm, investment decisions are taken by

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the margin. Suppose a firm can either borrow or lend all it wants at a fixed interest rate. It will undertake all investments which yield a higher return than the rate of interest, financed by borrowing if necessary. But if additional funds are available with it after this threshold has been reached, it can maximise its earnings by lending it out at the current rate of interest and not by further investing in its own projects. In the case of borrowing, it will borrow till the point where the marginal cost of borrowing equals the marginal yield of the investment. 4

In real-life situations, the response to tight money policies are quite different. Access to credit varies from firm to firm and so does the impact of credit availability. This theoretical framework does not give us much insight as to how there might be a differentiated impact on firms of different sizes. There is an additional problem when we look at the monetary structure of the Indian economy. The commercial banks in India, a major part of which is state-controlled, operate in a somewhat heavily regimented system, which defines many of the objectives that these banks ought to achieve. Since the state has for sometime, been unable to restrain its own spending, the onus of controlling liquidity in the economy has largely fallen on the banking sector. And given the social objectives of banking in India, the impact of the instruments of monetary controls has been severely felt by certain segments of borrowers. How these instruments affect industry is what is of specific

interest to us. But before that we shall take a look at what constitutes monetary policy and how its operations in India have a specific kind of impact on industry.

Monetary policy is concerned with managing the money supply in the economy. The consensus among monetary economists has been limited to this very generalised definition. There are, however, substantial differences on what constitutes monetary policy or in other words, what are the components of monetary policy.

The differences arise from the very definition of money. A very narrow definition of money has been its function as a medium of exchange which implies that only currency and demand deposits are constituents of money supply. The Chicago School, led by Milton Friedman, etc., consider time deposits to be one of the components of money supply. The reasoning is that money is to be seen as a temporary abode of purchasing power. Therefore, if time deposits are utilised to settle debts, which indeed they are, then it would be only logical to include time deposits in what should constitute money supply.\(^5\) In India, time deposits are included in the definition of broad money supply — \(M_3\).

Non-bank financial institutions too play a role in determining the quantity of money. Therefore, the liabilities of these institutions should be included in the quantity of money, according to Gurley and Shaw.\(^6\)

Finally, we have the liquidity approach to the definition of

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money supply, chiefly propounded by the Radcliffe Committee. 7

Starting from a premise that the objective of monetary policy is to influence the level of aggregate demand, the Committee asserts that it is the overall "liquidity" in the economy which determines to a large extent the level of aggregate demand in the economy. 8 "Liquidity" though not precisely defined by the Committee is taken to mean more than money supply as understood conventionally.

From the above, it is evident that there is little consensus on the definition of money among economists. The differences in approach are not confined to a narrow or broad explanation of stock of money but also the behaviour of this stock over time, i.e., the velocity of money. The broad explanation of money depends on substitutability between assets for money as an explanation towards aggregate demand.

The absence of any unique or universally acceptable definition of money supply leads to several other problems. What are the parameters, i.e., institutional factors that must be brought under the purview of monetary control. Gurley and Shaw opine that non-bank financial Institutions (NBFIs) must be brought under the control of the central bank in order to make monetary policy more effective. Their line of reasoning proceeds on the assumption that shifts in the preferences of the public are possible between claims on banks to NBFIs. Thus, if at any point of time, such shifts are magnitudinally large, traditional direction of monetary policy, which is aimed

8. Ibid, paras 397 (d) and 981.
primarily at the banking sector, loses its thrust. This problem can be surmounted if control of NBFIs is also included in the ambit of monetary policy. When we are looking at the Indian economy, how and where do we draw the line between monetary and non-monetary policy parameters. It is a difficult exercise but, nevertheless, we have to make a beginning somewhere even at the risk of being in error.

Those instruments that the RBI uses to directly regulate and re-orient key monetary variables and parameters we consider to be within the ambit of monetary policy. The quantity of money supply and demand within the economy, the cost of credit and its flow are some of the key variables and parameters that we are interested in. We have specified the term "directly" because the economy is an inter-linked system and many changes in policies not directly connected with monetary policy are likely to have some impact on monetary variables too. Such policies are not being examined here.

The reason why we consider money supply and demand, as well as cost of credit and its flow as key variables or parameters is that the basic aim of monetary policy is to regulate and re-orient demand and supply factors in the Indian economy. That is quite different from the usual role assigned to monetary policy in a developed, free market economy. This is only to be expected so, for in a developing economy, the state has to play an additional role of re-orienting resources towards certain priority sectors and social groups, in addition to its macro-

This is where cost of credit and its flow play a vital role in determining which sectors or social groups would be getting additional resources. Coming to the specific question of whether we include the functioning of NBFIs to be within the ambit of monetary policy, the answer is not quite simple. When we talk of the cost of credit, it is but natural that once the commercial banks raise their rates of interest and keep it at that level for a substantial point of time, the other rates of interest, including that charged by the NBFIs, would also go up with or without time lags. However, where NBFIs differ from commercial banks is in the sources of funds. The main source of the latter is in the form of deposits from the public while in the case of NBFIs it is their own capital, reserves and surpluses and borrowings. Quantitative restrictions on credit creation do not quite operate on NBFIs since these are applied in some proportion of the deposits mobilised, which in their case is almost non-existent.

INSTRUMENTS OF MONETARY CONTROL IN INDIA

The operation of monetary policy of the Indian economy generally rests with the Reserve Bank of India (RBI) whose powers and responsibilities have been defined. The objectives of the RBI have been stated as "to regulate the issue of bank notes and the keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

The instruments used by the RBI to secure monetary stability are well-known and we do not intend to list them out. What we intend to do is to use the balance sheet assets-liability of the banking sector (which has to be maintained at any point of time) to explore the probable impact of different instruments of control on the availability of loans to the private sector and the cost of such loans.

What are the assets and liabilities of commercial banks? On the assets side, cash with themselves and deposits with other banks (ER), cash reserves with the RBI (CR), investments in instruments stipulated by the RBI (I), loans (L), fixed and other assets (FA). Cash with themselves and in deposits with other banks is termed excess reserves, which in turn consists of two parts -- desired excess reserves, ER$_d$, and undesired excess reserves, ER$_u$. The former indicates that banks desire to keep a certain portion of their assets in the form of cash to meet day-to-day requirements of making cash payments. ER$_u$ is the surplus cash the bank is saddled with, which it has not been able to lend out. An efficient bank seeks to minimise ER$_u$.

Cash reserves, CR, is a stipulated proportion, which is called the cash reserve ratio, varying between 3 per cent and 15 per cent of the total demand and time deposits (DTD) of the banks. There is also an incremental CRR by which the RBI can impound up to 100 per cent of the increase in DTD of banks between a particular period, provided the entire cash reserves do not exceed 15 per cent of the DTD. The RBI pays an interest on those cash reserves which are in excess of the minimum of 3 per cent but not on that part which is in excess of the prescribed CRR.
Investment, I, by banks in certain stipulated government bills and securities, as a stipulated proportion of their DTD, are necessary as per the statutory liquidity ratio (SLR) requirements laid down by the RBI.

Loans extended by banks too constitute assets, since these are claims that banks have on others. There are various types of credit extended by banks. The policy has generally been to direct some flow of credit, sometimes on a preferential basis, to what is termed the priority sector. The present stipulation is that at least 40 per cent of the credit advanced by the commercial banks has to be given to the priority sector, which includes agriculture, small-scale industry, small road and water transporters and the export sector. Hence, medium and large industry and trade have to compete with non-priority sectors for the portion of credit which can be given out to them. Not that many of the banks have crossed the minimum threshold of 40 per cent, but given the directives of the government, there is always pressure on the banking system not to cut down on the advances already given to these sectors. In addition, there is food credit given to finance public food procurement, distribution and maintenance of buffer stocks. This too is accorded priority and is charged concessional interest rates. Therefore, there are two kinds of lending by commercial banks - priority sector lending, \( L_p \) and non-priority sector lending \( L_n \). The former also usually enjoys some concessional rates of lending as compared to the latter.

Finally, on the assets side, we have fixed and other assets,
which banks have acquired over the years. These are not related to the DTD of banks but enter the balance sheet.

On the liabilities side, we have demand and time liabilities, which we shall denote as $D$ in our system of equations. Total Paid-up capital, TPUC, and accumulated reserves and surpluses, $V$, are claims on the banks by their owners.\textsuperscript{11}

At any point of time, assets have to match liabilities. We shall denote the above components of assets and liabilities in the following form:

$$D + \text{TPUC} + V = L_n + L_p + I + CR + \text{ER}_d + \text{ER}_u + \text{FA} \ldots \ldots (1)$$

During the course of any year, TPUC and $V$ does not change. What is subject to change is the profitability of operations, which depends on the asset and liability portfolio of banks and the rate of interest that is charged on the various loans and the returns on investments and deposits with the RBI. This is net of the interest on deposits paid by banks, which is an outgo. Therefore, in the profit and loss account, undivided profits, $\pi_u$ is related to the other components of the bank finances in the following manner:

$$\pi_u = (r_nL_n + r_pL_p + r_iI + r_cCR) - r_dD + (OY - E) \ldots \ldots (2)$$

The last term on the right hand side ($OY - E$) denotes other net income, which we can assume remains unchanged.

The usual hierarchy of interest rates is

$$r_n > r_p; \quad r_n > r_i; \quad r_n > r_c \text{ and, } r_n > r_d.$$ 

The latter is a necessary interest differential for banks to earn some net revenue to finance their operations.

\textsuperscript{11} Culbertson, J. (1978), \textit{op cit.} pp. 611-12.
In practice, \( r_n \) is usually the highest rate and it is in the bank's commercial interest to maximise that component of the loan portfolio, which accords the highest return. But it would not be possible to specify the relationship between \( r_p, r_i, r_c \) and \( r_d \), since these tend to vary depending on the kind of loans and deposits, the kind of securities held and the policy of the monetary authorities with regard to the interest to be paid on cash reserves.

The performance of commercial banks in India is judged on the basis of two important criteria, apart from a whole host of other factors:

a) achievement of a certain proportion of \( L_p \) in total loans advanced; and

b) maximisation of \( \pi_u \) as a percentage of net worth \((V+TPUC)\).

Let us assume that the target level of profits for the banking sector is \( \pi_u^* \). Any attempt by the RBI to change the asset portfolio of the banks, in order to reduce liquidity in the system, will lead to a need for corrective action on the part of the banks in order to maintain their profitability.

We shall try and see how this operates. Broadly, I, CR and \( ER_d \) depend on the level of \( D \). Therefore, we can re-write equation (1) in the following manner:

\[
D + (TPUC + V) = L_n + L_p + iD + crD + erD + ER_u + FA \quad \ldots \quad (1')
\]

or,

\[
D(1 - i - cr - er) + (TPUC + V) = L_n + L_p + ER_u + FA \quad \ldots \quad (3)
\]

Since our analysis is based on a regime where restrictive monetary policy is effective, this implies that there are no excess cash reserves, or \( ER_u = 0 \). This is because if the banking sector is flush with funds, any attempt to restrict
credit by raising the SLR or CRR will merely imply a change in the asset portfolio of banks from idle cash reserves to interest-earning investments in government securities and reserves with the RBI. It will not lead to a reduction in bank credit.

In equation (3), we shall also ignore fixed and other assets, FA, since this is a non-monetary component of the bank's balance sheet.

When there is a reduction in bank credit, it is usually at the cost of $L_n$ rather than the entire volume of credit. What exactly do we mean by reduction in bank credit? At one level, it could imply that the commercial banks in order to meet reserve and liquidity stipulations of the RBI would recall some loans or reduce the credit limits of borrowers. This is quite a rare occurrence for it can take place only in a situation when inflation is very high and the monetary authorities decide to take drastic steps to slash demand in the economy. At the other level, which is the general method by which such reduction occurs is that a large part of the additional deposits are impounded by the RBI and banks are also forced to increase their portfolio holdings of government securities. This forces the banks to refuse overdrafts to their customers or freeze their credit limits. In any inflationary situation, the existing credit limits will not suffice for borrowers who will, thereby, feel the pinch of a squeeze on credit imposed on banks. Such a squeeze need not result in an actual decline in the magnitude of credit but supply of credit from the banking system in such cases is likely to be less than the demand for credit.
To illustrate the above, let us consider the demand for credit of a borrower. This demand is dependent upon a whole host of factors like the volume of turnover, the inventory:sales ratio, the credit terms of suppliers and the credit terms offered to buyers. The incremental demand in the subsequent year is dependent not only on the expected growth in demand for the products of the borrower, but also the manner in which inflation affects the cost structure, how suppliers may be willing or not willing to provide further accommodation and finally how buyers will influence the change in the terms of credit offered and given. Assuming that the sum total of trade dues and trade credit and their terms remain unaltered, there may still be the need for additional credit because demand or nominal turnover may be expected to go up which means that inventory costs are going to rise. Inflation may also add to the monetary value of the operating costs. Thus, in such a situation, if further credit is not given by banks, it amounts to a real effective squeeze despite the fact that the borrower may still enjoy the credit limits he was entitled to. It is important to note that we are not taking into account a severe demand constraint situation in the economy. For if that is the case, monetary policy is ineffective and the entire analysis breaks down. The overriding constraint that we assume is that of a credit supply constraint. This in actual practice has by far been one of the more important constraints operating in the sphere of monetary policy for over three decades, thanks to an overall cautious approach of the central bank.
We shall now take up the question of how various instruments of monetary policy influence the volume of availability of credit.

**Cash Reserve Ratio**

The CRR is the stipulated ratio of cash reserves to total demand and time liabilities that banks are expected to maintain with the RBI. This is a minimum average daily cash reserve equivalent to between 3 per cent and 15 per cent of their total time and demand liabilities. Co-operative and non-scheduled banks maintain 3 per cent of their liabilities as reserves. They are allowed to maintain these reserves in the form of cash with themselves or in current account with banks notified for this purpose. Apart from the normal CRR, the Reserve Bank also prescribes an incremental CRR from time to time. In this measure, all the deposits that have been mobilised by the bank after a certain base date attract an incremental CRR which does not exceed 100% of the incremental deposits and in addition does not cause the total cash reserve to exceed 15% which is the statutory maximum. The CRR is applied quite strictly and non-compliance with these requirements attracts penalties. The rate charged on the defaulted portion is 3% to 5% above the bank rate and banks are denied access to refinance or rediscount facilities. They further have to pay penal rates on the portion of refinance accommodation already granted equivalent to the extent of the shortfall. Table 1 below gives the changes in CRR from time to time.

12. Ibid. p. 246.
Table: 1

Changes in Cash Reserve Ratio

<table>
<thead>
<tr>
<th>Date of change</th>
<th>16-9-62</th>
<th>29-6-73</th>
<th>8-9-73</th>
<th>22-9-73</th>
<th>29-6-74</th>
<th>14-12-74</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level</td>
<td>3</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>5</td>
<td>4.5</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Date of change</th>
<th>28-12-74</th>
<th>4-9-76</th>
<th>13-11-76</th>
<th>31-7-81</th>
<th>21-8-81</th>
<th>27-11-81</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>6.5</td>
<td>7</td>
<td>7.25</td>
</tr>
</tbody>
</table>

Source: RBI Report (1985) op cit., pp.249

How does a change in the CRR affect bank lending? Let the initial level of CRR be cr*. Now suppose that the RBI increases this to cr' where cr' > cr*. The increase required in CR to maintain the stipulated ratio is (cr' - cr*)D. When this happens, there is an increase in the cash reserves components of the assets portfolio. But there is no change on the liabilities side. Hence, the assets-liability balance is brought about by a change in some other component of the assets portfolio. This is usually done at the cost of Ln and desired excess reserves, ERd since ERu = 0, and Lp is sticky in the short-run. If it is done at the cost of desired excess reserves, it implies that the banks may have to become net borrowers on the call money market, where the requisite funds may not be available in a tight money regime or would be quite expensive. The CRR is open to leakages in the form of banks making compensatory borrowings from the RBI or selling government securities. But in a situation where the central bank means business, such loopholes are usually
plugged. Therefore, we assume that the entire burden of a reduction in credit availability is borne by $L_n$.

$$(cr' - cr^*)D = \Delta L_n \quad \ldots \ldots \quad (4)$$

Since, medium and large industry is also a part of the non-priority sector, it is quite likely that it would also face some cuts in credit. Since $D$ is a multiple of $L_n$, a small change in CRR has a proportionally much larger impact on $L_n$. Let us take an example from actual data and see what kind of an impact increasing CRR has on bank credit to the non-priority sector.

In June, 1978, the following is the picture of the scheduled commercial banking sector: (all figures in Rs. crore)

<table>
<thead>
<tr>
<th>Category</th>
<th>Figures</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total demand and time liabilities</td>
<td>24,175</td>
</tr>
<tr>
<td>Total credit advanced by banks</td>
<td>14,505</td>
</tr>
<tr>
<td>Priority sector lending</td>
<td>5,802</td>
</tr>
<tr>
<td>Non-priority sector lending</td>
<td>8,703</td>
</tr>
<tr>
<td>of which, medium and large industry</td>
<td>5,222</td>
</tr>
<tr>
<td>Cash reserve ratio</td>
<td>6 per cent</td>
</tr>
<tr>
<td>Statutory liquidity ratio</td>
<td>33 per cent</td>
</tr>
</tbody>
</table>

Desired excess reserves are considered at one per cent and there are no undesired excess reserves. If now there is a one per cent increase in the CRR requirements, then the lending to the non-priority sector decreases by:

$$- (0.7 - 0.6) \times 24,175 = - \Delta L_n = - \text{Rs. 241.75 crore.}$$

Thus, a one per cent increase in the CRR, gives rise to a 2.78 per cent decline in lending to the non-priority sector. If the burden is to be equally shared among all the categories of borrowers in the non-priority sector, the credit advanced to
medium and large industry would decrease by Rs. 145 crore. But the decrease in availability of credit to individual borrowers in the non-priority sector is not going to be proportionate but differentiated. However, we shall not go into this question at this stage. But what happens to bank profits. Since \( r_n > r_C \), the fall in bank profits would be:

\[
\pi_u^* - \pi_u' = (r_n - r_C) \times 241.75
\]

Thus, two things happen when the CRR is raised in a tight money situation. First, lending to non-priority sector and especially medium and large industry gets affected and there is a downward pressure on banks' profitability. If such credit stringency conditions continue, the RBI will be forced to raise the lending rates in order to protect profitability of banks. Once again, as we shall later see, the impact is mainly borne by the non-priority sector.

**Statutory Liquidity Ratio**

The Reserve Bank also prescribes that banks maintain a certain percentage of their assets in the form of unencumbered government and other approved securities. Unencumbered securities are those against which loans have not been taken from the RBI. The reason that is usually put forward in support of such a secondary reserve requirement is that, first, by compelling banks to hold low risk assets, the solvency of banks can be ensured. Second, in a situation where the capital market and especially the market for government securities is weak, such a stipulation will enable the government to find an outlet for its securities. Third, the government uses this instrument as a means of ensuring that a certain portion of total bank credit is
allocated to the government for augmenting the resources of the public sector.

The reason why it is called secondary is that it comes in addition to the cash reserve requirement. By raising the SLR, the Reserve Bank effectively prevents banks from increasing credit at commercial terms to private or other institutional borrowers. Table 2 below lists the changes in the SLR over a period of time.

Table: 2

<table>
<thead>
<tr>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td>Level</td>
<td>20</td>
<td>25</td>
<td>28</td>
<td>30</td>
<td>32</td>
<td>33</td>
<td>34</td>
<td>35</td>
</tr>
</tbody>
</table>


What the above figures point to is a gradual increase in the SLR from 1964 onwards. If one takes into account the massive increase in bank deposits between 1970 and 1981, the volume of funds that have been diverted into approved securities through the SLR are enormous. However, the way in which the SLR has been used in India, it has served more as a fiscal instrument, used to mobilise resources for plan expenditure, rather than as an instrument to regulate money supply. We give below the total outstanding investment by scheduled commercial banks in government securities, which is indicative of the relative importance of this instrument.

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Table 3
Total Outstanding Investment in Government & Other Approved Securities for All Scheduled Commercial Banks (in Rs. crore)

<table>
<thead>
<tr>
<th>Year</th>
<th>Government Securities</th>
<th>Other Approved Securities</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1976</td>
<td>3,283</td>
<td>1,324</td>
<td>4,607</td>
</tr>
<tr>
<td>1977</td>
<td>3,930</td>
<td>1,606</td>
<td>5,536</td>
</tr>
<tr>
<td>1978</td>
<td>5,907</td>
<td>1,990</td>
<td>7,897</td>
</tr>
<tr>
<td>1979</td>
<td>6,621</td>
<td>2,488</td>
<td>9,109</td>
</tr>
<tr>
<td>1980</td>
<td>7,444</td>
<td>3,181</td>
<td>10,624</td>
</tr>
<tr>
<td>1981</td>
<td>9,219</td>
<td>3,967</td>
<td>13,186</td>
</tr>
</tbody>
</table>


Raising of the SLR, has an effect on lending by banks especially to the non-priority sector. We shall see how. Consider equation (3). Let us now assume that the SLR initially was \( i^* \). Now it is raised to \( i' \) where \( i' > i^* \). We retain the assumptions made earlier that lending to the priority sector is inflexible in the downward direction. Thus, the incremental investment that banks will have to undertake in approved securities is \( (i' - i^*)D \). This will have to matched by a corresponding reduction in the lending to the non-priority sector, \( L_n \). Or,

\[
(i' - i^*)D = \Delta L_n
\]  

(5)

This is quite analogous to the previous exercise whereby a small increase in the SLR leads to an increase in the investments of banks which is magnitudinally similar to a reduction in lending to the non-priority sector. But when seen in terms of
proportions, the effect is much larger.

The SLR in its actual operation might prove quite harmful to the profitability of the banks. Given the low yield on government securities, compelling banks to keep a large portion of their assets in the form of government securities, reduces their profitability as we saw in the discussion on the impact of raising the CRR. If the SLR is raised very high, then the banks will have to raise the differential between borrowing and lending rates. This again has an impact on the lending to industry which we shall discuss when we come to the interest rate policy of the banking system.

REFINANCE POLICY

The degree of liquidity constraint faced by banks influences the relative importance of the Refinance Policy (RP). The RP is essentially a scheme under which the RBI provides credit to banks in the form of a) advances against eligible securities, for example unencumbered government and other approved securities; and b) as rediscounts of eligible usance bills under its Bills Rediscounting scheme. The reason why banks need special accommodation in India is the seasonality of credit requirements. The 'busy season' is generally from November to April when the marketing of major crops takes place and the financial year ends forcing settlement of debts, and payment of government dues. The rest of the year is the 'slack season' when demand for credit drops.

There are various schemes under which refinancing may be resorted to. The agriculture sector, small-scale industries, export industries etc. come under the priority sectors as
outlined by the government. Advances to these sectors by the banks are encouraged and since 1970, banks are entitled to refinance against these advances under guarantee from the credit guarantee organisation. Refinance has been allowed against these advances not to the full extent of the loans but to a certain proportion. At the same time, refinance may be completely refused under certain conditions. It is effective only when there are no undesired excess reserves with the banks, i.e., ER_u = 0. The quantum and cost of refinance would entirely be at the will of the RBI which would grant the concerned bank refinance based on the latter fulfilling or complying with policy objectives like credit-deposit ratio, export credit performance, sectoral deployment of credit, etc. Thus, the refinance policy of a bank can alter its mix of assets and liabilities as depicted in equation (3), and thus can be instrumental in changes in the volume of credit available to medium and large industry.

OPEN MARKET OPERATIONS

As noted earlier, open market operations have a monetary policy aspect as well as a fiscal aspect to it. In India, the former is almost absent since first, the market for government securities is narrow and not broad-based and second, the use of government securities to raise resources in a perennial deficit budget situation, overrides considerations of monetary regulation. In the first instance, open market operations are largely restricted to the RBI itself and scheduled commercial banks with State controlled other financial institutions

accounting for a small share of securities held.

Open market operations as an effective instrument of monetary regulation suffers from a handicap due to the ability of commercial banks to switch their portfolio as outlined above. In plain terms, if the government decides to borrow from the RBI, in the process creating additional high-powered money in the economy, the RBI in turn can persuade the commercial banking system to buy up these securities. If the banks are flush with excess reserves, they would readily convert their idle reserves into interest-bearing securities. But, if the demand for loans were to increase, these being more profitable for the banks, apart from maintenance of the statutory liquidity ratio, nothing prevents them from offloading these securities on to the RBI. This provides them with the required liquidity to meet the demand for loans. Thus, open market operations are not an effective instrument in restricting the flow of credit to the commercial sector. It has little analytical significance for our purpose.

SELECTIVE CREDIT CONTROLS

This is operated in addition to general credit control. In the use of this instrument, certain sensitive commodities which are in short supply and amenable to sharp price increases are rendered ineligible for further increases in bank credit. By reducing pressure on demand for these commodities arising from excessive bank credit, it is hoped that prices could be controlled. The underlying assumption is that bank credit is being utilised to finance stockholding, including speculative holding, activities in foodgrains and other commodities to a certain extent. Therefore, restrictions of credit would render
the capacity of traders to hoard stocks to go down, thus forcing them to release stocks in the market. This instrument was first introduced in 1956 and since then has undergone many changes both with regard to the number of commodities brought under the purview as well as the direction and magnitude of controls. The controls have been tightened, loosened or scrapped depending on the supply and demand positions of these commodities.

The experience with selective credit controls has not been a happy one. Since these controls are generally security-oriented and not purpose-oriented in their operation, the manipulation that is usually resorted to is to provide other collaterals and using the funds thus obtained into speculative holding of sensitive stocks. This in turn renders anti-inflationary objective of selective credit controls void. While the restrictive aspect of selective credit controls have been directed primarily against trade and the commercial sector, it affects industry indirectly. For example, if trade is denied finance to build up stocks of certain commodities like edible oils, sugar, textiles, man-made fibres, jute, etc., the offtake of finished goods from industry declines. This implies that industry would need additional credit to finance that part of the stock which has not been lifted by trade. Therefore, though the absolute level of \( L_n \) need not change, there could be a shift within \( L_n \) in favour of industry, which could push up their costs via higher interest pay-outs and debt-servicing.

15. Ibid., p. 383.
BANK RATE POLICY

The Bank rate is the rate at which the RBI extends advances to various categories of borrowers or the rate at which it buys or rediscounts bills of exchange. However, this rate is not a single rate but consists of a hierarchy of rates revolving around a central rate. The RBI charges different rates for various types of refinance facilities provided by it which include penal rates and incentive rates.

The Bank rate policy has generally fallen in importance and into relative disuse. Strangely enough, this has been caused by the overwhelming dominance of the RBI in its role as supporter of the government's fiscal operations and as a regulator of monetary variables. The underdeveloped nature of the capital market have also contributed to this state of affairs. The other rates of interest are insensitive to the Bank rate in terms of reacting to changes in it. This has occurred due to the practice of the RBI in simultaneously raising or lowering interest rates chargeable by banks on borrowers since these rates are largely administered rates and are not determined by market forces. Thus, there is virtually no change in the interest-rate differential, i.e., the difference between the lending rates of banks and the cost of borrowed funds.

Bank rate, although not an efficient instrument from the point of view of the RBI, serves as an indicator of the direction of credit policy for the market. For example, increase in the Bank rate is interpreted as a move towards tighter bank credit. This does not mean that market rates of interest move in sympathy with changes in the bank rate, they tend to do so usually
independent of the bank rate.

The bank rate as such does not affect the cost of lending. It does so only when there is a simultaneous adjustment of lending rates. That we shall discuss when we take up interest rate policy.

INTEREST RATE POLICY

Some economists believe that demand for credit in India has not been influenced substantially by interest rates charged by the banks. This is because in a situation where high rates of inflation prevail, commodity sellers benefit relative to wage-earners by merely postponing a sale. This gives rise to massive profits implying a relative transfer of incomes to industry, businessmen and sellers of commodities. This inflationary process has paled the interest rate structure of institutions to insignificance. The above argument implies that in the absence of controls on the inflationary process, no matter what the interest rate, there will always be demand for credit because scope for profits exist.

It may be pertinent to note that the interest rate policy of the RBI is part and parcel of a long-term strategy to balance the demand for and supply of credit. The interest rate policy works at two levels, the deposit rate and lending rates. The table below outlines the interest rate structure that was prescribed by the RBI for implementation by the commercial banks. Though the minimum and maximum had been prescribed from time to time with regard to lending rates or deposit rates, banks offer only those

rates that are prescribed by the RBI in order to avoid competitive hiking of interest rates. The prescribed minimum lending rate was abolished in 1981 to facilitate the process of giving loans to weaker sections of society at concessional rates of interest.

### Table: 4

**Interest Rate Structure**

<table>
<thead>
<tr>
<th>Year</th>
<th>1-Year Deposits</th>
<th>Above Years</th>
<th>Lending Rates (per cent per annum)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Deposit Rates</td>
<td></td>
<td>Prescribed Minimum</td>
</tr>
<tr>
<td>1973</td>
<td>6.00</td>
<td>7.25</td>
<td>10.00/11.00 (December)</td>
</tr>
<tr>
<td>1974</td>
<td>8.00</td>
<td>10.00</td>
<td>12.50</td>
</tr>
<tr>
<td>1976</td>
<td>8.00</td>
<td>10.00</td>
<td>12.50</td>
</tr>
<tr>
<td>1977</td>
<td>6.00</td>
<td>10.00</td>
<td>12.50</td>
</tr>
<tr>
<td>1978</td>
<td>6.00</td>
<td>9.00</td>
<td>12.50</td>
</tr>
<tr>
<td>1979</td>
<td>7.00</td>
<td>10.00</td>
<td>12.50</td>
</tr>
<tr>
<td>1980</td>
<td>7.00</td>
<td>10.00</td>
<td>13.50</td>
</tr>
<tr>
<td>1981</td>
<td>7.50</td>
<td>10.00</td>
<td>Abolished</td>
</tr>
</tbody>
</table>

Note: Pertains to banks with demand and time liabilities exceeding 50 crores.


The rates of interest tended to vary depending on the purpose for which the loans were given and to whom it was given. The priority sectors were charged lower rates as compared to the commercial sectors who were charged the maximum.

Given the financial portfolios of banks, it may be interesting to note how variations in the structure of interest rates affect various kinds of borrowers and especially industry?
Second, it will also be interesting to note how with policy-induced changes in the reserve requirements and investment portfolio mix of the banks, this in itself brings about pressure to change the structure of interest rates.

Consider equation (2). Apart from the total credit to the priority sector being sticky in the downward direction, the rate of interest too is rather sticky in the upward direction vis-a-vis the non-priority sectors. If banks have to maintain a targeted level of profits, \( \pi^* \), they have to take corrective action whenever any of the following happen:

- a. variations in the rates of lending and borrowing;
- b. change in the structure of lending between the priority and non-priority sectors;
- c. change in the SLR or CRR which would affect the portfolio holdings of the banks which we have seen earlier.

A change in the rates of lending and borrowing will naturally have an impact on the net profits of the banks. Even if both lending rates and borrowing rates move in tandem, banks would still lose money unless the returns on their investment in government and other approved securities and the interest payable on cash reserves with the RBI also increase in the same proportion. Otherwise, the differential between borrowing and lending rates will have to be increased in order to compensate banks for the loss. As seen in the above table, the differential between borrowing and lending rates has increased over the years precisely because of the relative inflexibility of rate of return.
on government securities.

Now, assume that the rate of return on government securities is not changed. If banks have to be compensated by increasing the differential between average cost of borrowing and lending, the increase in the rate of interest will be higher generally for the non-priority sectors.

Suppose that the initial average rate of interest on deposits was \( r_d^* \) which has now been increased to \( r_d' \). Therefore, the additional expenditure for the banks is \( (r_d' - r_d^*)D \). Since \( r_iI \) and \( r_pL_p \) are fixed (given the assumption that these rates are generally sticky), the additional expenditure has to be met solely out of increased interest income from loans to the non-priority sectors. That is:

\[
(r_d' - r_d^*)D = (r_n' - r_n^*)L_n \quad \ldots \quad (7)
\]

Since, \( L_n \) is a fraction of \( D \), the increase in the differential rates of interest will have to much more than it was initially. Or in other words:

\[
(r_n' - r_d') > (r_n^* - r_d^*)
\]

What happens when there is a change in the structure of lending? This can happen by a stipulation from the RBI that there has to be a re-allocation of credit from the non-priority sector to the priority sector. Let the initial allocation of credit \( L_p^* \) and \( L_n^* \) change to \( L_p' \) and \( L_n' \) for the priority and non-priority sectors respectively. The result of the changes are:

\[
L_p' > L_p^* \quad \text{and} \quad L_n' > L_n^*
\]

\[
L_p' + L_n' = L_p^* + L_n^*
\]

The latter equality implies that there has been no increase in lending in the aggregate and that within the overall magnitude
of lending, there has been a reallocation of credit.

Given that \( r_n > r_p \), this reallocation will result in a fall in the profits of the banks.

\[
\rho pL_p^* + r_nL_n^* > \rho pL_p + r_nL_n
\]

Therefore, in order to make up for the loss, there will have to be an increase in the rate of interest which again has to be largely borne by the non-priority sector.

Finally, we have seen what happens when there is a change in the SLR or CRR requirements. What we wish to point out is that with every attempt by the RBI to change the assets portfolio of banks by reduction of lending to non-priority sectors, automatically brings about pressure to increase the differential between lending and borrowing rates. That is why the interest rate policy is important for banks, not in terms of regulating the demand for money but in ensuring the achievement of profitability targets.

AN OVERVIEW

The single largest instrument that has affected the monetary aggregates in the economy has been the budget of the central government. Year after year, the deficits of the government have been mounting which has greatly increased the high-powered money in the economy. In order to restrict the impact of this increase on an already volatile price situation, the RBI has been following a generally restrictive credit policy especially after the mid-sixties. The stress of the RBI has been on quantitative restrictions in general and sectoral restrictions at some points of time. The accent also has been on direct
quantitative restrictions rather than on influencing quantity through the price mechanism. Despite the fact that all rates, including bank rate, lending rates, borrowing rates and the differential between the lending and borrowing rates, have gone up, for the period under review, direct quantitative restrictions in terms of CRR and SLR requirements have pre-dominated.

The operation of most instruments of monetary control result in either increasing the cost of borrowing, especially for the non-priority sectors or else in reducing the availability of credit, which again, mainly is borne by the non-priority sector. This does not mean that the non-priority sector actually suffers from the operation of restrictive monetary controls. Large segments in these sectors pass on the burden in the form of enlarged trade dues on the small-scale sector or by surreptitiously enjoying the benefits granted to the priority sectors through legal maneuvering. We are not going into that question. What we are interested in is how the operation of the various instruments of monetary policy has an impact on industry - especially medium and large industry. That we shall take up in the subsequent chapters.