INTRODUCTION

CHAPTER I

INTRODUCTION

Before 1990, the financial sector of India was characterized *inter ali*a, by administered interest rates, large pre-emption of resources by the authorities and extensive micro level regulations, directing a major portion of the flow of funds to and from financial intermediaries. The interest rate on government debt was administered and the rate of interest charged by the Reserve Bank of India (RBI) for financing government deficit was concessional. The flow of external capital was also very limited. In such a closed economy debt markets remained underdeveloped and devoid of any competitive force. The provision of fiscal accommodation through *ad hoc* treasury bills contributed to high levels of monetisation of fiscal deficits during the 1980's.

This was a period of nationalization and 'Social Control' of financial intermediaries. It had its positive contribution to the economy. A sharp increase in rural branches of banks helped considerably the growth of deposits and savings. There was a marked rise in flow of credit towards economically very important but hitherto neglected activities, most notably agriculture and small-scale industries. The urban bias and preference of banks to lend to large industrial houses were contained. There was no major episode failure of financial intermediaries in this period. The administered interest rate was a major instrument of monetary policy to balance money supply and economic growth and to contain the rate of inflation.

However, as the economy grew and became more sophisticated, the banking sector had to develop *pari pasu* to support and stimulate such growth and also structural transformation; especially in the context of increasing global integration. In response to this need, the New Economic Reform Policy (NERP) was formulated, in mid 1990. It included also several financial sector reforms allowing for substantial transformation and liberalization of the whole financial system. This transformation was brought about by an extensive, well sequenced and coordinated policy measures aimed at making the Indian financial sector efficient, competitive and stable with the twin objectives of "maintaining price stability" and "ensuring availability of adequate credit to priority sectors" of the economy.

Progress

The period since 1991-92 has seen some important changes in the approach to, and content of, economic policy of India. The role of the state has undergone a vast change. There is a common thread running though the various measures introduced since 1991-92, for imparting a greater element of competition. Barriers to entry and growth have been dismantled. Viewed from the angle of the growth rate, the performance of the Indian economy in the post-reform period has been good. After the initial set back in 1991-92, the growth rate started picking up.

The broad economic parameters do point to the feasibility of the economy growing over the medium term at around seven percent per annum.[1] With the domestic savings rate ranging between 25 percent and 26 percent and even with a modest current account deficit of two percent of the GDP, with the Incremental Capital Output Ratio (ICOR) remaining more or less at four, necessary conditions exist for achieving a seven per cent rate of economic growth. But these are not sufficient. An improvement in the savings rate and better efficiency in the use of capital are required. In order to translate the resources available into the actual growth rate, certain other conditions need to be met.

A sound fiscal system is an essential prerequisite for sustained economic growth. The fiscal system must be capable of meeting adequately the responsibilities of the governments both at the Center and in the States and, at the same time, of ensuring that the overall fiscal deficit is kept within limits. There is no unique way of determining the appropriate level of fiscal deficit. Broadly speaking, there are two factors, which should determine the appropriate level of fiscal deficit. The first factor is the level of savings in the economy and second, the ratio of government revenues to the Gross Domestic Product (GDP). A higher level of private savings and a higher ratio of revenues to the GDP can permit a higher fiscal deficit. Investment is the major driving force of growth. All investment decisions are based on future prospects and hence, continuity of economic policy becomes the key to sustaining expectations in the right direction.

[1] C.Rangarajan (2004)., ***Perspectives on Indian Economy - A Collection of Essays***,(New Delhi : UBS Publishers' Distributors Pvt. Ltd), p.74.

Since the inception of development planning, the broad objective of India's economic growth was to ensure a reasonable degree of price stability in the economy and promote distributive justice. The working of monetary policy in India over the past several decades would reveal that monetary policy has emphasized these broad objectives of the economic policy.

Monetary Policy

With the introduction of Five Year Plans, the need for appropriate adjustment in monetary and fiscal policies to suit the pace and pattern of planned development becomes the imperative. The monetary policy of the government has to:

(a) speed up economic development in the country to rise national income and standard of living, and
(b) control and reduce inflationary pressure in the economy.

The policy of the Reserve Bank of India since the First Plan Period was termed broadly as one of controlled expansion, i.e., a policy of "adequate financing of economic growth and at the same time ensuring reasonable price stability."[2] Expansion of currency and credit was essential to meet the increased demand for investment funds in the country, which has embarked on rapid economic development. RBI recognized and appreciated the need for expansion of credit money supply commensurate with the rapid development and diversification of the economy. At the same time it was equally aware that an excessive expansion of money and credit would be clearly inflationary and would ultimately endanger the financial stability of the economy. Accordingly, RBI took care to expand money and credit and attempted to check rise in prices by the use of selective controls.

However, since1972, the Indian economy was working with considerable inflationary potential – a rapid increase in money supply with the public and also banking system. There was also expansion of bank credit to finance trade and industry. A serious inflationary situation was emerging fuelled by frequent fluctuations in agricultural

[2] Rudder Datt and K.P.M. Sundharam (2000), ***Indian Economy***, (New Delhi : S.Chand &Company Ltd), p.833.

production, faulty government policies, global inflationary situation arising from the hike in oil prices and the Gulf War. RBI was forced to abandon 'controlled expansion' and adopted a policy of credit restraint or tight money policy, with varying degree of success.

In 1994-96, RBI had to enter the foreign exchange market in a big way to prevent heavy depreciation of the rupee and in 1998 to guard against the experience of South Asian currencies leading to a crises situation.

Both the theoretical literature and empirical findings show that, among various policy objectives, monetary policy is best suited to achieving the goal of price stability in the economy. It has also been recognized that, in the long run, the objectives of price stability and growth need not necessarily conflict with each other. Rather, in today's altered economic context, a low and stable price environment is being increasingly regarded as an essential condition for improving the growth and productive potential of the economy.

Commitment to price stability does not mean blind faith in maintaining a certain level of inflation, without concern for the need to maintain and accelerate growth; far from it. In no country in the world has this been so. What this commitment implies is that monetary policy can help the growth process vastly by regulating money supply towards the goal of maintaining price stability in the economy and helping the economy to recover from independent shocks.

Empirically a general finding is that inflation adversely affects growth in the long run. Fischer's [1994][3] study of inflation and growth performance of a large number of countries has shown a predominantly negative long-term relationship between growth and inflation. An inflation rate beyond a threshold has significant adverse implications for growth. But what the appropriate inflation threshold beyond which costs tend to exceed benefits differs among the economies.

[3] Fischer, Stannly (1994), *Modern Central Bank in Forrest*, Cupie et. al (eds.) ***The Future of Central Banking*** – The Tercentenary Symposium of the Bank of England, (Cambridge University Press).

It is important to note that while an increase in money supply beyond what is consistent with the growth in real income could improve the credit availability, reduce the interest cost and promote investment and growth in the short run, the impact cannot be sustained for a long period. The ultimate effect will be a rise in the inflation rate.

Role of Monetary Policy

With the accumulation of evidence regarding what monetary policy can and cannot do, there has been a change in public perception about the role of monetary policy in promoting growth. Since firms, workforce and countries compete at the margin, public policies for providing a stable background to the economy have assumed a critical importance for promoting growth and productivity. These developments have made the countries, across the world, more conscious of the hidden costs of inflation and their adverse implications for growth. Perhaps the single most important contribution that monetary policy can make under these conditions is to maintain a low and stable rate of inflation that would provide the necessary condition for promoting competition, efficiency and growth in the economy. Necessarily it had its attention and impact on the banking sector.

Banking Sector

Commercial banking constituted the largest segment of the Indian financial system. Many of the regulatory and supervisory norms were initiated first for commercial banks and were later extended to other types of financial intermediaries. After the nationalization of major banks in two stages, starting in 1969, the Indian banking system became predominantly government owned by the early 1990s. Banking sector reforms of NERP essentially consisted of a two-pronged approach. While nudging the Indian banking system to better health through the introduction of international best practices in prudential regulation and supervision early in the reform cycle, the idea was to increase competition in the system gradually. Special emphasis was placed on building up the risk management capabilities of the Indian banks. Measures were also initiated to ensure flexibility, operational autonomy and competition in the banking sector. Active steps were taken to improve the institutional arrangements including the legal framework and technological system within which the financial institutions and markets operated. The development of the banking sector served the goals of competitive growth and diversification of portfolio to help priority sector.

Interest Rate

This type of target lending is necessary in a resource constrained economy of India. The monetary system would also have to ensure adequate flow of credit to the essential sectors of the economy. For the purpose, the restrictions on banks have, by and large, been removed, the cash reserve ratio on banks has been substantially reduced and the corporate sector has started accessing funds from domestic and global capital markets in a big way; the industrial sector no longer comes under the credit constrained behavior. In this environment monetary policy is expected to work through the *interest rate* in promoting the expansion of credit and overall investment activity in the economy. Indeed, this has remained the focused objective of the recent monetary policy initiatives, which have made (i) the interest rate as a signaling device, (ii) provided a free hand to commercial banks in the determination of lending rates and (iii) substantially improved the liquidity condition in the economy with a view to bringing down the level of the interest rate. Responding to these initiatives, the prime lending rates of commercial banks have come down steadily from the level of 17 per cent in 1993-94 to the range of 10.25 to 10.75 percent by March 2005.

The interest rate responds to several factors and the nominal interest rate comprises three important elements:

(i) the real interest rate
(ii) inflation expectations , and
(iii) a discount factor for uncertainties

In this sense, the real interest rate is not an observed variable. It is influenced by several factors such as saving and investment balance in the economy and the rate of return on capital. The effectiveness of monetary policy to bring down the nominal interest rate will depend on its impact on inflation expectations and on the perception of uncertainty in the economy. As the experience of many countries has shown an excessive expansion in money supply to bring down the interest rate can lead to a rise in the inflationary expectations.[4]

In India, money demand is less volatile [Arif, 1996][5]. Other researchers have also reached similar conclusions using different model specifications, sample periods and data

[4] C.Rangarajan (2004), op.cit., p.19.

[5] R.R.Arif (1996), "Money Demand Stability: Myth or Reality: An Economic Analysis", ***Development Research Group Study***, No 13, Reserve Bank of India.

frequency [Nag and Upadhyay, 1993[6] and Joshi and Saggar, 1995[7]]. The extent and pace of financial innovation in India are not such as to affect the stability of money demand behavior. The concept of monetary targeting that has been adopted is a flexible one, which takes into account various feed back effects.

Money Supply

The money supply target is relatively well understood by the public and provides unambiguously the stance of monetary policy. It is also important to note that while a target range for M_3 growth provides the annual or medium-term context of monetary policy[8] the Reserve Bank of India[9] (RBI) has to watch closely the behavior of interest rates in the various markets. It is because, despite the very substantial increase in credit by the banking system, the total availability of finance falls short of the overall requirement and this results in an increase in the interest rate. The experience of the past few years reveals that whenever the capital market is sluggish, the repercussion is felt in the credit market as corporates look for bank finances as a substitute for the equity money. In fact, with the inflation rate coming down it becomes possible to focus on the interest rate along with overall monetary growth. *Interest rate targeting becomes a possible course of action only when the inflation rate remains in a narrow range.*

Money supply as an intermediate target for monetary authorities seemed appropriate when fiscal and the monetary aggregates are strong and when interest rates were by and large regulated. During the last decade there is a transition from a tightly administered structure of interest rates to a stage of market induced determination of interest rates. The objective of policy has been to restore the *bank rate* to its primacy.[10] RBI has powers to use several instruments in combination to achieve its goals.

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[6] Ashok K. Nag and Ghaushyam Upadhyay, "***Estimating Money Demand Funtion: A Co-integration Approach***", Reserve Bank of India ***Occasional Papers***, 14 (1), 1993.

[7] Himanshu Joshi and Mridual Saggar, "The Demand for Money in India: Stability Revisited", Reserve Bank of India ***Occasional Papers,*** 16 (2), 1995.

[8] M_3 is one of the measures of money supply. See the concept in the next chapter.

[9] The Reserve Bank of India is the Central Bank of the country entrusted with powers to control money supply.

[10] C.Rangarajan (2004), op.cit., p.ix.

Instruments of Monetary Policy

RBI has instruments of monetary policy, broadly classified into quantitative and qualitative controls. Quantitative controls are used to control the volume of credit *per se* and indirectly, and also to control the inflationary and deflationary pressures caused by expansion and contraction of credit. Quantitative controls are also known as general credit controls and consist of bank rate policy, open market operations and cash reserve ratio. Qualitative controls or selective controls are affecting the use of credit for particular purpose.

(i) **Bank Rate:** As per the RBI Act, 1934, Bank Rate is defined as the standard rate at which the RBI is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase. The bank rate or the central banks' rediscount rate is an important monetary instrument in modern economies. Its most useful role is to signal and / or clarify the central banks' (RBI) monetary and interest rate stance to all participants in the financial sector and particularly to banks. If monetary policy is effective and credible, a change in the bank rate will result in a change in prime lending rate of banks and thus act as an independent instrument of monetary control.

(ii) **Cash Reserve Ratio:** Another instrument available to RBI for credit control is the use of variable Cash Reserve Ratio (CRR). Under the RBI Act, 1934 every commercial bank has to keep certain minimum cash reserves with RBI. High fiscal deficit and its uninterrupted monetisation lead to a steady rise in inflation. The increasing liquidity of the banking sector, resulting from rising levels of reserve money due to monetisation, have to be mopped up. Hence, RBI hikes the CRR to moderate liquidity and thereby to contain the inflationary impact of monetisation of fiscal deficit[11]. Higher CRR is imposing burden on the banking system, as resources are pre-empted without adequate return.

[11] P.D.Jeromi, "Monetary and Credit Policy : A Text of Reforms in India", ***Bank Quest***, 76 (2): 8-18, 2005.

(iii) Statutory Liquidity Ratio: It is a prudential norm mandating banks to invest a portion of their liabilities in risk free instruments. Central banks generally require commercial banks to hold liquid assets in the form of cash, gold and government securities against their total demand and time deposit liabilities in addition to the cash reserve requirements. This is called Statutory Liquidity Ratio (SLR). It can be varied to meet the objectives of monetary policy in the medium term.

(iv) Open Market Operations: The term open market operation means the purchase and sale of securities by the RBI. The sale of securities by the RBI leads to the contraction of credit and the purchase thereof to credit expansion.

Qualitative or Selective controls: The following are other instruments of monetary policy.[12] They are operated as an adjunct to general credit control. It is indented to ensure an adequate credit flow to the desired sectors while preventing excessive credit drawal for less essential economic activities. Selective credit control was usually applied to achieve a reduction in excessive advances against certain sensitive commodities in short supply and to reduce pressure on demand originating from bank credit.

(a) Margin Requirements: RBI directs commercial banks to lend up to certain value but not full value of the security. The difference between the loan amount and market value of the security is known as margin.

(b) Regulation of Consumer Credit: It seeks to control consumer credit through the control of hire purchase and installment sales of durable consumer goods.

(c) Control Through Directives: Under this system, the RBI can issue directives for the control of credit.

(d) Direct Action: Direct actions may be imposed in many forms. Firstly, the RBI may refuse to rediscount bills for those commercial banks whose behaviour is not in conformity with the existing monetary policy of the country. Secondly, the central bank may refuse to grant accommodation to those banks whose borrowings are considered to be in excess of their capital reserve.

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[12] K.P.M. Sundharam and E.N. Sundharam (1983), ***Modern Banking,*** (10th edn, New Delhi : Sultan Chand & Sons), pp.4.33-4.38

(e) *Moral Suasion:* Under this method, RBI requests the commercial banks to follow the credit policy formulated. This is a sort of moral appeal made by the RBI for getting the cooperation of commercial banks.

(f) *Rationing of Credit:* Under this method, the amount of credit to be granted is fixed by the RBI. Credit is rationed by limiting the amount available to each commercial bank and also by restricting the discounting of bills.[13]

Of all the instruments, the bank rate has an immediate impact on bank credit, lending rate and profitability of banks. Therefore it draws special attention in this study for its effect on financial performance of the commercial banks.

Performance of Commercial Banks

The formal banking system in India comprises the RBI, Commercial Banks, Regional Rural Banks and Co-operative Banks. The RBI is the central bank and monetary authority. It manages the country's money supply and foreign exchange and also serves as a bank for the Government and for the commercial banks. According to the Preamble of the RBI Act, the main function of the bank is " to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit systems of the country to its advantage."[14] In addition to these traditional central banking role, the RBI undertakes certain developmental and promotional roles. As the regulatory and monetary authority the RBI issues guidelines for promoting sound banking in India.

The commercial banks are commercial concerns, which provide various financial services to the customers with the objective of earning profit. With the inauguration of RBI, joint-stock banks in India were classified into two main groups, viz., scheduled and non-scheduled banks. Scheduled banks are those, which are included in the second schedule of the RBI. They are eligible for certain facilities, especially the facility of obtaining an accommodation from the RBI and correspondingly bear certain obligations

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[13] B.N.Ghosh and Rama Ghosh (2000), ***Fundamentals of Monetary Economics***, (2nd edn, Mumbai : Himalaya Publishing House), pp. 435-436.

[14] Reserve Bank of India (1970), ***Reserve Bank of India Functions and Working,*** Bombay.

to maintain minimum statutory reserves and abide by the directives of RBI.[15] Banks, which are not included in the second schedule, are known as non-scheduled banks. After 1969 scheduled commercial banks are broadly classified into nationalised or public sector banks and private sector banks. As on March 31, 2004 there were 90 commercial banks (excluding RRB) in India. These commercial banks comprising of the State Bank of India (SBI) and its seven associates (eight in number), 19 nationalized banks as nationalsied or public sector banks (NSB), 30 other scheduled banks (OSB) and 33 foreign banks (FB) as private sector banks.[16] Among the nationalised banks, the SBI stands in a class by itself. It is the largest commercial bank; has close association with the RBI and helps implement monetary policy[17]. By virtue of it being an agent of the RBI it has currency chest facilities at most of its branches.

There are 196 Regional Rural Banks (RRB) and several cooperative banks. As they function more for specific social purposes than on purely commercial purposes, they are excluded form this study.

The performance of Indian commercial banks can be measured on three fronts, *viz,*. profit and profitability (net profit, net profit to total Assets), efficiency (net interest income total assets, operating expenses to total assets, non-interest income to total assets) and stability (NPA).[18] Higher the profit / profitability, efficiency and lower the NPA better the performance. Apart from these measures the growth of deposits, advances, spread (number of branches), net worth, assets, investments and capital adequacy also be the performance indicators.

For long the bank credit remains one of the important elements in the operating procedure of the monetary policy in India.[19] The bank credit is the most important source

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[15] K.P.M.Sundharam and E.N.Sudharam, op.cit., p. 3.2.

[16] Statistical Tables Relating to Banks in India 2003-04, ***Reserve Bank of India***, Mumbai

[17] K.P.M.Sundharam and E.N.Sundharam, op.cit., p.3.31.

[18] Vepa Kamesam (2002), "Indian Economy – Financial Sector Reforms and Role of RBI", ***Reserve Bank of India***, 56 (5) : 375-391.

[19] L.M.Bhole (2004), ***Financial Institutions and Markets***,(4th ed, New Delhi : Tata McGraw-Hill Publishing Company Limited), p. 6-28.

of money supply in a country. Therefore, it is very essential to control the credit expansion and contraction of commercial banks.[20]

Hence, the RBI uses the various monetary policy instruments to expand or contract the money supply in the country. Among them the bank rate has an immediate effect on the bank credit. A change in the bank rate affects both the cost and availability of credit. If the bank rate is raised, commercial banks get less from the central bank by discounting the bills. Their credit creating power curtailed. As the credit becomes costlier, the demand for it contracts.[21]

Before banking sector reforms, changes in banks rate was infrequent in India. The bank rate, which has been reduced from 3.5 percent to three percent in November 1935, was raised again for the first time in November 1951 to 3.5 percent. It was raised to four percent in May 1957, 4.5 percent in January 1963, five percent in September 1964 and further to six percent in February 1965 to exercise a restraining influence in the context of a serious imbalance in the economy giving raise to inflationary pressures. In March 1968, the rate was lowered to five percent to stimulate economic recovery in view of the recessionary conditions in the economy.

In January 1971, the bank rate was enhanced to six percent to contain inflationary conditions caused by Bangaladesh war. The repercussions of the war continued and in May 1973, the rate was increased to seven percent and then again to nine percent in July 1974. After seven years, the rate was again raised to 10 percent in July 1981. During the reform period the bank rate underwent frequent changes. In July 1991 the rate was increased to 11 percent and due to the high pressure of inflation further increased to 12 percent in October 1991. The bank rate was linked to all other rates charged on RBI accommodation, effective from April 16, 1997. The reactivation of the bank rate has served as an effective signaling device and as a reference rate for the entire financial system. In pursuance to this objective, in April 1997 the bank rate was lowered to 11 percent and to 10 percent in June 1997. In October 1997 the rate was reduced to

[20] B.N.Ghosh and Rama Ghosh (2000), op.cit., p.373.

[21] Loc.cit., p. 424.

nine percent and within three months time it was increased to 11 percent in January 1998. In March 1998 the rate was reduced to 10.5 percent and in April 1998, to 10 percent. Further the rate was reduced to nine percent at the end of April 1998. The evolving economic condition further pushed down the rate to eight percent in March 1999. The rate further fell to seven percent in April 2000 and increased to eight percent in July 2000. The rate was 7.5 percent in February 2001, seven percent in March 2001, 6.5 percent in October 2001, 6.25 percent in October 2002 and six percent in April 2003. The current rate stands at six percent.

Problem Statement

The bank rate, administratively determined by the Reserve Bank of India, is a powerful instrument of monetary policy of the Government of India that favours a controlled expansion of money supply to meet the growing requirement of a developing economy with attention to inflation and price stability. It is the rate at which the Bank (RBI) is prepared to buy / discount bills of exchange or other commercial papers. It determines to a large extent, the supply of bank money and market rate of interest, in turn. Therefore, the bank rate is varied to influence money supply in general, institutional credit in particular and also investment and saving rates in the economy through its influence on market rate of interest for the deposits and advances of the scheduled commercial banks and other financial institutions. Therefore the Bank Rate, in combination with currency policy, Cash Reserve Ratio (CRR), Statutory Liquidity Ratio (SLR) and the open market operations of the RBI, determines the rate of interest charged for loans and advances and paid for deposits and investment in mutual funds, benefit funds and other forms of savings. Therefore, the earning power of the banks, especially scheduled commercial banks and their financial performance are largely affected by the Bank Rate. At the same time, the commercial banks in the country are committed to financially assist priority sectors of the economy to sustain growth rate of the economy, at levels exceeding six percent per annum and aiming at 8-10 percent in the next decade. These expectations and the bank rate are therefore the major determinants of the performance of the commercial banks in the country. Before 1990, the main task of Monetary and Credit Policy (MCP) was the management of aggregate demand with emphasis on containing inflation. So the interest was administered with the introduction of new economic reform policy (NERP) in 1991, the banks were given great functional autonomy and they had to act in a least regulated, fairly competitive, forex influenced globalized market. A new vibrant, dynamic market oriented monetary system had emerged and it worked monetary targeting " to achieve economic growth with price stability. The deregulation of interest rate became essential to the market oriented policy, to encourage the process of price discovery. As the commercial banks are the major sources of funding for commercial, industrial and also development activities, especially since nationalization of 20 major commercial banks[22] influence of MCP in general and bank rate in particular on their performance drew attention. Hence this study.

Objectives

Overall objective of the study is to evaluate the influence of the Bank Rate on the performance of commercial banks in India during the post-nationalization (of banks) period, with special attention to the period of economic reform:

Specific objectives of the study are stated below:

1. To study the performance of commercial banks during the post – (bank) nationalization period 1975 to 2004.
2. To make a comparative study of the performance of commercial banks during pre and post (economic) reform periods (i.e) (1975-1990 & 1991-2004).
3. To make a comparative study of performance of four categories of commercial banks viz., State Bank of India (SBI) and its associates, Nationalised Scheduled Banks (NSB), Other Scheduled Banks (OSB) and Foreign Banks (FB).
4. To study the variation in bank rate and rationale for it.
5. To study the relationship between the bank rate (R) and the macro variables viz., economic growth (g), foreign exchange reserve ($FOREX$), rate of inflation ($\dot{P} = rho$), money supply (M_3) and liquidity ($L = M_1/M_3$).
6. To study the influence of Bank Rate on performance of the Banking Sector in India.

[22] 14 banks were nationalized on 19th July, 1969 and Six banks nationalized on 15th April, 1980

Hypotheses

On the basis of the above objectives the following hypotheses were framed for empirical testing.

1. The NERP required further institutional reforms. The policy of liberalization provided great functional autonomy to commercial banks and the banks were encouraged to adopt internationally best practices, software technologies and diversification of portfolio consistent with the objective of growth with price stability. Thus, the path and the first hypothesis is that the commercial banks in India have shown significant growth in terms of size of their business.

2. The NERP has further accelerated the growth process of commercial banks, Hence the hypothesis that in post reform period, Indian Banking system has improved its performance further (growth plus wide reach and efficiency).

3. There were four groups among commercial banks in India SBI, NSB, OSB and FB. And they differed in their structure and objectives. Consequently, There is significant difference in performance of four groups of banks.

4. Due to diversification of portfolio of banks, earning of the banks does not depend upon loans and advances alone. Therefore, the bank rate is less effective on their profit. However, as an instrument of MCP, it is expected to influence their liquidity and net worth.

5. The Bank Rate has its effect on macro variables, and thus continues to be a policy instrument to achieve economic growth with price stability.

Scope of the Study

This study will show the effectiveness of Bank Rate as an instrument of monetary policy and as a determinant of the performance of commercial banks, especially in a partial analysis setting taking into account the impact of instruments of the monetary and fiscal policy and the general condition of the economy. Therefore, the results of this study will have implications for the policy of the government and credit policy of RBI. The relationship between Bank Rate and lending rates of the commercial banks provides a market signal for supply of credit.

Limitations of the Study

Among the several categories of banks, State Bank of India (SBI) and its associates, nationalized scheduled banks, other scheduled banks and foreign banks are covered by this study in the aggregate and no sample or individual units among them are studied, largely due to the limitation of time. The Regional Rural Banks (RRBs), non-scheduled banks and cooperative banks are excluded form this study, as they function more for specific social purposes than on purely commercial purposes, again for want of time and sufficient data to separate their banking and non-banking functions.

This study is based on secondary data collected largely from the publications of RBI and the commercial banks. Further the study is restricted to a period of 29 years from 1975 to 2003-04. Therefore all the limitations of the secondary data and the models of the time series data analysis apply. Further the study uses data for macro (aggregate) variables and the problems of aggregation inherent in such data have to be kept in mind in drawing inferences for policy. Further limitations arise from the specific assumptions of the empirical models used and they are evaluated with available statistical tools and their implications are explicitly stated while discussing the results of analysis.

It is however possible to draw inferences with specific implications for policy and they are presented in the last chapter.

Organisation of Thesis

This report is organized in five chapters as follows.

CHAPTER I - INTRODUCTION

The monetary policy of India and various instruments of monetary policy are reviewed and the problem statement, objectives, scope and limitations of the study are stated.

CHAPTER II - CONCEPTS AND REVIEW

Various concepts used in the study are explained and the relevant past studies are reviewed.

CHAPTER III - METHODOLOGY

The methodology used for the study is described showing sources of data, period of data, tools of analysis and models used.

CHAPTER IV - RESULTS AND DISCUSSION

The results of analysis are presented and discussed with reference to the objectives of the study and inferences are stated.

CHAPTER V - SUMMARY AND CONCLUSION

A summary of findings of the study is presented. Conclusions are drawn and their implications are stated.