# Changing Facets of Monetary Policy

<table>
<thead>
<tr>
<th>Chapter</th>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 1</td>
<td>Introduction</td>
<td>30</td>
</tr>
<tr>
<td>2 2</td>
<td>Concept of Monetary Policy</td>
<td>31</td>
</tr>
<tr>
<td>2 3</td>
<td>Theoretical principles guiding monetary policy</td>
<td>32</td>
</tr>
<tr>
<td>2 4</td>
<td>Objectives of monetary policy</td>
<td>34</td>
</tr>
<tr>
<td>2 5</td>
<td>Tools of monetary policy</td>
<td>39</td>
</tr>
<tr>
<td>2 5 1</td>
<td>Bank Rate</td>
<td>40</td>
</tr>
<tr>
<td>2 5 2</td>
<td>Open market operations</td>
<td>40</td>
</tr>
<tr>
<td>2 5 3</td>
<td>Reserve Requirements</td>
<td>41</td>
</tr>
<tr>
<td>2 5 4</td>
<td>Selective credit controls</td>
<td>42</td>
</tr>
<tr>
<td>2 5 5</td>
<td>Moral suasion</td>
<td>42</td>
</tr>
<tr>
<td>2 6</td>
<td>Role of Central Bank</td>
<td>43</td>
</tr>
<tr>
<td>2 7</td>
<td>Effectiveness of monetary policy</td>
<td>44</td>
</tr>
<tr>
<td>2 8</td>
<td>Monetary vs Fiscal Policies</td>
<td>46</td>
</tr>
<tr>
<td>2 9</td>
<td>Monetary Policy in India</td>
<td>49</td>
</tr>
<tr>
<td>2 9 1</td>
<td>Aims and objectives</td>
<td>51</td>
</tr>
<tr>
<td>2 9 2</td>
<td>Evolution of monetary policy instruments</td>
<td>53</td>
</tr>
<tr>
<td>2 9 2 1</td>
<td>Bank Rate</td>
<td>53</td>
</tr>
<tr>
<td>2 9 2 2</td>
<td>Reserve Ratios</td>
<td>54</td>
</tr>
<tr>
<td>2 9 2 3</td>
<td>Open market operations</td>
<td>54</td>
</tr>
<tr>
<td>2 9 2 4</td>
<td>Selective credit controls</td>
<td>55</td>
</tr>
<tr>
<td>2 9 3</td>
<td>Efficacy of Monetary Policy</td>
<td>56</td>
</tr>
<tr>
<td>2 9 4</td>
<td>Monetary Policies up to the Chakravarthy Committee</td>
<td>57</td>
</tr>
<tr>
<td>2 9 5</td>
<td>Monetary policies in 1950s</td>
<td>58</td>
</tr>
<tr>
<td>2 9 6</td>
<td>Monetary policies in 1960s</td>
<td>61</td>
</tr>
<tr>
<td>2 9 7</td>
<td>Monetary policies in 1970s</td>
<td>62</td>
</tr>
<tr>
<td>2 9 8</td>
<td>Monetary policies in 1980s</td>
<td>63</td>
</tr>
<tr>
<td>2 10</td>
<td>Conclusion</td>
<td>64</td>
</tr>
</tbody>
</table>
2.1 Introduction

The term Monetary Policy refers to the actions taken by central banks to affect monetary and other financial conditions in pursuit of the broader objectives of the economy, specially by manipulating the supply of money, credit and rates of interest. Monetary Policy is as old as monetary system and money itself. Monetary policy has had a long and chequered history since the days of Mercantilists. There are evidences to show that monetary management was known in ancient periods. To quote Paul Einzing,

Managed currency was not entirely unknown to the ancient Egyptians, Greeks and Chinese, who shifted bullion to and from the shrines of their temples in order to counteract movements in the price level.  

But before 1914, the whole thinking about monetary policy was based upon the idea of automatic gold exchange system.

The genesis of the modern monetary policy took place during the World War I, when the gold exchange standard showed a breakdown. Inflation in Germany in 1920, and two International conferences in Brussels one in 1920 and the other in Geneva in 1922 compelled the statesmen in the world to think about a new monetary system, which was bound to affect the monetary policy of every country. Before that, as has already been stated, automaticity of gold exchange system was cherished, though the idea of central banking remained nebulous. In due course, the return of Great Britain to the Gold standard was hailed as giving a lead in the great work of monetary reconstruction. But this was only the beginning of a Herculean task. To quote Report of the Macmilan Committee,

At the time scarcely anyone considered that the price level could or ought to be the care and pre-occupation, far less a main objective of policy of a Central Bank.

Increasing unemployment was a reminder to the world that the monetary problem, that of providing and working a thoroughly satisfactory currency and credit mechanism, cannot be solved easily and finally for a long time. The depression of the 1930s provided further stimulus to reforms in the field of monetary management.

In the recent past, the horizons of the monetary policy were widened greatly. It required that the central bank of a country have to decide whether to maintain or to change the terms on which it is prepared to grant credit. Exchange control authorities have to take action day by day and hour by hour. 

22 Nagpat C S, Op cit , p 10
23 Kumar B Monetary Policy in India, Amar Prakashan Publishing Corporaion, Delhi, 1983, p 1
treasury officials have to be in constant touch with each other to consider the questions that arose daily

2.2 Concept of Monetary Policy

Different economists defined monetary policy in different words. Monetary policy can be defined in specific terms as the control of availability, cost and use of money and credit. Dr Paul Einzig brands monetary policy as the attitude of political authority towards the monetary system of the country under its control. Monetary policy can be active or passive. An active monetary policy can be defined as a step or a number of steps taken by the monetary authority to promote the economic welfare of the economy. A passive policy is the steps taken to minimize the disadvantages of monetary system. Geoffrey Crowther defines

Monetary policy as the steps taken to reduce to a minimum the disadvantages that flow from the existence and operations of the monetary system.

The definition given by Geoffrey Crowther clearly envisages the disadvantages of the monetary system and avoidance of such disadvantages from the monetary system can safely be called a passive monetary policy. To quote Paul Einzig again,

Monetary policy should aim at increasing the advantages and reducing the disadvantages that flow from the existence and operations of the monetary system.

Report of the Commission on Money and Credit, 1968, defined monetary policy as

All monetary decisions and measures irrespective of whether their aims are monetary or non-monetary, and all non-monetary decisions and measures that aim at affecting the monetary system.

In this category will be included the steps taken for influencing the value and volume of money and the monetary measures which pursue non monetary, economic, social or political aims. Monetary measures like debasement, inflation, deflation and devaluation etc., and non monetary measures like price and wage controls, physical controls, budgetary devises, export drives, import cuts, quotasystem, etc., come under monetary policy because they aim to influence the

---

26 Geoffrey Crowther, An outline of money, Amart Prakashan Publishing Corporation, Delhi, 1969, p 178
27 Nagpal C S, op cit 50
monetary situation in a country. All of them testify that it is concerned to the measures and decisions of a monetary nature.

2.3 Theoretical Principles Guiding Monetary Policy

The main developments in monetary theory can be summarized by three chronological stages: the classical quantity theory, the Keynesian revolution, and the monetarist hypothesis. While monetary theory was passing through these stages, it had a significant impact on monetary policy in most of the western countries. First, in classical economic thought the main channel of monetary policy was a straightforward application of the quantity theory of money as developed by Fisher. Using the equation of exchange \( MV = PY \) where \( M \) is the money supply, \( V \) is the velocity of money, \( P \) is the price level and \( Y \) is the real output, Fisher concluded that an increase in the money supply would necessarily increase the general price level in an economy especially when the velocity of money was constant and there was full employment. Appealing to price, wage and interest rate flexibility, classical economists were able to show full employment general equilibrium conditions in the product, labour and capital markets. Situations where economic activity was less than the level necessary for full employment of these resources were necessarily short lived, given the market flexibilities assumed by classical economists. As a result, the theory was unable to explain the depth and duration of the great depression. A policy consequence of the classical theory was reliance on a hands-off or laissez faire approach to monetary affairs. Inability of the classical theory to explain the great depression provided the impetus for a new theory and John Maynard Keynes rose to the challenge with the publication of his General Theory of Employment, Interest and Money.

In the Keynesian way of thinking the status quo of the great depression was perfectly possible. In fact, it was most likely to occur when governments were inactive and when prices were inherently rigid, or made institutionally rigid by trade unions or other organizations. Another explanation for economic stagnation was due to low interest rates and a resulting liquidity trap and more importantly, when the expected profit rate or the marginal efficiency of capital was extremely low. The recognition of underemployment economic equilibrium observed in capitalist economics, where governments are inactive, was probably the single most revolutionary point in the General Theory. Keynes and his followers argued that at least in severe recessions and depressions, the government sector should

\[27 \text{Nagpal C S, op cit, p 13}\]
come forward to ‘socialize investment’. The socialization of investment occurs when the Government takes on public works projects, such as building bridges, dams, highways, and so forth. Obviously the pertinent message from the General Theory was the activation of a third economic sector, viz., the Government. The policy consequence of such thinking should be clear and fiscal policy should be expansionary in times of economic stagnation and ‘money does not matter’ since monetary policy has a limit with regard to its effectiveness. Observing the special chain of events that run through can see the limited effectiveness of monetary policy in Keynesian analysis. This line of reasoning has been termed the Keynesian Chain and is summarized as follows. When monetary policy is expansionary and the money supply increases, interest rates decline, investment is stimulated and that, via the multiplier process, increases the output level. If policy effectiveness is defined with respect to GNP level, then monetary policy in the above fashion is certainly effective, as GNP will most likely increase. The puzzling questions, ‘why is Keynes well known for saying that money does not matter?’ The answer is the liquidity trap, where interest rates are so low that any increase in the money supply is unable to bring down the interest rate further. Obviously, in the liquidity trap situation, the whole chain breaks down leading to completely ineffective monetary policy. The optimum monetary policy in the Keynesian tradition was the one that pegged the interest rate at its minimum level. By keeping the interest at a minimum level monetary policy was able to create maximum investment and output. Given the presence of a liquidity trap it can be believed that ‘money does not matter’. Pegging the interest rate was the main aim of monetary policy in all the countries in post-Keynesian era. This led to an unprecedented increase in money supply levels in several economies during the fifties and sixties. The decade of seventies has shown that ‘money does matter’ as far as inflation is concerned and another theoretical hypothesis that points to fallacies in the Keynesian model has arisen.

The monetarist school, led by Milton Friedman argued that the major cause of modern inflation has been the consistent and sometimes erratic increase in money supply. Friedman’s theory of the demand for money is partly Keynesian and partly non-Keynesian. It is non-Keynesian in that Friedman neglects completely Keynes’ classification of the motives for holding money and the corresponding component demands for money. Instead, for identifying the key determinants of the demand for money, he classifies the holders of money as between ultimate wealth-holders and business enterprises. By revising some theoretical points in the Initial Fisherian quantity theory, Friedman showed that
excess money supply was able to create very severe periods of inflation and concluded that "money also matters"

2.4 Objectives of Monetary Policy

Monetary policy has an active role to play in any economy. Monetary Policy has to sub-serve the objectives of overall economic policy. The objectives keep on changing and are not fixed for all times. The objectives, approach, role of Monetary Policy in case of developed countries and developing countries is different as the situation in developing countries is very different from that of developed countries in every respect whether it is monetary environment, objective, approach for instruments or Monetary Policy. Though the objectives of monetary policy differ with the economic conditions of the country, there still is a spectrum of objectives that a country can adopt. In his lecture on "The balance between Monetary Policy and other Instruments of economic policy in a modern Society", the Per Jacobson foundation lecture, Washington, 1965, Sri C D Deshmukh, opined that

Since monetary policy is a means to an end in itself, it is expected to achieve certain objectives determined by the monetary authority and/or the State. Its objectives must be regarded as being part of overall economic objectives, to the extent that monetary policy is concerned with subsidiary objectives of its own, these latter must assist in attaining the basic objectives of economic policy.38

The objectives of monetary policy have been changing from time to time. The instruments available to the central bank also differ from country to country. Even for the same country, the objectives differ at different times. Monetary policy in the narrow sense has signified one thing at one time and yet another at another time. Its objectives change with the changing conditions of the economy. Still monetary policy has been directed to achieve a few traditional and set objectives.

Under the gold standard regime, maintenance of exchange stability was the most important objective of monetary policy. Because the monetary system was an automatic system, the central bank was practically passive. The automatic inflow and outflow of gold regulated the supply of money. As commented by the Radcliffe Committee

38 Deshmukh CD, The balance between Monetary Policy and other Instruments of economic policy in a modern Society, Reserve Bank of India, Mumbai, April 1965, p 310
At that time scarcely anyone considered that price level ought to be the care and pre-occupation, far less a main objective of policy of a central bank.

After the end of First World War, with the abolition of gold standard, the central bank was expected to exercise a discretionary influence on monetary system. The international monetary instability, the growth of nationalist feelings, the rigidities in economic structure and the appearance of a huge volume of 'hot money' sounded the death knell of the gold standard. In the words of Sayers, The Inter-war period can perhaps be called the heyday of central banking. In the changed circumstances there was a good deal of discussion about the objectives of monetary policy. The MacMillan Committee (1929-31) spoke of the Central Bank as being called upon to look after the maintenance of the parity of the foreign exchanges without unnecessary disturbance to domestic business, the avoidance of the credit cycle and the stability of price level. The regulatory functions of central banking were emphasized.

With the emergence of Keynesian revolution, maintenance of full employment became the objective of monetary policy. With the advent of great depression in 1929, resulting in mounting unemployment, the role of monetary policy to stimulate aggregate demand and thereby help maintenance of a high level of income was emphasized. This was sought to be achieved by making available enough credit at a low cost. Thus, cheap money policy was adopted. But experience and the lessons of the 'General Theory of Employment, Interest and Money' made the people believe that monetary policy was completely ineffective. It is easy to discourage investment by raising interest rate, but we are not sure that lowering the interest rate would increase investment. Moreover, the cheap money policy was indispensable to loan-financed compensatory spending. In the words of K K Kurihara,

The scope for effective anti-depression monetary policy is clear from the fact that even if credit policy is incapable by itself of turning the tide of depression it can increase overall liquidity via open market operations and other conventional methods, thereby creating the monetary atmosphere necessary for the successful operations of more effective measures of fiscal and other policies.

After the World War II, the inflationary trends in the world again revived the interest in monetary policy, especially in the interest rate mechanism. The "Dear money" policy as a measure of controlling inflation caught the attention of the

29 Nagpal C.S, Monetary Policy and Inflation in India, B R Publishing Corporation, Delhi, 1982, p 15


policy framers. The political feasibility of effective fiscal policy in the form of tax increases and reduction in public expenditure was doubted. The Central Bank's credit control measures seemed to be effective in controlling credit expansion. An additional reason was the relative freedom of the central bank to operate unpopular anti-inflationary monetary measures. The following extract from Radcliffe Committee Report amply bears this out:

The most serious handicap of fiscal measures, as a method of operating on the level of demand, is that individual tax changes, as distinct from the budget total, have to overcome opposition on varied grounds having nothing to do with the general economic situation. Their timing, too, is handicapped by dependence on the parliamentary timetable, and there are real administrative difficulties in making frequent changes in many tax rates. The more flexible fiscal weapon can be made, the less will it be necessary to rely on monetary measures. On the other hand, if the authorities are unable to manipulate taxation with sufficient flexibility there will have to be more reliance on monetary measures.

The analysis of the objectives of monetary policy attains a different shape as compared to the conditions explained above. The Radcliffe Committee, which examined the working of the monetary policy, made a list of a new set of objectives to be followed by the monetary authorities. They included the attainment of full employment, stability in the internal value of money, steady economic growth, and some contribution to the economic development of other countries and strengthening of international reserves. There were possibilities of conflict among these five objectives. Stability of price and stability of internal value of money were the major objectives. The government, independent of the economic situation in the country, could decide on its own as to which objective is the foremost. It depends upon the importance of each of these objectives. To choose any one of these objectives is not a problem, but it is very difficult to bring out co-ordination and consistency among different objectives. In addition to traditional objectives, economic growth has become an important objective of monetary policy. In a developing country, economic development with an equitable distribution of income becomes a central objective of monetary policy. R C Nayak said that:

In the administration of development objective, a number of difficulties may arise. Economic development is a moving target. It is indefinite. It is possible to predict the projected rate of growth but to find out that the ideal rate of growth is a problem.

32 Nagpal C S, Monetary Policy and Inflation in India, B R Publishing Corporation, Delhi, 1982, P.16, 17
33 R C Nayak, Credit Policy and Economic Growth, Conference volume of IEA, 1968, P 134
A battery of policy measures are called for to channel the flow of resources into the investment goods sector and away from the consumption goods sector, to provide appropriate price inducements for the purpose of attracting resources into new investment, and at the same time, to contain the inflationary resources generated by the creation of money incomes whose impact upon the prices of food grains and wage goods, generally is likely to be very strong. Last but not the least, to cope with the balance of payments problem by export promotion and import substitution.

The postwar experience shows the imperative necessity for association of high rate of economic development with price stability. The main emphasis of monetary policy, therefore, should be to assure an amount of money supply, which will be adequate to support the envisaged rate of economic development. At the same time, the rate of money supply should not fall below the rate of growth of real output, otherwise deflationary trends will develop. The concept of a 'safe' rate of increase in money supply has come into use in determining whether monetary expansion in a particular case has been adequate, inadequate or excessive. In the words of J. Ahresdorff:

A 'safe' rate of money expansion can be quantitatively determined by dividing the aggregate national income at current prices by total money supply at that time. Judged by this criterion, there has been an increase in total central bank credit beyond the safe limit in several developing countries. Besides India, this safe limit crossed in many developing countries in Africa, such as Ghana, Libya and Sudan during 1960-65 and in Mexico, Nicaragua, Paraguay and Indonesia in the earlier period.

In the developing countries the role of monetary policy is promotional. This nature of monetary policy makes the role of the Central Bank in such countries, entirely different. The traditional objective of Monetary Policy and the central bank of the country have been to control the commercial banks. But in developing countries, the primary objective is the encouragement of long term development in the key sectors of the economy. In the words of Edward Nevin:

The contribution to the regulations, directions and guidance to the credit institutions as may exist at the time must be a secondary and less considered objective of the monetary policy, whereas, its

34 J. Ahresdorff, "Central Bank policies and Deflation," IMF Staff papers, October, 1969
assistance to the process of economic growth and capital formation is assessed as the first and the foremost objective. In this context, it may be held that though there could be multiple objectives of monetary policy, for example, sustained growth of real output, higher productivity and employment, equitable distribution etc., cross-country experiences show that maintaining low and stable order of inflation should constitute the fundamental objective of monetary policy. This is on account of two important considerations. First, empirically, it has by now become abundantly clear that, in the medium to long runs, inflation is associated with sustained growth in monetary aggregates viz. some measure of money and/or credit. The negative relationship between the rate of inflation and economic growth on the one hand and positive correlation between the rate of inflation and variations in money supply across countries on the other underscores the fundamental objective of monetary policy. Second, maintaining a stable and low rate of inflation is considered best for ensuring efficiency and improving overall social welfare. It is for these reasons central banks all over the world have been re-orienting their strategies and focusing almost exclusively on price stability.

The relative importance of growth and price stability as the objectives of monetary policy as well as the appropriate intermediate target of monetary policy became the focus of attention. Over the years, a consensus has emerged among the industrially advanced countries that the dominant objective of monetary policy should be price stability. Differences, however, exist among central banks, even in industrially advanced countries, as regards the appropriate intermediate target. While some central banks consider monetary aggregates, and therefore monetary targeting as operationally meaningful, some others focus on the interest rate, even though the inter-relationship between the two targets is well recognized.

A similar trend regarding monetary policy is discernible in developing economies as well. Much of the early literature on development economics focused on real factors, such as savings, investment and technology, as mainsprings of growth. Very little attention was paid to the financial system as a contributory factor to economic growth. In fact, many writers felt that inflation was endemic in the process of economic growth and it was accordingly treated more as a consequence of structural imbalance than as a monetary phenomenon. However, with the accumulated evidence, it became clear that any process of economic growth in which monetary expansion was disregarded led to inflationary...
pressures with a consequent impact on economic growth. Accordingly, the importance of price stability and, therefore, the need to use monetary policy for that purpose also assumed importance in developing economies. Nonetheless, the debate on the extent to which price stability should be deemed to be the overriding objective of monetary policy in such economies continues. To quote C Rangarajan,

Commitment to price stability does not mean blind faith in maintaining a certain level of inflation, without concern for the need to maintain and accelerate growth. Far from it, what this commitment implies is that monetary policy can help the growth process by regulating money supply towards the direction of maintaining price stability in the economy to recover from independent shocks 36

2.5 Tools of Monetary Policy

Monetary Policy is a branch of economic policy which aims at achieving economic policy objectives, through regulation of monetary system by operating on monetary variables like money supply, level and structure of interest rates and availability of credit. The effectiveness of monetary policy depends upon the instruments of credit control. The extent of success of the policy depends upon the instruments employed.

The techniques available to the monetary authorities to maintain internal stability consist of

a) Regulating quantity of the money and to some extent of the near money with the purpose of directing and influencing the volume or expenditure

b) Manipulating the level of interest rates or the relationship between short run and long run rates, and

c) Regulating quality of credit according to purpose or use of it

The powers of the monetary authorities to regulate creation of money and of near money depends largely on their power to control, by direct or indirect means, and the credit and investment policies of the money creating institutions. The techniques of monetary policy in the contemporary world are undergoing rapid transformation. Formerly, the exclusive Instrument, which most of the central banks in the world were using, was the variation in the rates of interest at which

the central bank was willing to discount bills. During the depression of the 1930s, however, monetary orthodoxy was gradually abandoned. In recent years, central banks have become concerned, not only with the control of volume of credit, but also with the direction of flow of credit into specific sectors of the economy. With the objectives of the economy in view and depending upon the time to time requirements of the economy, the central bank of a country applies constantly changing combinations of various instruments. These instruments can be quantitative or qualitative in nature. Quantitative techniques are applied through variations in the interest rate or bank rate, reserve requirements and open market operations. Qualitative techniques consist of credit regulation for a specific sector known as selective credit control and moral suasion. Of these the most important and widely used instruments are bank rate, open market operations and selective credit controls.

2.5.1 Bank Rate

The bank rate or the discount rate is the officially announced rate charged by the Central bank for discounting or advances to member banks. In other words, it can be called the cost of borrowing by the banking institutions from the central bank. By changing bank rate, the central bank affects the cost of borrowing and thereby influences the demand for credit. A rise in the discount rate discourages the banks from lending because of the high rates involved in funding. In most countries the discount rate is used as a signal, and a change in it is followed by a similar change in the interest rates the banks themselves charge to their customers.

2.5.2 Open market operations

In a broad sense, open market operations refer to the purchase or sale of securities in the market by the central bank. Open market operations involve either outright or temporary purchases of government securities by the central bank. Open market operations alter the amount of securities held in the central bank's asset portfolio have, as their counterpart a change in the non-borrowed reserves held by banks, that is, the reserves that do not originate through bank discount borrowings. The amount of these non-borrowed reserves is also changed by variation in other non-controlled items on the asset or liability side of the central banks' balance sheet, such as gold holdings that were important historically or the deposits of domestic and foreign governments that can vary considerably today. Still, central banks routinely monitor these items and
prevent them from having sizeable undesired impacts on non-borrowed reserves by engaging in offsetting open market operations. The objective is to influence the reserve position of the banks, which indirectly would bring about relative changes in money rates and credit conditions. The end result is to affect desired adjustment in domestic prices, cost and production. A notable feature of open market operation is that, regardless of the parties involved, these operations have a direct and positive impact on the volume of bank reserves. A distinctive aspect of this instrument of credit control is that it is used at the initiative of the central bank. It can be applied in desired magnitudes and the direction can be quickly reserved. To quote C S Nagpal

The efficacy of open market operations depends upon a variety of factors, chief among them being the existence of an active and broad money market. This is imperative if the central bank wishes to buy or sell securities in appropriate amounts in order to exert the desired effect on banks' reserve.

These operations are, therefore, an active reflection of the prevailing monetary philosophy of a country.

2.5.3. Reserve requirements

Commercial banks, by law, hold a specific percentage of their deposits and required reserves with the central bank, either in the form of reserve accounts or as cash. This reserve requirement acts as a brake on the lending operations of the commercial banks. A change in the variable reserve ratio does not change the total reserve position of the commercial banks. It only affects the amount of excess or secondary reserves. The logical reason for this is that the power of the banks to create credit mainly depends upon the excess reserves. Hence, changes in the reserve requirement affects the credit creating capacity of the banks, and in turn their power to affect money supply. A change in the reserve requirements has two-fold effect. Assuming that there is an increase in the reserve requirements, there is an immediate decline in the excess reserves of commercial banks. They must find additional funds to meet the larger reserve requirements, which can only be had by reducing the excess reserve on the basis of which credit is created and an increase in reserve requirements would reduce the rate of multiple expansion of deposits for the entire banking system.

Nagpal CS, op cit., p 46
2.5.4 Selective credit controls

Overall quantitative controls operate by affecting overall bank reserves and credit. Selective controls, by contrast, are applied to influence specific sectors of the economy, which are most vulnerable. Under this type of regulation, no attempt is made to restrict the general flow of credit, rather, restrictions are imposed upon the use of credit in specific sectors regardless of the quantum of credit available for such purposes. The rationale of selective controls is that, consistent with a general credit situation appropriate to a healthy economic system, credit may be so easy to obtain for some purposes that demand expands unduly in particular directions, or speculative activities are over activated, endangering the stability of the whole economy. Charles Schultze felt that

A further need of selective credit control relates to its use as a supplement to general controls, when the latter cannot be expected to act in a specific sector, either quickly or effectively to deal with the partial or sectoral inflationary situation. While there is nothing to prevent a central bank from using selective controls independently, the experience of various countries show that their effectiveness is considerably enhanced when used along with general credit controls. In one form or another, many central banks also make use of direct regulations, either as an alternative to the quantitative and qualitative controls or in conjunction with them. The direct method can be very important in countries, which have considerable central planning and supervision by government business. These controls also assume special importance in situations where the banking system is either non-responsive to central banks’ appeals or consists of a few large banks which could be easily directed to follow the central bank’s general line of policy.

Direct actions may take several forms. The central bank may refuse rediscounting facilities to those banks whose credit policy is inconsistent with the bank’s policy. The central bank may issue directives to banks generally concerning their lending or investment operations. It can also be taken as a coercive measure against an offending bank. Whatever the form, direct actions always carry punitive threats for non-compliance and are used primarily to buttress general and selective credit policies.

2.5.5 Moral Suasion

Another form of implementing the selective credit controls is Moral Suasion. In the wider sense of the term, moral suasion may be treated as one of the milder

38 Schultze, Charles, “Recent Inflation in United States”, Study paper No 1, Joint Economic Committee Study of Employment, Growth and Price Levels, 1959, p 4-16
forms of selective credit control with the important difference that statutory compulsion or threats of punitive action do not accompany this instrument. Moral suasion carries with it the advantage of creating a less unfavorable psychological reaction and a greater response to the appeal of the bank. It is therefore easier for the central bank to secure the willing and active co-operation of the commercial banks in spirit as well as in letter. Another advantage of moral suasion is that this informal method of control can be adopted by the central bank for exerting an appropriate influence on non-scheduled banks and also on the other kinds of credit and financial institutions generally considered being outside the scope of the central bank regulation. To quote C S Nagpal again:

Moral suasion can be effected in many forms. The central bank may call in the leading bankers for heart-to-heart talks, a appeal to their nationalistic spirit may be made, displeasure may be expressed over their non-compliance with law, vague threats concerning future availability of credit may be made, or banks may be warned of direct and punitive actions.

2.6 Role of Central Bank

The monetary policy acts through influencing the cost and availability of credit and money. The effectiveness of Monetary Policy depends on institutional framework available for transmitting impulses released by the Central Bank. The central bank acts as monetary authority to influence the entire financial system in the country. It has power to operate currency and credit systems to the advantage of the country. It is the banker to banks and the lender of the last resort and the banker to the Govt. It is the custodian of foreign exchange. It also exercises control and supervision over financial institutions and banks. But the most important function of all is to control the volume of money and credit in the country.

A Central Bank by its operations can expand or contract money supply popularly known as M3 which includes currency with public and Demand Deposits of banks. If there is increase in M3, interest rates will go down and there is more take off in bank credit, which leads to expansion in capacity of production of all borrowing units which results into more production of goods and services. Generally, demand for goods and services do not correspond with increase in production. The prices move down and inflation is contained. In case of tight money policy, the reverse will happen. Decrease in M3 will shoot up interest rate and there will be lesser off take of credit and lower production. As the demand does not fall and is greater than supply of goods and services in such a situation, prices go up.

39 Nagpal C S, op. cit, p 49
The Central Bank focuses on key areas that have an impact on inflation, e.g., money market, the fiscal deficit, capital and trade flows, foreign exchange reserves, money supply and demand for bank credit. Central Bank has to evolve suitable monetary policy in a given environment. A true Central Bank should always be ready to perform any function, if the conditions and circumstances in its area of operation render it necessary or desirable. The guiding principle for a Central Bank, whatever function or group of functions, it performs at any particular moment, is that it should act only in public interest and without regard to profit as a primary consideration.

### 2.7 Effectiveness of Monetary Policy

While framing Monetary Policy, the entire gamut of economic environment is kept in view. Monetary policy is to be formulated and implemented in a given environment. For example:

1. **Degree of monetisation of economy.**
2. **Monetary habits**, i.e., extent of use of cheques/credit cards or currency.
3. **Degree of development of money market**, i.e., several sub-markets primary and secondary.
5. **Integration of money and financial market.**
6. **Sensitivity of interest rates**, i.e., market determined rates.
7. **Variety of short-term financial instruments.** The effectiveness of monetary policy would depend on the type of environment in which the policy has to operate.

Monetary policy can hold any inflationary dangers in check by a slower rate of monetary growth than would otherwise be desirable. This will temporarily mean higher rates of interest to enable the government to borrow the sums needed to finance the deficit. In public policy debates, the issue of the appropriate role of monetary policy has probably drawn the maximum intellectual attention. The diverse views that have been put forward centered on the principal question whether monetary policy matters for the economy. Initially, at the theoretical level, there were two broad stands holding opposite views about the efficacy of monetary policy, viz., Classical theory and Keynesian theory. As discussed earlier, while the former held that under conditions of full employment, variations in money supply would only have a corresponding impact on price level leaving real output completely unaffected, the latter maintained that under less than full employment, it is the fiscal policy as opposed to monetary policy which would have dominant influence on the real economy.

Deepak Mohanty et al., felt that
In a Keynesian framework, monetary policy was seen to be passive and directed mainly at influencing interest rates, which, however, were considered important in influencing investment. While the Keynesian paradigm was found to have wider acceptance during the post-Great Depression period, it was the Phillips Curve relationship, brought to the fore in the late 1950s, which provided a link between inflation and unemployment that reinforced credibility of the Keynesian demand management policies. However, the increasing pressure on inflation resulting from sustained high order of fiscal deficit not accompanied by commensurate gains on the unemployment situation during the late 1960s pointed to the lack of micro foundations of the Phillips Curve in particular Friedman, 1968 and Phelps, 1967 and Keynesian policies in general. Milton Friedman demonstrated that in the long run, there is no trade-off between inflation and output. Furthermore, Thomas Sargent and Neil Wallace (1975) showed that in a rational expectation framework, government interventions through acquiring seigniorage in a systematic manner couldn't have enduring impact on real output. This dealt a severe blow to the Keynesian policies as it attempted to espouse the premise that systematic government intervention is output neutral. As this line of reasoning had the attributes of classical theory, it had come to be known as the 'New Classical Economics'.

In a rational expectation framework, money supply could influence real output only when monetary action is unanticipated. Therefore, there could at best be only a transitory short run trade-off between money supply and output but in a medium to long time horizon, all economic agents would have fully anticipated the government's actions thereby nullifying the trade-off completely. In fact, under an extreme situation, the government could lose its credibility completely and be forced to surrender the privilege of seigniorage as economic agents may not prefer holding domestic currency, which may give rise to currency substitution. This led to an intense debate among academics as well as practitioners regarding the appropriate role of monetary policy. What stands out from this debate is a broad consensus among academics and policy makers that money supply cannot influence real output in medium to longer time framework. However, there could be a very limited short run trade-off that could be exploitable.

An extension of the Keynesian approach known as the 'New Keynesian Economics' emphasized this short run trade-off by identifying various factors causing price rigidities for example efficiency wage theory, insiders and outsiders in the context of wage bargaining, menu costs, monopolistic competition etc. In a rational expectations structure with strong micro-foundations. Even in this perspective, as

---

40 Mohanty Deepak, Amalava Sardar and Abha Prasad "Perspectives on monetary development in India and Policy in India" RBI occasional paper Vol XVII, Nos 2 & 3, Special Issue, June & September, 1997, RBI, Mumbai, p 226-277
the search for reasons for price rigidities gradually veered from labor market to goods market, the arguments for price rigidities came to be centered on the fact that since markets are imperfect and information is costly. In a world of imperfect competition, since output tends to be lower and prices higher compared to those under perfect competition, social welfare thus adversely affected could be enhanced through government interventions. As such, there exists a reasonable rationale for fiscal and monetary policies to play an active role in real world situations as opposed to the prescriptions put forward by the New Classical School.

To wit, it is necessary to recognize that on the basis of theoretical developments and on the weight of empirical evidence, particularly those from Latin American and East European countries, imprudent monetary regimes would be always destabilizing, though it remains statistically inconclusive as to the extent to which prudent monetary policy could stabilize the economy. It has, however, been recognized that prudent monetary policy is extremely important for the smooth functioning of an economy, and more so particularly with the progressive globalization of economics over the years consequent upon dismantling of capital controls and gradual movement towards flexible exchange rates.

Management of an economy is a complex process, more so, if ideology, political faith and economic philosophy of the Govt of the day influence of the objectives of management. The government has many a tool for regulating the economy towards its desired objective. The tools of economic management are (i) Fiscal Policy, (ii) Central Government’s Economic Policy, (iii) Controls - Physical and Financial and (iv) Monetary Policy. Each of these overlap and have merits and demerits. But Monetary Policy is the more flexible of these tools and easy to operate. Also, monetary data is available with shorter time lag than other data, and with greater precision.

2.8. Monetary Vs Fiscal Policies

Monetary policy is part of macro-economic policy, whose other arm is fiscal policy. Fiscal policy can be defined as the manipulation of the size, form and timing of government expenditure and taxation. Fiscal Policy generally refers to the use of taxation and government expenditure to regulate the overall economic activity. Fiscal policy has a direct effect on spending through government outlays. It also directly affects, through taxes, the income available for spending. In contrast to the direct effects of fiscal policy, the impact of monetary policy is...
wholly indirect, as monetary policy acts on the supply and cost of credit. The impact of the monetary policy also depends upon the response of borrowers and spenders to changes in monetary and financial conditions. However, the aims of fiscal policy are much the same as those of monetary policy.

Fiscal policy affects money supply in the economy. When the government levies taxes, it results in withdrawal of money, and purchasing power from circulation and this in turn reduces spending in the economy. If the government spends the amount of taxes collected immediately, there would be no change in money supply and spending. When the government reduces taxes or increases its expenditure, it results in an increase in money supply and therefore spending in the economy. More importantly, borrowing by the government causes changes in money supply. The size of the government borrowing and the way it is financed affects the money supply. Government borrowing needs are financed by three main methods. They are: a) borrowing from the non-bank private sector, i.e., borrowing from households and firms, b) borrowing from the banking sector including the Central Bank, and c) borrowing from external sources. When the government borrows from the non-bank public, there is transfer of funds (deposits) to the government from the public and money supply goes down. If the government borrows by selling its securities to the banking system, including the central bank, the money supply will increase, because the government spends the funds borrowed which will increase bank deposits, thereby enabling the banks to lend. When the government meets its borrowing needs from external sources, there is no increase in money supply. But, much depends on what it does with the money borrowed. When the budget is in deficit, government borrowing invariably increases bank deposits, because of government payments to those who supply goods and services to government. Less goes back to the government itself through taxes. Reductions in money supply come through any situation, which lowers the volume of deposits.

The two arms of policy are inter-dependent. Keynesians regard both fiscal and monetary policy as tools of economic stabilization that should be used in coordination. It is a truism that one should support the other, and fiscal policy affects financial variables. Keynesians differ among themselves on the relative importance of monetary policy vis-à-vis fiscal policy. In the early days of the Keynesian revolution, until the early 1960s, most Keynesians regarded monetary policy as a relatively impotent tool of stabilization. Although some of them still regard monetary policy as ineffective in stimulating the economy, most now regard monetary policy as a useful approach to economic stabilization. They
regard the economic system as inherently unstable, constantly requiring active
government stabilization policy to achieve the goals of economic stabilization
Keynesians regard all four goals as important from the point of view of society,
but they tend to regard full employment as the most important. They reject the
notion that the economy will always generate enough spending to maintain full-
employment levels of economic activity. The only solution resides in active
government stabilization policy via monetary and fiscal policy

Monetarists have a very little regard for fiscal policy as a tool of stabilization
policy. There are essentially two reasons for this attitude. One, fiscal policy
simply has no lasting impact on economic activity other than to shift resources
from the private to public sector of the economy. Any increase in government’s
spending to stimulate the economy will have crowding out affect and will lead to a
reduction of private spending. The other reason is that monetarists tend to be
much more politically conservative than Keynesians and less willing to interfere
with the allocation of resources determined in the private sector of the economy.
Even if fiscal policy worked, it would interfere more directly with allocation of
resources than would momentary policy. To the extent that the economy needs
stabilization policy, it should be done through monetary policy. In addition, the
Central Bank should be concerned primarily with the money supply, as this is the
most important variable determining the level of economic activity. Monetarists
downgrade the role of changes in the cost and availability of credit and focus
more on changes in the money supply as the instrument of monetary policy.
Monetarists are less motivated to use stabilization policy actively to ensure that
the economy will achieve goals of full employment, price stability and so forth.
They regard the market system as inherently stable, always tending toward a
level of employment determined by the economy’s resources, technology and
productivity. In the long run, government stabilization policy can do very little to
change the trend in the level of real output and employment. Although modern-
day monetarists do not invoke Say’s law of markets, most of their models and
discussions imply that the system will achieve the lowest rate of unemployment
consistent with the economy’s resources. This is referred to as the natural rate of
unemployment. Government’s stabilization policy can affect a temporary change
in the level of unemployment and output from their natural or long run
equilibrium levels. The modern day monetarists’ position with respect to the
nature of the equilibrium solution appears to have a lot in common with the old
quantity theory view prior to 1929. In terms of basic philosophy about the role of
government and the basic stability of economic system, the two views have a
great deal in common. Here, the similarity ends. The modern day monetarists’
position is based on a much more sophisticated analysis of the role of money in the economic system and has included an enormous amount of empirical research on the relationship between money and economic activity.

All payments between the public and private sectors have monetary repercussions. The financing of budget deficit or the disposal of a budget surplus infringes on one or more of the financial variables. Since fiscal policy affects money supply there is a great need for coordination between monetary and fiscal policies. Combinations of fiscal and monetary policies can suitably influence macroeconomic activity. A tight monetary policy combined with loose fiscal policy retards investment and encourages consumption while easy monetary policy together with tight fiscal policy encourages investment and retards consumption. The various facets of monetary policy as a concept are discussed in detail. Since the study is confined to monetary policy in India, the concept of monetary policy is discussed in detail hereafter.

2.9 Monetary Policy in India

The origin of Monetary Management in India can be traced back to the period of unrecorded history. The Rig Veda reference to the existence of the Panis, the moneylenders of Southern India, is an evidence of the developed state of banking or credit system during the Vedic age, although the date of the origin of the coins and credit instruments are lost in the mists of antiquity. In the Mauryan Era the system of currency, credit and coinage was fully developed as Kautilya has devoted a chapter of his Arthasastra on rules for minting and credit.

The history of Monetary Management and Policy in the terms of central banking technique and practice in India can be traced to as far back as January 1773 when Lord Hastings, the then Governor and later on the First Governor General of British India, placed before the Board of Revenue his plan for a "General Bank in Bengal and Bihar." The Bank was set up in April 1773. But it proved to be only a short-lived experiment. The next attempt for a Central Bank was made in 1807-08 by Mr. Robert Rachel, a member of the Bombay Government, who submitted a scheme for a "General Bank" to be owned by the public and Government in the ratio of 2:1. The Directors of the East India Company rejected the scheme. Hence, Mr. Robert Rachel's scheme could not see the light of day.

The first Presidency Bank of Calcutta was originally constituted as the Bank of Calcutta in 1806, with an initial capital of Rs. 50 Lakhs. The Government of Bengal took up one-fifth share. The Bank was set up at the initiative of the Bengal Government to check erosion in the value of treasury bills, which was then
the important mode for raising money for the Government. The Bank of Calcutta could be regarded as the beginning of the Central banking in the country, as its primary function was to deal in the Treasury bills. In 1836 a body of merchants of England having business interests in India submitted a proposal for a ‘Great Banking Establishment for British India under an Act of Parliament’. But the proposal could not go beyond the initial stages.

Two Presidency Banks, viz., the Presidency Bank of Bombay and the Presidency Bank of Madras were set up in 1840 and 1843 respectively. All the Presidency banks were permitted to issue notes up to a specified level. But the right to 'issue notes' was terminated under the Paper Currency Act of 1862, under which the Government of India took over the sole right to issue notes in the country. However, the Presidency Banks were performing some of the functions of maintenance of cash balances of the Government, free of interest, and manage the public debt affairs of the Government.

Late Lord J M Keynes was one of the members of the Royal Commission on Indian Finance and Currency also known as Chamberlain Commission set up in 1913. He had prepared a blueprint for the establishment of an Imperial Bank of India to perform the functions, which were being performed by the Presidency banks, Management of Note Issue, Management of public debt in India and To act as the Banker to the Government.

The Imperial Bank came into being in January 1921 by amalgamating the three Presidency Banks, as a commercial bank with some of the functions of the Central banking also. In August 1925 the Government appointed a Royal Commission on Indian Currency and Finance known as the Hilton Young Commission. The Commission observed that India was the only big trading country in which the currency and note issue was under direct Government control. The Committee recommended several measures to reform the monetary system. The issue of constitutional reform including transfer of financial powers to the Government of India also necessitated the formation of a Central Bank. The Government of India took the stand that formation of a Reserve Bank on sound lines was in their view a condition precedent to any transfer of financial responsibilities from the British Parliament to the Indian Legislature. The Central Banking Enquiry Committee of 1931 also recommended for the establishment of a Reserve Bank at the earliest date possible. Accordingly Reserve Bank of India was established through Reserve Bank of India Act, 1934.

The main functions of the Reserve Bank of India, as of all other central banks is to formulate and administer Monetary Policy.
Monetary Policy refers to the use of instruments within the control of the Central Bank to influence the level of aggregate demand for goods and services. Central Banking instruments of control operate through varying the cost and availability of credit, these producing desired changes in the assets pattern of credit institutions primarily commercial Banks.\(^1\)

Monetary Policy has now moved to the center stage of economic policy-making the world over. In the 1930s and in the first two decades after the Second World War, monetary policy was relegated to the background. The ascendancy of fiscal policy during this period was due in part to the depression of the 1930s and in part to the process of reconstruction immediately after the Second World War and the acceptance of the Keynesian dictum that fiscal action was necessary to prevent deficiency in the aggregate demand. However, the 1970s saw the emergence of a combination of high inflation and low growth - 'stagflation' as it came to be called and the standard Keynesian analysis was hard put to explain that phenomenon. Consequently, monetary policy re-emerged as an instrument of economic policy particularly in the fight against inflation. Issues relating to the conduct of monetary policy came to the forefront of policy debates in the 1980s.

**2.9.1 Aims and Objectives**

In a developing country like ours, acceleration of investment activity in the context of supply shocks in the agricultural sector tends to be accompanied by pressures on prices. To quote Dr. C. Rangarajan, former Governor of Reserve Bank of India,

Monetary Policy is an arm of economic policy and hence, the objectives of monetary policy are no different from the overall objectives of economic policy. Broadly, the three major objectives of economic policy in India have been growth, social justice implying a more equitable distribution of income and price stability. Faced with multiple objectives that are equally relevant and desirable, there is always the problem of assigning to each instrument the most appropriate target or objective. Of the various objectives, price stability is the one that can be pursued most effectively by monetary policy.\(^2\)

Therefore, monetary policy has much to contribute in the short-run economic management. Promoting growth through appropriate credit policy, encouraging sectoral development according to plan priorities and supporting programs aimed at social justice by influencing the cost, volume and direction of credit are all different and effective ways through which monetary policy contributes to the

---

\(^1\) Kumar B, op cit, p 8

\(^2\) Rangarajan C, Presidential Address at the 71st Annual Conference of the Indian Economic Association at Jadavpur University, Calcutta, 29 December, 1988
achievement of plan objectives. Monetary policy is, however, able to make a more effective contribution to the achievement of the objective of price stability than other objectives. This is also consistent with the preamble of the Reserve Bank of India Act which enjoins the bank to conduct its operations with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage.

The course of Indian economic development since the early fifties has been charted by the successive five-year plans. There has been an essential continuity in the objectives of planning, though the relative emphasis on specific objectives has varied from one plan to another. To quote Chakravarty Committee report:

> Growth with stability, social justice, removal of poverty and achievement of self-reliance are objectives which continue to receive the highest priority in the formulation of successive five-year plans. In more recent years other related objectives such as modernization, the need to create larger employment opportunities in the rural areas and increasing productivity have also drawn increasing attention of the policy makers.

The functioning of the monetary system must necessarily be in consonance with the national development strategy as articulated in the successive five-year plans. The monetary system should therefore seek to perform the tasks of mobilizing the savings of the community and enlarging the financial savings pool, promoting efficiency in the allocation of the savings of the community to relatively more productive purposes, in accordance with national economic goals, enabling the resource needs of the major entrepreneur in the country, the government, to be met in adequate measure, promoting price stability and promoting an efficient payments system.

To quote C Rangarajan again,

> Monetary Policy is an arm of macro economic policy and as such its role and importance is determined in any economy by the overall policy framework and the various instruments available for implementing policy. As opposed to fiscal policy, which rests on instruments such as Government expenditure, taxes and borrowing, monetary policy acts through influencing cost and availability of credit and money. While fiscal policy impacts aggregate spending directly, monetary policy acts indirectly through changes in the level of investment and output. Thus, between changes in monetary policy and its ultimate impact intervene many behavioral and institutional relationships on whose magnitude the effectiveness of monetary policy depends. The transmission mechanism thus

---

43 Reserve Bank of India, Report of the Committee to Review the Working of Monetary System, RBI, Mumbai, April 1985, p 144
becomes crucial for an understanding of the impact of monetary policy 44

2.9.2 Evolution of Monetary Policy Instruments

Viewed from a historical perspective, the application of monetary policy instruments has witnessed a distinct qualitative change over time. Though the instruments available at the disposal of the Reserve Bank remained more or less unchanged throughout the period, their relative efficacy and the environment in which they have been applied have undergone a sea change, particularly during the nineties. The monetary policy instruments can be classified into general instruments viz. the bank rate and interest rates, Reserve Ratios, open market operations (OMO), refinance facilities, and selective instruments such as various directed credit programs e.g. priority sector credit, export credit, food credit etc. and application of margins in lending.

2.9.2.1. Bank Rate

The RBI Act defines bank rate as the “standard rate” at which RBI is prepared to buy or rediscount bills and other commercial paper eligible for purchase under the Act. But in actual practice, in the absence of a genuine bill market, bank rate has become the rate on advances charged by RBI and is commonly treated as Bank Rate. During the pre-Independence period, of the instruments, the Bank Rate was particularly important, since it was the signaling rate and the Reserve Bank used to provide accommodation uniformly at the Bank Rate except its ways and means advances to the Central and provincial governments (at one per cent less than the Bank Rate). The effectiveness of the Bank Rate dwindled sharply with the emergence of differential interest rates system initially in the form of a 'quota-cum-slab' system. In October 1960 followed by a similar but more stringent system based on net liquidity position of borrowing banks in September 1964 as also the absence of a genuine bill market. In the post-nationalization phase, with increased emphasis being bestowed on priority sector lending and concessional lending, the Bank Rate lost much of its significance till the announcement of resurrecting made in April 1997. The Bank Rate was changed nine times during 1951-74 and only thrice during the period 1975-96, despite the substantial growth of the financial sector and the pressures on liquidity exerted at different points of time over the 45 years between 1951 and 1996.

2.9.2 Reserve Ratios

Another weapon available to RBI for credit control is the use of variable cash reserves ratio. Under the RBI Act 1934, every commercial bank has to keep certain minimum cash reserve with RBI. Initially it was 5 per cent against demand deposits and 2% against time deposits. These are known as the statutory cash reserves. Since the year 1962, the RBI was empowered to vary cash reserve requirement between 3% and 15% of the total demand and time liabilities. Apart from cash reserve requirements which commercial banks have to keep with RBI under RBI Act 1934, all commercial banks have to maintain under Section 24 of the Banking Regulation Act liquid assets in the form of cash, gold, unencumbered approved securities equal to not less than 25% of their total demand and time liabilities. This is known as Statutory Liquidity Ratio SLR, in brief. Maintenance of liquid assets is a basic principle of sound banking. Hence the RBI has been given this power. Accordingly the SLR was raised from 25% in September 1964 to a maximum of 38 5% by September 1990.

With the gradual downgrading of the Bank Rate as a policy instrument, the CRR and SLR, which were, once considered as prudential requirements to safeguard the interests of banks and of depositors, increasingly became the active policy instruments, particularly since the 1970s. It is important to note that the basic CRR was kept constant for 38 years between 1935 and 1972 while the SLR was changed only once between 1949 and 1969. Following the weakening of fiscal position of the Central Government, the resources of the banking sector came to be increasingly absorbed to support the market borrowing program of the government on long term basis at highly concessional rates of interest through prescriptions of a higher statutory liquidity ratio. As the resources thus garnered often fell short of financing the fiscal deficit, the Central Government took recourse to the Reserve Bank through issue of ad hoc treasury bills at relatively low rates of interest. These and other statutory liabilities not only 'crowded out' the private sector, the government securities market, which had been once vibrant with wider participation, but also lost its depth as the rates of interest and maturity period of securities reflected essentially the perceptions of the issuer i.e. the government rather than those of the market and Investors. As a result, open market operations were rendered ineffective. The evolving situation led to gradual scaling up of CRR and SLR to reach the unsustainable level at 53 5 per cent in 1991 from only 22 per cent in 1962.

2.9.2.3 Open Market Operations

In economies with well developed money markets, central banks use open market operations i.e., buying and selling eligible government securities by the central
bank in the money market to influence the volume of cash reserves with commercial banks and thus influence the volume of loans and advances they can make to the industrial and commercial sectors. Open market operations as a monetary policy instrument is of no significance in India. The reasons are narrowness of the government securities market, securities are held by few large institutions and are held till maturity, low volume of transactions in government securities. Open market operations are entirely in central government securities. A high level of SLR also severely curtailed the volume of transactions in securities by banks. Though SLR was originally intended to be a safeguard for banks' and depositors' interest it was increasingly sued to divert bank deposits into government securities. This procedure created a "captive" (assured) market for government securities. This affected the growth of a wider market for government securities, which is necessary for the success of open market operation as a monetary instrument.

The RBI has not used this weapon for many years. The enormous inflow of foreign funds into India since 1991 created the problem of excess liquidity with the banking sector and the RBI had to undertake large-scale open market operations. When the RBI sells government securities in the market, it withdraws a part of cash reserves of commercial banks and thereby reduces the ability of the banks to lend to the industrial and commercial sectors resulting in reduction in money supply and putting a strain on the banks to create credit further. If the RBI buys government securities from the market and pays for it, the opposite will happen. The commercial banks will find surplus cash and they will create more credit. The supply of money will expand and vice versa, with the appointment of six primary dealers to deal in government securities the RBI has expanded the Government securities market and it hopes to use this tool very often with ease in future.

2.9.2.4. Selective Credit Control

In addition to the general or quantitative methods of monetary regulation, the RBI uses qualitative techniques also known as Selective Credit Control (SCC) and moral suasion. SCCs are used by Central Bank, for regulating the distribution or direction of bank credit to particular sectors and for specific purposes. They have special relevance in developing countries where supply of credit is scarce and is likely to flow to less essential activities. The controls are regarded as useful supplements to general credit regulation. Section 21 of the Banking Regulation Act 1949, empowers the RBI to issue directives to the banking companies about their advance portfolio. These directives may relate to - the purpose for which
advances may or may not be made, the margins to be maintained in respect of secured advances, the maximum amount of advance to any borrower, the maximum amount up to which guarantee may be given by the banking company on behalf of the firm or company and the rate of interest and their terms and conditions for granting advances

Since 1956-57, the RBI has made full use of these powers to check speculation and rise in prices. The controls are selective as they are used to control and check the rising tendency of the prices of certain individual commodities of common use. A number of commodities have been covered by SCCs from time to time on the basis of fluctuations in production of commodity, its price trends and potential for speculative holding of that commodity. While imposing selective controls, the RBI takes care that the bank credit for production and transportation of commodities and exports is not affected. Selective credit controls are meant mainly to prevent hoarding and speculation by traders.

To quote C. Rangarajan again:

The Chakravarty Committee recommended the adoption of a system of "monetary targeting with feedback" with a view to regulating money supply in line with the increase in output. Many countries, such as Canada, have totally abandoned the formal reserve requirement. Institutional changes occurring in the Indian financial system also imply in the Indian context, a shift from direct to indirect instruments.

In 1990s a switchover from direct instruments of monetary control to indirect measures gained momentum. This was effected through the reduction in reserve requirements for banks, limiting automatic monetisation of the fiscal deficit by replacing ad hoc Treasury Bills with Ways and Means Advances at market related interest rates from first April 1997. Developing money market and securities market through introduction of new instruments, auction system for government securities including repos/reverse repos and instituting a network of primary and satellite dealers with the view to enabling open market operations as the principal instrument of liquidity management, liberalizing interest rates and rationalizing concessional credit and refinance facilities, revitalizing the Bank Rate as a signaling instrument of the stance of monetary policy and putting in place prudental accounting norms and a more effective supervisory system.

2.9.3. Efficacy of Monetary Policy

The Reserve Bank formulates and administers monetary policy. The efficacy of monetary policy depends on the prevailing economic situation and structural

ibid p. 53
factors like the proportion of currency in money supply, the size of the public debt, the size of the non-monetised sector in the economy and the presence of active sub-markets. Again, the manner in which monetary policy is operated hinges on the particular needs of the situation, such as the degree of imbalance in the overall supply-demand situation, the trends in agricultural and industrial production, the general price level, and the balance of payments situation. An appropriate monetary policy evolved by adjusting money supply to the needs of growth, directing the flow of funds in keeping with the overall economic priorities, and providing institutional facilities for credit in specific areas of economic activity, creates a favorable environment for economic growth. The central bank attempts to ensure an adequate level of liquidity to support the rate of economic growth envisaged and to assist in the fullest possible utilization of resources without generating inflationary pressures.

2.9.4 Monetary Policies up to the Chakravarthy Committee

In the two decades after it was founded in 1935, there were no much significant changes in the RBI's credit policy till the initiation of the planning process in India. This may probably because of the colonial rule. An active role by the Reserve Bank of India in terms of regulating the growth in money and credit became evident only from the mid-1950s. With the objective of achieving rapid economic ends and social development of the country, the democratic planning process was initiated in April 1951 with the launching of India's first five-year plan. According to Chakravarthy Committee report,

The central objective of planning as enunciated in the first five-year plan was to "initiate a process of development, which will raise the living standards and open out to the people new opportunities for a richer and more varied life". Accordingly the main objectives of planning which have been emphasized in varying degrees over the successive five-year plans have been growth, social justice, self-reliance, alleviation of poverty, modernization and improvement in productivity. The objectives of alleviation of poverty and reduction in inequalities in incomes and wealth have acquired greater importance in recent the plans.46

The first five-year plan emphasized the role of monetary and credit policy as an important instrument for maintaining price stability and for regulation of investment and business activity. Increase in volume of production and trade in the economy cannot be sustained without expansion in the supply of money and credit and therefore the supply of money has to respond to the increase in volume of transactions in the economy. The First Plan document stated, as quoted from Chakravarthy Committee Report,
This must come about through extension of credit institutions, which will impart the necessary elasticity to money supply without generation of inflationary pressures.\(^4^7\)

It was postulated that the growing credit needs of agriculture and industry, particularly cottage and small scale industries, had to be met through a large network of credit institutions which will mobilize savings in the rural areas and disburse credit on a large scale. To quote Chakravthy Committee Report again, in the initial stages, credit creation in anticipation of generation of savings might become necessary to give a "push" to production, as said in the first plan document that,

Judicious credit creation somewhat in anticipation of the increase in production and availability of genuine savings has also a part to play, for it is conceivable that without this kind of initial push the upward pressure may not start at all or may fail to gather momentum.\(^4^8\)

The Reserve Bank of India was therefore expected to play its part in furthering economic development along agreed lines by aligning the banking system to the needs of a planned economy.

As economic development progresses the monetary system would be called upon to meet the financial needs of growing economic activities. This would bring in its wake organizational and structural changes. The task of the central bank would not then be confined to mere regulation of the overall supply of credit. It would also include creation of the machinery needed for financing developmental activities in the country and for ensuring that the finance made available flowed in the desired direction. In this context special credit facilities to high priority sectors became necessary. It is clear that the operation of the monetary system should be consistent with the priorities laid down in the plans so that the process of mobilization of savings and utilization of these resources becomes socially purposive as emphasized in the first five-year plan.

2.9.5 Monetary Policy in 1950s

During the 1950s, price stability came to be clearly recognized as the principal objective of the Indian monetary policy. However, the dilemmas facing the

\(^{47}\) ibid, p.5

\(^{48}\) ibid p 6
monetary authority arising out of the need for development finance was amply evident in the statement of the then Governor, H V R Iyengar.

It is a fundamental aim of monetary and fiscal policy in India that such inflationary pressures that exist must be vigorously controlled and steps taken to avoid generation of fresh inflationary pressures. Both Government and the central banking authority are determined to ensure monetary stability, even if this means a temporary setback in investment. The dilemma before the monetary authorities in India is this: the very considerable development expenditure which is not immediately productive, on the great river projects, the power schemes, and the steel plants, is generating an upward pressure on the prices of consumer goods and it is of the utmost importance to regulate the supply of credit so as to check this pressure.

An active role by the RBI in terms of regulating the growth in money and credit became evident only from the mid-1950s. During post-war years up to 1949, monetary policy was beset on the tent that a cheap money policy could ensure economic development though the inflationary consequences thereof were realized only around 1951. Moreover, the role of the Reserve Bank was restricted to matters of public debt management and note issuance. The advent of planning saw monetary policy functioning actively in accelerating economic development through extension of promotional finance, strengthening of the structure of financial institutes and keeping monetary expansion within limits. The first decade of the plan era saw extensive use of traditional weapons of monetary control. During the second half of this decade, the regulatory functions were developed.

During the early 1950s, a synoptic analysis of price trends relative to other indicators showed two enlightening facts that (a) money supply had an important operative influence on the level of wholesale prices and cost of living, and (b) equally, the growth of agricultural production, in particular food articles, had a decisive bearing on the price level. The movements in prices and money supply with the public during 1950-54 showed that they were parallel during the first three years, indicating the inflationary tendencies associated with the Korean War boom and the subsequent readjustment to normal conditions, when the war ended. The correlation was absent during 1954-56. While money supply expanded sharply, prices fell, owing to good cultur of agriculture. But subsequently, both prices and money supply moved up consistently. The rise in

the latter is being appreciably higher from 1959-60. During 1957-58, the Reserve Bank gave accommodation to apex co-operative banks at two per cent below the Bank rate in order to provide finance for agriculture. Monetary policy thus did not just content itself with modulating interest rates, instead, it related itself to the operation of an integrated structure accounting for the diversified needs in the economy. The heavy drawl on foreign reserves in the early part of the second plan provided only a temporary cushion, but for it, the expansion in money supply might have been higher still. The rise in monetary demand together with the increasing requirements of a fast growing population, as also the long lags between investment and output, accounted for the shortage of supplies of a wide range of goods and price rises.

In the face of the rising demand for funds, interest rates also moved up, the rise being reinforced by monetary measures. To some extent, this checked further increase in the demand for funds and expansion in money supply. But the rise in interest rates was only a partial cure for inordinate monetary expansion. Steps were taken directly to curb its volume. Increase in taxation was one such measure, and as seen from changes in the ratio of taxes to national income from 7.4 per cent in 1951-52 to 12.1 per cent in 1962-63, it was employed with some vigor.

During the first two plan periods, monetary authorities had to be content with the consequences of the substantial increase in developmental expenditure on infrastructure which were not immediately productive, but generated an upward pressure on prices of consumer goods, hence, it was of utmost importance to regulate the supply of credit to check this pressure. Simultaneously, sufficient finance had to be made available to private sector for complementary expansion of investment. Thus, a policy of selective control was followed. Some sectors were provided with liberal credit, while for others it was restricted, sometimes even made expensive. Hence, monetary policy did not work towards general tightening or relaxation of credit. It was directed towards selective control. As monetary control has to accord with the objectives of development and planning, the role of the RBI was to ensure monetary stability in concert with the objectives of development and deficit financing. During the first and second five-year plans, currency formed a dominant component of total money supply vis-à-vis bank money. In 1951-52, currency formed 58 per cent of the total money supply. This set limitation on the extent to which monetary policy could make itself felt.
296 Monetary Policy in 1960s

In 1960, the WPI rose to 125 over the base 1952-53 = 100 and the Reserve Bank's role was then to reduce the pressure of monetary demand without hampering production. In the 'sixties, the problems of stabilization were replaced by a greater concern for economic growth and control over the accompanying increases in money supply. Money was made dearer, although not at the expense of production. It was termed an "holding operation" - to keep inflationary pressures at bay while the production forces gathered momentum. The objective was sought to be achieved by an exhortation to banks to reduce overall credit, by reducing Reserve Bank accommodation to the banking system and selective credit controls. Moreover, in order to ensure that credit was available for genuine productive purposes and also that its use was optimal, not extravagant, banks were given accommodation from the Reserve Bank and the Bank Rate only up to limited amounts on the basis of quotas fixed at a uniform basis and beyond that at a higher cost.

The control on the volume of money would have been better facilitated if the main expansionary factors, viz. net bank credit to Government and the private sectors had been under greater control. However, the superimposition of larger defense requirements since November 1962 on the investment needs for development had also affected Government finances adversely. The government had to, as a result, bring about economy in its administration, undesirable consumption and investment expenditures in the private sector were to be avoided and in this task the Reserve Bank supplemented the fiscal measures by regulating commercial banks' capacity to lend through direct methods of credit control. Soon after the nationalization of the 14 major commercial banks in July 1969, among other policy measures, increased emphasis was laid on the flow of credit to the priority sectors of the economy which till then had not received sufficient attention from commercial banks. Thus, along with determining the level of bank credit or borrowal facilities from the Reserve Bank, the resources position of banks for meeting the needs of the priority sectors and other preferred sectors had to be given due consideration by the monetary authorities.
2 9.7. Monetary Policy in 1970s

During the seventies, monetary policy continued to operate within the overall framework of restraint. From 1970 to 1981 several important steps had been taken by the RBI to control changes in money supply which was necessitated primarily due to severe cost increases arising from the 1973 petrol price increase and due to inflationary conditions arising from drought like conditions in many states in the early 1970's. In January 1971 two changes were made to tackle the problems of accelerating inflation. The bank rate was raised to 6 per cent from 5 per cent and the net liquidity ratio (NLR) was increased from 33 to 34 per cent. Again in August and November 1972 the SLR was raised by one per cent each month to take the SLR to 30 per cent. In November 1972 the NLR was raised again to 36 per cent. In 1973 the NLR was further raised to 40 per cent in three steps and in May 1973, the bank rate was raised to 7 per cent. In addition, the banks were asked to put the minimum lending rate at 10 per cent. Over the period from May 1973 to December 1973, the CRR was raised from 3 to 8 per cent to put the brakes on the growth of money supply in the economy. As a result of this credit crunch all interest rates were allowed to rise. However, 1974 began with a decline in CRR from 7 to 5 per cent. But the bank rate was raised from 7 to 9 per cent. In December 1974, the CRR was further reduced to 4 per cent and to support the decline in the CRR, the NLR was also reduced from 40 to 39 per cent. Thus in 1974 there were signals indicating that monetary policy has been too tight in 1973, and some of the actions were reversed. In September 1976 the CRR was raised from 4 to 5 per cent and the SLR was raised from 37 to 38 per cent. In November 1976, the CRR was further raised to 6 per cent. The year 1977 was basically uneventful for the functioning of monetary policy in India. In 1978, it was apparent that the monetary authorities had intentions of easing their control on money supply. The maximum interest rate charged on commercial bank loans was reduced to 15 per cent and the maximum deposit rate was reduced to 9 per cent. The interest rate paid by the RBI on bank cash reserves was raised to 6 per cent. In December 1978 banks were asked to raise the SLR to 34 per cent and in September 1979 the lending and deposit rates of banks were raised. The maximum lending rate on short-term advances was increased from 15 to 18 per cent for large banks and from 16 to 19 per cent for small banks. In July 1980 the minimum lending rate was raised from 12.5 to 13.5 per cent, and the maximum rate was raised from 18 to 19 per cent. Thus in 1979 and 1980 there was a clear trend towards increasing interest rates at the official level.
The scope of the Reserve Bank’s refinance facility was progressively curtailed and made discretionary in most respects to combat conditions of excess aggregate demand and the relatively liquid position of the banking system. The banks were expected to keep credit expansion within their own resources and recourse to refinance facilities from the Reserve Bank was limited to only very special cases of need arising from sudden or specially heavy demands for credit from particular sectors. In order to influence the level of borrowing from the Reserve Bank, the net liquidity ratio which determined each bank’s entitlement of refinance and the maximum rate of interest chargeable thereon were manipulated till the time it was discontinued in November 1975. An important element in the conduct of monetary policy since 1970 was seen in the phenomenal increase in reserve money. The major component of this increase was the rise in Reserve Bank credit to Government on which the central bank had little control. In view of this, the only feasible approach to the control of monetary expansion was to influence the value of the money multiplier by raising the CRR. This was done repeatedly and the rise in the average money multiplier was more or less arrested after the mid-1970s and stabilized at a level slightly below 3.0. This achievement fell far short of the requirements of the situation in several years, when a drastic reduction in the rate of growth of M3 was called for. The inflationary situation of the seventies prompted Dr I G Patel, to remark that

I think there is general agreement in India now that inflation is harmful both from the growth and equity point of view. Not long ago, there were at least some businessmen who advocated inflation as a deliberate policy to promote higher savings and investment and thus accelerate the pace of development.  

During the period since 1970, when drastic monetary control measures were needed, both the Reserve Bank and the government closely co-ordinated their actions to achieve the desired results. Instances of such co-ordination demonstrated the powerful impact of concerted action by the RBI and the government, which highlighted the importance of consultations between the two to develop common perceptions of emerging trends and desirable policy action.

2.9.8. Monetary Policy in 1980s

Issues which impinged on monetary policy formulation during the 1980s related to the determination of the appropriate rate of liquidity growth, the allocative role of credit policy, the administered nature of interest rate policy, its cross-

---

subsidization, and the dynamics of the financial system characterized by the imperatives of promoting institutions and instruments and increasing the interface between banks and capital and money markets. The instruments of controls were restricted to variations in CRR, SLR, variations in the cost and availability of the RBI accommodation to banks, changes in the deposit and lending rates of banks, selective credit controls, and quantitative guidelines on credit expansion. The main burden of containing the growth of liquidity fell on the reserve requirements viz. the CRR. The use of open market operations was limited since bonds carried below market rates of interest. Refinance facilities played an important role in not only affecting the availability of resources with banks but also directing resources to desired sectors. Interest rates were changed from time to time in keeping with the evolving economic situation. On the lending side, the maximum interest rate, which reached 19.5 per cent in 1981 from 15 per cent in 1978, was gradually reduced to 16.5 per cent by April 1987 reflecting moderation in inflation. In October 1988, it was decided to free the maximum commercial lending rate from the ceiling stipulation. Thus, effective October 10, 1988, all lending rates then prescribed at a fixed 16.5 per cent were made subject to a minimum of 16.0 per cent in order to accord flexibility to banks in credit rating procedures.

2 10 Conclusion

The RBI’s monetary policy became an important tool of economic development since the inception of planned economic development in India. The Government was completely dependent on RBI for financing its fiscal deficit. Monetisation of fiscal deficits has become a routine affair and has reached exorbitant levels. The Government exercised full control over the financial system to allocate resources for planned developmental needs of the economy. A distinct shift occurred in the late 1960s, when stronger Central control over credit allocation was imposed, seeking to achieve greater congruence between credit flows and the pattern of production in the five year plans. These trends received further impetus after bank nationalization in 1969. The period from the early 1970s was also characterized by weakening of fiscal discipline leading to a large expansion in the Central Govt.’s domestic and foreign borrowing requirements. The ratio of the gross fiscal deficit to GDP increased from 3.5 per cent in 1970-71 to 8.4 per cent in 1990-91. Through obligatory reserve ratios, the resources of banks came to be incorporated into the fiscal allocation process, with less emphasis on bank profitability. With a view to keeping the Govt.’s borrowing costs down, the yields on both treasury bills and longer term paper were kept artificially low. This limited...
the demand for Govt paper to the captive market of the banks and the other term financial intermediaries, such as insurance companies and provident funds. Residual financing needs of the Govt thereby devolved upon the RBI. The government and the RBI felt that there was an imperative need to reform the financial sector by assessing the working of monetary policy. Various committees were appointed to study the impact of various changes of monetary policy and to suggest changes required for the betterment of the policy. Foundations for monetary reforms were laid by the recommendations of all these committees, discussed in the forthcoming chapter.