Monetary policy in an advanced industrial economy concerns chiefly with the regulatory aspect of the money market. In an underdeveloped economy, however, the developmental aspect of the monetary policy is beyond any question. In India, where the economy has been charged with so many developmental programmes, the monetary authority cannot avoid the responsibility devolved upon it towards the growth of the economy. Much of the success of the monetary policy in India, therefore, depends upon the effective coordination between the regulatory and promotional roles of the Reserve Bank of India.

The workings of the instruments of control go ahead without any disturbance in a matured economy having developed money market. But in an underdeveloped country like India a lion's share of the money market is still constituted as unorganised sector and scattered profusely throughout the country. Besides, the presence of a vast non-monetised sector poses threat to the success of any monetary policy. But as compared to other underdeveloped money markets in South-East Asian and African countries, the Indian money market cannot be considered as rudimentary one. Institutional settings in India are quite favourable for the employment of the instrument of monetary control. The money market under the leadership of the Reserve Bank of India is in the process of organisation—the field of organised sector is rapidly expanding. Besides, there is an increased monetisation of the economy; the capital market is almost active; and the banking system in the organised sector is effective enough for the successful operation of the monetary policy. There are, however, limitations for the smooth running of the monetary policy. Yet within the various limitations there still remains a strong ground for the operations of the monetary policy.
For the regulation of the money market the Reserve Bank had applied throughout the period of our study both the traditional and modern techniques of the western developed counterpart. It had introduced instruments, one after another, to control the structure and volume of credit both quantitatively as well as qualitatively. Among the traditional instruments of control, the Reserve Bank had utilised Bank rate changes and open market operations throughout the period of the Plan. Since 1960 it had invoked the aid of instruments like variable reserve ratios, the cota-cum-slab system and of late the net liquidity ratio.

**BANK RATE CHANGE**

The effectiveness of an instrument of monetary policy is to be judged from the standpoint of the very purpose for which it has been set forth. The Bank Rate change as an instrument has been used for various purposes. Among these, two are most important. The first one is to influence the foreign exchange market and the second one is to bring about a desired change of the credit structure in the money market and indirectly, to influence the volume of investment, income and prices.1 As a first step, the effectiveness of the Bank Rate changes is, however, to be judged by the influence felt by other short-term rates of interest.2 If the Bank Rate change has not been responded quickly by other short-term rates of interest then the Bank Rate change as an instrument of credit control remains without any significance. But the responsiveness of the short-term rates to the Bank Rate change depends mainly on two things — the habit of rediscounting bills on the one hand and the availability of standardised bills in the market on the other.

In an underdeveloped money market Bank Rate changes are not ordinarily followed by corresponding changes of other short-term rates.3

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1. S. N. Sen, Central Banking In Underdeveloped Money Market 1967 edn. P. 30
2. Ibid P. 30
For, the commercial banks work with excess liquidity and are not in the habit of borrowing from the central bank. In India, for example, this rediscounting until 1949 was very slow. The passive attitude on the part of the commercial banks was not due to any prejudice in the sense of London or New York money market as it is clear from the Report of the Central Banking Enquiry Committee, 1931. They were, on the other hand, ready to approach to the central bank in periods of needs. Dr. Sen has aptly remarked that “If such a prejudice exists at all it acts primarily to set a limit to the amount of borrowing rather than against rediscounting itself, and thus aids and does not hinder the operation of the central bank.” This absence of the borrowing habit of the commercial banks in India is assigned to two reasons — the possession of excessive cash reserves by the commercial banks on the one hand and the lack of sufficient rediscountable papers on the other.

Different factors had led to the development of the habit of maintaining sufficient cash reserves by the commercial banks in India. First, these banks were born and brought up in an atmosphere which lacked a central bank until 1935 from which to borrow and this gave them footing to act independently rather. Secondly, even after the establishment of the central bank they had to tolerate a large variations in cash reserve ratio. Thirdly, they had to function in an economy which was dominated mostly by the rural sector, and naturally, they had no outlets for their excess funds during the off season.

5. S.N. Sen, Central Banking In Underdeveloped Money Market (Book land 1962 edn.) P. 40.
7. Ibid P. 94.
Next to the excessive cash reserves, is the non-availability of sufficient rediscountable papers. The Reserve Bank did not allow any and every paper to be rediscounted. For the purpose of rediscounting, only the standardized and eligible papers were allowed according to law. These criteria of eligible and standardized papers excluded among others the most important credit instrument in Indian money market. There is no gainsaying the fact that hundi which is the principal credit instrument has not yet been recognized by the Reserve Bank. Besides, not only the absence of sufficient standardized/in sufficient quantity but also the absence of sufficient tangible assets has retarded the process of rediscounting and borrowing in India. The commercial banks are in the habit of operating on overdrafts and the like. In addition, Treasury Bills and Government Securities constitute an important instrument for the purpose of borrowing from the Reserve Bank. Naturally, therefore, the influence of the Bank Rate change may not be felt in various sectors of the money market in India. Moreover, a large part of the market still remains outside the orbit of the organized sector of the money market. This feature of the money market in India had undermined the monetary policy in general and Bank Rate policy in particular. With this end in view let us now focus our attention on the workings of the Bank Rate policy of the Reserve Bank of India throughout the period of First, Second and Third Plan.

**BANK RATE CHANGE IN INDIA**

The Bank Rate change was not frequent in India. Still it is encouraging to note that Bank Rate change in India, despite so many obstacles, was not ineffective in the organized part of the market. Upto the end of 1956 there were only two changes in the Bank Rate— one in November 1955 from 3\frac{1}{2}\% to 3\%
and the other in November 1951 raising it again to 3%. Both the changes were followed by similar changes in the rates of Imperial Bank as well as that of the other commercial banks. The Bank Rate policy, up to 1951, was more or less stable. But because of the Korean War boom on the one hand and the starting of economic plan on the other the supply of money was expanded in the market to a considerable extent. Inflationary symptoms were growing slowly and it was expected to rise further. To meet this situation monetary authority had pursued a policy of regulating the structure of credit by changing its Bank Rate from 3% to 3%. The impact of this change had been felt well on other short-term rates of interest.

After January, 1952 a marked deviation had been noticed in respect of the nature of rediscounting practice. Uptill 1952, the commercial banks borrowed money from the central bank against the government securities. No other instrument had been used for the purpose of credit. Hence the Bank Rate on loans indicated an interest on loans against government securities. With the introduction of the Bill Market Scheme in January, 1952 the usuance bills came to supplement the government securities. The interest rate charged on advances against usuance bills was half per cent below the Bank Rate. Thereafter, this facility had been partially withdrawn and banks had to pay ½% below the Bank Rate. From 1956 this facility was completely withdrawn and the rate on usuance bills touched the level of usual Bank Rate. Side by side with this, the facility concerning the Stamp duty was progressively withdrawn from March 1, 1956 and with effect from February 1, 1957, after the enhancement of stamp duty on bill at ½%, the rate on usuance bills stood practically at 4%. It is interesting to note that this change in rates had been reflected on other short-term money rates of interest in the market. As it is evident from Table 10.1 when the Reserve Bank was granting facilities at ½% below the Bank Rate the call money...
rate had been recorded as 3%. Similarly, with the raising of advance rate to 3%, call loan rate had been shifted to 3%. This call rate had jumped to 4%. This upward adjustment had, however, signified that the Bank Rate policy was successful in influencing the structure of interest rates in the money market so far as the organised sector was concerned. But looking at from the point of view of the unorganised sector of the money market the Bank Rate policy had remained insignificant. The Bank Rate changes did not have any bearing on the Bazaar rates as shown by the diagram. It can, however, be pointed out that the behaviouristic pattern of the different money rates had revealed the success of the Bank Rate Policy, at least partly. Moreover, it should be noted that this reaction of the structure of the interest rates gave foundation to the policy of selective monetary control. It was considered that the Bank Rate as an instrument of monetary policy had been applied rather selectively if we look at from the point of view of the facilities granted in respect of the discounting against the usance bills. Here in India the Bank Rate had been redefined rather. It was a marked fluctuation from the traditional concept of Bank Rate followed, especially in India.

The differential rates of interest had further been appreciated by the rising of the rate of interest against government and other eligible securities under section 17(4)(a) of the Reserve Bank of India Act, 1934 with effect from Feb 1, 1957. It is interesting to note that the rate on advances to scheduled banks against usance bills was maintained at 3% which was the official Bank Rate. Yet the rate of interest had been raised to 4% per annum on advances against government and other eligible securities. Thus the official rates were maintained rather qualitatively at 3% and 4% simultaneously. But in actual practice, with the withdrawal of remittance facilities and with the enhancement of stamp duty on...

bills at the rate of 4\%, with effect from February 1, 1957 the effective rate on advances against usuance bills stood at 4\%. This change of the rate of interest on question of advances against government and other eligible securities was to give an effective halt to the increasing preference for borrowing against government securities at Bank Rate, i.e. 4\%. It was marked already that the Reserve Bank was going to be loaded with large blocks of government securities as it was noticed during 1951-52. Borrowings by the scheduled banks against government securities were accounted for Rs.467 crores in 1956 as against Rs.200 crores in 1955. Similarly, borrowings against usuance bills stood at Rs.437 crores only in 1956. This condition of affairs had retarded the progress of the Bill Market Scheme. To meet this deficiency in the process, the raising of the interest rate on advances against government and other eligible securities in line with that of against the usuance bills was a logical necessity.

Henceforth, to meet the upward tendency in the money market because of the successive doses of deficit finance during the second plan for the purpose of development expenditure, the Reserve Bank had raised its Bank Rate from 4\% to 4\%, with effect from May 16, 1957. Simultaneously, by lowering the stamp duty on usuance bills to 2\%, the effective rate for borrowing came to 4'2\% under the Bill Market Scheme. Thus on and from 16th May, 1957 the effective rate of lending by the Reserve Bank was stepped up to 4'2\% against bills and 4\% against government securities. This change in 1957, both in February 16 and May 16, had quickly been responded by other short-term money rates in the organised part of the money market, as it is evident from the Table 10'1. But the Bazar bill rates did not behave in accordance with the Bank Rate change as shown by the table 10'1 and the Diagram.

Not only the Bank Rate change remained ineffective, so far as unorganised sector of the money market was concerned, but also, because of the increasing
Money rates in India during the plan period

Diagram 10.1

Money rates

- Bank Rate
- Treasury Bill Rate
- Call Loan Rate (6%)
- Bank Advance Rate
- Advance Rate
Money Rate in India

<table>
<thead>
<tr>
<th></th>
<th>Bank Rate</th>
<th>Advance Rate</th>
<th>Call Loan Rate</th>
<th>Bazhar Bill Rate</th>
</tr>
</thead>
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<tr>
<td></td>
<td>Bombay</td>
<td>Calcutta</td>
<td>Madras</td>
<td>Bombay</td>
</tr>
<tr>
<td>1951-62</td>
<td>3-3½</td>
<td>4</td>
<td>6½</td>
<td>9</td>
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<td>1952-63</td>
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<td>9</td>
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<td>10½</td>
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<tr>
<td>1956-57</td>
<td>3½</td>
<td>4-4½</td>
<td>6½-4</td>
<td>9%-10½-11½</td>
</tr>
<tr>
<td>1957-58</td>
<td>3½-4</td>
<td>4½-4½</td>
<td>6½-5½</td>
<td>9½-%-11½</td>
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<tr>
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<td>4½</td>
<td>6½-6½</td>
<td>4</td>
<td>8½-10½</td>
</tr>
<tr>
<td>1959-60</td>
<td>4½</td>
<td>6½</td>
<td>4</td>
<td>9-11½</td>
</tr>
<tr>
<td>1960-61</td>
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<td>4-6</td>
<td>.9 to 12</td>
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<td>6½-7½</td>
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<td>12</td>
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<td>4½-6</td>
<td>6-7</td>
<td>7½-9½</td>
<td>12</td>
</tr>
<tr>
<td>1965-66</td>
<td>6½</td>
<td>7½-8½</td>
<td>9½-9½</td>
<td>12-15</td>
</tr>
</tbody>
</table>

* Prior to October 1, 1960 the rates relate to call loans above Rs. 5 lakhs; the loans below Rs. 5 lakhs were charged quarter P.C. more during the period.

Source: (1) S.B.I. Bulletin Dec. 1959 pp 1647-650
(2) " Dec. 1961 pp 2066-69
(3) " Dec. 1966 pp 1567-69
money supply and excessive liquidity, the money market was running with inflationary pressure after the starting of the Second Plan. It is needless to say that because of the budgetary deficit and consequential credit expansion the prices in the market were rising steadily. The situation called for more stricter policy of monetary control. Many suggested for an upward revision of the Bank Rate. Yet focussing its attention on the growth aspect of the economy the monetary authority was hesitant on the question of raising the Bank Rate. The Bank had steered a mid-way in pursuing a policy of controlled expansion. To that end, in September 1960, the authority had introduced a system of graded lending rate without changing the Bank Rate itself. This graded system allowed the scheduled banks to borrow at the Bank Rate upto 50% of their statutory deposits with the Reserve Bank. The borrowings from this point (over 50%) to an amount equal to the basic quota were to be charged at 5% rate of interest. Borrowings above the quota was chargeable at a rate of 6%. Another important change noticed was that the Bank had directed the scheduled banks to raise their lending rate by a minimum of 3%. This served two purposes. It was welcomed by the bankers because this would increase their profit. Secondly, this system would check the undesirable investment on the one hand and check the credit expansion on the other without impairing the quick march of cooperative credit institutions and other organised non-bank financial institutions like the State Financial Corporation, especially, which were dealing with the improvement of small-scale and cottage industries.

BANK RATE CHANGE DURING THE THIRD PLAN

Throughout the period of First and Second Plans the monetary authority was a bit hesitant to make any upward revision of the Bank Rate because of its doubts in the efficacy of the Bank Rate policy in such an under-developed money market. Moreover, a higher rate might have an adverse impact upon the developmental aspect of the monetary policy. But as the picture of the money market had changed...
to a considerable extent during the period, especially when the organised sector of the market had been expanded to the extent of 50% from a stage of only 10%, estimated some 30 years ago, the case for higher rate of interest was sounded by many. Yet as a matter of fact the monetary authority instead of raising the Bank rate had directly pursued an indirect policy of raising the rate of interest through a system of graded rate of interest and directives to banks to raise their lending rates. In strict sense the Bank had, hereinafter, followed the trend of the money market instead of leading the same, as has been aptly remarked by Dr. S.K. Basu.\(^{10}\) The steady increase in interest rate in the money and capital markets since October, 1960 brought to the limelight the question of adjusting the Bank Rate in line with the prevailing pattern of interest.\(^{11}\) The Bank Rate was thus raised after a long period of time, from 4% to 4.5% with effect from January 2, 1963. As in the past, the impact of Bank rate change had also been felt on other short term markets constituting the organised sector of the market. As for the Bazar rate no appreciable change had been observed.

In terms of the All India Inter Bank Agreement on the Minimum Rate of Interest on advances, banks which were signatories to the Agreement had further stepped up their minimum advance rate from 6% to 6.5%, viz. 2% above the Bank rate with effect from January 3, 1963.\(^{12}\) In April, 1963 the State Bank, which previously had not increased its borrowing and lending rates, also raised its general advances rate by 1% — though retaining the rate of 5% for advances against government securities — and its savings and fixed deposits rates by 2%, thus bringing its interest rates on savings and fixed deposits at par with the maximum rates on deposits fixed under the Inter Bank Agreement.\(^{13}\) The long term lending agencies had also raised

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11. The last revision of the Bank Rate was made in the same way in May 1957 when the Rate was raised from 3.5% to 4%.  
their lending rates generally by ½% in keeping with the increasing Bank rate.

As for the bazar rate no appreciable change had been observed. Yet with a rapidly
accelerating price level and with a record expansion of Rs. 376 crores in the scheduled
Bank credit during the busy season of 1963-64 followed by an inadequate contraction
during the succeeding slack season, control on the expansion of bank credit was
clearly indicated in order to reduce monetary pressure in the economy. Conse­
quently the Bank rate had been changed again in September, 1964 by ½% from 4½% to
5%. Although the pace of expansion of credit was slower hereinafter than in the
preceding year, this was on top of an already expanded base, the seasonal expan­
sion in 1963-64 being itself abnormal. As a further tightening of control the
Bank had raised its rate by a full 1% with effect from February 1965. This
change of Bank rate along with other measures had been followed by a series of
chain reactions in the money market, especially the organised sector of the money
market as it is evident from the Table 10'. But here again the Bazaar Bill rate
remained indifferent to this changed Bank rates as shown in the Diagram 10'.

RATIONING OF CREDIT—QUOTA SYSTEM

After the starting of the Second Plan the money market was running with
inflationary pressure due to the increase in money supply and excessive liquidity
in the market. It is needless to say that because of the budgetary deficit and
consequential credit expansion market prices were rising steadily. The situation
called for more stringent policy of monetary control. Many had suggested for an
upward revision of the Bank Rate. Yet focussing its attention on the growth aspect
of the economy, the monetary authority was hesitant on question of raising the
Bank Rate. Quite naturally, it had steered a midway in pursuing a policy of
controlled expansion. For the purpose of making the best use of credit the
Reserve Bank had introduced a quota system which meant the rationing of credit without altering the Bank Rate.

Rationing of credit implies limitation of the amount of loans made available to each member bank or the minimisation of the currency of bills eligible for rediscount. It is an important instrument for the regulation of the money market. This instrument could not be invoked up to the end of the fifties of the century because of the legal and institutional barriers. Efforts had, however, been made towards the end of 1959 to put ceiling on the borrowings of the member banks. But the first successful attempt was made in September 1960 when the quota system was actually introduced and the borrowings at the Bank Rate were suspended beyond the quota fixed for each scheduled bank.

Accordingly, the quotas of borrowings at Bank Rate had been stipulated for scheduled banks equal to 50% of the Statutory deposits with the Reserve Bank during each week of the preceding quarter under Sec 42(1) of the Reserve Bank of India Act. With effect from Oct 1st, 1960 no scheduled bank was permitted to borrow at Bank Rate an amount more than the prescribed quota. Any borrowing over the quota up to 200% of the quota (i.e. 100% of the average of the reserves) was charged a penal rate of 1% over the Bank Rate (i.e. 5%) and beyond the further limit, the borrowings could be made at an interest of 7.2% above the Bank Rate (i.e. 6%).

The introduction of the system of rationing of credit had two important bearings on the money market in India. First, it involved an increase in the average rate charged on all borrowings from the Reserve Bank which was above 6% at the hour. Secondly, the State Bank of India had begun to perform a quasi-central banking functions ‘in acting as a bank of intermediate resort’. Consequently, it had raised its lending rates from 4 and 4.2% to 6% at centres.

16. DIBO, No. BM/727-C/297 A-59 dated 13.10.59
17. Circular DIBO No. Sch.7347/C 96-60 dated Sep. 21, 1960
where an office of the Reserve Bank was located and to 5% at other centres for a limited amount's. This had enabled the Reserve Bank to make its Bank Rate policy more effective.

With the starting of the Third Five Year Plan money market was charged with the pressure on prices and slow pace of seasonal credit contraction during the slack seasons. This had led the Bank in July 1962 to tighten access to its accommodation by reducing the quota for borrowing at the Bank Rate from 50% of the average statutory reserves of each scheduled bank for the preceding quarter to 25%. Borrowings in excess thereof, up to 50% of the average statutory reserves, were to be at 1% above the Bank rate, those in excess of 50% and up to 100% of the average statutory reserves at 2% above the Bank rate and those above 100% at 2.5% above the Bank rate.

During the emergency period, viz, the Chinese attack the monetary authority had adopted a more stringent policy of credit restrain for the possibility of a further pressure on prices. With effect from 31st, October, 1962, the Bank had revised the system of lending rates, reducing the existing tiers to 3 and for the first time regulated the availability of credit to banks by fixing a ceiling, on such accommodation equal to a bank's statutory reserves during the previous quarter. Borrowing up to 25% of the statutory reserves were to be permitted at the Bank rate, i.e., 4%, another 25% at 5% and the balance at 6%. Borrowings in excess of the basic quota were to be charged a higher rate; which, in effect, was 26% more. With the change of Bank rate itself in January 2, 1963 this quota system was simplified into a two tier system by merging the first two slabs. Banks were allowed to borrow in each quarter a sum equal to 50% of the average statutory reserves at the Bank rate and the remaining 50% at 6%. Any borrowing beyond this level was to be charged a higher rate which was fixed at 6.5%.
The impact of the Bank rate change as well as the continuance of this credit rationing had an important bearing leading to credit contraction in the economy. Now it was felt, therefore, to give a fillip to productive activity in the market. Thus it underlined the need for some relaxation in credit policy. With effect from 31st October, 1963 the Bank had modified its system of lending rates and borrowing quotas. Under the new system the normal quota for borrowing by scheduled banks, both against bills and government securities was raised from 100% to 150% of their average statutory reserves. Banks could borrow half of this quota at the Bank rate, i.e., 5% and the other half at 6%. Borrowings beyond this limit was to be in the nature of special accommodation to be granted by the Bank, after an overall assessment of the borrowing banks' position, at a rate of 6% as against 6⅔% hitherto charged.

Hereinafter, with rapid expansion in bank credit financed by increased recourse to the Reserve Bank, the Bank had reduced on March 11, 1964 the borrowing quotas and lending rates to a level prevailing before the end of October, 1963. Banks were again permitted to borrow a sum equal only to 50% of the statutory reserves at the Bank rate of 5% and the remaining 50% at 6%. Borrowings beyond that were charged at the rate of 6⅔%.

It is interesting to note that the quota system was intended to make a compromise between the obligations of the Bank as a lender of last resort and its duties as the controller of credit. It was a flexible system permitting of modifications, and such modifications had been made from time to time to suit the requirements of the situation. The system, however, in the process of its workings, suffered from a number of defects. First it did not and could not take into account the differences in the assets distributions of the different banks.

19. 75% of the average statutory reserves as against 50% till then.
20. In excess of 150% of bank's statutory reserves.
The system had placed banks having high credit ratios with those having lower ones on the same footing. Secondly, to evade the wide net of the quota system banks had resorted to measures which went against the success of the open market operation adopted by the monetary authority. Inspite of their investment in debted securities they had shown greater interest in treasury bills as the rediscounting or running off their treasury bills had enabled them to obtain funds even outside the quota arrangements. Again the special accommodation procedure under the system was also unsatisfactory in that many a banks by taking its advantage had tended to offset the very purpose of the system. In light of these defects of the system and the growing pressure in the money market, an alternative mechanism of the control was thus deemed necessary.

THE REGULATION OF ACCESS RIGHTS WITH REFERENCE TO NET LIQUIDITY RATIO.

Because of the shortcomings of the system of lending to banks on the basis of quotas which placed relatively greater emphasis on the availability, rather than the cost of credit, and which, therefore, did not reflect adequately the scarcity of savings in the country, the monetary authorities had introduced a system of controlling credit in September 1964 in which the cost of credit was the governing factor. Under this system the cost of borrowings from the Reserve Bank would rise progressively with the decline in the ratio of a net liquid assets of the borrowing banks to its aggregate demand and time liabilities. The concept of the net liquidity ratio was defined as "the total of a bank's cash balances with the Reserve Bank and with other banks in current account and all investments in approved securities less its total borrowings, from the Reserve Bank, the State Bank and the Industrial Development Bank of India." 21
Or in other words the net liquidity ratio was the statutory liquidity ratio minus the total of its borrowings from the Reserve Bank against eligible assets other than approved securities of its borrowings from its subsidiaries. Thus the system had brought within its sphere borrowings against other assets from the Reserve Bank which was in effect under the Bill Market Scheme as well as borrowings from the Industrial Development Bank. In a strict sense, the real liquidity position of a bank was best indicated by the net liquidity ratio at the time. With every unit of borrowing there was a fear of reduction of net liquidity. The banks under the system were not in a position to gain by disinvesting their securities or rediscounting their treasury bills and thus offsetting the open market policy of the Bank as was used under the quota system. The minimum ratio of the net liquidity was introduced in September, 1964 was fixed at 28%. Upto this level the borrowing cost was just the Bank rate; but for every percentage point drop in the ratio the cost of borrowing on the entire borrowing would go up by half per cent. Quite naturally, this cost would rise progressively with the declining position in the net liquidity ratio. Thus the rate under the system was not a fixed rate but rather a floating one. At any one time different banks would have to pay different rates of interest depending upon their individual liquidity ratio.

The net liquidity ratio had been raised in February, 1965 to 30%. Simultaneously, the rate of escalation was also raised to one percent for a drop of over one per cent from the minimum net liquidity ratio of 30% per cent instead of ½% as before. It signified a sort of flexibility in the system. This flexibility was also confirmed by the application of selectivity under the system. Refinance provided by the Reserve Bank under the Rupee Export Bill Scheme had been charged the Bank rate irrespective of the net liquidity ratio of a bank. More precisely, while rupee bill refinance was available at the Bank rate it had the effect of raising the cost of other refinance from the Reserve Bank. Moreover, this system was revised in November 1965 to provide for refinance at Bank rate with reference to three new
priority areas such as food procurement and allied finance, defence supply finance and export packing credits on the same term as rupee bill refinance.

The net liquidity ratio was an improvement upon the quota system in that it had not only retained control on the availability aspect of credit but had sought to limit this availability of credit through raising the cost of central bank credit. Besides, a greater amount of flexibility, side by side with the selectivity, had been associated with the system which made, along with the directives relating to the maximum and minimum rate of interest to be charged by the banks, the system more effective. The system was expected to work well with the directives relating to maximum amount of rate to be charged by the borrowing banks instituted at different stages of money market trend.

**OPEN MARKET OPERATION.**

With the shortcomings of the rediscount policy in the thirties of the century open market operation had gently appeared before the scene. Bank Rate change had been used as principal weapon of credit regulation in the formative stages of the central banking. But in the process of development of central banking as well as of money market in different countries, the institution of open market operation as an additional weapon emerged as a second line of defence. Year after year it had established itself among the different techniques of monetary control. The institution of open market operation had been used to bring about desired changes in the flow of credit and the structure of interest rates and thus in a way to influence the money market as a whole.

By open market operation we mean the purchases and sales of government securities by the central bank to the commercial banks or other investing institutions. Sometimes, however, the operation includes the purchase and sales of equities and foreign exchange. The purpose is to regulate the supply of credit, investment and
the general level of economic activity. It has often been used to make the Bank Rate effective or to create necessary conditions for a change in Bank Rate, to give effective support to the price of the government securities, to create cheap money for the recovery of the business and to meet the seasonal requirements in the economy.

In recent years there is a revival of interest rate policy as has been pointed out by Radcliffe categorically. Yet the open market operation continues to play an important role side by side with other instruments of credit control. It is more effective than that of the bank rate changes in that it brings about a change directly and that almost immediately. Besides, the bank rate changes are made occasionally while open market operations maintain flexibility by acting continuously according to the upswing and downswing of the market.

The success of the open market operations, however, unquestionably demands the presence of an active and broad based money and capital market that helps the purchase and sale of the necessary quantity to exert influence over the money market. Secondly, a central bank must possess in its portfolio a sufficient amount of security to be utilized as and when necessary to bring about an effective change in the money market. In addition, it requires suitable legal and institutional setting. Moreover, the stability of cash ratio of banks is of utmost necessity for the success of the open market operations.

In India, however, the legal and institutional settings had never acted as bar to the smooth running of the open market operations. Section 17(2) of the Reserve Bank of India Act had empowered the Bank to purchase and sell securities of any maturity of both central and state governments.
Secondly, the Reserve Bank is well equipped with sufficient securities. But a well
developed market for Treasury bills is still lacking in India. The market is in strict
sense a broker market 'rather than a dealers' market'.

Because of the absence of
dealers or jobbers, which are the vital factors in the market, the market itself is
a narrower one. Consequently, the brokers who act as purely intermediaries are not
in a position to undertake the necessary risk associated with a market for its conti-
nuity. This defective organisation has its impact on the size and depth of the gilt-
edged market which limits the importance of the open market operations as a regulatory
instrument in the Indian money market. Moreover, the Indian market is not well equipped
with the various categories of securities in the sense of highly organised market
of London or New York.

Last but not least, the stability of cash ratio is not usually
maintained by the commercial banks in India. There was a continuous reduction in the
cash ratio since 1935.

As it has already been mentioned in Chapter II the most striking feature
of Indian money market lies in its swing character — a swing from the busy to slack
season and again from slack to busy season. Busy season begins with the harvesting
of crops. During the busy season the market is charged with the financial stringency.
At this hour the Reserve Bank provides financial accommodation to the commercial
banks. Again, during the slack season when the commercial banks have no other invest-
ment opportunity they invest in short dated government securities. Thus in India,
open market operations have not assumed a full-fledged instrument of credit policy.

22. Of course, the period between 1935 to 1939 was not associated with sufficient
securities. But since the war expansion of government securities was a general
phenomena. The amount of security had been accentuated further during the period
of Five Year Plans. Gradually the institutional setting had been developed to a
considerable extent to conduct the open market operations.

23. Alak Ghosh - "Open market operations of the Reserve Bank" in Monetary Policy and

These operations have been used to assist commercial banks to tide over seasonal monetary stringency, but they have been rarely made use of deliberately for the purpose of restraining credit. The Bank has sought to restrict credit, when necessary, through other monetary measures like bank Rate change and selective credit controls. Moreover, the open market operations have been used in India more to assist the Government in its borrowing operations and to maintain orderly conditions in the Government securities market than for influencing the availability and cost of credit.

During the early years of the Bank's existence (covering the period 1935-44), open market operations were undertaken on a very limited scale and were mainly in the nature of seasonal open market purchases to relieve the pressure in the money market. The scope of the open market operations was expanded during the war to include sales of new government loans on tap. The Bank gained valuable experience in the management of security market during the war years. Apart from tap sales, it was also necessary for the Bank to support the gilt-edged market on several occasions, particularly when important political developments gave rise to panic sales. Post war years were associated with large scale purchase of government securities by the Reserve Bank in order to release funds for the reconstructions of the economy, especially to re-build the war affected industries by a process of increased monetisation of the bank held government debt. These operations, quite naturally, were followed by large scale credit expansion and with the resultant inflation in the money market, especially in 1950-51 busy season.

The outbreak of Korean war in 1950 had greatly accelerated the speculative activities in the market with increase in the demand for funds during the busy season. In response to this demand, the commercial banks had begun to liquidate their holdings of government securities. As a result, the gilt-edged market went down

and the rates of interest were moving up rapidly. At this hour of crisis, the Bank
had entered the market in December 11, 1950 to prevent any further deterioration in
the security market and to put the commercial banks in possession of funds with which
to meet the seasonal demands. As a first step, the Bank had increased its purchase
to a considerable extent as it is shown in Table 10.2. This had led to a sharp
increase in money supply during 1950-51.

Open market policy took a fresh turn from November 1951 side by side
with the raising of the Bank rate. The Reserve Bank had announced a change of its
open market policy, whereby seasonal finance was to be provided to banks not by
making purchases of Government securities outright but by granting temporary accommoda-
dation against the collateral of government securities. It is interesting to note,
again, that since November 1951, the Bank's purchases of securities had been mostly
"switches" which were operations involving purchase of one security against sale of
another as distinct from outright purchase or sale of a security. These switch trans-
sactions were generally done with the Bank's brokers. Whatever support was given was
more or less of a discriminating nature and of a temporary duration. The operations
were directed mainly to meet the requirements of the market of particular loans or to
enable banks and other institutional investors to adjust their investment portfolios.

Throughout the period of our study the Bank's open market operations had
been more flexible and meaningful. In fact the Bank had sought to maintain orderly
conditions in the gilt-edged market with a minimum of buying and selling and had
operated on a large scale only in the event of a serious imbalance between demand
and supply. It had not been the Bank's policy normally to lend support to prices of
loans either of the Central or State Governments, and by and large, government secu-
rities had been allowed to find their own levels. Table 10-2 shows the replacement of
the prevailing trend of one way purchases by a growing two way flow of purchases and
sales.
## Table 10.2


(Rs. in Crores)

<table>
<thead>
<tr>
<th>Year Ended March</th>
<th>Total Purchases</th>
<th>Total Sales</th>
<th>Net Purchases (−), OE Sales (+)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1948</td>
<td>75.9</td>
<td>23.5</td>
<td>− 52.4</td>
</tr>
<tr>
<td>1949</td>
<td>121.9</td>
<td>30.6</td>
<td>− 91.3</td>
</tr>
<tr>
<td>1950</td>
<td>89.1</td>
<td>70.4</td>
<td>− 18.7</td>
</tr>
<tr>
<td>1951</td>
<td>155.4</td>
<td>96.8</td>
<td>− 58.6</td>
</tr>
<tr>
<td>1952</td>
<td>66.7</td>
<td>54.7</td>
<td>− 12.0</td>
</tr>
<tr>
<td>1953</td>
<td>12.9</td>
<td>14.3</td>
<td>+ 1.4</td>
</tr>
<tr>
<td>1954</td>
<td>17.8</td>
<td>40.0</td>
<td>+ 22.2</td>
</tr>
<tr>
<td>1955</td>
<td>30.1</td>
<td>57.8</td>
<td>+ 27.7</td>
</tr>
<tr>
<td>1956</td>
<td>22.1</td>
<td>38.0</td>
<td>+ 15.9</td>
</tr>
<tr>
<td>1957</td>
<td>47.5</td>
<td>28.3</td>
<td>− 19.2</td>
</tr>
<tr>
<td>1958</td>
<td>24.2</td>
<td>89.2</td>
<td>+ 65.0</td>
</tr>
<tr>
<td>1959</td>
<td>65.2</td>
<td>154.3</td>
<td>+ 89.1</td>
</tr>
<tr>
<td>1960</td>
<td>23.3</td>
<td>63.6</td>
<td>+ 60.3</td>
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<tr>
<td>1961</td>
<td>138.4</td>
<td>26.0</td>
<td>− 112.4</td>
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<tr>
<td>1962</td>
<td>66.6</td>
<td>33.0</td>
<td>− 33.6</td>
</tr>
<tr>
<td>1963</td>
<td>72.3</td>
<td>49.5</td>
<td>− 22.8</td>
</tr>
</tbody>
</table>

* Excludes transactions with State Governments and those relating to purchase of securities against issue of Indian Currency in Hyderabad.

Since the adoption of new open market policy the total sales up to the end of 1962-63 were accounted for Rs. 668 crores as against total purchases of Rs. 587.1 crores. The net sales, therefore, stood at Rs. 81.6 crores. The period was marked by a stringent monetary policy so far as the open market policy was concerned. Yet, in strict sense open market policy could not be followed according to the desired aims in a developing economy. With a series of plans, especially after passing some abnormal periods like war, post war transition and partition, the open market policy of the Reserve Bank could not be anti-cyclical in strict sense of the term.

Open market operations had thus, during the period of our study, not assumed the role of a full-fledged instrument of credit policy. These operations had been used to assist commercial banks to tide over seasonal monetary stringency. The Bank had sought to restrict credit through other monetary measures including selective credit control. Besides, open market operations had been used in India more to assist government in its borrowing operations and to maintain orderly conditions in the government securities market than for influencing the availability of cost of credit. Moreover, the success of open market operations as a regulatory weapon depends upon proper coordination between the various regulatory instruments like variable reserve ratio, rediscounting technique, selective control and open market operations. But the period of our study was marked by lack of an effective coordination between all these instruments. Even when the Variable Reserve Ratio came in forefront in 1960 the open market operation was not integrated with this device considering the more important fiscal aspect of open market operations. During the Third Five Year Plan also this integration was completely lacking.
The policy of variable reserve ratio was first introduced in the Federal Reserve system of the U.S.A. in order to prevent injurious credit expansion. As an instrument of credit control it was intended to act as third line of defence to regulate the affairs of money market. Experiences of a number of countries revealed that this type of credit control is more effective than that of the traditional instruments like Bank Rate and open market operations. Bank Rate policy can not alone be effective in developing the economy where the money market is bound to be injected with deficit financing. Similarly open market operations in an underdeveloped country like ours can not by itself be successful because of the absence of a number of essential conditions. The success of the open market operations depends largely upon the whims of the commercial banks and other financial institutions. By contrast the variable reserve policy is expected to do well in Indian money market. It might act as a substitute for very high Bank Rate or stricter open market policy. The effect of variable reserve ratio is direct and immediate. It affects, rather instantaneously, the operating reserves and liquidity positions of the affected banks which naturally affect the lending and investment activities of the banks in particular and money market in general. "It is a weapon", observes Sayers, "which should always be placed in the hands of a central bank whose technique is circumscribed by the conditions blundering the effective utilisation of the open market operations. Given such powers the Central Bank can perform useful functions that commercial banks can not be expected to perform." 

In India the policy of the variable reserve ratio had of late been operative. For the rapid economic development the Plans were associated with successive doses of deficit financing which intensified the deposits of the commercial banks quite sizably. As a natural consequence, the capacity of the commercial banks to create credits in the forms of loans, advances and overdrafts had also been increased to a considerable extent. It was, therefore, considered as necessary to arm the Reserve Bank with new powers to fight the inflationary expansion of bank credit. To achieve this aim the Amendment Act (Reserve Bank Amendment Act, 1956) had introduced a system of flexible reserve ratios which empowered the Reserve Bank to vary the cash reserves of the scheduled banks which were required to be maintained with the Bank. Hereafter the ratio would be between 5% to 20% in case of demand deposits and between 2 to 8% of the time deposits as against the fixed ratios of 5% and 2%.

With the beginning of the year 1960 the trends in the economy had shown that bank credit to the private sector constituted the largest single factor for monetary expansion. Moreover, while shortfalls in agricultural output explained part of the rise in material prices the rise in the general price level was also due to the pressure of monetary demand. There was a high degree of liquidity in the banking system as reflected in the rise in the investment deposit ratio since the second half of 1959. The ratio which continued to remain high during the first quarter of the year, stood at 47 in January 1960. The expansion of deposit was also larger at Rs. 48 crores during the first quarter of 1960 than in the corresponding period of 1959 at Rs. 38 crores. Bank credit was also recorded at Rs. 160 crores during the same period as against Rs. 142 crores in the previous year. Besides, this increase in bank credit was considered to be larger than was
The situation thus called for some positive steps by the monetary authority. In this context, the Bank had decided to extend the area of quantitative control, and, to that end, had exercised the power, for the first time, of varying within specified limits the cash reserves of the scheduled banks maintained with the Bank by an announcement on March 11, 1960.

Under the variable reserve ratios the scheduled banks were required to maintain with the Bank additional reserves equivalent to 25% of the increase in their deposit liabilities from that date, over and above the minimum statutory reserves, viz., 5% of demand and 2% of time liabilities. In order to compensate the banks for the loss of interest on fresh deposits, interests were paid on the additional reserves maintained by individual banks at the average rate of interest paid by them on their deposits during the corresponding quarter subject to a ceiling equal to the Bank Rate.

The policy of variable reserve ratios took a fresh turn from the 15th May, 1960 when the Reserve Bank had raised the quantum of additional reserves from 25% to 50% of the deposits by a notification, with effect from 6th May, 1960. The interest payment to banks on additional deposits was, henceforth, to be made half-yearly in stead of quarterly. Subsequently, on June 29, to provide further incentive to banks for deposit mobilisation, the rate of interest on additional deposits was raised by 3% over the average rate of interest paid by the individual bank during the corresponding half-year, subject to a ceiling of 4% or 1% above the Bank Rate. There was some modifications, however, on July 1960 to exclude interbank borrowings from the total liabilities in calculating the additional reserves and to stipulate that no bank was required to maintain additional reserves exceeding 50% of the

increase in the liabilities since March 11, 1960. This was indeed relief to
banks which were experiencing a decline in deposits.

The conditions imposed upon were further relaxed on November 11, 1960
with a suspension of the additional reserve requirements concerning the increase
in deposits liabilities of the scheduled banks. There was also a further
relaxation in respect of the reserve requirements from 50% to 25% as applied to
the increase in deposits since March 11, 1960. This relaxation was due to the
growing credit requirements during the ensuing busy season and was in conformity
with the policy of flexible credit regulation. The policy of relaxation was under­taken by the Reserve Bank against the backgrounds of a reduced level of liquid
assets and stiffening of the terms of access to the Reserve Bank’s credit.

Subsequent to the stringent measures undertaken by the monetary authority
the money market had experienced a stringency throughout the slack seasons. This
situation was further aggravated after the notifications in September 1960. The
bank credit recorded a decline of Rs. 375 crores. To meet this crisis this policy
of relaxation of control had worked well at least for a short period of time. The
call rate among the larger banks had tended to decline from 4% to 3%. The whole­sale prices were recorded a decline by 0.9%. This borrowing from the Reserve Bank
which began to decline had declined by Rs. 16.8 crores by October. It had further
been declined by Rs. 4.3 crores by November as a result of the release of reserves
which were placed by the reserve requirements rule.

29. D B O. No. Sch. 7347/C. 96-60 dated September 21, 1960, and
also the amended directives DBO No. Cre 7349/C 218(m)-60,
dated September 21, 1960.
But the result of this relaxation of the reserve requirements was proved to be very short lived. The money market had experienced a severe stringency during the busy season, 1960-61. The commercial banks had to borrow from the Reserve Bank even at penal rates, much above the quota fixed by the directives in September 21, 1960. To meet this challenge in the market and to facilitate the credit needs, the Reserve Bank had revoked the impounding introduced so far, with effect from January 13, 1961. Hereinafter, the scheduled banks were required to maintain with the Reserve Bank only 5% of the demand and 2% of time liabilities.

The experiment with the variable reserve ratio was thus proved to be ineffective or at least of a very limited effect as it was admitted by the Reserve Bank. The Reserve Bank of India Amendment Act 1962, however, urged the commercial banks to maintain with the Reserve Bank 3% of their total time and demand liabilities as against the previous requirement of 5% of demand and 2% of time liabilities. Upto the end of our study, there was a flat 3% minimum reserve requirements against all types of deposits which could be varied upto 15%.

It can not be denied that a direct regulation of reserves through the instrument of variable reserve ratio would be a more potent weapon in a situation where the money and capital markets are not well developed. But in India this technique had not been given a full trial in the sense of Australia. Besides, the success of the variable reserve ratio depends upon its integration with other instruments of control. This integration, however, was always lacking in India.

In the Indian situation this weapon did not offer any positive advantage by way of easing seasonal pressure in the busy season for the level at which the statutory requirements had been maintained at 3% that is, at the minimum range of variation. The variability, in effect, was therefore only in the upward direction. It implied that this instrument could be pressed into service to exert liquidity pressure, if it deemed necessary, in the slack season but its use in the busy season was by the same token limited.

30. A. Ghosh, Control Techniques In Indian Monetary Management, World Press, 1971, p.69
SELECTIVE CREDIT CONTROL.

While the quantitative methods of credit control affect both the cost and availability of bank credit in general it can not prevent the flow of credits in particular directions. The volume of reserves available for credit can be determined by the policy of open market operations and Variable Reserve Ratio. Similarly, the cost of credit can be affected by the discount rate policy. But these instruments of credit control can not restrain the overflow of credits in a certain direction which dampens not only the economic growth but sometime often morality of the society. Until and unless the distributional problems of credit are taken into consideration the economy will run the risk of anti-social and harmful use of credits. Under such circumstances a central bank can not play the role of an idle spectator. It must discriminate between different types of borrowers and the purposes of borrowings. It must judge the affairs of the banking system and categorise good and bad banks and thereby take positive steps. "The good banker," observes R.S. Sayers, "is one who can distinguish the sound from unsound borrower. His whole life is spent in selecting, in deciding which lines of activity may be safely supported as well as distinguish the wise and honest from the follish men and knaves." Thus arises the question of selective method of credit control in controlling the affairs of money market.

In an underdeveloped money market like India the selective method of credit control has been considered to be one of special significance. In such a market a quantitative credit control may not ordinarily prove to be effective. Besides, the underdeveloped countries, where the governments had instituted plans for rapid economic development, are associated with expansion of credit which for economic reason should not be regulated. A lion's share of this increase in money supply may be drained to hoard essential commodities which are usually of short supply and will thus accentuate the price rise. It is necessary, therefore, that bank credit should be restrained from using in speculative hoarding of commodities without hindering the flow of bank credit to the directions having economic potentiality. "Restricting money" observed Dr. John Mathai, "where non-essentials were concerned and releasing money where essentials were concerned is a wise policy of the central bank."

The excessive reliance on selective control, however, does not mean that the other instruments of credit control like the open market operation and Bank rate changes are less important but that it operates in more flexible and direct manner according to the changing demands in the money market.

The policy of selective control involves direct action by the central bank by issuing directions to banks concerning their lending and investment operations against certain specific types of bank lending. With this end in view, let us now consider the operation of selective methods of credit control in India.

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35. Dr. J. Mathai, Presidential Address at the Golden Jubilee of the Canara Bank, November 20, 1956.
37. V.R. Mutalik Desai And B.D. Ghosasgi, An article entitled "Selective credit controls In India" "Monetary Policy and central banking in India" Bombay, popular Prakash, 1969.
The germ of the selective credit control might be traced back to the doctrine of 'eligibility' provided by the Reserve Bank of India Act as early as in 1934. The provision for eligible bills had some qualitative implications on the distributional aspect of the bank advances. This was reiterated further by the Banking Companies (Central) ordinance, 1948 which authorised the Reserve Bank to issue directives to banks concerning their lending policies. But all these were not in a systematic and codified form to be termed as selective measures in strict sense of the term. Yet this feature of the control had gained momentum in the Banking Companies Act, 1949 which empowered the Reserve Bank under section 21 to control and direct advances of the banking companies. This section was supplemented by section 20(3) and section 36 of the same Act for the purpose. But all these provisions remained under dormant condition and the letters of this section had been considered as dead letters just as we find Arts 106 and 107 of the Charter of the U.N.O.\(^\text{39}\) In a regular form this section of the Banking Companies Act had never been activated. Selective credit control had gained momentum and took shape after the passing of the Banking Companies Amendment Act, 1956 which authorised the Reserve Bank to issue directives to the Banking Companies in the affairs of their loans and advances as well as their administration. The powers conferred upon the Reserve Bank were undoubtedly absolute powers to control the volume and direction of advances by the banking companies in the organised part of the market. The Act was considered as a landmark in the history of monetary policy. It really gave birth to an additional instrument of credit control in India which was not only necessary from the point of view of a developing economy but also in the

process it proved as an important instrument for the purpose of controlling the credit in the market. The selective method of credit control can be viewed from three angles: (1) direct control, (2) policy of flexible credit and (3) policy of margin requirements.

Let us now analyse them one by one:

**THE DIRECT CONTROL**: From time to time attempts had been made to apply direct control over the advances made by the banks since 1943 on an experimental basis for the purpose of restraining the growth of inflationary pressure in particular sectors of the economy. But any forceful attempt, especially to regulate the margins in respect of loans and advances, was lacking up to 1956. Regular and systematic use of selective measures started from 17th May, 1956 to curb the inflationary pressures in the economy due to the developmental programme started by the Plans. With the execution of the Plans the money market was burdened with the expansion of bank credits. The flood gates of inflation was about to be opened. It was at that hour the Reserve Bank had taken a bold step to prevent the undue credit expansion meant to be channelised in wasteful and socially undesirable production. On May 17, 1956, the Reserve Bank issued a directive under section 21 (2) of the Banking Companies Act, 1949 urging all the scheduled banks not to increase any credit limit in regard to advances against the security of paddy and rice or sanction any fresh credit limit in excess of Rs. 60,000 in respect of such advances. Moreover, the scheduled banks were required by the same directive to increase the margin provided by an amount not less than 10% of the value of paddy and rice. Besides, the banks were directed to reduce aggregate advance against such commodities to a level of not more than 25% above that of the advance in May 1965 in cases where the existing advance were higher. The directive had been favourably responded. As it is evident from Table 10.3.
The outstanding advances of scheduled banks against paddy and rice stood at Rs. 26.30 crores in April, 1956, declined to Rs. 22.30 crores in May and Rs. 18.62 in June. During May and June the advances had been reduced by 43% as against a fall of 9% during the corresponding period in 1955. The advances fell to Rs. 4.34 in October 1956 and this ultimately led to the withdrawal of the restrictions by the Reserve Bank on November 14, 1956 in order to facilitate the harvesting and marketing during the busy season.

With the successful operation of the selective credit control, the Reserve Bank had issued another directive on September 13, 1956, asking the scheduled banks to restrict fresh advances against wheat and other food-grains and cotton textiles to check the rising prices. The year 1956 was associated with the soaring prices of wheat and other cereals because of short supply. Prices of wheat were about 27% higher in July 1956 in comparison to those in July 1955. The prices of Jowar, Bajra and Gram increased by 120%, 24% and 43% respectively over the year. Because of the scarcity of food stuff there was pent up demand for advances for hoarding purposes in anticipation of high rise in prices. The price of cotton including yarn had been raised to a considerable extent. Consequently, the Reserve Bank had directed the banks not to increase any existing credit limits against wheat, Jowar, Bajra and other cereals and pulses to an amount exceeding Rs. 50,000 where the existing limits were less than Rs. 50,000 and also not to sanction any fresh limit in excess of Rs. 50,000. The commercial banks were also urged to raise their margins by 10% over the level prior to this directive. Simultaneously, they had also been urged to maintain higher margins on all such future advances.
<table>
<thead>
<tr>
<th>Month</th>
<th>1956</th>
<th>1957</th>
<th>1958</th>
<th>1959</th>
<th>1960</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
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<tr>
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<tr>
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<td>22.56</td>
<td>21.48</td>
<td>13.31</td>
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</tr>
<tr>
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<td>11.40</td>
<td>13.11</td>
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<td>11.69</td>
<td>7.13</td>
<td>9.89</td>
<td>10.40</td>
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<tr>
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<td>4.48</td>
<td>7.41</td>
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<tr>
<td>September</td>
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<td>3.95</td>
<td>3.38</td>
<td>5.37</td>
<td>5.26</td>
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<td>3.46</td>
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<td>5.65</td>
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<tr>
<td>November</td>
<td>6.86</td>
<td>4.66</td>
<td>4.40</td>
<td>6.62</td>
<td>7.27</td>
</tr>
<tr>
<td>December</td>
<td>9.61</td>
<td>6.18</td>
<td>5.40</td>
<td>7.82</td>
<td>8.93</td>
</tr>
</tbody>
</table>
Last but not least, the Bank had requested the commercial banks to make every effort to reduce their advances against foodgrains by the end of October 1956 to a level not substantially higher than that in the corresponding period of the last year. The impacts of these directives were encouraging. As it is evident from Table 10.4, the outstanding advances of scheduled banks against wheat reduced to Rs. 4.22 crores in September 1956, Rs. 2.02 in October and Rs. 2.05 in November, 1956. Similarly, outstanding advances of scheduled banks against other food grains were reduced to Rs. 8.46 crores in September 1956, Rs. 6.47 crores in October, and Rs. 6.33 crores in November as shown in Table 10.5. Taken as a whole, outstanding advances of scheduled banks against all food grains had been recorded as Rs. 37.38 crores in May, 1956. It had been reduced gradually to Rs. 13.69 in October, 1956 as it is evident from Table 10.6. The banks were also asked to raise margin by 10% over the existing balance as well as in respect of future advances against cotton textiles including yarn. This directive, after achieving the normal situation was withdrawn on February 1, 1957. The directives issued on 17th May, 1956 had also been withdrawn in busy season simply to give incentive to production. The selective credit control thus continued to work sometime to facilitate and sometime to restrict the money market according to the changing needs of the hour. Herein lay the flexibility of the system. Again the Bank became active to intervene in the affairs of the money market in restricting advances against speculative activities. As on June 7 and June 10, 1957 the Bank had issued directives not only to restrict advances meant to be utilized in speculative holding of stocks but also to bring down the level of advances against foodgrains and sugar. In pursuance of this policy, the Governor of the Reserve Bank wrote a letter to all scheduled banks and 3 state-associated non-scheduled banks. The contents of the letters indicated the restrictive measures that should be adopted by the member banks.

It is interesting to note that the selective measures had been utilized
<table>
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<tr>
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<td>1,11</td>
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<td>March</td>
<td>1,13</td>
<td>1,56</td>
<td>1,04</td>
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<td>1,56</td>
<td>1,44</td>
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</tr>
<tr>
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<td>2,92</td>
<td>1,89</td>
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<tr>
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<td>4,36</td>
<td>2,93</td>
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not formally but literally. In anticipation of a high price rise in 1958 because of the shortage of foodgrains a directive had been issued even in bush season. As on December 11, 1957 the banks were directed to maintain in each month effective on January 1958, an average aggregate level of credit against paddy and rice not exceeding 75% and against wheat and other foodgrains at 60% of the average of advances for the corresponding month in 1955, 1956, 1957 and also to maintain in each month, in the States of Andhra and Madhyapradesh, a level of advances against paddy and rice not exceeding 60% of the advances in the corresponding month of 1957. The directive had achieved a striking success as it is evident from the tables, especially in Table number 10-6. Directives in this way had been issued from time to time to achieve the desired aim on question of foodgrains. The directives were not only confined to the advances made against foodgrains and cotton but also it had been extended to other categories like groundnuts. A directive on question of advances against groundnuts had been issued on December 11, 1959. 40

POLICY OF MARGIN REQUIREMENTS ON SECURITY LOANS.

Along with the policy of direct control the policy of margin requirements on bank loans and advances had been invoked. The policy of margin requirements can be traced back to the American practice in 1934 in respect of advances against stock exchange security only. In India the policy of margin requirements was invoked first in May 1946 by a circular with which the banking companies were advised to restrict their advances against shares to check this speculative activity on the stock exchanges. 41 By another circular dated 29th January, the Bank had advised the banking companies to maintain sufficient margins of their advances against shares. 42

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In the year 1948 the Bank had realised the efficacy of selective credit control. To that end the Bank advocated for the restrictions on speculative advances and accordingly suggested the banking companies. But these circulars issued only in the form of advice. In the absence of any statutory powers the Bank could not direct the banking companies. Nor could it use compulsive measures against the banking companies. To fill up the gap the Banking companies Act had included section 21(2) which empowered the Reserve Bank to determine margins to be maintained by the banking companies in respect of loans and advances. The section provided:

"The Reserve Bank may give directions to banking companies, either generally or to any banking company or group of banking companies, in particular, as to the margins to be maintained in respect of secured advances and each banking company shall be bound to comply with any directions as so given".

After the passing of the Banking Companies Act 1949 the provision of section 21(2) had been invoked in 1952 suggesting the commercial banks to reduce the margins from 25% to 15% on stocks to sugar mills considering the financial position of the sugar mills.

But the first systematic attempts had been made on and from 17th May, 1956. The Bank had issued a directive on the same date to the Banking Companies to raise the margins of 10% over and above the existing 25% on advances against paddy and rice. This change of policy had been in consonance with the policy of direct control

from the same date for checking the speculative activities in the money market in respect of paddy and rice as we have seen earlier. The banks were also directed to reduce aggregate advances against paddy and rice to a level not more than 25% above that of the advances a year before in such cases where the existing advances were already higher. The directive had worked effectively. The advances against paddy and rice had been reduced month after month as it is evident from Table 10.3.

Encouraged by the success of these measures the Bank issued another directive on September 13, 1956 requiring all scheduled banks in the country to restrict fresh advances as well as to maintain higher margins in respect of all advances against wheat and foodgrains including Gram, Jowar and other pulses and cotton textiles including yarn. These directives too had been responded effectively and the advances against such commodities had been sufficiently reduced as it is evident from Table 10.3, 10.4, 10.5 and 10.6. But from April 1957 the prices of the commodities were reaching high and the advances against such commodities had also continued to rise. To arrest this upward trend in advances the Bank had issued another directive to all scheduled banks on June 7, 1957 restricting fresh advances in excess of Rs. 15,000 to individual parties. The Bank had directed the banking companies to raise the existing margins by 5% for all advances against foodgrains, subject to a minimum of 40%. By another circular the banks were directed to raise margins by 10% for advances against sugar, subject to a minimum of 35%.

By a directive on December 11, 1957 the banks were required to maintain margins on advances against sugar at a minimum of 35% to parties other than manufacturers. The same was raised to 45% with effect from 16th July 1958 to check the rising tendency of the prices. This margin requirements had been reduced to 25% with effect from December 9, 1960 because of the achievement of the stability in sugar price.

The control over margin in respect of advances against groundnuts had been effective from February 9, 1959. With the rising prices and advances as well against groundnuts the Bank had to bring within its purview the same commodity by a directive on the same date requiring the scheduled banks to maintain a minimum margin of 40% on advances against groundnuts. Section 21(2) of the Banking Companies Act had been invoked by the Bank to check the speculative activities in the stock exchanges in 1960. By a directive on March 11, 1960 the banks were required to maintain a minimum margin of 50% in respect of advances against ordinary shares. But in order to avoid any damping effect on the small investors advances upto Rs. 5,000 were exempted.

With the rising tendency of the advances against paddy and rice again, the Bank took a positive step very quickly on August 1960. By a directive issued on August 20, 46 the margin of 40 per cent was directed in respect of each credit limit against the security of all categories of food grains. Towards the close of the year, jute and jute goods were taken within the purview of the selective control, for the first time, to curb the rising tendency of the prices as well as the advances against jute and jute goods. On December 12, 1960 a directive had been issued to all scheduled banks 47 to maintain minimum margin of 25% on all advances against raw jute going to jute mills and 40% to that of the others.

47. D.B.O. No. Cr 10972/C. 218 (N) 60.
THE POLICY OF FLEXIBLE CREDIT.

The sun of the fifties of the century had set amid the considerable increase in the rate of growth of industrial production, increase in aggregate investment, pent up rise in price level, expansion of money supply and bank credit, acceleration of stock market boom and declining agricultural output. The dawn of 1960 naturally, therefore, called for a realistic monetary policy in accordance with the policy pursued by the central government in respect of the food zones of rice. In India the production tempo in respect of food staff and other allied commodities was not uniform in all parts of the country. Among the states there were surplus while the others having shortage of supply. A general policy of selective central would, therefore, be nullified in the absence of any uniformity in the production of the commodities concerned. Understanding the problems the Reserve Bank had attempted to pursue a policy of flexible credit. The Reserve Bank, accordingly, had issued a directive on January 16, 1960. 48 "which provided for some relaxation in credit ceilings, in respect of paddy and rice". The ceiling was abolished in Madras and Orissa which had merged with other states for the purpose of larger food zones. But the credit had been retained in M.P. and Andhra Pradesh.

Similarly, attention of the Reserve Bank had also been drawn on the activities in the stock exchanges. The activities in Bombay market was too high. When the general rise in advances against shares was 14% it was 27% in Bombay market. In the same year in February 12, 1960 advances against shares and debentures had increased by Rs. 15.3 crores which was about 18% of total rise in bank credit. It was, necessary, therefore,

to regulate the speculative activities in stock exchange markets. But at the same
time caution should be taken so that it might not dampen the progress of genuine
investment. Accordingly, another directive had been issued on March 11, 1960 by
the Reserve Bank "imposing, inter alia, a ban on direct financing of badla transac-
tions by scheduled banks through purchase of shares in their name for current settle-
ment and the sale for the next settlement, and also fixing a ceiling on clean
(unsecured) advances so that the ratio of clean advances to total advances in any
month from April 1960 was not to exceed the corresponding ratio in 1959. For the
realisation of the flexible credit control the banks were assured of suitable exemp-
tions judged by the circumstances of the cases, especially on question of merit of
individual banks. By pursuing a policy of flexible credit the Reserve Bank had attemp-
ted to control the speculative activities in the money market without interfering
with the progress of genuine investment.

A relaxation of control was noticed during the year 1960-61 in respect of
sugar and foodgrains. The control was, however, extended to the advances against
raw jute and jute goods. Moreover, with the improvement of supply situation of wheat
the restrictions imposed on advances against the wheat had been withdrawn with effect
from 15th May 1961.

SELECTIVE CREDIT CONTROL DURING THE THIRD PLAN.

At the initial stage of the Third Five Year Plan the Bank's policy in
respect of selective credit controls was one of progressive relaxation and withdrawal.
Because of the declining trend in jute good prices the Bank had withdrawn the margin
requirement of 40% in respect of advances against jute goods in June 1961. On
August 29, 1961 the Bank had withdrawn the remaining restrictions in respect of
margin requirement of advances against raw jute and ceiling limits on advances
against jute goods. With effect from May 15, the Bank had withdrawn all restrictions relating to wheat. The Bank had also removed the control on clean advances of banks on October 23, 1961. It was contended that with the relaxation or removal of most of the selective credit control measures the need for the continuance of the control on clean advances no longer existed. 49 Again, the minimum margin requirement for advances against ordinary shares of joint stock company was also reduced from 50% to 40% in January, 1962.

The ceiling limit on advances against paddy, rice and groundnuts for the year 1962-63 had been raised in February, 1962 to 100% of the levels permitted to be maintained in the period March, 1961 - February, 1962. During the second year of the Third Five Year Plan selective credit controls were tightened up along with the general quantitative controls. During the year, the exemptions granted by the Bank in respect of advances against warehouse receipts had been wiped out. For the first time the Bank had imposed a minimum margin of 25% on advances against warehouse receipts covering stocks of paddy, rice and other foodgrains including wheat by two directives in January and March, 1963. These directives had also imposed ceiling limits in respect of paddy and rice and other foodgrains at the aggregate average level of advances in the corresponding period of 1962 inclusive of advances against warehouse receipts. 50 The control was also tightened in respect of sugar. The impact of these control measures during the year was generally salutary.

During the year 1963-64 the main developments were the (1) relaxation of control on advances against shares, (2) tightening up of the control on advances against paddy, rice and groundnuts and (3) reimposition of the control on advances against wheat.

The last two measures had been considered in the face of shortages of supplies in relation of demand and the prevailing higher level of prices of the commodities concerned. During the year 1964-65 the Bank’s selective credit control, in respect of essential articles, had been tightened further. During the last year of the Third Five Year Plan the overall credit policy initiated in September 1964 had been modified for the purpose of ensuring adequate supply of credit to a number of essential commodities.

Restrictions on advances in respect of credit against stocks of food grains were relaxed on November 12, 1965. For facilitating financial assistance to units of textiles industry facing stock accumulation the Bank had introduced on October, 1965 a scheme of special accommodation to banks under the Bill Market Scheme. It was, however, a purely temporary measure. Moreover, with effect from October 13, 1965 bank advances, in respect of new cotton crop, had been exempted from the minimum margin requirement of 50%. Again bank advances against indigenous cotton seed oil had also been exempted with effect from January, 1966 from ceiling restrictions imposed on advances against vegetable oils (including vanaspati).

RESULT OF THE SELECTIVE CONTROL.

To judge the effectiveness of the Selective Control throughout the period of our study we have to focus our attention to two points — how far this technique of control had prevented the undue speculative activities and how quickly the result obtained in the market. With the issue of the first directive in May 1956, the volume of bank advances against the rice and paddy had gradually declined from Rs. 22'30 crores on 25 May, 1966 to Rs. 7'49 crores on August 31. 51 Or, in other words the advances declined by 66'5 per cent as against 46'7 per cent during the corresponding period of 1955. Again, the advances rose by 36'2 per cent with the withdrawal of the

51. Table No. 10'3.
directive on November 14, 1956. There is no doubt that the specific terms of the directives were fully observed by the banking system but they did not pay any heed to the Bank’s request to bring down their advances to the prescribed limits. Besides, the borrowers seemed to evade the very spirit of the selective control by borrowing on some other accounts. As it was evident from the market trend, the advances against rice and paddy had reduced. But the advances had increased against shares and debentures of joint stock companies from Rs. 39.42 crores on May 25 to Rs. 43.60 crores on June 16 and thereafter on June 29, 1956 to the tune of Rs. 44.96 crores. As a result the prices of these commodities had also risen by 7.5 per cent from May to August in 1956. Subsequently, with the withdrawal of the restrictions, the advances against rice and paddy rose again from Rs. 5.09 crores on November 15, 1956 to Rs. 9.66 crores on December 28, 1956 and Rs. 16.13 crores on January 25, 1957. The withdrawal of restrictions were thus proved to be a hasty step and not a timely action. As a result, the Bank was forced to reintroduce the selective control by subsequent directives over the commodities. It is interesting to note, again, that while the advances against paddy and rice tended to decline with the imposition of the control, the impact of control was not felt equally everywhere. The rate of declination was more in the consuming centres than at the producing centres. As it is evident from the market behaviour from May to October 1957, while the advances were declined by 63.5 per cent in U.P., 76% in Andhra Pradesh and 77% in Madras, the main producing centres, the advances were declined by 90% in West Bengal, 91% in Bihar and 95.4% in Assam, the main consuming centres.

During the year 1957-58, the restrictive measures were successful, to a large extent, in holding down the advances against the selected commodities to specified levels. But prices were not however affected equally. Yet, "but for the

52. Ibid.
57. Diagram 10.3.
58. Diagram 10.4.
The selective directives issued in 1959 had undoubtedly brought down the bank advances against foodgrains at the end of April, 1959. But these measures could not hold down the rising tendency of the price level. The monthly average prices of food grains which were recorded as 102.3 in March 1958 amounted to 113.8 in March 1959, that of wheat from 84 to 114 and of groundnut from 103 to 121 during the period.

With the rising trend of the inflationary prices in 1959-60, controlling measures had been imposed, especially on advances against raw jute and goods, shares and clean advances. These measures had, however, arrested the rising trend of bank credit and had brought down the prices. The selective credit controls had worked with a larger measure of success during the year 1960-61 than in the earlier years, since they were operated in conjunction with general quantitative controls. The control policy was much more effective during the year than that of any other previous year. Advances against paddy and rice raised well within the permitted level at Rs. 12.3 crores in March 1961. This success was due mostly to the package deal approach followed by the Reserve Bank. The selective approach aided by other techniques of control had never worked more effectively. The satisfactory situation led to the relaxation of controls one by one hereinafter. But this situation turned into thin air within a very short period of time.

The year 1963 was a year of crisis as a result of failure of crops in two successive years. The prices had mounted to 4.6 per cent as against 1.5 in the previous year. Selective controls were again tightened up along with tightening of the quantitative control. The impact of the controls was, however, a salutary one.

The controls had, however, been relaxed in 1964. But again they had to be tightened up in 1965 because of the spurt. As a result, the advances against particular commodities had declined. But the economy as a whole had been thrown out of gear, selective controls had failed to achieve the desired aims.

Throughout the decade of its operation the selective controls had been directed, along with other quantitative measures, to restrain the growth of the inflationary forces in particular sectors of the economy. The controls were mostly aimed against food grains because of their wide fluctuating character leading to a dangerous speculative holding. The period 1955-56 to 1965-66 was marked by an overall increase in paddy, rice, wheat, sugarcane, groundnuts and jute as it is evident from Diagram 10.2. Bank advances against the selected agricultural commodities during the same period had also increased to a considerable extent. These advances had followed the seasonal trend in agricultural activities as it is clear from the Diagram 10.3. Thus advances against all commodities, save and except wheat had mounted very high during the month of April each year when the operation of speculative holdings actually took place. This period was followed by a slack season of three to four months. Similarly the month of October was associated with the speculative activities in respect of wheat as shown by the Diagram 10.3. Throughout the period of the plan both the agricultural production and bank advances against such commodities had undoubtedly increased. But the price rose much faster than those of bank advances and production. During the period of the Second Plan because of the selective credit measures price of cereals could not exceed 25 points as in the Diagram 10.5. But during the period of the Third plan, the workings of the selective credit controls had proved to be a complete failure in regulating the structure of the money market. The price soared too high and the economy had been thrown out of gear.

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60. As shown in Diagram 10.4.
Survey of Bank advances against selected commodities (1955-1966)

- Paddy and Rice
- Wheat
- Gram
- Total Cereals
- Sugar
- Ground Nuts
- Total Oil Seeds
- Jute

- represents the amount of advances for the month of April
- represents the amount of advances for the month of October
Movements in price indices of selected agricultural commodities 1966-1966 (1962-63 = 100)


1963 1964 1966 1966

Diagram 10.4

100-200
120-140
160-180
200-220
240-280

-120
-80
-60
-40

Bank advances (April 1966)

Variation during Third Plan period

1961-62 to 1965-66

Production (in lakhs of tonne)

Rice
Wheat
Gram
Total Cereals
Sugar Cane
Groundnuts
Total Oil Seeds
Jute

during Second and Third Five Year Plan period

1956-57 to 1960-61

Variation during Second Five Year Plan period

1960-61 to 1965-66
MORAL SUAISON

The lending policy of the commercial banks besides being controlled
statutorily may also be influenced by suasion and advice of the Central bank
of that country. The purpose is to direct the flow of credit in particular
directions having priority in the programme of economic development. It has
very often been used to curb the speculative activities in the market which
threats the stability in the money market. The institution of moral suasion
was operative even before the War in various countries like Australia, Ceylon,
Sweden, Switzerland. In country like Japan and England moral suasion has been
associated very often with pressure. The Reserve Bank of India had used this
method of credit control several times during forties in the form of per-
suasion as well as warning against their undue expansion of credit. But during
the period of first plan moral suasion had not been invoked in strict sense
by the Reserve Bank. Only on June 29, 1957 the banks were advised by the
Governor of the Reserve Bank to follow a "cautious lending policy". It was
followed by several conferences of the representatives of banks in Bombay and
Calcutta in July and August which decided to bring down the outstanding credit
of the member banks to a level of about Rs.800 crores within October, 1957
side by side with the maintenance of the flow of credit to essential sectors.
It had a good result in that the bank credit was brought down to Rs.840 crores
from a level of Rs.938 crores in early June. A further reduction was not possible
because of increase in advances to the textile industry and the Bank employees'
strike in Calcutta.

2. Circular No.RBD/100/94-45
Nov. 11, 1948
The banks were advised by a circular in August 1953 "to be cautious in matters of advances against shares". Again, during the busy season in 1958-59 the banks were persuaded to exercise credit restraint and to limit to a minimum their reliance on the bank for funds. But this suasion had been dashed to the ground as it is evident from the expansion of bank credit in the year. The expansion of bank credit was accounted for Rs. 102 crores which was considered as the highest during the last four years.

The instrument of moral suasion had been extended to non-scheduled banks also on May 21, 1959 by making an appeal to them to pursue a cautious policy in the expansion of credit against foodstuffs and to refrain from stock- hoarding as well. A month later another circular was issued on June 15, 1959 for a considerable reduction in credit in the current slack seasons which would enable the banks to meet the credit requirements without much strain and without large-scale resort to the bank. Moral suasion was invoked again in the form of request to all banks on December 11, 1959 to discourage the practice of rediscounting clean bundle drawn by parties affected by directives. The purpose was to dissuade the banks from accommodating the parties through other means in order to make the directives more effective. With the continued rise in price level the monetary authority was seriously disturbed. As a result, on May 8, 1960, the Governor of the Reserve Bank had made an appeal to all scheduled banks for the reduction of credit in the slack season in order to bring down the level of prices. It was admitted by him that the money market was continuously running beyond control and until and unless the authority was cooperated by the member banks the money market...
could not be regulated. However, this sort of moral suasion had again proved to be a failure. During the period of the Third Plan moral suasion had been invoked several times. But as a matter of tragedy, this instrument was not so much effective.

The success of moral suasion depends upon various factors like the commanding force of central bank, the nature of cooperation between central bank on the one hand and commercial banks on the other, and last, but not least, the structure and organisation of the money market. Unfortunately, all these factors are lacking in India. The Reserve Bank which was assumed to take the leadership in the money market had remained a private shareholders' bank until November 1949. Naturally, therefore, it was not possible for the Bank to exert commanding influence over the commercial banks so easily within a very short period of time even after its nationalisation. Secondly, there was a lack of cooperation between the Reserve Bank and the commercial banks having branches outside India. Besides, the existence of a number of powerful foreign banks was a headache to the Reserve Bank. Thirdly, the structure of Indian banking and credit was not conducive for the success of moral suasion. There were different categories of commercial banks. The banking system was marred with group jealousy and group hostility among different categories of banks, big, medium and small. Moreover, a large number of indigenous bankers who were beyond the bound of the Reserve Bank's control had retarded the smooth working of moral suasion in India.

CONCLUSION

Regulatory aspect of monetary policy had to operate with due regard to the credit needs for the expanding economy. The policy was one of...
of controlled expansion. The purpose was to restrain the supply of money
and credit to such an extent which might not dampen the flow of credit into
certain desirable sectors. The techniques employed by the Reserve Bank had
sought to regulate (a) the cost of credit, (b) the quantity of credit and
(c) the purpose or use of credit. As regards (a) and (b), the instruments
generally used during the Plan are the open market operations and rediscount
rate followed by a system of quota and regulation of access right. Next one
is the variable reserve requirement which came into use temporarily at the
fag end of the second plan. As regards (c), selective credit controls had been
used fairly widely during the period of Second and Third Plans, primarily in
application to advances against food grains and other selected articles or
raw materials like sugar or groundnuts, cotton textiles, jute goods and raw
jute and in recent years, also to regulate the margin of advances against
shares.

An active credit policy was, however, undertaken by the monetary
authority since the inception of the Second Five Year Plan. An active policy
was not necessary during the period of the First Plan because of several
favourable factors like good agricultural output followed by fall in price
level, moderate rate of deficit financing and accumulation of sterling
balances. Since Second Plan monetary policy had been directed to contain the
pressure of inflation in the money market, Bank rate had been raised frequently,
selective controls had been imposed on several commodities and variable
reserve ratio had been introduced so as to limit the overall size of bank
credit. Besides, minimum and maximum lending rates had been fixed, a quota-cum
slab system, side by side with a differential rates of interest, had been
introduced so as to restrict the borrowings of the scheduled banks. These
policy measures had been varied according to the changing situation with a view to "restraining the overall size of credit, cutting down of expansion of credit in certain lines and making provisions for enlarged credit supply in some more desirable or priority lines." (66)

With increased monetisation and diminishing influence of the unorganised sector of the money market the importance of the rate of interest as an instrument of credit control grew especially since the Second Plan. But in raising the rate of interest the monetary authority was a bit hesitant, throughout the period of the First and Second Plan for two reasons:—firstly, the progress of the Bill Market Scheme and secondly, the development programme of the Economy. Even in raising the rate of interest the monetary authority had given so many facilities in respect of remittance and stamp duty on question of advances against usance bills. Thereafter, the rate of interest had been raised in 1957. Yet that was not at par with the actual rate necessary at the hour. Even after observing the symptom of inflation crossing the flood gate, the Reserve Bank was hesitant to raise the rate of interest. Only in September 1960, it had introduced a graded rate of interest, side by side with a directive to scheduled banks to raise their lending rate by at least 5%. This attitude on the part of the monetary authority implied an inclination towards raising the Bank Rate only through the back door. (67)

During the period of the Third Plan, however, the rate had been pushed up uniformly. Here again the Bank rate changes had been followed by other short term rates in the organised sector of the market. But the Bazar Bill rates, on the other hand were not equally responded to.

The quota system had sought to strike a neat balance between the obligations of the Reserve Bank, as a lender of the last resort, and its duties as a controller of

credit. But this system had suffered from certain inherent defects. The net liquidity ratio was an improvement upon the quota system in that it had, apart from its flexible character, not only retained control on the availability aspects of credit but had sought to limit this availability of credit through raising the cost of central bank credit.

Open market operations did not assume a full-fledged instrument of credit policy. In the absence of an articulate and broad based security market the scope of open market operations were limited. Besides, because of the lack of an effective coordination between all the instruments, especially the variable reserve ratio and the bank rate change, the open market policy was proved to be a failure from the point of view of its regulatory aspects. In a way, the fiscal aspect of the instrument used was considered as more important during the period of the Plan. The operations were mainly to tide over the seasonal monetary stringency. Moreover, they had been used for the purpose of government’s borrowing operations and to maintain orderly conditions in the government security market rather than for influencing the availability of cost of credit.

In an underdeveloped money market there was room enough for the operation of the Variable Reserve Ratio as a control technique. But in India this technique had not been given a full trial in the sense of Australia. Besides, the Variable Reserve Ratio had never been integrated with other instruments of control as we have noted earlier. The system as an instrument of control had turned into thin air.

A general method of credit control, although expected to squeeze the credit in general is not expected to do justice in matters of investment. In a developing economy the effectiveness of the selective method of credit control as compared to the general method of credit control is beyond any question. In a developing economy the investment can not be stopped. The monetary authority has only to judge what sort of investment is lucrative one and what sort of investment would be socially unproductive. Monetary authority must, therefore, differentiate between essential and non-essential
industries on the one hand, and productive and unproductive concerns on the other. But in actual practice it is very difficult, not only for the Reserve Bank but also for the commercial banks, to judge what sorts of investment are productive. For the success of the selective credit control the Reserve Bank and other scheduled banks have to be cooperated with the business communities at large. Besides, as has been stated by the then governor of the Reserve Bank, it was difficult for the bankers with a net work of branches, established in different monetary and economic environment, in different parts of the country to observe the pros and cons of the directives. The vast sector of the money market in India, again, was also controlled by the indigenous financial agencies on the one hand and the non-scheduled and Multani banks on the other. Credits, had also been supplied to a considerable extent by these institutions. If credits in the organised sectors of the market had been controlled by some monetary policy without closing the floodgates of credit coming from these indigenous agencies the monetary policy as a whole remained ineffective. That was exactly what happened throughout the period of the Plans.

In the process of its working the selective credit control had suffered mostly due to the inadequacy of the collateral and declaration tests which were necessary for the purpose of advances. The borrowers very often threw dust to the directives by borrowing from the banks against such collaterals which remained out of the reach of the directives and had utilised the borrowed funds for the purpose of speculative holding. It is interesting to note that after the issuing of directives raising the margin requirements on loans against paddy and rice — there was a sharp declination of advances against such commodities. But at the same time, advances against the collaterals of shares and debentures had increased to a considerable extent. This rise in advances had far exceeded the declining bank advances against paddy and rice. Besides, there was a time lag between the issuing of directives and the actual realisation of directives because of the presence of the net work of branches in different regions of the country. Within this period of time the purpose of selective control had turned into thin air.
In a developing economy selective control is useful undoubtedly. But a fiscal and defence-oriented economy like India made it difficult for the successful operation of the selective credit control. The country had spent crores of rupees during the period of Second and Third Plans. The rising trend of these investment expenditures financed by constant deficit financing, coupled with inelastic nature of food supply, had led the economy to a painful crisis of economic inflation. In issuing the directives, attention was not given to proper timings. As has been rightly observed by Dr. S.K.Basu, "They have been introduced either too late or long after the need for them was over and released or withdrawn too hastily. Action was based not on anticipation of a future danger but was taken long after the red light had become clear." This organisational deficiencies had contributed to a great extent for the failure of the selective credit control in India.

Morale suasion had been invoked, especially, since the Second Plan. But this system for all practical purposes, had proved to be a mere theoretical tool during the period of the Plan. Its appeal had a very little impact on the workings of the financial agencies in extending their credit.

Thus, to conclude, as the large part of the money market had still remained beyond the jurisdiction of the Reserve Bank and as there was no direct link between the different sectors of the market, the operations of the regulatory devices had been confined to the organised part of the market only. Naturally, therefore, the regulatory aspect of the monetary policy, in spite of all efforts, was not successful in controlling the affairs of the market as a whole. The policy had to work within two principal limitations - the unorganised sector of the money market on the one hand and the developmental work of the economy initiated by the government on the other.