Chapter – 3

Foundations for Monetary Reforms

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3 1 Introduction

Since the establishment of the Reserve Bank of India and since the inception of Planned Economic growth, the Monetary Policy in India has aimed at financing the Government to meet its targeted growth. No reforms undertook in the monetary sector during the first twenty-five years of the planning era. In early the 1960s, the Government and the Reserve Bank felt that there was a need to reform the monetary sector. Since then onwards, constituted various committees to look into various aspects of the monetary sector and suggested ways and means to reform. The recommendations of all these committees laid foundations for reforms in the monetary and financial sector of India. Hence, it is essential to look into the various committees constituted for improving the monetary sector.

3 2 Chakravarthy Committee

The subject matter of monetary policy assumed importance since the early seventies, when strong Inflationary pressures began building up in the economy. In attaining the objective of growth with social justice, the monetary policy has played a crucial role. Since the time the Hilton Young Commission and the Central Banking Enquiry Committee reviewed the working of the Indian monetary system as far back as the twenties and thirties of the 20th century, many changes have taken place in the Indian economy. Since Independence, for instance, the Indian monetary system has helped in mobilization of resources for implementation of the Five year plans and has also attempted to control the inflationary process in rapid economic development. Various working groups and committees were appointed by the Reserve Bank of India and Govt. of India to examine specific areas of the monetary system. But a comprehensive study of the entire monetary system was never undertaken. Hence, the Reserve Bank of India appointed a Committee in December 1982 to undertake a comprehensive review of the working of the monetary system and suggest measures for improving the effectiveness of the monetary policy as an instrument for promoting the basic objectives of planned economic development. It undertook an in depth study of the working of the monetary system drawing upon the work of the earlier working groups and committees and a detailed investigation of the issues that were relevant to the working of the monetary system as a whole. Considering the fact that the economy then was facing challenging tasks ahead, it would be interesting to have a glance at the recommendations of the Sukhamoy.

51 Reserve Bank of India, Op. cit., p 1
52 Commerce Research Bureau, Sukhamoy Chakravathy Committee on Monetary Policy, The Journal of Indian Institute of Bankers, Janu Mar, 1995, p 234
The Committee has called for several changes in the existing monetary system for achieving growth with stability. The Committee recommended far-reaching changes in the monetary system of India, in its report submitted to the Reserve Bank in May 1985. It produced a very comprehensive report and its recommendations touched practically all the important aspects of Indian monetary policy. It made several recommendations in regard to restructuring of the monetary system with a view to enhance the effectiveness of economic policy in achieving the socio-economic goals. It has also recommended that the Reserve Bank of India should be empowered to discharge its functions of implementing effective monetary policy.

The committee has emphasized that the operation of the monetary system should be consistent with the priorities laid down in the successive Five Year Plans so that the process of mobilization of savings and utilization of resources become 'socially purposive'. It has examined the implications of the planning effort in the pursuit of monetary and credit policy. While noting that the saving rate has increased from 10.2 per cent in 1950-51 to 22.6 per cent in 1983-84 in the course of the planned economic development, the committee has drawn attention to the growing demand on Government spending, which has resulted in government incurring deficits despite the rise in the saving rate. In this context it has stressed that deficit financing, measured in terms of government's recourse to credit from the Reserve Bank should not exceed safe limits. Accordingly, the committee has emphasized the need for financing the plans in a non-inflationary manner by tapping the savings of the public in greater measure than in the past, apart from realising higher savings from the public sector enterprises, and improving efficiency in revenue gathering and expenditure functions. Such an approach was felt necessary to ensure that the process of planned economic development maintained its momentum and that its benefits reached the target groups without being eroded by inflation.

The Committee held price stability in the broadest sense as the dominant objective consistent with the other goals of socio-economic policy as embodied in the Five Year Plans should provide the basic frame for the conduct of monetary policy in a developing economy like that of India. It believed that an average annual increase in the wholesale price index of no more than 4 per cent per annum should be the aim of price policy. It stressed that both the government and Reserve Bank should show due concern for achievement of price stability objective. This concern must underlie government actions aimed at raising
output levels and Reserve Bank’s actions relating to the control of expansion in reserve money and money supply.

The Committee was of the view that the observed inter-relationships between money, output and prices permitted the formulation of monetary policy in a framework of monetary targeting with feedback. The committee has recommended that the target for growth in money supply (M₃) during a year should be reviewed in the course of the year to accommodate revisions if any in the anticipated growth in output, in the light of the price situation. The original target range should be announced in advance, and the circumstances under which modifications will be made should also be made clear. Further, the modifications too should be announced in advance. Monetary targeting, in their view, was an aggregate concept, which lent clear direction to the monetary authority in the use of several monetary policy instruments and hence the Committee recommended that the Reserve Bank should adopt monetary targeting as an important policy tool.

It recommended that an average yield on dated securities should be of the order of 2 per cent per annum in real terms and the discount rate on treasury bills should be marginally positive in real terms. It emphasized the need for close coordination between the Reserve Bank and the government in regard to determining in advance the extent of increase in RBI credit to government that might be accommodated within the monetary target from year to year.

As a corollary to the above approach to monetary regulation, the committee has highlighted the need to redefine the budgetary deficit of the Central government. The existing definition did not provide a clear picture of the monetary impact of fiscal operation as the deficit was related largely to changes in the level of outstanding treasury bills. Moreover, the budgetary deficit did not cover the rise in Reserve Bank’s holding of dated securities, which had a monetary impact. It also did not distinguish between an increase in Reserve Bank’s holdings of treasury bills, which had a monetary impact, and an increase in holdings of treasury bills in the portfolio of non-RBI investors, which did not have a direct monetary impact. The Committee was of the view that changes in the level of RBI credit to Government provided an unambiguous and economically meaningful measure of the monetary impact of fiscal operations and warranted a suitable modification in the definition of the budgetary deficit. The committee was of the opinion that closer orchestration of fiscal and monetary policies would be facilitated when both the Government and Reserve Bank were able to determine in advance the desired
monetary impact of the Government's borrowing program as part of the annual budget exercise

The committee was also of the opinion that the then existing system of administered interest rates has become unduly complex and needs to be modified. Augmenting the pool of financial savings, providing a reasonable return on savings of small savers who are unable to take advantage of fiscal concessions, reinforcing anti-Inflationary policies, the need to provide credit at concessional interest rate to the priority sector and profitability of banks are some of the important aspects of interest rate policy to be taken into account in modifying the present administered interest rate structure.

Taking the concept of improvement in profitability into account, the Committee recommended 'controlled competition' among banks based on an 'administered spread' of 3 percentage points between the maximum interest rate on deposits and the basic (minimum) lending rate of banks. The Committee further recommended that the maximum interest rate on deposits should be fixed by the Reserve Bank and this rate should apply to deposits with a maturity of 5 years or more. The Reserve Bank should also fix the interest rate payable on deposits of one-year maturity. Interest rates have been almost completely deregulated in tune with the Economic Reforms initiated in the economy. Banks are now free to set their own deposit rates, in tune with these recommendations.

In order that savers earn a reasonable return on their long-term savings, the Committee recommended that the deposit rate to be offered by banks on deposits with a maturity of 5 years or more should be such as to offer the saver a minimum positive real return of 2 per cent per annum and the deposit rate on deposits of one-year maturity should be marginally positive in real terms. The committee has suggested that the Reserve Bank might fix the nominal deposit rates accordingly. It has also suggested that banks should devise innovative schemes to provide small savers a better return than they have been getting so far on their deposits. It also recommended that not more than two concessional interest rates should apply to bank credit made available to specified priority sector borrowers, one of which should be equivalent to the basic (minimum) lending rate and the other somewhat lower than basic or minimum lending rate. The then existing system of concessional interest rates should be accordingly rationalized. It expressed concern about the high level of overdue in the priority sector-lending program and suggested that a detailed review of overdue by area

53 Reserve Bank of India, Op cit, p 173
and by activity should be undertaken to facilitate remedial action by the developmental agencies concerned and banks.

The recommendations relating to revision of deposit and lending rates of banks aimed at promoting effective use of bank credit and introducing an element of price competition among banks. Restructuring of interest rates would also promote development of the money market, and in this context the committee has recommended that the call money market should be broad-based by permitting new institutional members to participate in that market.

It recommended a steady reduction in its importance in bank lending and greater resort to financing of working capital through loans and bills. In order to improve the credit appraisal system based on Tandon/Chore norms, and reduce the extent of dislocation in credit flows caused by delayed payments by government and other large buyers in the public and private sectors, the Committee recommended institution of an earmarked cash credit facility for financing supplies to government, and another cash credit facility specifically for meeting unforeseen contingencies.

The recommendations made by the Committee have a bearing on the development of the money market. In the restructured monetary system envisaged by the Committee the treasury bills market, the call money market, the commercial bills market and the inter-corporate funds market would be expected to play an important role in the allocation of short-term resources with minimum transaction costs and delays. Further, a well-organized money market provided an efficient mechanism for the transmission of the impact of monetary regulation measures to the rest of the economy. Accordingly, the Committee has recommended that the Reserve Bank should take measures to develop an efficient money market.

The Committee has stressed that improvement in productivity in all aspects of banking operations has to be pursued by banks as an important management objective as it vitally affected the efficiency of the monetary system. The low profitability of banks has been kept in view by the Committee while making recommendations relating to various aspects of banking. Suggested that a system of licensing should be introduced to protect the interests of depositors of the non-banking financial intermediaries and a suitable cut-off point is laid down in regard to their level of business beyond which they would be under a legal obligation to obtain a license.
The Committee in the context of the restructured monetary system has also examined the role of the various instruments of monetary regulation. On the basis of past experience, it has cautioned that the conduct of monetary policy should not be dependent excessively on any singly or just a few instruments or monetary regulation. Further, the committee was of the view that while monetary brakes are to be applied it is necessary to start early and in a phased manner as the impact of regulatory measures should not be allowed to be so drastic as to cause unintended hardship to specific sectors of the economy. It had also drawn attention to the cost of delayed decisions in the context, when the growth of the banking system reached significant proportions. The Committee was of the view that it was essential to ensure that there was no miss-match between the responsibility of the Reserve Bank to supervise and control the functioning of the monetary system on the one hand, and its authority to do so on the other.

The Committee has produced a very comprehensive report and its many recommendations touched practically all the important aspects of Indian monetary policy. On going through the report, one ends up with a deep and wide enrichment of one's knowledge of the Indian monetary system, but some basic questions remain unanswered. Perhaps one of the more fascinating features of the Report is the comprehensive package of recommendations, the technical details of which have been worked out in such a painstaking manner. There has not been in India up till then such a comprehensive treatise on the Indian monetary system. The report easily takes its place as the best text book on Indian currency and banking.

The presentation is lucid and the basic theory used does not go beyond the usual\(c+r(1-c)\), the reciprocal of which determines the relation between 'reserve money' and the total money supply ('c' is the ratio between currency and total money supply and 'r' the ratio between bank reserves and deposits). The Committee has not said anything about any necessity of organizational changes in the Reserve Bank and the Central banking structure. The first eight chapters, about half of the report, are historical and descriptive. If we analyze the Committee's findings, step by step, it reveals that further research is needed to review the monetary policy in India.

The Committee has summarized the salient features of the financial development and growth in India over the decades. The Committee was silent about the operational significance of the Reserve Bank's series \(M_2\) (\(M_1\) plus postal savings bank deposits) and \(M_4\) (\(M_3\) plus all postal deposits, excluding the National Savings
It was not noticed that the difference between $M_2$ and $M_1$ was relatively small, about 7 per cent, while that between $M_4$ and $M_3$ is greater, about 10 per cent. These relative differences have not changed much in the recent years. It was asserted that "the money multiplier can be predicted", which may not be always true.

The objectives of the monetary policy were described conventionally as enlarging the financial savings pool, mobilizing the savings, promoting a planned allocation of savings, promoting price stability and promoting an efficient payments system. The Committee sought to ensure that there was no mismatch between the responsibility of the central bank and its authority to attain its ends. But it went too far when it said that it is the function of the monetary system to ensure that the resource needs of the government are met adequately. The monetary system is only a part of the total resource-output complex. In fact, Committee had in its final chapters emphasized the need for reducing substantially the reliance of the government on the monetary system through the monetisation of the public debt.

The Committee felt that the short-term Treasury Bills were used by the Government as sources of long term finance at low cost. It suggested that all outstanding Treasury Bills should be funded before the new higher rates were made operative and that the major loan resources of the Govt should be raised through 15 year securities yielding a positive 3 per cent real rate of return. At the time of the Report, the highest coupon rate was 10.5 per cent on 30-year securities, but subsequently this was raised to 11.5 per cent. A three per cent positive rate of real return meant a coupon rate of 12 per cent or more in some years. The question that at once arises relates to the impact of the changes in the yield rates on the earlier holdings. The banks have been partially protected from the difficulties arising from a decline in the capital values of their holdings of securities, whenever new securities were issued carrying higher rates.

It is difficult to understand why the Committee wants to retain the interest on saving deposits with banks at the level of 5 per cent, which generally means a negative real rate. In regard to lending rates the Committee recommended controlled competition within certain limits fixed by the Reserve Bank. No clear argument or calculation was given, but it believed that a 3-percentage point spread between the maximum rate on deposits and the minimum lending rate should provide an acceptable spread to banks. The Committee was not worried about the budgetary impact of the higher rates on treasury bills and Govt securities. The fiscal monetary inter-relations do not appear explicitly in the Report.
The Report stimulated further research in the total problem linking the real economy with its monetary component. It has initiated thinking on revamping the financial system. It has become the basis for all further studies and a founding stone for monetary reforms. Many of its suggestions were accepted and implemented in a phased manner. Its importance of the report will be all the greater if monetary management and the management of the entire economy are recognized as different facets of the complex, but single problem of growth, stability and economic justice.

Major recommendations of the Chakravarty Committee were implemented during the year 1985-86 and thereafter. Some of the suggestions were implemented immediately and the rest in a phased manner.

✓ The committee has emphasized the desirability of developing aggregate monetary targets to help secure acceptable and orderly monetary growth. The Government has, accordingly, carried out, on an experimental basis, an exercise to evolve and monitor such targets in consultation with the Reserve Bank of India, with an historic agreement between RBI and the Government of India in 1997.

✓ The Government had accepted, in principle, the Committee’s recommendation that increase in entire RBI credit to the Government should be reflected in the budget in addition to the more narrowly defined figure of budgetary deficit. After further technical examination and in consultation with the RBI, it has been decided to show the increase in RBI’s net credit to the central Government as a memorandum item in the Budget documents.

✓ Following the committee’s recommendations, a new form of 182 days treasury bills was introduced in 1986, on the basis of monthly auctions to serve as a short-term instrument with flexible rates which would enable banks to manage their liquidity better and promote the evolution of an active secondary market in short-term instrument.

✓ Pursuant to the Committee’s recommendations, the yields on the long-run government securities were increased and the maximum maturity was reduced.

✓ With a view to providing a forum at which financial flows in the economy could be formulated to promote development of requisite policies, the RBI appointed in June 1986 a National Finance and Credit Council, with the following objective of taking an overall view of the flow of finance and credit, both short-term and long-term for industry, agriculture and trade and to consider
developments in capital and money markets with a view to enhancing their role and efficiency

✓ As recommended by the Committee, the 'administered spread' of 3 per cent points is being maintained between the maximum interest rate on deposits and the basic lending rate of banks.

✓ The Committee's recommendation of fixing the maximum interest rate on deposits by Reserve Bank and permitting banks to fix their own interest rates within the overall ceiling fixed by the Reserve Bank was also implemented.

✓ Maintaining a uniform interest rate structure at all its branches of a bank, was implemented.

✓ Banks' have been formulating various innovative schemes to provide small savers a better return than they have been getting on their existing deposits.

✓ The system of various rates of concessional interest to priority sector were rationalized as recommended by the committee.

✓ New institutional members were allowed to participate in the Call money market.

✓ The Regional Rural Banks were given special assistance by both State and the Central Governments. The Central Government to make the Regional Rural Banks more viable and profitable units implemented a restructuring package.

✓ The concern of the Committee on high level of over dues in the priority sector lending programs was taken care of and a detailed review of over dues by area and by activity is being undertaken to facilitate remedial action by the developmental agencies concerned. The refinance facilities available to banks for their credit to priority sector is linked to the quarterly overdue position of the existing advances to priority sector.

✓ Review of working capital limits and financing of working capital through loans and bills were implemented by Reserve Bank by appointing various committees to study the working capital requirements and the method of calculating the working capital requirement.

✓ Much Importance has been given for improving the productivity and profitability of the commercial banks and revamping of the financial system.

✓ The system of issuing license to the non-banking financial companies was started by the Reserve Bank and stringent norms were formulated to protect the interests of the depositors.
Mismatch between the supervisory and controlling functions of the Reserve Bank were eliminated with the formation of a separate Department of Supervision at Reserve Bank.

The term structure of interest rates was rationalized, reducing the number of administered rates and realigning short term and long term rates in the system.

With a view to encouraging secondary market activity, the maximum coupon rate, which had been as low as 6.5 per cent in 1977-78 was raised in stages to 11.5 per cent in 1985-86. Concurrently, the maximum maturity was reduced from 30 years to 20 years.

The maximum maturity period of Govt Paper was reduced from 30 years to 20 years.

Most of the rates in the money market (those for call money, notice money, inter-bank deposits, and rediscounting of bills) were freed in 1989.

Non-banking institutions were permitted to participate in the money market, although only as lenders.

A number of instruments were developed to provide breadth and depth to the money market. A 182-day Treasury bill placed by auction, not re-discountable with the central bank, was introduced in 1986. Certificates of deposits (CDs), commercial paper (CP) and inter bank participation's (PCs) all entered the scene at the initiative of the RBI, which framed guidelines for the issuance of these instruments, subject to certain portfolio ceilings.

A Discount and Finance House of India (DFHI) was set up in 1988 as a Reserve Bank subsidiary with participation from other money market institutions to facilitate smoothening of short term liquidity imbalances and to impart greater flexibility to the money market.

The term structure of interest rates was rationalised in introducing the number of administered rates as also realigning short term and long term rates in the system.

The RBI and the Government appointed many a Committees and working groups to study various concepts of financial sector, to make the Indian financial system stronger, healthier and more competitive in order to meet the challenges posed by the International Financial markets. Most prominent committees that effected the financial system, in general and monetary policy in particular are described in brief.
3.3 Narasimham Committee - I

The Government has appointed a Committee to review financial system in the year 1991 under the chairmanship of Narasimham. The Purpose of the committee was to review the Financial System viz., aspects relating to the structure, organizations and functioning of the financial system. The main recommendations of the Committee are:

- Phasing reduction of Statutory Liquidity Ratio (SLR) to 25 per cent over a period of five years
- Progressive reduction in Cash Reserve Ratio (CRR)
- Phasing out of directed credit programs and redefinition of the priority sector
- Adoption of uniform accounting practices in regard to income recognition, asset classification and provisioning against bad and doubtful debts
- Setting up of Asset Reconstruction Fund (ARF) to take over from banks a portion of their bad and doubtful advances at a discount
- Deregulation of interest rates
- Stipulation of minimum capital adequacy ratio of 4 per cent to risk weighted assets by March 1993, 8 per cent by March 1996, and 8 per cent by those banks having international operations by March 1994

Other recommendations include imparting transparency to bank balance sheets and making full disclosures, setting up of special tribunals to speed up the process of recovery of loans, restructuring of the banking system so as to have 3 or 4 large banks which could become international in character, 8 to 10 national banks and local banks confined to specific regions and rural banks including RRBs confined to rural areas, setting up one or more rural banking subsidiaries by public sector banks, permitting RRBs to engage in all types of banking business, abolition of branch licensing; liberalising the policy with regard to allowing foreign banks to open offices in India, rationalisation of foreign operations of Indian banks, giving freedom to individual banks to recruit officers, inspection by supervisory authorities based essentially on the internal audit and inspection reports, ending duality of control over banking system by Banking Division and RBI, a separate authority for supervision of banks and financial institutions which would be a semi-autonomous body under RBI; revised procedure for selection of...
Chief Executives and Directors of Boards of public sector banks, Segregation of direct lending functions of IDBI to a separate institution, Obtaining resources from the market on competitive terms by DFIs, Speedy liberalisation of capital market by removing restrictions on promia, dispensing with prior Government approval etc, Supervision of merchant banks, mutual funds, leasing companies, etc., by a separate agency to be set up by RBI and enactment of a separate legislation providing appropriate legal framework for mutual funds and laying down prudential norms for such institutions.

Several recommendations have been accepted and are being implemented in a phased manner. Among these are the reductions in SLR/CRR adoption of prudential norms for asset classification and provisions, introduction of capital adequacy norms, and deregulation of most of the interest rates.

3.4 Tarapore Committee

RBI appointed a Committee on capital account convertibility headed by Tarapore, Dy Governor, in the year 1997, to review the international experience in relation to capital account convertibility, recommended measures for achieving capital account convertibility, to specify the sequence and time frame for such measures and to suggest domestic policy measures and changes in the institutional framework. The Committee has recommended a phased implementation of capital account convertibility over a three-year period. The Committee also recommended reduction of fiscal deficit, inflation rate, CRR obligation, NPA level of Banks and more stringent capital adequacy ratios. The liberalized policies and arrangements to facilitate higher level of inflow and outflow of capital were the other important recommendations.

3.5 Narasimham Committee - II

The creation of a strong and efficient financial system, functionally diverse and geographically widespread system was the objective that has inspired the process of financial sector reforms since 1992, as part of the broader program of structural economic reforms. The reform measures taken in this area have followed the recommendations of the Committee on Financial System-I which reported in November 1991. That report was conceived as holistic exercise. Since the submission of the Report, several measures have been instituted in line with its recommendations. The Government felt it necessary to institute another Committee to go into the details of the implementation of the recommendations of the earlier committee, review the progress achieved till then and to
recommend measures to improve the financial system further. Hence, the government appointed a committee under the chairmanship of Narasimham which is popularly known as Narasimham Committee - II in 1997. The committee was asked to review the progress in reforms in the banking sector over the past six years, with particular reference to the recommendations made by the Narasimham Committee in 1991 on the Financial System, chart out a program on banking sector reforms necessary to strengthen India's banking system and make it internationally competitive and to make detailed recommendations in regard to banking policy, institutional, supervisory and technological dimensions.

The Committee made several recommendations relating to the financial sector, on Capital Adequacy, Investment, Asset Quality, NPA Management, Directed Credit, Prudential Norms, Structural issues, and Systems and methods in banks.

It recommended 100 per cent risk weight on foreign exchange open credit limit. It advocated increase in the risk weight of investment in Government securities and advances under the government guarantee. It should also be similar for other advances. It recommended increase in the capital adequacy from 8 per cent to 10 per cent in a phased manner. On investments, the Committee felt that within the next three years or so, entire government securities should be marked to market and thus the schedule of adjustment should be announced at the earliest. On Asset Quality, the Committee recommended more stringent norms for classification of assets and an independent loan review mechanism. On the NPA management, the Committee recommended that loans backed by government guarantee should also be classified as NPA and these should be shown separately in the balance sheets of banks to facilitate fuller disclosure and greater transparency of operations. The Committee felt that the NPA level has to be reduced to the level of 3 per cent by 2002 and suggested to create an Asset Reconstruction Company. The Committee recommended reducing the share of priority sector lending in the total bank credit from existing 40 per cent to 10 per cent and recommended redefining the concept of priority sector lending. It suggested elimination of interest rate subsidy for priority sector credit and de-regularization of interest rates to scheduled commercial banks. A general provision of 1 per cent on Standard Assets and provision of incentives for making specific provisions by way of tax deductions was also recommended. It recommended mergers of public sector banks and reduction of equity of GOI/RBI in nationalized banks and more autonomy for banks for recruitment of skilled manpower from the open market, developing Information and control systems in several areas like tracking of spreads, costs, NPAs for higher profitability.
3 6 Working group on 'money supply'

Working group on 'money supply' analytics and methodology of compilation (1998), was appointed by RBI, to examine the analytical aspects of monetary survey in the light of changing dimensions and depth of financial sector consequential to the implementation of the financial sector reforms, headed by Y V Reddy. The group made a number of suggestions to strengthen the statistical system in order to enlarge the coverage of financial statistics beyond the traditional methods, which confines to the banking sector. According to the group there should be four monetary aggregate and three liquidity aggregates and a comprehensive measure of credit aggregates to effectively capture the dynamics of monetary and the financial system. Therefore, the group has suggested following monetary and liquidity aggregates:

- $M_0$: Currency in circulation + Bank deposits with the RBI as well as other deposits with the RBI (including the deposits of Primary dealers)
- $M_1$: Currency with public + Demand Deposits with the banking system + other deposits with the RBI or
- $M_1 = M_1$: Currency with public + Current deposits with the banking system + Demand liabilities portion of saving deposits with the banking system + other deposits with the RBI
- $M_2 = M_1 + C$ Time liabilities portion of savings deposits with the banking system + CDs issued by Banks + Term deposits of residents with a contractual maturity of up to one year with the banking system
- $M_3 = M_2 + C$ Term deposits of residents with a contractual maturity of over one year with the banking system + Call borrowings from non-depository financial corporations by the banking system

Liquidity aggregates:
- $L_1 = M_3 + C$ All deposits with the post office savings banks (excluding NSCs)
- $L_2 = L_1 + C$ Fixed deposits with developmental Financial Institutions + CDs issued by Developmental Financial Institutions
- $L_3 = L_2 + C$ Public deposits with NBFCs
The group also recommended the compilation of money supply on residency basis, in line with international best practices, by not directly reckoning non-resident repatriable foreign currency fixed deposits in the monetary aggregates. The report suggested enlarged monetary and liquidity aggregates. But at present most of the transaction among the organized core sectors of the economy are being routed through the credit card system, which was not taken into consideration. In the absence of which the liquidity aggregates do not reflect the actual position of the monetary aggregates. The RBI introduced the new monetary, credit and liquidity aggregates compiled on the basis of the recommendations of the working group from the year 2000-2001.

3 7 Advisory Group on Transparency in Monetary and Financial Policies

Developments in the international financial system and discussions of the international financial architecture have focused attention on the need to evolve sound standards. There is now increased international convergence that transparency of monetary and financial policies is an important element in the evolution of such standards. Transparency is now regarded not only as an aspect of good governance and promoting credibility, integrity and in the ultimate analysis accountability for policies, but also as a positive contribution to putting the operations of financial institutions on a sound footing. Indeed the perceived lack of transparency has been suggested as a proximate cause of the South East Asian Currency crisis, a few years ago. In this context, the IMF evolved a Code of Good practices on Transparency in Monetary and Financial Policies, which was adopted by the interim Committee (September 1999) and recommended its adoption by various countries. In order to deal with various aspects of relevance these recommendations in India the RBI, in December 1999, set up a Standing Committee on International Financial Standards and Codes. A number of Advisory Groups were also constituted to go into specific aspects. An Advisory Group on Transparency in Monetary and Financial Policies was set up with Shri M Narasimham as Chairman and Shri S S Tarapore as member, with the following terms of reference:

- To study the present status of applicability and relevance and compliance in India of the relevant standards and codes.

- To review the feasibility of compliance and the timeframe within which this can be achieved given the prevailing legal and institutional practices in India.
To compare the levels of adherence in India, vis-a-vis industrialized countries and also emerging economies particularly to understand India’s position and prioritize actions on some of the more important codes and standards.

To chalk out a course of action for achieving the best practices.

The Group undertook a detailed scrutiny of the IMF code of Good Practices on Transparency in Monetary and Financial Policies essentially from the viewpoint of India’s compliance with the Code. It studied the IMF Supporting Document to the Code of Good Practices on Transparency in Monetary and Financial Policies (May 2000) and surveyed the experience of select countries in putting in place “Best practices”. It made an assessment of India’s compliance with these international standards and chalked out a roadmap indicating how India could move towards conforming to these Codes. The group felt that the degree of transparency, which would be desirable, needed to be modulated to suit evolving market conditions and as such an attempt at excessive precision could be unproductive.

The Advisory Group has set out a inter-lined package of recommendations to enable India to move towards attaining internationally accepted best practices on transparency in monetary and financial policies. These recommendations would need to be properly sequenced and implemented over time. It felt that monetary policy was only an aspect of overall economic policy and opined that convergence in policies were also transparency in other aspects of economic policy. Transparency in monetary policy and greater responsibility and accountability for the RBI would be meaningful only if there was legislative amendment of RBI Act to provide the necessary autonomy to the RBI to fulfill its responsibilities. It also felt that the objectives of monetary policy should be set out by the government, as part of its overall economic policy package and that the government should seek Parliamentary approval for these objectives as also any change in these objectives thereafter, which should be in the public domain. It recommended providing through legislative amendments, reasonable security to tenure to the Top Management of RBI. It was essential that a clearly assigned specific responsibilities in the conduct of monetary policy and accountability for the same to the wider public.

The group recommended that the determination of interest rates should be exclusively a monetary policy function. There should be well-calibrated legislative measures to separate debt management and monetary policy functions. The government should set up its own independent debt management office, to take
over in a phased manner, the present debt management functions discharged by
the RBI It also recognized that separation of debt management and monetary
policy is a necessary but not a sufficient condition for an effective monetary
policy, which would also require a reasonable degree of fiscal responsibility It
advocated more autonomy for RBI to operate monetary policy It felt that the
RBI should progressively work towards greater clarity in publicly setting out the
objective of monetary policy and move to greater transparency in setting out the
process of monetary policy formulation so that accountability of the RBI can be
properly assessed

With a view to moving towards a more transparent system, the group
recommended that it would be best to veer towards prescribing to the RBI a
single objective while the government could have for itself a clearly set out
hierarchy of objectives for which it could use its other instruments of policy
Illustratively, the government can unequivocally set out to the RBI a medium
term inflation objective, say over a prospective three year period, and while fixing
this objective the government can take cognizance of other objectives and the
government can retain the right, with Parliamentary endorsement, to reset the
single objective in the light of evolving developments The initial statement and
consequent resetting of the objective should be done transparently and the
rationale of the change should be fully explained For purposes of credibility,
frequent resetting of the object, for a particular period, should be the exception,
rather than the rule The Government of India should consider setting out to the
RBI a single objective for Monetary Policy viz the inflation rate Once the single
objective is set out the remit of the MPC would be clear and the RBI should be
given unfettered instrument freedom and held fully accountable for attaining this
objective There is some merit in having an over-riding provision under which the
government can give a directive on monetary policy to the RBI but this should be
in writing and specific in terms and applicable for a specific period This should
require parliamentary endorsement after being placed on the table of the House

The Group recommended that the RBI should set up a seven member Monetary
Policy Committee (MPC) as a Committee of the RBI Central Board, MPC consisting
of the Governor, the three Deputy Governors and three other members drawn
from the RBI Central Board. It recommended that there should be a monthly
meeting of the MPC on a predetermined date, such as the last Wednesday of the
month A convention should develop wherein the RBI should time its measures
immediately after the MPC meeting A short statement should be issued
immediately after the meeting of the MPC even when no measures are envisaged.
The minutes of the meetings of the MPC should be made public with progressively increased details over time. The RBI should develop a healthy tradition accepting the recommendations of the MPC, save in very exceptional circumstances. In such cases the RBI should publicly justify its actions.

3.8 Other Committees

In addition to the above committees/working groups, directly affecting the Monetary Policy in India, various other committees/working groups were constituted to study the various aspects of the Indian Financial System viz., Money & Capital markets, Non-Banking Financial Companies, Banking Security & Supervision, various segments of credit, Technology upgradation in Banks, Customers Service, committee on Weak Banks etc.

3.8.1 Verma Committee

A Working Group was constituted in February 1999 under the chairmanship of Verma to suggest measures for revival of weak public sector banks. The Group recommended restructuring of the weak banks in two phases, an independent agency to approve the restructuring plans of the banks. The group was of the opinion that DRTS and ARPS should help weak banks in NPA management. The group has visualized that the restructuring program would be a time-bound program. As per the recommendations of the group, the Government constituted a Weak Banks Monitoring Cell at RBI, Delhi, to monitor the performance of these banks. Introduced VRS in public sector banks. The Government called for restructuring plans from these banks and the performance of these banks is now being assessed in terms of these plans. The Government is yet to infuse capital to these banks, as recommended by the group and the ARC's are yet to be constituted.

3.8.2 Committees on Industrial Sickness

The Goswami committee on Industrial Sickness (1993) recommended various measures to reduce industrial sickness. A package of measures was suggested for reducing incidence of industrial sickness. The J. V. Shetty Committee (1993) reviewed the system of lending under consortium arrangements. The committee recommended a system of lending designed to ensure smooth transformation of the banking system in the existing phase of transition and initiate measures to ensure financial discipline on the part of borrowers. Substantial modifications in the system of consortium lending were recommended to make it simple and more
flexible to meet credit needs of trade and industry quickly. It recommended enhancement of the threshold limit for mandatory formation of consortium from Rs. 5 crore to Rs. 20 crore with immediate effect and to Rs. 25 crore or above by March 1996. It also recommended introduction of syndication for borrowers enjoying fund-based working capital limits of Rs. 25 crore or above from the banking system.

3.8.3 Committees on Export Credit

The Sundaram Committee (1993) inquired into the structure of Export Credit and recommended raising the current level of Rs. 5 crore and above for consortium method of lending to Rs. 10 crore and above, which will enable many exporters to get their limits expeditiously sanctioned from their bankers. Banks were advised to dispose of the applications for loans within a period of one month in case of non-consortium lending and within 45 days in case of consortium lending. The committee also recommended that export credit should be considered part of priority sector advance.

3.8.4 Committees on SSI Advances

The Nayak Committee (1991) examined the adequacy of institutional credit to Small Scale Industries and Related Aspects. The committee recommended that village and tiny industries with credit limits upto Rs. 1 lakh should have the first claim on priority sector credit to SSI. Certain procedural changes were suggested to create mutual confidence between banks and SSI entrepreneurs. It was also suggested that banks should prepare budgets in respect of working capital required by SSI sector covering the functioning of healthy units, those under appraisal and sick units under nursing. In regard to larger units with aggregate credit limits of over Rs. 10 lakh, the unit level budget will follow the Inventory norms wherever such norms are available.

3.8.5 Committees on Priority Sector Credit

The Mehta Committee (1994) reviewed the IRDP programme and made recommendations to improve the scheme further. The Khusro Committee (1986) reviewed the Agricultural Credit System in India. An Expert Committee (1995) headed by Hussain recommended policy changes for development of small and medium scale enterprises to make them viable and efficient units in the light of technological changes and increased level of international competitiveness. The
Kapur Committee (1998) recommended various changes on Bank Credit in Banks to SSI Sector

3.8.6 Committees on NBFCs

Various committees made several recommendations on the other organised financial institutions, other than Banking Sector. The Committees recommended stringent licensing norms of the co-operative urban banks and NBFCs. The Marathe Committee (1991-92) on Licensing on New Urban CO-operative Banks recommended a new licensing system for Urban-Co-operative banks, based upon viability norms. Working group on Non Bank Financial Companies (1992) headed by Shah, recommended compulsory registration of existing deposit taking companies which have net worth of Rs 50 lakhs and over. Expert Group on NBFCs (1994-96) headed by Khanna, recommended introduction of semi-annual returns for collecting information from NBFCs and periodic off-site monitoring by RBI. The RBI Working Group on Creation of separate instruments of regulation and supervision of residuary and other NBFCs (1996) headed by Shere, reviewed the efficacy of the supervision and control exercised by the RBI and examined the feasibility of introduction of deposit insurance scheme for depositors of all non-banking finance companies. The Vasudev Committee to Review the Regulatory Framework relating to NBFCs (1997-98) suggested a series of prudential measures to strengthen the NBFCs and enhance depositors protection.

3.8.7 Committees on Supervision, Technology and Inspection

The financial sector reforms mainly concentrated on strengthening the financial organizations, especially banks. Various committees were appointed to suggest improvements in the functioning, supervision, technological up-gradation, autonomy and service of the Banks. Working group on site supervision of Banks (1996) headed by Padmanabhan, former Deputy Governor, RBI, introduced a rating methodology for banks on the lines of the CAMEL (Capital Adequacy, Asset quality, Management, Earnings, Liquidity, Systems and controls) model with appropriate modifications. RBI Working Group on Security Equipment, headed by Rashid Jilani, Committee (1992) recommended that once the standards and specifications, approved by the Bureau of Indian Standards (BIS), the Indian Banks Association (IBA) may issue a circular addressed to all its member banks to procure only such equipment bearing the relevant ISI mark. RBI Committee on Customer Service in Banks, headed by Golporia, (1990-91) recommended enlarging the scope of teller services, existing banking hours for non-cash...
transactions, devising appropriate procedure to render uninterrupted service during business hours, etc

Working Group on Internal Control Systems of Banks headed by Rashid Jilani, (1995) examined the efficacy and adequacy of the internal control systems in banks and suggested improvements in them. The Saraf Committee (1994) on Technology issues suggested far reaching changes relating to payment system, cheques clearing and securities settlement technology and training in technology for banking industry. The Shere Committee (1996) proposing Legislation on Electronic Funds Transfer and Other Electronic Payments suggested a mix of regulatory and contractual model for Electronic Funds Transfer, with RBI assuming the role of Service provider as well as the regulator. The Vasudevan Committee (1999) on Technology up gradation in the Banking Sector recommended usage of comminication, infrastructure and usage of INFINITE should be given high prority through effective usage of VSAT network. More recently the RBI has set up a Working Group to study and recommend changes in the concept of Directed Lending. The working group consists of RBI officials, practical bankers and Bank Economists, drawn from various banks and NIBM are studying the various aspects of the directed lending.

3 8 8 Committees on Money Markets

Hedging (1997) recommended core principles for various participants in the process of hedging either in domestic commodity market or overseas commodity market. SEBI Committee on Credit Rating Agency (1998) headed by Vijay Ranjan framed regulations for credit rating agencies operating in India. The Gupta Committee (1998) recommended introduction of derivatives in Indian Stock Market including developing appropriate regulatory authority. The Dave Committee on collective investment schemes (1998) made recommendations for protecting interests of investors, who have invested in collective investment schemes of plantation companies. The Dhanuka Committee (1997) reviewed the legal framework relating to Capital Market. The Varma Committee (1997-98) reviewed the revised carry-forward trading which was suggested by Patel Committee. The Shah Committee (1997) looked into the matter of lending or borrowing of stocks and recommended modalities for regulation of short selling in the stock exchanges. The Bhagawati Committee (1996-97) recommended acquisition of shares and take over activities. The Pratip Kar Committee (1998) finalised the norms on overseas investment by domestic mutual funds.

3.9 Malhotra Committee

Committee on Reforms in the Insurance Sector (1993-94) was appointed under the chairmanship of Malhotra, Governor of RBI to suggest the structure of the insurance industry, to assess its strengths and weaknesses in terms of the objectives of creating an efficient and viable Insurance industry, which will address wide reach of insurance services, a variety of insurance products with a high quality of services to the public and servicing as an effective instrument for mobilization of financial resources for development. The Committee has made several recommendations with a view to develop the Insurance industry in years to come.

Reforms are an ongoing process. There is every need to assess the Implementation and Impact of the recommendations of various committees and working groups. As such, more recently the Government constituted an advisory group to review the prevailing economic situation and suggest corrective measures. The group constituted on a permanent basis and comprises prominent financial experts, identify immediate tasks in the financial sector reforms, which require administrative action without legislative recourse and long-term moves in the sector which would require legislative amendments.
The foundations of the monetary and financial sector reforms were laid by the recommendations of all these committees. The implementation and progress of the financial sector reforms is discussed in the forthcoming chapter.

3.10 Conclusion

Various committees were appointed by the Government of India and Reserve Bank of India to suggest measures for improvement in the monetary and financial system of the country. The foundations of the monetary and financial sector reforms were laid by the recommendations of all these committees. The implementation and progress of the financial sector reforms is discussed in the forthcoming chapter.