1. **Economic Crisis in India:**

Need for a policy on liberalization was recognized in early 1991, when major economic crisis surfaced in India. There was a time in 1991 when inflation rate and interest rates were very high and the foreign currency assets in the Reserve Bank of India had fallen as low as one billion US Dollars.

The continued fiscal deficit, which was getting out of control and the adverse balance of payment situation year after year, both had serious implications for money supply. The liability of the repayment of mounting internal and external debt on one hand and low growth rates of national income on the other hand forced India to be in debt trap.

High degree of regulation in various sectors was hindering the economic growth and was lowering the efficiency and competitiveness. To make the various sectors more liberal and open many exceptions were put in order.

Since July 1991 the government has introduced not only the series of financial and banking sector reforms on the basis on Narasimham Committee's recommendations in 1991 and later in 1998 but also series of reforms in other sectors too, which helped integration of Indian economy better with the rest of the world.

1.2 **Recommendations of the Narasimham Committee on the Financial System:**

1. The Committee's approach to financial sector reforms is to ensure that the financial service industry operates on the basis of operational flexibility and functional autonomy with a view to enhance efficiency, productivity and profitability. A vibrant and competitive financial system alone will be suitable to ongoing structural reforms of the real sector economy.

2. One major factor responsible for depressed income of banks identified by the Committee was the system of directed investment in terms of the SLR requirement and relatively low rate of interest paid on these investments. Accordingly the Committee has recommended that the SLR should be brought down in a phased manner to 25% over the period of five years.
3. The Committee has rightly pointed out that CRR had been too high. In fact, since July 1, 1989 it had been pitched at its statutory maximum of 15% of the net demand and time liabilities of banks. The RBI’s justification for such a high CRR had been its perceived need for keeping the growth of money supply in the economy under control, in the face of much deficit spending by the Government resulting in excess increase in H year after year. With the Government’s resolve to reduce its fiscal deficit, the Committee has recommended progressive reduction in the CRR from its highest level.

   It was also said that with the deregulation of interest rates, there would be more scope for the use of open market operations as a monetary control instrument by the RBI. Consequently, there would be less dependence on variations in CRR as a measure of monetary control. In addition, the Committee has recommended that the interest rate paid to banks on their impounded reserves should be above the basic minimum.

4. The most debatable recommendation of the Committee has been scaling down the directed credit to priority sector from the 40% of aggregate credit to 10%. The Committee has admitted that such directed credit has been contributed much to the growth of agriculture and small industries. But Committee was of the view that such programmes should be re-examined.

5. The Committee has recommended further deregulation of interest rates to reflect emerging market conditions. However, for this, a reasonable degree of macro-economic balance through sufficient reduction in the fiscal deficit is necessary. Meanwhile, concessional interest rates should be phased out. Interest rates on bank’s deposits and the spread between the key rates were continued to be regulated by the RBI.

6. Banks and financial institutions in India had been suffering from capital inadequacy in relation to their risk-weighted assets. This should be removed within the next three years. The banks whose operations have been profitable and which enjoy a good reputation in the market should raise fresh capital from the public through the capital market. In respect of other banks, the Government should meet the shortfall in their capital requirements by direct subscription to
capital or by providing a loan which should be treated as subordinate debt.

7. Two important recommendations of the Committee concern the system of income accounting and loss provisioning followed by banks and other financial institutions in India. The Committee has strongly recommended that the balance sheet of these institutions should be made transparent with full disclosure made in them according to international accounting standards.

In regard to income recognition, the Committee has recommended that the institutions following the accrual system of accounting should not recognize any income in their accounts in respect of "non-performing assets". They are defined as assets on which interest remains due for a period exceeding 180 days on the balance sheet date. For the purpose of provisioning, the Committee has recommended that the assets of banks and other financial institutions should be classified into four categories, namely, standard, sub-standard, and doubtful and loss assets and provisioning has been done accordingly.

8. Banks had been experiencing considerable difficulties in recoveries of loans and enforcement of security charged to them. The Committee, therefore, has recommended strongly the setting up of Special Tribunals to speed up the process of recovery.

9. A novel recommendation of the Committee is the establishment of a new financial institution called the Assets Reconstruction Fund (ARF), which would take over from and financial institutions a portion of their bad and doubtful debts at a discount, and subsequently follow up on the recovery of the dues owed to them from the primary borrowers.

10. The Committee has made some suggestion (not operational recommendations) about the reorganization of the structure of the banking system and of rural credit.

11. The Committee has proposed that the Government should indicate that there would be no further nationalization of banks, that new banks in private sector would be welcome subject to the normal requirements of the RBI, that branch licensing should be abolished and that the policy towards foreign banks should be more liberal.

12. The Committee has said that the internal organization of banks is best left to the
judgment of the management of individual banks and that they should be free to make their own recruitment of offices, instead of having a common recruitment system with other banks except at the clerical level. The Committee has stressed the need for a radical change in work technology and culture and greater flexibility in personnel policy.

13. In Committee's judgment, the Indian banking system had been over-regulated and over-administered. Instead, supervision should be based on prudential norms and regulations, with greater emphasis on internal audit and inspection.

14. The Committee was firmly opposed to the duality of control over the banking system by the RBI and the Banking Division of the Ministry of Finance.

An expansionary monetary policy was adopted to lower down the bank rates, Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) so as to increase the liquidity with the banks and to lower down the interest rates of commercial banks and non-banking financial institutions. RBI has allowed the banks to determine their interest rates on their own on competitive basis. They have also been allowed to deal in foreign exchange etc. Steps were taken to increase the efficiency, productivity, profitability etc. on one hand and to enhance their competitiveness on the other.

The Nationalization Act has been amended with a view to allow public sector banks to raise money from the capital market and their by reduce the stake of the government in the total equity. The proportion of government holding in the total equity may come down to around 33 percent.

The reforms were implemented and bank rate and CRR have been bought down from 12 percent in 1991 to around 5 percent in 2005-06. The SLR has been reduced from 38.5 percent to 20 percent. Full convertibility of rupee on current account and partial convertibility on capital account was introduced.

Industrial sector had also been suffering from controls of various forms: industrial licensing, which regulated entry and expansion, reservation of a large number of industries for the public sector as well as small sector, time consuming procedure required for the exit of industrial units, and price and distribution controls on various industrial products.

The requirement of the industrial licensing has been abolished for all but 6
Privatization was adopted to increase the efficiency. Limit on the size of the companies, which was earlier enforced under the Monopoly and Restrictive Trade Practices Act has been scraped. Liberalization in industrial sector required improvement in quantity and quality of industrial finance, which could be possible through liberalization in the financial sector.

Establishment of WTO has given a further boost to the process of liberalization in particularly in the field of international finance; banking sector and capital movements consequently Foreign Direct Investment inflow has been constantly rising in India, expending thereby the money supply.

1.3 Need and Justification of the Present Study:

To accelerate economic growth of Indian economy through liberalization of sector like Agriculture, Industry, Trade etc. would have no meaning without liberalization of the financial and banking sector. Hence liberalization of the financial sector has been launched simultaneously to meet the growing demand of the aforesaid sectors as per recommendation of the Narasimham Committee on one hand and to ensure the stabilization of the economy on the other.

Consequently not only controls in the financial sector were loosened in terms of lowering bank rate, CRR, SLR etc. but removal of restrictions was carried for bringing improvement in the efficiency, productivity, profitability etc. through increasing competition in banking sector. Here we cannot ignore the effect of liberalization on money supply, its components, rate of interest and prices and these are very important macro variables of an economy which play very important role not only in analyzing the level of growth of economy, but also in boosting its economic growth.

Banks and other financial institutions have been supposed to provide enough liquidity in the form of credit creation and availability of funds, especially after the liberalization. In this way by affecting money supply, it has been affecting rate of interest and prices too. Whether the liberalization of financial sector has generated the desired effect on money supply, interest rates, prices etc or not, need to be probed, which is problem of the present study?
1.4 Objectives:
Detailed objectives of the study are:
1. To study the impact of liberalization, on money supply and its determinants.
2. To study the impact of liberalization on real and nominal rate of interest.
3. To study the impact of change in rate of interest on depositors and investors.
4. To assess the relationship between money supply and prices, and money supply and national income.

1.5 Methodology:
A study like this has to depend purely on secondary data. The data is collected from various sources like Government Publications, RBI Publications, reports, journals and standards books etc.
The main are:
1. RBI Bulletin, monthly issues.
3. Annual Reports, RBI publication.
7. Statistical Tables Related to Banks in India, RBI publication.

The study is based on time series analysis of the data spreading over a period of 30 years, from 1975-76 to 2004-05. Time period from 1975-76 to 1989-90 is taken as pre-reforms period and from 1990-91 to 2004-05 is taken as post-reforms period.

For analysis of the data and inferences, statistical techniques like average, average growth rate, simple growth rate or percentage change, geometric mean, mean of deviation, Granger test, Regression and t test have been used.
The annual percentage change, for various variables are computed by an equation:
\[ Q = \left( \frac{C-B}{B} \right) \times 100 \]

Where,
\[ Q = \text{Annual percentage change}, \]
\[ C = \text{Current year's quantity} \]
\[ B = \text{Base year's quantity} \]
Granger causality test has been used to find out causal relationship between various macro variables. While using Granger test, we regress one variable on its own lag values as well as on the lag values of another variable, with which we are finding the causal relationship. We can use t test to check the significance of coefficients and F test to see overall significance.

1.6 Limitations of the Study:

Time period taken as pre-reforms period is only from 1975-76 to 1989-90 and as post-reforms period data is taken from 1990-91 to 2004-05 only. Another limitation is regarding Granger test, which is sensitive to the selection on lags used in causality test. Though it provides empirical evidence about the causal flow of relationship, it gives no evidence about the short run and long run dynamics of the relationship.

1.7 Scheme of Chapterization:
The study has divided among the following chapters:

1. Introduction.
2. Survey of literature
3. Behaviour of money supply in pre and post-liberalization
4. Impact of liberalization on money supply in India
5. Impact of liberalization on interest rates and behaviour of depositors and investors in India
6. Causality between money supply and prices, and money supply and income in India
7. Conclusion, implications and suggestions.