CHAPTER - 3

THEORETICAL AND CONCEPTUAL FRAMEWORK

3.1 Introduction

In an economy aiming at attaining a reasonable growth rate through planning without recourse to any comprehensive central direction of resources, the banking system has a significant role to play. Performing the roles of intermediation, commercial banks increase not only the rate of capital accumulation but also productivity, thereby boosting the economy’s steady-state growth. By fostering and institutionalising savings and channelling funds in desired directions, in consonance with the aims and priorities laid down in the plans, they can influence the pace as well as the pattern of growth. They can redirect real resources into more productive channels with a high rate of social return or exploit their quasi-monopolistic position by actively encouraging a pattern of investment not in harmony with policy objectives. It is in this context that the first plan emphasized that the banking system had to be fitted into the scheme of development to make the processes of saving and their utilization "socially purposive". The Reserve Bank of India (RBI) has been playing a developmental and regulatory role. In its developmental role, the RBI focused attention on deepening and widening the financial system. It played a major part in building up appropriate financial institutions to promote savings and investment. In the realm of agricultural credit, term-finance to industries, and credit to export, the apex institutions that are now operating were essentially
spun off from the RBI. Strengthening and establishing new institutions to meet the country’s requirements is a continuous process. The promotional role has taken the RBI into the area of credit allocation as well.

3.2 Indian Economy and Banking System – A Historical Review

The banking system that India inherited at independence was wholly inadequate for the purpose of achieving the socially purposive planning. Under the Banking Regulation Act, the monetary authorities acquired extensive powers of regulations and control, which they never had before, and restored stability to the system disorganized through a series of post-war bank failures. The dimensional importance of the banking system as a financial intermediary started increasing over the successive plan periods. The share of the net financial surplus of the household sector routed through banking rose from 24 per cent in the first plan, (1951-52 to 1955-56) to 50 per cent during the third plan (1961-66)\(^3\). Also, the share of banking in the financing of the private corporate sector increased over the same period from 15 per cent to 52 per cent \(^4\).

The fundamental shift in the pattern of financial flows brought a crucial significance to the role of the banking system, for, as distinguished from other classes of intermediaries, it determines the flow of finance due to credit creation. The power to create credit carries with it the responsibility not only for the right amount of credit consistent with monetary stability but also for the direction of credit flows. By choosing to create credit or by refusing to do it, the system can give or deny users or potential users of credit, command over real resources. One notices a growing disillusionment from the mid-sixties that the policies and
practices of commercial banking system were not in harmony with the socio-economic objectives and priorities of development planning. The response of the authorities was a tightening of the regulatory framework and a shift towards a more positive role.

After a brief interlude of the social control phase during 1967-68 in order to regulate the pattern of credit flow, the government acquired in July 1969, direct control over a substantial segment of the banking system, signifying a commitment by it to reshape the system in order to "meet progressively" and serve better, the needs of development of the economy in conformity with the national policy and objectives.

With the ownership by the government of the major units of the banking system, the policy issues involved in integrating the banking system with the strategy of development have been coming into sharp focus. In giving a meaningful operational content to the concept of budgeting and planning of overall credit, several important issues have to be faced, namely, assessment of sectoral credit allocation at the national level as between different states and regions, and between units of the banking system and allied credit institutions, as well as the rationale of identifying the priority sectors and criteria of optimum and efficient use of credit by the different sectors. It is not easy, therefore, to reach a consensus on the contents of monetary management.

An appraisal of the role of the banking system in economic development cannot be divorced from the socio-political framework in which the economy functions. In the centrally planned economies, the banking system is assigned
the specific function and responsibility to help economic enterprises in the fulfilment of their targets. As each economic enterprise is attached to a particular unit of the banking system, and the enterprises are entitled to credit within planned limits, the banks cannot refuse to grant credit so long as the actual needs are consistent with the statement of plan targets. While the banking system functions as the agent on behalf of the government for the planned distribution of credit, it is also responsible at the same time for the efficient use of public resources. The distribution and control functions entrusted to the banking system are an integral part of the methods and policies of national economic management of the centrally planned economies.

The impact of policy changes on the demand and supply of bank credit has therefore to be studied in the Indian context in its wider historical and institutional perspective. The expression “policy” is used in this research work for covering the policy measures taken by the RBI for regulating the flow of credit in the economy such as Bank rate, CRR, repo rate, and reverse repo rate. This chapter is divided into the following sections.

A. Monetarism and Fiscalism - An Overview
B. Monetary Policy-An Outline
C. Monetary Transmission Mechanism
D. Interest Rates in India-Structure and Policy
SECTION - A

MONETARISM AND FISCALISM - AN OVERVIEW

Policies are the guidelines for action framed by the authorities for achieving a specific goal. Policies which directly influence the demand and supply of bank credit are framed by the central bank of our country. The RBI makes these policies by considering the directions that the central government gives them from time to time. An active role by the RBI in terms of regulating the growth in money and credit became evident only after the 1950s. Monetary policy is part and parcel of the economic policy. It consists of all those measures through which the central bank of a country controls the supply of money to attain general economic objectives. The policy directly associated with the government finance and budgetary aspect is referred to as fiscal policy. The conduct of monetary policy and that of fiscal policy are generally assumed to be the respective responsibilities of the central bank and the government. In practice, both of these along with trade and exchange policies, form the essential ingredients of a macro-economic policy. Therefore, monetary and fiscal policies are part of an overall package of policies aiming at subserving the common objective of stability and growth. Though the paradigms of the monetary and fiscal policies are different in reality, these two arms of the macro-economic policy are not disjointed or totally independent, but there exists a considerable overlap between the two policies. A course in the fiscal policy has its effects on the monetary side of the economy, which induces changes in the monetary policy, and this, in turn, influences the results of the initial changes in the fiscal
policy. Most of the recent literature on monetary theory has basically stemmed from the two distinct schools of thought, namely, monetarism and fiscalism or Keynesianism. Therefore, while studying the impact of policy changes on bank credit, it is necessary to make a theoretical framework of monetarism and fiscalism.

3.A.1 Fiscalism – Its Genesis

The doctrine of fiscalism, in essence, implies that money does not matter so much as the monetarists make it out. The fiscalists hold that monetary policy is important but its potency is weakened by the institutional forces. To them, fiscal policy is, by and large, a more effective and powerful economic stabilization device.

Fiscalism stresses the importance of fiscal policy-budgetary surpluses and deficit-as a stabilization device and other related matters in controlling the macro-economic variables. Fiscalism has stemmed from John Maynard Keynes’ epoch-making book, The General Theory of Employment, Interest and Money. The work, General Theory, in fact, was the outcome of the experience of the Great Depression of the thirties which proved that a completely free market economy and the government’s non-interventionalist policy had failed to bring about automatic economic adjustment in the optimal use of resources for growth with stability. Keynes attributed the cause of the depression to the deficiency of aggregate demand and focused on his attention on the role of budget and fiscal policy as a stabilizer of the economy. It provides a general model for determining the level of employment, output, and income in the economy.
Keynes developed the theory of effective demand, which is logically based on the income-expenditure approach that emphasises the fact that decisions to spend are largely influenced by income or expected income and that one person’s expenditure is another’s income, so that the total flow of expenditure determines the flow of the aggregate income. He linked up the real sector with the monetary sector in analyzing the macro-behaviour of an economy and regarded effective or aggregate demand as the crucial variable as against the classical paradigm of aggregate supply in explaining the theory of income and employment. In the general theory, he explains the complexity of many ingredients of macro-economic relationships and dynamic interdependent forces at work in the determination of consumption, investment, employment, money and liquidity preference, GNP, interest rate and the price level in the frame-work of an economy.

Keynes’ great contribution has been to develop a model in which the determination of the levels of income and employment by aggregate demand, which is composed of consumption, investment, and government expenditure, played a central part. Thus, aggregate demand is to be identified with aggregate expenditure. Keynes maintained that the low level output trap is the result of deficiency of aggregate demand. He thus strongly pleaded for governments’ active intervention through appropriate fiscal policies and measures for timely demand management, to minimize cyclical fluctuations in a market economy.

The fiscalists argue that monetary policy is less effective because it influences indirectly, whereas fiscal policy is more effective because it
influences directly the aggregate demand behaviour. Monetary policy works indirectly through changes in interest rates caused by the variation in money supply. Fiscal policy can directly affect aggregate demand through autonomous changes in the government expenditure and also indirectly through changes in consumption expenditure. Apparently fiscal policy is more effective, reliable and predictable than monetary policy. Fiscal policy, therefore is the best stabilizing instrument. Monetary policy, at the most, has only a secondary role to play.

3.A.2 The Key Propositions of Fiscalism

The basic assumptions and propositions of the doctrine of fiscalism are:

1. Fiscalism rests on the income-expenditure approach. However, the fiscalists do make difference in the relative importance of many variables entering into the income-expenditure model.

2. Fiscalism is basically concerned with the short-run changes in contrast to a longer time horizon assumed by the monetarists.

3. Inflation is not a pure monetary phenomenon.

4. Interest rate is determined by the interaction of supply and demand for money. They, thus hold that an increase in money supply leads to lower the fall in interest rates.

5. Demand for money is an unstable variable which responds quickly to interest rate changes.

6. Fiscal policy is much superior to and more effective as a stabilization device, than monetary policy.
7. Supply of money is not a variable exogenously controllable by the central bank. It is an endogenous variable, which may be influenced by changes in economic conditions and credit market indicators.

8. Government deficit has a significant expansionary effect on income, employment and output in the short run, even when there is no addition to money supply.

To sum up, the fiscalists have prescribed discretion, activism and fine tuning through budgetary operations in designing a suitable policy for stabilization, as against the monetarist position of favouring a target-rule-based growth of money supply. The Fiscalists like Kaldor opine that it is no use relying on the central bank for stabilization purpose, for it cannot really control the supply of money—a central bank is like a monarch who can reign but cannot rule.

3.A.3 Monetarism - the Genesis of Evolution

The term “monetarism” is coined by Karl Brunner (1968) to represent the school of thought led by Milton Friedman and his colleagues at the Chicago University and also by a few others like Don Patinkin and Brunner himself, who assert that money alone matters most in the macro-behaviour of a market-oriented economy. In economic thinking, monetarism has emerged as a counter-revolution to the Keynesian revolution in the thirties. The basic ideology among the policy makers over two decades of the post-world war II era was “money does not matter”. They asserted that fiscal policy effectively governs the run of the economy; so, monetary policy has only a subordinate role to play.
at the most as stabilization device. The word “monetarism” was thus coined as an antinomy to “fiscalism” in the sixties, to re-emphasise the role of money and monetary policy. Milton Friedman, the *father of monetarism* with profound arguments and empirical support, inverted the relationship between monetary and fiscal policy giving a clear precedence to the former. Though the credit for advocating monetarism with all its sophistication and assertion goes to Milton Friedman, Clerk Warburton was actually the pioneer monetarist who challenged Keynes and stressed that “*money matters*”\(^\text{13}\).

According to the monetarists, there is a direct and observable link between money supply and GNP. The link is revealed by the stability of velocity of circulation of money. A characteristic monetarist proposition is thus: changes in the money supply are an important factor in the determination of the level of real output, employment and prices. In this respect, the quantity theory of money forms the basis of monetarism\(^\text{14}\). In the history of economics, therefore, the monetarists are recognized as quantity theorists-their lineage can be traced at least as far back as J. Boden in the sixteenth century, and through John Locke, David Hume, David Ricardo, and John Stuart Mill in the eighteenth and nineteenth centuries up to Irving Fisher in the 20’s and 30’s and then Milton Friedman in the 60’s and 70’s of the twentieth century\(^\text{15}\).

### 3.A.4 The Structure of Monetarism

Monetarism is not a precisely defined idea or a systematically stated doctrine. Even though monetarism has stemmed from the simple quantity theory of money, it is not that simple as it involves a number of issues like demand for
money, velocity of money, relation between money, output, prices, and rate of interest monetary rule, among such intricacies of theoretical and practical consideration. Monetarism has been interpreted differently by different people. Therefore, there are several variants of monetarism.

- Orthodox monetarism (Fisherian Version)
- Neo-monetary with variants like Chicago or Friedmanian monetarism
- Brunner-Meltzer monetarism
- Patinkin monetarism
- Laidler monetarism
- Neo-neo monetarism or the new classical macro-economics of Lucas, Sargent, Sim and other rational expectationists.
- International monetarism (Frankel and Dornbusch and Mundell’s monetary approach to balance of payment, for instance)
- Practical as well as Political monetarism

Monetarism thus contains several ideas and propositions of different vintages. A survey of monetarist writings is seemingly required to form some concrete idea about the contents and coverage of monetarism in tracing its relevance in funding the monetary policy of recent times. Thomas Mayer in 1975, Douglas Purvis in 1980, Meghnad Desai in 1981 undertook such survey and came to enlist the propositions with an exposition of the meaning of monetarism.
3.A.5 Main Postulates of Monetarism

These postulates/prepositions are the basic themes which frame the structure of monetarism.

1. Money only matters or it matters most.
2. Money is a definable and measurable concept.
3. There exists a stable demand for money function which is determined by a specified set of variables. The stable demand for money plays a vital role in determining important macro-economic variables such as the level of national income or of prices.
4. The stability of demand for money implies that income velocity of money is stable.
5. The demand for money is either interest inelastic or it has low interest elasticity.
6. The supply of money is an exogenous variable. That means, the determinants of money supply are different from the factors determining the demand for money. The money supply basically depends on the “monetary base” or “high powered money” which is determined primarily by the central bank’s holding of the government securities, gold, and exchange reserves, and its consequent decisions in creating the stock of money. The exogeneity of money supply also implies that changes in the stock of money are not demand-determined but supply-determined. The fact that factors affecting the supply of money do not affect the demand for money and the stable demand
for money functions enables one to trace the effect of change in money supply.

7. The money stock and changes in the money stock have a profound impact on nominal income (GNP), thereby on the aggregate economic activity.

8. Changes in the stock of money and money supply cause changes in prices. Inflation or price rise is mainly due to the growth of money supply in excess of the growth of real income.

9. The rule of thumb is that a rise in the money stock would have a transitory effect on output after a year and a permanent upward effect on the price level after about two years.

10. Unemployment can be maintained below the “natural rate of unemployment” in an economy only at a high cost of accelerating rate of inflation.

11. According to Friedman, there is a two-edge relationship between money and interest rates. Initially, a rapid rise in money supply and stock tends to lower interest rates. Eventually, it causes spending to rise and stimulates prices. Inflation as well as rise in the demand for money/loans, in turn, may cause interest rates to rise.

12. The monetarists also condemn fiscal policy on account of its “crowding out effect”. Fiscal policy in their view, for a given level of savings, simply diverts resources to the public sector and crowds out private expenditure through taxation or borrowing, thereby distorting the allocation of resources. The monetarist argues that under deficit budgetary policy, when the government resorts to public debt on a large scale to meet its heavy
expenditures, it competes with the available loanable funds in the money markets. So there is the possibility that the additional borrowing by the government may tend to crowd the market for the volume of borrowings which could have financed private sector investment/expenditure. If the government borrows more to finance higher expenditure, the "everything else" is no longer constant\textsuperscript{20}.

13. Money plays a vital role in the determination of the balance of payment. This view is regarded as a monetarist approach to the balance of payment, which asserts that the real factors do affect the balance of payments but through the monetary variables, especially the exchange rates and the money supply in an open economy.

14. On the practical side, the monetarists suggest that government policies should continue in respect of just a few selected macro-economic variables and they should be regulated under fixed rules. The government can and should control changes in the stock of money as a stabilizing device. For monetary policy, there should be a monetary rule implying a constant rate of growth of money supply at all times.

Monetarism is essentially a policy-oriented doctrine. Friedman particularly has prescribed a monetary rule under which a target is to be specified for the growth of money supply, which would permit real growth of output in the dynamic economy corresponding to the expansion of its productive capacity each time but it should not permit any flow of money into the system which may cause inflation\textsuperscript{21}.  

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The monetarist have favoured monetary policy as a stabilization tool on the basis of their two essential postulates: first, that excessive growth of money supply against the rise in real income growth is the main or the only cause of inflation, that is, inflation being always and everywhere a monetary phenomenon, and, second, that output, employment and productivity growth are determined by market forces independently of changes in the money supply except for temporary disturbances. These two postulates together imply not only that fiscal policy is ineffective, but also that rules are preferable to fine tuning. It follows thus that the monetarists look to a strong rule-based monetary policy accompanied by a rule-bound fiscal policy.

3.A.6 Political/Practical Monetarism

Monetarism became an influential doctrine in the 70s to the mid-80s. Keynesianism was blamed for the great stagflation of the 50s and 60s, and monetarism offered a way out. Ostensibly, the monetarist dogma, due to its powerful propaganda by Milton Friedman and others, had become the official creed of the monetary authorities in many western countries. Sir Alan Walters, Economic Advisor to the British Prime Minister, Mrs. Margaret Thatcher, from 1980 to 1983, spelled out three major tasks of a practical monetarist monetary policy to be as follows.

1. To maintain liquidity in the very short run by the day-to-day management of financial markets, monetary authorities have to ensure that there is no liquidity crisis and that banks and financial institutions basically face no difficulty in their access to cash, so that confidence of the people in the
system is maintained and unnecessary dislocation and collapse of credit is avoided.

2. To avoid sharp changes in monetary growth inducing unnecessary fluctuations in economic activity and employment in the short run (up to two years or so).

3. To control inflation in the long run (two to three years or more). A low steady rate of growth of the money supply will insure against inflation.

Traditionally, central banks have pursued the twin objectives of price stability and growth. Central banks have to keep in mind the consideration of exchange rate stability and financial stability in pursuing the basic objectives of monetary policy. In the early eighties, the governments in the U.K and the U.S.A adopted, somewhat loosely, the monetarist’s course of the monetary policy and their experience does indicate the usefulness of formulating monetary policy in terms of the monetary aggregates in containing inflation in the long run.

Japan’s experience in this context is more remarkable. When Japan resorted to the policy of stable growth in M₂ plus CDs during the period 1974-1984, she had witnessed that the rate of inflation had declined steadily to low and stable levels. Countries which have permitted erratic monetary growth have experienced oscillations in output, income and employment. During 1974-85, however, many OECD countries did follow a shadow of monetarism, having reduced the trend rate of the growth of money supply which eventually moderated the inflation rate.
Monetarism was turned into a potent political idea by Mrs. Margaret Thatcher by making it an important issue in her Conservative Party’s election manifesto of 1979 which promised to deal with the problems of recession and inflation in the British economy. The Manifesto of 1979 clearly shows the idea of monetarism in the statement: to master inflation, proper monetary discipline is essential, with publicly stated targets for the rate of growth of the money supply. And the politics of monetarism did help her in winning the election in May 1979.

In short, like changing fashions, there has been a rise and fall in the trials and tribulations of practical monetarism. Despite all the imperfections of the monetarist experiments, despite failures in exactly hitting the monetary targets by the monetary authorities, one cannot dismiss the claim of monetarism in bringing down inflation by curbing monetary growth through appropriate monetary policy. Nigel Lawson, British Chancellor of the Exchequer, in one of his addresses, said thus: “The acid test of monetary policy is its record in reducing inflation … the inflation rate is the Judge and Jury”.

As a matter of fact, these two schools of thought, monetarism and fiscalism, represent the revolution and counter-revolution in economic ideas. Monetary policy and fiscal policy are two instruments of macro-economic policy which the government adopts to influence the economic activity in the attainment of specific macro-goals.
Monetary policy, in a broad sense, comprises all monetary decisions and measures, irrespective of whether their implications are monetary or non-monetary, as well as non-monetary decisions and measures that eventually aim at affecting the growth and working of the monetary and financial system. It is directly related to the monetary apparatus of the country. Monetary management is basically concerned with control of liquidity in an economy by regulating the cost and finance through adjustment of money supply with a view to realizing pre-determined objectives such as control of inflation or price stability and growth.

Monetary policy fundamentally relates to the central bank policy, as the central bank of the country is the traditional agent which formulates and operates monetary policy. It is mainly conducted through central banking measures designed to influence the monetary variables such as:

1. the supply of money
2. the flow of credit
3. interest and exchange rates.

But monetary policy is wider in scope and operation than central bank policy. For, in reality, a central bank is not a sole controller of objectives, instruments and channels of monetary policy. The principal task of the monetary authorities has been to bring about an appropriate degree of monetary expansion to meet the increasing requirements of a growing economy. Their
objectives have been to prevent variation in credit conditions from disturbing stability in growth or manipulate such variations to counter disturbing factors. They have attempted to correct in different phases of the developmental process, the disequilibrating tendencies arising from multifarious factors operating in the market economy. The working of monetary policy can be explained in the St. Louis Model, which is the most popular monetarist model.

![ST. LOUIS MODEL-Monetarist Transmission Mechanism of Monetary Policy](image)

The model suggests that changes in money supply directly affect aggregate spending. Changes in total spending directly affect aggregate output.
A change in aggregate spending also implies a demand pressure which affects the price level. The price level is a function of current and past demand pressure and expectations of price changes. A rise in money supply causing an increased aggregate spending fosters higher demand pressures as a result of which prices tend to rise. The change in price level may exert an influence on aggregate output. However, the price level is inversely related to the output level (the real GNP). The model also shows that money supply, prices and output exert their influence in determining the rate of interest. Monetary policy is, therefore, the most logical and effective way to stabilize the economy to stabilize monetary growth. The goals of monetary and fiscal approach overlap since both are macro-economic stabilization tools. This makes the task easy for the authorities to devise a monetary-fiscal policy mix. Monetary-fiscal policy mix provides a set of effective instruments without having to confront major trade-off between economic growth and stability, with social justice.

On analytical grounds, economists usually distinguish monetary policy from fiscal policy and banking policy. In a strict theoretical sense, monetary policy encompasses all monetary measures of the central bank which influence the cost and availability of money in the financial system of the country, while fiscal policy pertains to the finances of the government, that is, the budgetary activities such as revenue, expenditure and borrowings (including deficit financing). Banking policy, on the other hand, addresses itself to the credit development aspects. In practice, however, there is a great deal of overlapping between monetary banking or credit and fiscal policies, and it is not easy to draw
a sharp demarcation line in determining their powers, scope of and impact on the working of the monetary system at large. In most countries including India, the central bank is no longer a totally independent, sole monetary authority. The Ministry of Finance has also an equal say in the financial matters of the country, Rather, the Ministry of Finance is perhaps more powerful as a super-monetary authoritiy these days.

In India, Monetary policy is primarily determined and executed through the RBI headed by the Governor as the chairman of the Central Board of Directors which exercises all the powers of the Bank. Fiscal policy is determined by several government authorities—the Prime Minister, the Finance Minister, the Secretary of the Ministry of Finance, the Council of Economic Advisers and above all, Parliament. Thus, the responsibility for monetary policy and fiscal policy is shared by several authorities. Monetary-fiscal policy is an integral part of economic policy which attempts to achieve the broad objectives, such as price stabilization, economic growth and favourable balance of payments, through direct and indirect management of the monetary system, and the functioning of the money economy by operating on such monetary variables as the supply of money, availability of credit, the level and structure of interest rates interacting with the monetary impact of the budgetary exercises of the government involving public borrowing and deficit financing. Sole dependence upon monetary policy as a means of promoting growth and development and coping with inflation is dangerously one-sided in the macro-economic set up of a developing economy. This results in macro imbalances. In a rational approach,
the monetary policy has to be devised in a way that works effectively as an integral part of the total economic policy\textsuperscript{37}.

The central bank should be treated as an equal partner in the decision-making and execution of the monetary-fiscal policy mix. A central bank has to be always cautious to give timely warning to the government of the emergence of any condition which may endanger the country’s monetary stability\textsuperscript{38}. Monetary and Fiscal policies affect the economy through different routes. Monetary policy has an indirect impact on spending or aggregate demand behaviour by affecting liquidity position which largely depends on the response of spenders and borrowers to the changes in monetary and financial conditions brought about by policy actions\textsuperscript{39}. Fiscal policy, however has a financial aspect in the sense that budgetary deficits or surpluses involving changes in government debt influence total credit demand and interest rates in the economy.

The transmission mechanism of monetary-fiscal policy, its main objectives, prominent targets, major instruments, and indicators in influencing the level of aggregate demand in an economy, etc., are depicted in a chart by D.M. Mithani\textsuperscript{40} and that is reproduced below to get a clear idea about the monetary-fiscal policy mix.
Monetary-Fiscal Policy Transmission Mechanism

Fig: 3.2

3.B.1 Definition of Monetary Policy

Monetary policy has been defined by different economists. Some of the definitions are given below:-
1. Henry G. Johnson\textsuperscript{41} has defined it thus: “Monetary Policy employing the central bank’s of the supply of money as an instrument for achieving the objectives of general policy.

2. According to Paul Einging\textsuperscript{42}, “Monetary Policy includes all monetary decisions and measures irrespective of whether their aims are monetary or non-monetary and all non-monetary decisions are measured that aim at affecting the monetary system”.

3. According to Prof. R.P. Kent\textsuperscript{43}, monetary policy is “the management of the expansion and counteraction of the volume of money in circulation for the explicit purpose of attaining a specific objective such as full employment”.

The above definitions reveal that the central bank in every field or sector is the motivator of monetary policy.

3.B.2 Objectives of Monetary Policy-A Brief Outline

There are three major objectives of general economic policy, namely, growth, price stability and equitable distribution of income. The traditional theory of economic policy suggests that there should be as many instruments as there are objectives. This means that for these three objectives, in general, at least three instruments are needed. We need, for instance, monetary policy for price stabilization, fiscal policy for stimulating growth through public spending and income policy for equitable distribution. India’s income policy has been in name only, where legislative measures prescribe only minimum wages. So, monetary policy and fiscal policy are the major levers of economic policy to pursue the goals of price stability, growth, and social justice.
C.M. Choudhary in his book “Recent trends in Indian Banking” specifies the important objectives of the monetary policy, as follows:-

1. **Price Stability**: Fluctuations in prices are to be controlled and regulated through various measures in such a way that it can have desirable effects on production, income and employment generation.

2. **Exchange Stability**: Foreign exchange rate stability is one of the traditional objectives of monetary policy because, for the development of international trade exchange, stability is an essential condition. This objective of monetary policy has been criticized on several grounds and it is not a major objective of monetary policy because internal price stability fulfils the interest of the country.

3. **Neutrality of Money**: The objective of neutrality means to make ineffective, the effects of change in the quantity of money on various elements like price, income, employment, etc. Under the policy of neutrality of money, price level which depends on the productive capacity of the country. There is opposite relationship between the productive capacity and price level of an economy.

4. **Full Employment**: Full employment does not mean an unemployment-less situation, but the situation in which the resources are utilized to the optimum level and thereby higher level of national income is attained. The full employment situation depends on the effective demand which consists of consumption expenditure and investment expenditure variables. According to
professor Crowther, the monetary policy aims to attain the equilibrium between saving and investment (S =I) at full employment level.

5. Economic Development:- In a developing country, monetary policy is an important instrument of economic development while in a developed economy the objective is to attain full employment situation with economic stability. The environment of economic development is encouraged to attain equilibrium between aggregate money supply and demand through monetary policy.

The RBI Act requires the RBI 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”. According to George, Governor of Bank of England (1996), “It is true that most central banks at least would traditionally have regarded controlling inflation as a core responsibility. In some cases- most famously, in the case of Bundesbank- the duty of preserving the value of their currency has long been written into the central bank’s statutes. But what is remarkable today is the extent of the international consensus on effective price stability–in the sense of eliminating inflation as a factor in economic decision–as the immediate aim of monetary policy; and this is increasingly reflected in more or less explicit targets for low rates of inflation against which monetary policy performance can be measured”\textsuperscript{45}.

The Chakravarty Committee Report (1985), and especially Sukhamoy Chakravarty, firmly hold that the objective for which the monetary policy could be most appropriately utilized is \textit{“price stability”}\textsuperscript{46}. It has been argued that in a
country like India with a complex economy, however, to use monetary policy as a primary instrument for effectuation of the socially desired income distribution cannot be an acceptable proposition\textsuperscript{47}. Using monetary policy as a stimulant to growth process would be a more manageable objective. But without paying adequate attention to the problem of inflation or price stability, growth-oriented monetary policy too can be quite counter-productive\textsuperscript{48}. In a broad sense, the objectives of monetary policy can be no different from the overall objectives of economic policy. The broad objectives of economic policy in India have been: to maintain a reasonable degree of price stability and to help accelerate the rate of economic growth. The emphasis as between the two objectives has changed from year to year, depending upon the conditions prevailing in that year and in the previous year\textsuperscript{49}.

Indian banking sector and monetary system assumed new dimensions and dynamism with the bank nationalization of July 1969. During the post-bank nationalization era, price stability has been attentively prescribed as the major objective of monetary-fiscal policy in India, as a pre-requisite for growth and social justice. In the fulfilment of this goal, however, the Indian monetary-fiscal policy appears to have had no much success as it has failed to control inflation over the years.

The following are the objectives of monetary policy in India:

1. To encourage savings; and collect potential savings
2. To mobilize savings for capital formation and development;
3. To encourage investment and to create environment for investment in a planned programme.

4. To supply credit in adequate quantum to meet the increasing needs of agriculture, industry, trade, commerce and other productive activities so that overall economic development is encouraged.

5. To control inflationary pressures to maintain relative price structure and general price stability.

6. To encourage economic growth without financial hindrance.

Traditionally, central banks have pursued the twin objectives of price stability and growth. Central banks have to keep in mind the considerations of exchange rate stability and financial stability in pursuing the basic objectives. Faced with multiple objectives that are equally desirable, there remains the problem of assigning to each policy instrument, the most appropriate objectives. Accordingly, there is a broad consensus, both in academic and policy circles, that monetary policy is useful as an instrument in achieving the goal of price stability.

The adoption of price stability as the only objective of monetary policy is, however, by no means universal. While a number of prominent central banks, including the European Central Bank, the Bank of England and the Bank of Japan, have adopted price stability as the single objective of monetary policy, the Federal Reserve of the US continues to pursue multiple objectives of monetary policy, viz., (a) maximum employment, (b) stable prices, and (c) moderate long-term interest rates. Central banks in several developing countries have taken up
exchange rate management as another important policy objective. In recent years, particularly after the financial crisis of the 1990s, the concern for financial stability has become an integral part of the central bank’s activism.

The principal task of the monetary authorities has been to bring about an appropriate degree of monetary expansion to meet the increasing requirements of a growing economy. Their objective has been to prevent variations in credit conditions from disturbing stability in growth or manipulate such variations to counter disturbing factors. They have attempted to correct, in different phases of the developmental process, the disequilibrating tendencies arising from multifarious factors operating in the market economy in India. The content and timing of credit policy are very closely related to pronounced seasonality in the demand for money. Seasonality in the Indian economy arises from the fact that a substantial portion of the national product is accounted for by the primary sector. The content of credit policy is in essence the regulated easing of pressures on bank liquidity in the busy season and the required contraction of such liquidity in the slack season.

The choice of a dominant objective arises essentially because of the multiplicity of objectives and the inherent conflict among such objectives. Faced with multiple objectives that are equally relevant and desirable, there is always the problem of assigning to each instrument the most appropriate objective. This ‘assignment rule’ favours monetary policy as the most appropriate instrument to achieve the objective of price stability.
3.B.3 Operating Procedures of Monetary Policy

Operating procedures refer to the day-to-day implementation of monetary policy by central banks through various instruments. Monetary management is the primary task of the central bank. Monetary management, in a broad sense, refers to the supervision of liquidity-money supply, bank credit and other financial facilities-in the working of the monetary system by the monetary authorities, particularly the central bank, in the pursuit of certain socio-economic objectives. Operating procedures play a crucial role in the effective monetary management which is essential for maintaining macro-balances and price stability. Macro-economic stability is a prerequisite for sustainable growth in a developing economy.

The crucial point in monetary management is the choice of targets which maximize the precision with which one can expect to achieve the ultimate objective. If the monetary authorities, over the relevant time horizon, have complete knowledge of the structure of the economy and were able to accurately forecast exogenous developments, then the need for a target variable disappears, since the operational policy may be unequally determined. The fixation of a proximate target to serve as link between policy instruments and ultimate goals becomes inescapable for the policy maker. From the angle of controllability, such targets may be divided into operating targets and intermediate targets. Operating targets are positioned somewhere in the transmission process between policy instruments directly controlled and intermediate targets. Intermediate targets are positioned somewhere between operating targets and ultimate targets.
of policy. Intermediate targets either directly influence expenditure or are closely related to financial variables. The central bank may not be in a position to directly achieve their ultimate objectives and hence monetary policy is often formulated in terms of an intermediate target. For example, in a monetary targeting framework, a suitable monetary aggregate is considered an intermediate target based on the basic relationship between money output and prices. The exchange rate as an intermediate target can be suitable for small open economies, setting it against a low-inflation anchor country, and this may, however, entail a loss of independence in steering domestic interest rate. Therefore, the next section deals with the operating procedures, instruments and targets of monetary Policy.

3.B.4 Instruments of Monetary Policy

A significant objective of the RBI has been to assist the planned process of development of the Indian economy. It aims at the promotion of monetization and monetary integration of the economy filling in the “Credit Gaps” and gaps in the financial infrastructure, catering to the financial needs of the economy with appropriate sectoral allocation, as well as supporting the planners in the efficient and productive deployment of investible funds with a view to attaining the macro-economic goals of maximization of growth with stability and social justice.

The traditional classification of monetary policy instruments are is as follows:-

1. General or Quantitative Techniques, and
2. Qualitative or selective Techniques.

3.B.5 General or Quantitative Techniques

The total supply of credit is regulated by the quantitative methods of credit control in the country. These techniques either increase the credit or decrease the credit, by processes known as ‘expansion of credit’ and ‘contraction of credit’ in the country. The RBI seeks to control and regulate the flow of credit in the economy such that it can sustain the tempo of development and promote the maintenance of internal price stability. It uses quantitative controlling weapons, such as bank rate policy, open market operations and reserve ratio requirements.

1. **Bank Rate Policy**: Bank rate is the traditional weapon in the armoury of credit control of the Reserve Bank. The rate at which commercial banks borrow from the central bank is known as bank rate. It is also called discount rate, as the central bank discounts the bills or first class securities of commercial banks, and loans and advances are made by the bank. Whenever the bank rate is changed by the central bank, commercial banks also change it accordingly as the cost of borrowing is affected. When bank rate is raised, the commercial banks will also charge high interest on the loans and advances given to different sectors of the economy and different sections of the society. Credit becomes costlier, it discourages investment; thereby output and employment are affected. The income of people decreases and the price level can be controlled to some extent. Thus raising of bank rate implies a **dear money policy** of the RBI, which makes the money market tight. Contrary to it, when the bank rate is reduced, the credit
becomes cheaper. Commercial banks can borrow from the central bank at lower rates of interest and consequently they also charge lower rates of interest on their loans and advances. This encourages investment. Production increases and consequently income increases; purchasing power of people increases with the rise in price level. Economic activities are revived with the lowering of bank rate.

Bank rate affects the cost of credit and this cost of borrowing affects the borrowing of commercial banks, and of the public from commercial banks. The bank rate policy has two dimensions: (i) by changing the bank rate, the cost of credit is influenced; (ii) by widening or narrowing the list of eligible securities, the member banks’ borrowing capacity is directly affected. Again, the significance of the bank rate variation lies in the money market more as a pace-setter for the entire interest rate structure, short-term as well as long-term.

Section 49 of the RBI Act 1934, defines bank rate as “the standard rate at which it is prepared to buy or rediscount bills of exchange or other commercial papers eligible for purchase”. But until 1970, this provision had no practical meaning, because there existed no well-developed market in the Indian credit system; so the rate on advances by the Reserve Bank to member banks was regarded as the bank rate. Only since November 1970, with the introduction of the new bill market scheme, there has been some improvement in the rediscounting of bills of exchange by the banks, with the Reserve Bank. From time to time, the bank rate has been manipulated by the RBI. The following
Table indicates the frequency and the extent of variation in the bank rate over the years.

### Table: 3.1

**Changes in Bank Rate during the Years 1935-2010**

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>Bank Rate per annum</th>
<th>Extent of variation</th>
</tr>
</thead>
<tbody>
<tr>
<td>July 5, 1935</td>
<td>3.5</td>
<td>-</td>
</tr>
<tr>
<td>November 28, 1935</td>
<td>3.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>November 15, 1951</td>
<td>3.5</td>
<td>+0.5</td>
</tr>
<tr>
<td>May 16, 1957</td>
<td>4.0</td>
<td>+0.5</td>
</tr>
<tr>
<td>January 3, 1963</td>
<td>4.5</td>
<td>+0.5</td>
</tr>
<tr>
<td>September 26, 1964</td>
<td>5.0</td>
<td>+0.5</td>
</tr>
<tr>
<td>February 17, 1965</td>
<td>6.0</td>
<td>+1.0</td>
</tr>
<tr>
<td>March 2, 1968</td>
<td>5.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>January 9, 1971</td>
<td>6.0</td>
<td>+1.0</td>
</tr>
<tr>
<td>May 31, 1973</td>
<td>7.0</td>
<td>+1.0</td>
</tr>
<tr>
<td>July 23, 1974</td>
<td>9.0</td>
<td>+2.0</td>
</tr>
<tr>
<td>July 12, 1981</td>
<td>10.0</td>
<td>+1.0</td>
</tr>
<tr>
<td>July 4, 1991</td>
<td>11.0</td>
<td>+1.0</td>
</tr>
<tr>
<td>October 9, 1991</td>
<td>12.0</td>
<td>+1.0</td>
</tr>
<tr>
<td>April 16, 1997</td>
<td>11.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>June 26, 1997</td>
<td>10.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>October 22, 1997</td>
<td>9.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>January 17, 1998</td>
<td>11.0</td>
<td>+2.0</td>
</tr>
<tr>
<td>March 19, 1998</td>
<td>10.5</td>
<td>-0.5</td>
</tr>
<tr>
<td>April 3, 1998</td>
<td>10.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>April 29, 1998</td>
<td>9.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>March 2, 1999</td>
<td>8.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>April 4, 2000</td>
<td>7.0</td>
<td>-1.0</td>
</tr>
<tr>
<td>July 22, 2000</td>
<td>8.0</td>
<td>+1.0</td>
</tr>
<tr>
<td>February 17, 2001</td>
<td>7.5</td>
<td>-0.5</td>
</tr>
<tr>
<td>March 2, 2001</td>
<td>7.0</td>
<td>-0.5</td>
</tr>
<tr>
<td>October 23, 2001</td>
<td>6.5</td>
<td>-0.5</td>
</tr>
<tr>
<td>October 30, 2002</td>
<td>6.25</td>
<td>-0.25</td>
</tr>
<tr>
<td>April 30, 2003 onwards 11 2010 April</td>
<td>6.00</td>
<td>-0.25</td>
</tr>
</tbody>
</table>

Source: RBI Monthly Bulletin, various issues
On 28th November, 1935, the bank rate was reduced to 3% and kept unchanged till November 14, 1951. On this day, it was raised for the first time from 3 percent to 3.5 per cent with a view to checking undue expansion of bank credit. It was further raised to 4 per cent on May 16, 1957. Again on January 3, 1963 and September 26, 1964, it was raised on a 500 basis points. In February 17, 1965, it was further raised to 6 per cent. In March, 1968, the rate was reduced to 5 per cent, which involved a reduction of 1 per cent. It was again raised to 6 per cent in January 1971 and till 9 October, 1991 there was only one upward revision of the rate up to 12 per cent. This 12 per cent rate was kept unchanged up to April 1997 and from April 26, 1997 onwards there was a downward revision in the rate. This was due to the result of banking sector reforms introduced in India from the beginning of 1991. After continuous reduction in bank rate (excluding two upward directions), from 2003 April it is 6 per cent till date.

Bank rate policy does not play the initiating role as usually envisaged in the theory of bank rate. Probably in India this has often been the case. Unlike other countries, the bank rate policy in India is used by the Reserve Bank in a discontinuous manner often with a small marginal change causing little effect on the cost and flow of bank credit. Frequent and sharp changes have been avoided for fear of conflict with the development and equity goals of the monetary-fiscal policy.

A rise in bank rate provides a warning signal, besides its psychological announcement effects on the Indian financial system. Thus, though during the
entire decade of the eighties the “bank rate was not touched by the Reserve Bank, it should not be regarded as a dead weapon of monetary control in India. The Reserve Bank should make it a point to use it as an anchor to influence the cost of credit in the Banking System.\textsuperscript{72}

2. Open Market Operations: Those operations under which government securities are bought and sold by the central bank are known as open market operations. When government securities are purchased by the public and commercial banks, the purchasing power is transferred from the public to the central bank. It leads to contraction of credit. Contrary to it, when government securities are sold by the public and commercial banks, it increases the purchasing power of the public and the banks. It increases the deposits, and consequently expansion of credit is encouraged. Thus when the central bank purchases government securities it will lead to contraction of credit. This tool of credit control as an instrument of monetary policy is used to make bank rate policy more effective.

In the conduct of monetary policy, the Reserve Bank of India is also legally empowered to use the technique of open market operations which is a flexible instrument of credit control for altering the liquidity position of banks by dealing directly with the market. Under Section 17(8) of the RBI Act, 1934, the bank is authorized to purchase or sell government securities in any quantity of any maturity and of any value.

Open market operations (OMO) have a direct effect on the availability and cost of credit. The open market operations policy has two dimensions: (i) it
directly increases or decreases the loanable funds or the credit-creating capacity of banks; (ii) it leads to changes in the prices of government securities and the term structure of interest rates. The OMOs serve two objectives; (i) to affect the reserve or liquidity position of banks and thereby the extent of credit/monetary expansion, (ii) to create and maintain the desired pattern of yield on government securities and thereby to help the government in raising resources. Thus, the OMO instrument has two aspects, namely, the monetary policy aspect of credit regulations and the fiscal policy aspect of public debt management.

The instrument of open market operations is generally regarded as a technically superior measure of monetary policy if the central bank possesses enough capacity to deal in government securities on a large scale, and it is also not impeded by other considerations to do so for the sake of monetary policy. The crux of the matter is that under open market operations, the RBI did not purchase any security against payment in cash (except in stray cases), purchases were made only in switch transactions of offering new securities against the old ones during the 80’s. This has been done to prevent unchecked expansion of liquidity through monetization of public debt. The entire post-bank nationalization period (except 1981-82) is thus characterized by net sales resulting in withdrawal of liquidity from the economy. Along with the increasing trend of net sales over the years, however, the holdings of Central Government securities by the Reserve Bank has also steadily increased, indicating a perpetual support by the Reserve Bank to the government securities market. During the
eighties, for example, the RBI’s holdings of the Central Government securities have gone up more than seven times from Rs.3858.4 crore in 1980-81 to Rs.28762.7 crore in 1988-89. During 1988-89 against the net sale of Rs.1485.2 crore, the RBI’s holding of Central Government securities have increased by Rs.46307.7 crore\(^77\).

To enhance the significance and rate of open market operations as an instrument of credit as a first step, fields on government securities were made market-related. At the same time the Reserve Bank helped create an array of other market-related financial products. At the next stage, the interest rate structure was simultaneously rationalized and banks were given the freedom to determine their major rates. As a result of these developments, the Reserve Bank could use OMO as an effective instrument for liquidity management, including curbing short-term volatility in the foreign exchange market\(^78\).

Through the financial sector reforms, the monetary policy has begun to operate within a changed institutional framework and this leads OMO to be under the purview of indirect monetary control tool. OMO, through outright sale and purchase of securities, are also an important tool. In view of the large stock of government securities in its portfolios, OMOs were used effectively by the RBI from the second half of the 1990s to 2003-04 to manage the impact of capital flows\(^79\).

3. **Change in Cash Reserve Ratio (CRR):** According to the RBI Act of 1934, scheduled commercial banks were required to keep with the Reserve Bank a minimum cash reserve of 5 percent of their demand liabilities and 2 percent of
their time liabilities. The Amendment Act of 1956 empowered the Reserve Bank to use these reserve requirement ratios as a weapon of credit control, by varying them between 5 and 20 percent on the demand liabilities and between 2 and 8 percent on the time liabilities. In September 1962, the Act was further amended. With this, the distinction between the demand and time liabilities for the purpose of reserve requirements vanished and, statutorily, the reserve requirements were fixed uniformly at 3 percent of the bank’s total demand and time liabilities (DTL) in India. Moreover, the Reserve Bank was empowered to vary the minimum CRR between 3 percent and 15 percent. This variability in CRR directly affects the availability and cost of credit. An increase in CRR leads to an immediate curb on the excess funds of the banks. When the banks’ credit volume decreases, their profit quantum also decreases. To maintain the same total profits, a decrease in profitability is to be compensated by raising the lending rate. Eventually, when the banks’ lending rates are raised, the cost of credit increases. Since October 1956, the minimum reserve requirements relate to the average daily balance of banks with the Reserve Bank.

For statutory reserve requirements the total of demand and time liabilities (DTL) of the bank is worked out as follows:-

$$\text{DTL} = D + T + B + O$$

Where

- $D =$ Demand deposits from the public and other banks.
- $T =$ Time deposits from the public and other banks.
- $B =$ Borrowings from the public and banks excluding the borrowing from the RBI, IDBI and ARDC.
- $O =$ Other demand and time liabilities.
D and T are the most significant elements in this measure, constituting over 90 per cent of the aggregate. Elements B and O, that is, inter-bank borrowing or inter-bank deposits, do not comprise the part of banks’ total loanable or investible funds. They only smoothen the working of the banking system through redistribution of funds among deficit banks from the surplus banks. As an instrument of credit control or monetary policy, the CRR can be changed from time to time. The central bank can contract or expand credit with the increase or decrease in CRR, and it adopts dear money policy or cheap money policy accordingly. In theory, because of its direct impact on the bank’s excess cash reserves, the banks’ potential to supply the credit, the variable CRR is supposed to be the most powerful weapon of credit control. Changes in reserve requirements through manipulation of CRR can be applied either to total liabilities or to incremental liabilities of banks after a specified date of announcement. The Reserve Bank has tried both strategies.

Since 1956, the RBI used the CRR in a very frugal manner, only once in the sixties. In the seventies, however, the CRR appears to have been manipulated a dozen times. Besides, by a hike in the minimum cash reserve ratio in 1976, the Reserve Bank imposed incremental CRR at 10 per cent on net DTL of the banks accruing since January 14, 1977. It was however, withdrawn in October 1980, but again re-imposed in November 1983, which remained effective till October 1987 when the minimum CRR was brought on a par with the incremental CRR, so that the distinctions between the two become void.
The most important advantage of incremental CRR is that it distinguishes between strong and weaker banks in the growth of deposits and provides a relief to the weaker banks. But, the Chakravarty Committee, in its report argues that when the weaker banks could be helped with suitable refinance facilities, there is no point in imposing an extra burden on the better and efficient banks, and that it keeps the dull banks dull and provides negative incentives to improve their performance in raising deposits and credit business. Therefore, in the report, the Chakravarty committee recommended that the provision of incremental CRR should very sparingly be used by the RBI and it should be imposed only for short durations under circumstances compelling for a drastic step of monetary control. Further, when an incremental CRR is imposed, efforts must be made to convert it to an average at an appropriate moment\textsuperscript{81}.

In the eighties, the CRR was used more frequently, and was manipulated twenty times. Since July 1989, it was raised to 15 percent, which is an all-time high. The system of incremental CRR was, however, reintroduced on May 4, 1991. In addition to the CRR of 15 percent, scheduled commercial banks were required to maintain an incremental cash reserve ratio of 10 percent of the increase in their net demand and time liabilities over the position as on May 3, 1991.

Frequent hikes in the CRR are indicative of the restrictive monetary policy stance of the Reserve Bank over the years. The Chakravarty Committee (1985) observe thus: “Several factors such as the limited scope for open market operations in the absence of an active market for government securities, the low
level of refinance which had already been achieved resulting in little scope for further curtailment, the continued popularity of fixed deposits with banks as a mode of financial savings in the absence of other competing financial instruments, in the aggregate led to the adoption of CRR as a major instrument of monetary control together with refinance in respect of food credit” 82.

In practice, the CRR is not completely a foolproof instrument of monetary control. It is subject to some leakages in impounding the bank reserves to a desirable extent. The major sources of such leakages are: (1) falling short of required reserves and for additional reserve due to non-compliance or incomplete compliance of banks, (2) banks’ compensatory borrowings from the Reserve Bank to fill the gap in their liquidity position arising on account of a hike in CRR, and (3) selling of government securities by banks to the Reserve Bank, thereby to improve their position in lendable resources 83.

In India, the leakage is inherent in the system as the law allows banks to default for a limited period by paying some fine which is usually nominal. During inflation or busy seasons, banks do not mind small fines and would purposely default for using the cash to make loans. Since January 1982, the scheme of graduated penalties has been introduced by the RBI for shortfall in the CRR of the banks. The scheme was revised in April, 1987 in order to give some relief to banks for small shortfalls in the CRR, by increasing the number of slabs for the tapering scale of interest rates. It was further revised in 1990, and the revised scheme of interest corresponding to a rise in shortfall is made less steep.
During busy seasons as well as normal periods of a growing economy, demand for credit by the banks’ customers usually tends to be high and/or raising. Then, often, banks have to borrow from the Reserve Bank which is a lender of the last resort. During an inflationary period it is contrary to the intention of the Bank to impound banks’, liquidity position by raising the CRR. Thus, when the Reserve Bank is serious in controlling the growth rate of money supply, it must ensure that it should not permit a leakage by giving away to banks with one hand (through increased accommodation to them) what it wants, to take away with the other in the form of higher cash reserve ratio.

The Narasimham Committee Report (1991) on the financial system asserts that the Reserve Bank should have the flexibility to operate the CRR as a weapon to serve its monetary policy objectives. The Committee opines that since the government has resolved to reduce the fiscal deficit, there is lesser need for using the CRR to control the secondary expansion of credit. It, thus, proposes that the Reserve Bank should consider reducing progressively the CRR from its high level. The committee also recommended that the interest paid to the banks on impounded deposits through CRR above the basic minimum should be kept in alignment with the banks’ average cost of deposits.

Under the deregulated financial system, when interest rates are determined by the market forces, the Bank rate and the open market operation of the Reserve Bank should become more significant than the cash reserve ratio as an instrument of monetary management. As a matter of fact, the CRR has been reduced to 4.5percent with effect from June 14 2003 and again hiked to 5
percent in October 2004. Till September 2008, it was hiked 9 times and brought upto 9 percent. Then it was reduced thrice and brought down to 5 percent in March 2009. It was further increased to 6 percent from Nov. 2, 2010 and it is the present rate of CRR (March, 2011).

Table: 3.2

Changes in CRR from 1962 to 2010

<table>
<thead>
<tr>
<th>Effective Date</th>
<th>Rate</th>
<th>Extent of variation</th>
<th>Additional cash reserve on incremental DTL* over a base data</th>
</tr>
</thead>
<tbody>
<tr>
<td>16 Sept 1962¹</td>
<td>3.00</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>29 June 1973</td>
<td>5.00</td>
<td>+2.00</td>
<td>-</td>
</tr>
<tr>
<td>8 Sept 1973</td>
<td>6.00</td>
<td>+1.00</td>
<td>-</td>
</tr>
<tr>
<td>22 Sept 1973</td>
<td>7.00</td>
<td>+1.00</td>
<td>-</td>
</tr>
<tr>
<td>29 June 1974</td>
<td>5.00</td>
<td>-2.00</td>
<td>-</td>
</tr>
<tr>
<td>14 Dec 1974</td>
<td>4.50</td>
<td>-0.50</td>
<td>-</td>
</tr>
<tr>
<td>28 Dec 1974</td>
<td>4.00</td>
<td>-0.50</td>
<td>-</td>
</tr>
<tr>
<td>1 Nov 1975 ²</td>
<td>-</td>
<td>-</td>
<td>Pertaining to FCNR Account</td>
</tr>
<tr>
<td>4 Sept 1976</td>
<td>5.00</td>
<td>+1.00</td>
<td>-</td>
</tr>
<tr>
<td>13 Nov 1976</td>
<td>6.00</td>
<td>+1.00</td>
<td>-</td>
</tr>
<tr>
<td>14 Jan 1977</td>
<td>-</td>
<td>-</td>
<td>Additional CCR of 10% on net DTL accruing since 14.1.1977</td>
</tr>
<tr>
<td>1 June 1978 &amp; 5June 1979³</td>
<td>3.00</td>
<td>-</td>
<td>Impounding of additional 1.5% of net aggregate pertaining to NRE &amp; FCNR Accounts</td>
</tr>
<tr>
<td>31 Oct 1980</td>
<td>-</td>
<td>-</td>
<td>10% incremental as above withdrawn, the balance not released</td>
</tr>
<tr>
<td>31 July 1981</td>
<td>6.50</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>21 Aug 1981</td>
<td>7.00</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>27 Nov 1981</td>
<td>7.25</td>
<td>+0.25</td>
<td>-</td>
</tr>
<tr>
<td>27 Dec 1981</td>
<td>7.50</td>
<td>+0.25</td>
<td>-</td>
</tr>
<tr>
<td>29 Jan 1989</td>
<td>7.75</td>
<td>+0.25</td>
<td>-</td>
</tr>
<tr>
<td>9 April 1982⁴</td>
<td>7.25</td>
<td>-0.50</td>
<td>-</td>
</tr>
<tr>
<td>11 June 1982</td>
<td>7.00</td>
<td>-0.25</td>
<td>-</td>
</tr>
<tr>
<td>27 May 1983</td>
<td>7.50</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>29 July 1983</td>
<td>8.00</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>27 Aug 1983</td>
<td>8.50</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>12 Nov 1983</td>
<td>-</td>
<td>-</td>
<td>Incremental CRR of 10% of net DTL accruing after 11-11-1983</td>
</tr>
<tr>
<td>4 Feb 1984</td>
<td>9.00</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>27 Oct 1984 &amp; 1 Dec 1984</td>
<td>-</td>
<td>-</td>
<td>One fifth of additional cash balance of 31.10.1980 released in two instalments on these dates</td>
</tr>
<tr>
<td>Date</td>
<td>CRR</td>
<td>Change</td>
<td>Note</td>
</tr>
<tr>
<td>-------------</td>
<td>------</td>
<td>--------</td>
<td>----------------------------------------------------------------------</td>
</tr>
<tr>
<td>28 Feb 1987</td>
<td>9.50</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>2 May 1987</td>
<td>-</td>
<td>-</td>
<td>The CRR in respect of FCNR deposits is raised from 3% to 9.5%</td>
</tr>
<tr>
<td>24 Oct 1987</td>
<td>10.00</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>2 July 1988</td>
<td>10.50</td>
<td>+0.50</td>
<td>-</td>
</tr>
<tr>
<td>30 July 1988</td>
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14 June 2003 | 4.50 | -.25  
18 Sep 2004 | 4.75 | -.25  
2 Oct 2004 | 5.00 | -.25  
23 Dec 2006 | 5.25 | +.25  
6 Jan 2007 | 5.50 | +.25  
17 Feb 2007 | 5.75 | +.25  
3 Mar 2007 | 6.00 | +1.25  
14 Apr 2007 | 6.25 | +.25  
28 April 2007 | 6.50 | +.25  
4 Sep 2007 | 7.00 | +.50  
Nov 2007 | 7.50 | +.50  
May 2008 | 8.25 | +.75  
July 2008 | 8.75 | +.50  
Sep 2008 | 9.00 | +.25  
Oct 2008 | 6.00 | -3.00  
Nov 2008 | 5.50 | -.50  
Jan 2009 | 5.00 | -.50  
Nov 2010 | 6.00 | +1.00  

*DTL = Demand and Time liabilities of the Scheduled banks.

1. Prior to 16-9-1962, the CRR was 5% of demand deposits and 2% of time deposits.

2. Since this date, banks are permitted to maintain foreign currency non-resident (FCNR) Account and the CCR has been prescribed at 3% on deposits in such accounts.

3. The banks are called upon to deposit from week beginning 1-7-78, with the RBI in terms of rupee, the equivalent of ½ of the net aggregate amount which accrued after 1-6-1978 under Non-Resident (External) (NRE) Accounts in rupee and FCNR Accounts. This requirement was withdrawn on 5-6-1979 and the amount earlier impounded was allowed to be set off by the banks against their obligation under the CRR.

4. Prior to 9-4-82, NRE Accounts in Rupee attracted the same CRR as applicable to the local deposit accounts from time to time. Since 9-4-1982, the CRR is prescribed at 3% on these deposits.

**Issues Related to CRR:** In recent times, the CRR has been increasingly used as a tool to modulate credit growth and as an instrument of monetary management. The payment of interest on the CRR results in attenuation of monetary control, since interest payments lead to infusion of further liquidity in the second round. After the amendment to the RBI Act in 2006, the RBI is barred from paying interest on banks’ CRR balances. The Panel on Financial Stability Assessment and Stress Testing (herein after referred to as CFSA) observed that in a market-oriented financial system, a high CRR, when unremunerated, causes distortion in the term structure of interest rates. However, the quantum of the impact on a bank’s balance sheet depends on several factors, particularly on the vibrancy of the money market and the ability of the bank to pass the burden to customers. The CFSA notes that the CRR has increased in recent years (which was 9 percent as on August 2008) to contain liquidity generated by foreign exchange operations and control inflation expectations, and that its use largely depends on the prevailing monetary, macro, and liquidity conditions in the economy. This is borne out by the fact that during September 2004 to August 2008, the CRR, as an instrument of monetary management, was increased in phases by 400 basis points and subsequently, on a review of liquidity condition was reduced by 400 basis points by January 2009.

Monetary Policy has begun to operate within a changed institutional framework brought about by the financial sector reforms. It is this change in the institutional framework that has given a new dimension to monetary policy. This new dimension brings a change in the classification of the instruments of
monetary policy as direct and indirect instruments. Typically, the CRR comes under the direct instrument as it determines the level of reserve, bank needs to hold against their liabilities.

4. Variation in Statutory Liquidity Ratio (SLR): The SLR, as a weapon of monetary control in the armoury of the Reserve Bank, was the outcome of the measure taken to prevent banks from offsetting the impact of the CRR by liquidating their government security holding. The statutory liquidity ratio essentially implies a supplementary or secondary reserve requirement to fulfil the main objectives, such as:

(i) To assure solvency of banks by compelling them to hold low-risk assets up to the stipulated extent,

(ii) To create or support the gilt-edged security market, and

(iii) To allocate resources to government.

In India, the Banking Regulation Act 1949 originally prescribed that the banks should maintain secondary reserve as a minimum proportion of their total demand and time liabilities in the country as liquid assets in the form of cash, gold and unencumbered government and other approved securities. Thus, banks in India, besides being subject to cash reserve, requirements also are subject to a statutory liquidity requirement as prescribed by the statutory liquidity ratio. The SLR is the ratio of the banks’ liquid assets to their demand and time liabilities in India. As per the amendment of the Banking Regulation Act, in 1962, the liquid assets of the banks should consist of:

(i) Excess cash reserves,
(ii) Current account balances with the RBI, and

(iii) Unencumbered government and other approved securities. Thus the statutory liquidity ratio (SLR) of a bank is defined as under:

$$\text{SLR} = \frac{\text{ECR} + \text{CAB} + \text{ISS}}{\text{DTL}}$$

Where, ECR=Excess cash reserve (total cash reserves in hand plus balances with the RBI minus Statutory or required reserves with the RBI)

ISS; Investment in unencumbered government and other approved Securities and DTL=Total demand and the time, CAB= inter-bank balances on Current Account.

Initially, the SLR of 20 percent was imposed under the Banking Regulation Act which was revised upward to a minimum of 25 percent in 1964. Prior to the nationalization of banks, the objective of the SLR was just to provide some cushion against the banks’ liability. So, the SLR was kept unchanged and the reserves were also very meagre. In the seventies, the SLR was used as a policy tool by raising it from time to time. The hikes in the SLR are applicable only to the scheduled commercial banks; the state co-operative banks have been exempted (For them SLR continues to be at the minimum level of 25 percent). The SLR was 25 percent in 1970-71. It was gradually stepped up to 33 percent in 1974 and further to 34 percent in December 1978. The Banking Regulation Act was further amended in 1983, which empowered the Reserve Bank of India to increase the SLR for scheduled commercial banks up to 40 percent. The amendments were made effective on March 29, 1985.
The SLR system in India, though initially devised to supplement the CRR with a view to making it more attractive, in the seventies and eighties, it was used such as to reflect a command approach to monetary policy. From time to time, a steady hike in the SLR, as shown in Table 4.3 highlights the greatest commandeering of the authorities to seize increasing proportions of the deposit resources of the banks every year for government use. The SLR was 20 percent in 1949. By 1990 it was raised to 38.5 percent. This implies a compulsory shift of the country’s scarce resources from the non-government sector to the government sector mobilized through the banking sector. The SLR system provides a captive market for the government securities at low administered interest rates. With the raising of the SLR, the banks are compelled to invest more in low-yielding government securities which would create an adverse impact in their profitability. In fact, profitability of Indian banks deteriorated at the end of the eighties. One of the major reasons for this decline is the prevailing high SLR at 38.5 percent over the year’s lower yield on the government securities, and the high quantum of investments in them compelled by high SLR adversely affected the income of banks in India.

Under the monetary-fiscal policy over the years, the statutory liquidity ratio, instead of retaining its intended character as an instrument for prudential safeguard, has turned to be a handy weapon for the government to channelize bank resources in financing the public sector borrowing requirements at a lower cost. The over-use of the SLR has resulted in creating the banking sector as a captive market for the government securities. Even the Narasimham Committee
(1991) admits that the “high level of SLR investments has also tended to “crowd out” the non-governmental sector’s access to bank funds, thus depriving more productive activities of the resources from the banking system”\(^8\). The following recommendations have been made by the Narasimham Committee for reforming the system of SLR\(^8\).

**First**, the level of the SLR should be gradually reduced to its minimum, that is, 25 percent of the net demand and the time liabilities of the banks. **Second**, the interest rates on government securities should be raised to bring them on a par with market-determined rates. By accepting the Narasimham Committee recommendations the government gradually reduced the SLR to the 25 percent in 1997.

Furthermore, a reduction in statutory pre-emption of the SLR below 25 per cent could be considered while taking account of the SLR requirements as a prudential instrument. It needs to be mentioned that internationally, central bank collateral policies have come under pressure since the 2007-08 financial crisis\(^9\). In India, the SLR was reduced from its minimum statutory limit of 25 per cent to 24 percent on 28\(^{th}\) September 2008. The following Table discloses the statutory liquidity ratio to commercial banks in India over the years.
Table: 3.3
Statutory Liquidity Ratio (SLR) for Commercial Banks in India

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<th>Effective from</th>
<th>As percentage of DTL</th>
<th>Extent of variation by (%)</th>
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<td>1949</td>
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</table>

Source: RBI, Report on Currency and Finance, various issues

3.B.6 Selective Credit Control (Qualitative Methods)

Selective credit control is operated as an adjunct of general credit control, with a view to ensuring an adequate flow of credit to the desired productive sectors while restricting the excessive financing of speculative, unproductive and less essential economic activities. The idea of selective credit control is
essentially based on the principle of discriminating use of powers of the monetary authority-the Central Bank- as an apex institution in the banking system\textsuperscript{91}. In India, the Reserve Bank enjoys wide directive powers to operate selective credit controls by virtue of the provisions of section 21 and 35A of the Banking Regulation Act 1949. The main instrument of selective credit control used by the Reserve Bank of India were: (i) the fixation of minimum margin requirements, that is, the margin for the lending against the value of specified security; (ii) the fixation of the level of credit ceiling, and (iii) the fixation of the minimum interest rate on advances against specified commodities. The objectives of the first two measures are to regulate the quantum of credit, and that of the last one is to work as a leverage on the cost of credit for specific borrowings. The margin control is to operate on the demand side of credit by making it costlier while the ceiling impinges on the supply side of credit\textsuperscript{92}. These instruments of selective credit control have been modified and operated by the Reserve Bank from time to time to deal with the changing conditions and achieve the discard directional flow of credit.

3.B.7 Changes in Monetary Policy Instruments: Shift from Direct to Indirect Instruments

In 1983, the RBI appointed a committee under the chairmanship of the distinguished economist Prof. Sukhamoy Chakravarty to review the working of the Indian Monetary System. The Committee’s report (RBI, 1985) covered a wide range. One of its major recommendations was to regulate money supply, consistent with the expected growth rate in real income and a tolerable level of
inflation. Recognizing the fact that government borrowing from the Reserve Bank had been a major factor contributing to the increase in reserve money and, therefore, money supply, the committee wanted an agreement between the Central Government and the Reserve Bank on the level of monetary expansion and the extent of monetization of the fiscal deficit. Without such a co-ordination, the committee felt, the Reserve Bank’s efforts to contain monetary expansion within the limits set by expected increase in output could become impossible.

In the wake of the economic crisis in 1991, triggered by a difficult balance of payments situation, the government introduced far-reaching changes in India’s economic policy. Monetary policy was used effectively to overcome the balance of payments crisis and to promptly restore stability. An extremely tight monetary policy was put in place to reap the full benefits of the devaluation of the rupee. Banking sector reforms covered a wide gamut. The most important of the reform was the prescription of prudential norms including capital adequacy ratio. In addition, certain key changes were made with respect to monetary policy environment, which gave commercial banks greater autonomy in relation to the management of their liabilities and assets. First and foremost, the administered structure of interest rates was dismantled step by step. Banks in India today enjoy full freedom to prescribe the deposit rates and the interest rates on loans except in the case of very small loans and export credit. Second, the government began borrowing at market rates of interest. The auction system was introduced in relation to both Treasury Bills and dated securities. Third, with the economic reforms emphasizing a reduction in fiscal deficit, pre-emptions in the
form of CRR and SLR were steadily brought down. **Fourth**, while the allocation of credit for the priority sector credit continued, the extent of cross-subsidization in terms of interest rates was considerably brought down because of the reform of the interest rate structure.

Monetary policy has begun to operate within a changed institutional framework brought about by the financial sector reforms. It is this change in the institutional framework that has given a new dimension to monetary policy. New transmission channels have opened up. This brought a new mode of classification of the instruments of monetary policy, as **direct** and **indirect instruments**. The indirect instruments generally operate through price channels which cover repurchase (repos) and outright transactions in securities (OMO), standing facilities (refinance) and a market-based discount window. Through repo (selling securities) and reverse repo (buying securities) auctions of daily and longer – term tenor the RBI started to manage market liquidity. This instrument, at the same time, provides the RBI with an operating tool to transmit interest rate signals through changes in repo/reverse repo rates.\(^93\)

With the progressive dismantling of the administered interest rate structure and the evolution of a regime of market-determined interest rate on government securities, open market operations including ‘**repo**’ and ‘**reverse repo**’ operations emerged for the first time as an instrument of monetary control. Before the advent of repos, market operations by the RBI almost invariably focused on open market operations through outright transactions in government securities.
Active liquidity management is an integral part of the RBI’s monetary operations. There has been a worldwide trend for shifting from direct instruments of monetary control to indirect instruments. India is one of the emerging market economies, where such a change has distinctly occurred. A major transformation occurred in the monetary policy framework in the 1990s. In response to the changing financial landscape, the Reserve Bank adopted several policy changes which transformed the monetary policy framework. In the context of the shift, and in line with international trends, the RBI has put in place a liquidity management framework.

Before the advent of repos, the RBI almost invariably focused on open market operations through outright transactions in government securities. The scope of open market operations in the earlier period was limited, as yields were repressed by an administered interest rate regime including auctions of T-bills. The move towards a market-determined system of interest rates began with the development of the secondary market by increasing coupons and decreasing maturity of government debt. During 1985-86 to 1997-98, the maximum coupon rate was increased from 6.5 per cent to 11.5 per cent. The maximum maturity was brought down from 30 to 20 years. The yields were made substantially market-determined by the introduction of auctions since the mid-1980s. T-bills auctions introduced included 182-days’ T-bills in November 1986, 364 days’ T-bills in April 1992, and 91 days’ T-bills in January 1993.
The Reserve Bank introduced reverse repos for absorption from December 1992. With the objective of improving short-term management of liquidity in the system and of smoothing out interest rates in the call/notice money market, the RBI began absorbing excess liquidity through auctions of reverse repos (then called repos). For example, if the central bank desired to inject liquidity for a short period, it could do so by providing funds to banks in exchange of securities at a desired interest rate, reserving the transactions at a predetermined time. Similarly, if the central bank desired to absorb liquidity, it could resort to OMO, involving the outright purchase of securities.

With the objective of improving short-term management of liquidity in the system and to smoothen out interest rates in the call/notice money market, the RBI began absorbing excess liquidity through auctions of reverse repos. The development of repos into a full-fledged instrument in the form of Liquidity Adjustment Facility (LAF) was introduced in June 2000.

At the time of introducing these indirect instruments, repo was meant for absorption and reverse repo for injections. Internationally, as a matter of practice, central banks generally use the term ‘repo’ for liquidity injections. Repo is defined as an instrument to borrow funds. The central banks choose to use the term from the market’s point of view. The RBI adopted this usage as effective October 29, 2004.

3.B.9 The Liquidity Adjustment Facility

The choice of operating framework and operating procedures in any economy is always a difficult one and depends on the stage of macro-economic
and financial sector development and is somewhat of an evolutionary process. As part of the financial sector reforms launched in mid-1991, India began to move away from direct instruments of monetary control to indirect ones. The transition of this kind involves considerable efforts to develop markets, institutions and practices. In order to facilitate such transition, India developed a Liquidity Adjustment Facility (LAF) in phases, considering the country-specific features of the Indian Financial System. The LAF is based on repo/reverse repo operations by the central bank.

In 1998, the committee on Banking Sector Reforms (Narasimham Committee II) recommended the introduction of LAF, under which the Reserve Bank would conduct auctions periodically, if not necessarily daily. The Reserve Bank could reset its repo and reverse repo rates which would in a sense provide a reasonable corridor for the call money market. In pursuance of these recommendations, a major change in the operating procedure became possible in April 1999 through the introduction of an Interim Liquidity Adjustment (ILAF) under which repos and reverse repos were formalized. With the introduction of ILAF, the general refinance facility was withdrawn and replaced by a collateralized lending facility (CLF) up to 0.25 per cent of the fortnightly average outstanding of aggregate deposits in 1997-98 for two weeks at the bank rate. Additional collateralized lending facility (ACLF) for an equivalent amount of CLF was made available at the bank rate plus 2 per cent. CLF and ACLF availed for periods beyond two weeks were subjected to a penal rate of 2 per cent for an additional two weeks period. Export credit refinance for scheduled
commercial banks was retained and continued to be provided at the bank rate. Liquidity support to PDs against collateral government securities at the bank rate was also provided, for ILAF was expected to promote stability of money market and ensure that the interest rates moved within a reasonable range.

The transition from ILAF to a full-fledged LAF began in June 2000 and was undertaken in three stages.

In the first stage, beginning June 5, 2000, LAF was formally introduced and the Additional ILF and level II support to PDs was replaced by variable rate repo auctions with same-day settlement.

In the second stage beginning May 2001, CLF and level I liquidity support for banks and PDs was also replaced by variable rate repo auctions. Some minimum liquidity support to PDs was continued but at interest rate linked to variable rate in the daily repos auctions as determined by the RBI from time to time. In April 2003, the multiplicity of rates at which liquidity was being absorbed/rejected under the back-stop facility was rationalized and the back-stop interest rate was fixed at the reverse repo cut-off rate at the regular LAF auctions on that day. In the case of no reverse repo in the LAF auctions, back-stop rate was fixed at 2.0 percentage point above the repo cut-off rate. It was also announced that on days when no repo/reverse repo bids were received/accepted, the back-stop rate would be decided by the Reserve Bank on an ad-hoc basis. A revised LAF scheme was operationalised, effective from March 29, 2004, under which the reverse repo rate was reduced to 6 percent and aligned with the bank
rate. Normal facility and back-stop facility were merged into a single facility and made available at a single rate.

The third stage of full-fledged LAF began with the full computerization of Public Debt office (PDO) and the introduction of RTGS, which marked a big step forward in this phase. Repo operations today are mainly through electronic transfers. Fixed rate auctions have been reintroduced since April 2004. The possibility of operating LAF at different times of the same day is now getting materialised.

With the introduction of the second LAF (SLAF) from November 28, 2005, market participants now have a second window to fine-tune the management of liquidity. In the past, the LAF operations were conducted in the forenoon between 9.30 am and 10.30 am, and the SLAF operations by receiving bids between 3.00 pm and 3.45 pm. The salient features of the SLAF are the same as those of LAF and the settlement for both is conducted separately and on gross basis. The introduction of LAF has been a process and the Indian experience shows that phased, rather than a big bang, approach is required for reforms in the financial sector and in monetary management.

The important contribution of the LAF has been in keeping overnight interest rates by and large range-bound. With the activation of bank rate as a policy instrument, reverse repos helped in creating an informal corridor in the money market with the reverse repo rate as floor and the Bank rate as the ceiling. The use of these two instruments enabled the RBI to keep the call rate by and large within this informal corridor.\(^98\)
3.B.10 Advantages of the Introduction of LAF

- **First** and foremost, it helped the transition from direct instruments of monetary control to indirect, and in the process, certain dead weight loss for the system was saved.

- **Second**, it provided monetary authorities with greater flexibility in determining both the quantum of adjustment and the rates by responding to the needs of the system on a daily basis.

- **Third**, it enabled the Reserve Bank to modulate the supply of funds on a daily basis to meet day-to-day liquidity mismatches.

- **Fourth**, it enabled the central bank to effect demand for funds through policy rate changes.

- **Fifth** and most important, it helped stabilize short-term money market base.

After the introduction of the second stage of the LAF in May 2001, liquidity had generally been in surplus mode with the increase in levels of capital flows and in the presence of a current account surplus till 2003-04\textsuperscript{99}. With the continuing accretion to foreign exchange reserves, there was corresponding injection of liquidity that had to be sterilized. At the same time, the reverse repo policy interest rate was reduced in successive steps from 6 per cent in March 2002 to 4.5 per cent by August 2003, before raising it to 5.50 per cent by January 2006 in four increases of 25 basis points each. Thus, the aim of monetary policy was to keep overnight call money market rates in the system within the informal interest rate corridor\textsuperscript{100}. 

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On the whole, the LAF has had a pronounced favourable impact of lowering the volatility of short-term money market rates. Monthly average call rates, which were volatile in a 5 to 35 percent during 1990-98, got clearly stabilized subsequently and generally ranged between 5 to 10 percent in 2007 – 08. The call rate has since been largely within a corridor set by the repo and reverse repo rates, imparting greater stability in the financial markets.

The LAF has now emerged as the principal operating instrument of monetary policy. Although there is no formal targeting of overnight interest rates, the LAF is designed to nudge overnight interest rates within a specified corridor, the difference between the fixed repo and reverse repo rates being 150 base points as on 31 March 2009. The LAF has enabled the RBI to de-emphasise targeting of bank reserves and focus increasingly on interest rates. This has helped in reducing the CRR without loss of monetary control. The nineties have paved the way for the emergence of monetary policy as an independent instrument of economic policy.\textsuperscript{101}

\textbf{3.B.11 Limitations of LAF Operations}

A limitation of the introduction of LAF has been the passive role adopted by some banks in managing their day-to-day liquidity position. It is observed that often banks access the LAF window \textit{as the first resort}, and not the last, and then arbitrate their positions across market segments\textsuperscript{102}. This access to the LAF window as the first recourse raises questions regarding its efficacy as an instrument of liquidity management. The operation of LAF is constrained by the availability of securities with the RBI when the liquidity has to be absorbed and
by the availability of SLR surplus securities with the market participants when they have to avail themselves of liquidity from the RBI.

The corridor between repo and reverse repo rates, which was set at 200 basis points initially and was widened to 250 basis points in August 2003, was lowered to 150 basis points in March 2004, to 125 basis points in October 2004, and further to 100 basis points in April 2005. Monetary management since mid-2002 has clearly focused on managing surplus liquidity. This was accomplished by the simultaneous operation of the LAF and open market operations.

The liquidity impact of large inflows was managed till 2003-04, largely through the day-to-day LAF and OMO. In the process, the stock of government securities available with the RBI declined progressively, and the burden of sterilization fell increasingly on LAF operations. Moreover, the LAF is essentially designed to take care of fictional liquidity on a day-to-day basis; hence its function was itself beginning to get distorted by such sterilization.

3.B.12 Market Stabilisation Scheme (MSS)\textsuperscript{103}

The money markets operated in the liquidity surplus mode since 2002, due to large capital inflows and current account surplus. The initial burden of sterilization was borne by the outright transaction of dated securities and T-bills. However, due to the depletion in stock of government securities, the burden of liquidity adjustment shifted on to LAF, which is essentially a tool of adjusting for marginal liquidity. Keeping in view the objective of absorbing liquidity of enduring nature using instruments other than LAF, the Reserve Bank appointed a Working Group on Instruments of Sterilisation. (Chair-person: Smt. Usha
Thorat). The Group recommended issue of T-bills and dated securities under the Market Stabilisation Scheme (MSS), where the proceeds of the MSS were to be held by the Government in a separate identifiable cash account maintained and operated by the RBI. The amount credited to the MSS Account would be appropriated only for the purpose of redemption and/or buying back Treasury Bills and/or dated securities issued under the MSS. In pursuance of the recommendation of the Government of India, the RBI signed a Memorandum of Understanding on March 25, 2004. As part of the MOU, the scheme was made operational since April 2004. It was argued that the Government would issue Treasury Bills and/or dated securities under the MSS in addition to the normal borrowing requirements, for absorbing liquidity from the system. MSS securities are being treated as eligible securities for SLR, repo and LAF.

The payments for interest and discount on MSS securities are not made from the MSS Account. The receipts due to premium and/or accrued interest are also not credited to the MSS Account. Such receipts and payments towards interest, premium and discount are shown in the budget and other related documents as distinct components under separate sub-heads. The T-bills and dated securities issued for the purpose of the MSS are matched by an equivalent with the Reserve Bank. Thus they only have a marginal impact on the revenue and fiscal balances of the government to the extent of interest payment on the outstanding total under the MSS.

The MSS has considerably strengthened the Reserve Bank’s ability to conduct exchange rate and monetary management operations. It has allowed
absorption of surplus liquidity by instruments of short term (91-day, 182 day, and 364 day T-bills) and medium term maturity (dated Government securities). Generally, the preference has been for the short-term instruments. The ceiling on the outstanding amount under the MSS was fixed initially at Rs.60,000 crore but in accordance with the MOU provisions, it is subject to revision through mutual consultations. The total outstanding amount absorbed under the Market Stabilization Scheme (MSS) had increased to over Rs.78,906 crore as on September 2, 2005. The operationalisation of MSS to absorb liquidity of a more enduring nature has considerably reduced the burden of sterilization on the LAF window.

**Table: 3.4**

<table>
<thead>
<tr>
<th>Year</th>
<th>MSS</th>
<th>LAF</th>
<th>Centre’s Surplus with RBI</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004 - 05</td>
<td>47264</td>
<td>35640</td>
<td>12038</td>
<td>94942</td>
</tr>
<tr>
<td>2005 - 06</td>
<td>60240</td>
<td>11100</td>
<td>25820</td>
<td>97160</td>
</tr>
<tr>
<td>2006 - 07</td>
<td>38675</td>
<td>21970</td>
<td>28000</td>
<td>88645</td>
</tr>
<tr>
<td>2007 - 08</td>
<td>130229</td>
<td>4742</td>
<td>28211</td>
<td>163182</td>
</tr>
<tr>
<td>2008 – 09*</td>
<td>161526</td>
<td>-4897</td>
<td>16135</td>
<td>172764</td>
</tr>
</tbody>
</table>

*Source: www.rbi.org.in

*For 2008 -09, the period from April 1 2008 to January 31 2009 has been considered.*

The introduction of the MSS had succeeded in restoring the LAF to its intended function of daily liquidity management. With the MSS levels averaging about Rs.54000 crore in November 2004, the total surplus liquidity averaged around the levels seen before the introduction of the MSS as excess capital flows continues. The LAF operations returned to surplus made thereafter, and by March 2005 averaged around Rs.30,000 crore with total surplus liquidity as reflected in LAF, MSS and government cash balances in the vicinity of Rs.
1,15000 crore\textsuperscript{105}. In short, the availability of LAF and MSS has enabled the RBI to manage the changes in the liquidity situation in an orderly manner.

From the Table (4.4) it can be concluded that the introduction of the MSS has succeeded in restoring the LAF to its intended function of daily liquidity management. In its monetary operations, the RBI uses multiple instruments to ensure that appropriate liquidity is maintained in the system, so that all legitimate requirements of credit are met, consistent with the objective of price stability. In practice, the choice between direct and indirect instruments is not easy\textsuperscript{106}. While direct instruments are effective, they are considered inefficient in terms of their impact on the financial market. On the other hand, the use and efficacy of indirect instruments depend on the extent of the development of the supporting financial markets and institutions. These instruments are usually directed at attaining a prescribed value of the operating target. Central banks typically adopt either (a) bank reserves, or (b) a very short-term interest rate (usually the overnight-interbank rate) as the operating target\textsuperscript{107}. The bank pursues a policy of active management of liquidity through OMO, including LAF, MSS and CRR and using the policy instruments at its disposal, as and when the situation warrants.
SECTION - C
MONETARY POLICY TRANSMISSION MECHANISM

In its conduct of monetary policy, the central bank responds to the evolving economic activity within an articulated monetary policy framework which involves three basic constituents, viz., (a) the objectives of monetary policy, (b) the analytics of monetary policy focusing on the transmission mechanism, and (c) the operating procedure, focusing on operating targets and instruments. The macro-economic literature distinguishes between the money view and the credit view of monetary policy transmission. The money view takes bonds and loans to be perfect substitutes and only allows for the effects of monetary policy on aggregate investment, consumption and savings through changes in interest rates. The credit view allows for an additional effect on investment and economic activity operating through bank credit supply, controlled by changes in bank reserve requirements.

An understanding of the transmission mechanism is critical to the conduct of monetary policy. The process through which changes in the monetary policy get transmitted to the ultimate objectives like inflation or growth has come to be known as the monetary transmission mechanism. The transmission mechanism explains how the actions taken by the monetary authorities influence the key macro-economic variables in the economy. The literature on monetary economics identifies four transmission channels. They are:
(i) **Quantum channel**, especially through money supply and credit (credit availability effects)

(ii) **Interest rate channel** (interest rate effects)

(iii) **The exchange rate channel** (exchange rate effects)

(iv) **The asset price channel** (wealth effect)\textsuperscript{114,115}

The quantum channel focuses on changes in money supply and credit brought about by monetary authorities while tracing the impact on output and price. During the last decade and a half, there has been a revival of interest in the role of banks in the transmission of monetary policy. This is primarily due to a revival of the credit channel of monetary transmission\textsuperscript{116}. The interest rate channel traces the impact of changes in interest rate initiated by monetary authorities on output and price through changes in aggregate demand. The exchange rate channel emphasis the impact on the outflow or inflow of funds from abroad resulting from monetary actions. The asset price channel traces the impact of interest rate changes on aggregate demand through the changes in the price of assets principally those of bonds, equities and real estate.

How these channels function in a given economy depends on the stage of development of the economy and its underlying financial structure. For instance, in an open economy, one would expect the exchange rate channel to be important; similarly, in an economy where banks are the major source of finance (as against capital market), the credit channel seems to be a major conduit for the monetary transmission. In the real world, these channels work simultaneously\textsuperscript{117}. 

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The financial structure can have an important bearing on the transmission of monetary policy. Some of the aspects that have an impact on the transmission are the nature of balance sheets of entities, viz; banks, financial institutions, households, firms, etc., the extent of interest rate deregulation, the substitution between foreign currency and local currency denominations in the composition of loans and deposits, the access of finance from outside the banking system, the extent of disintermediation and the depth and liquidity of secondary markets for debt and equity. Romer and Romer observe that if banks are able to obtain funds by tapping financial markets, the monetary policy would affect banks only through changes in interest rates. The development of financial market and the market integration, domestically and globally bring down the transaction cost and help to improve the transmission mechanism of policy. The transmission channel has important implications for monetary authorities in terms of determining what the appropriate intermediate target should be for the central bank.

Financial deregulation with greater emphasis on completion would help integrate financial markets and promote the effectiveness of the interest rate in the monetary transmission mechanism in general. Central banks may not be in a position to directly achieve their ultimate objectives and hence monetary policy is often formulated in terms of intermediate target. For example, in a monetary targeting framework, a suitable monetary aggregate is considered an intermediate target based on the basic relationship between money, output and prices. In India with the freeing of interest rate structure, interest rate can also
become an appropriate intermediate variable. This has also been facilitated by the reduced direct monetization of fiscal deficit\textsuperscript{120}. It appears from Indian experience that while money supply may be an appropriate intermediate target, while inflation rate remains high, interest rate may be more appropriate when inflation remains low and fluctuates within a narrow range. Changes in interest rates cannot be ordained. The appropriate quantitative changes in money will have to be brought about even though the signal for change may be given by the price variable like interest rate\textsuperscript{121}.

The financial sector has an important bearing on the transmission of monetary policy. The institutional environment in which the Indian monetary policy operates underwent a significant change in 1990. The administered structure of interest rate was dismantled. Governments at the centre and in the states borrow at market rates. Reserve requirements have been drastically reduced. The relationship of the government with the latter is acquiring a greater manoeuvrability. All these changes have provided the Reserve Bank with enhanced ability to influence the economic variables. Direct instruments of control are getting substituted by indirect controls.
SECTION - D

INTEREST RATES IN INDIA: STRUCTURE AND POLICY

The dynamism of interest rates structure and policy is an integral aspect of monetary-fiscal management. Interest rates are important as both an input into and an output of monetary policy decisions-they are instrument variables as well as indicator variables. Indirect monetary policy is often seen as a precondition for the adoption of inflation targeting. High interest rates, however, can contribute to economic stagnation even after significant efforts have been made in liberalizing and developing financial systems in developing countries. An attempt is made in this section to examine some major issues related to the interest rate structure and policy in India.

3.D.1 Interest Rates and Policy in a Developing Economy

Interest is the price for capital. For all practical purposes, interest is the price paid for the loanable funds. It is expressed as a rate (percent) per unit of time. Monetarists, particularly Friedman, hold that interest rate is the price of credit rate than the price of money. It represents the return of lending but also the cost of credit. It serves as a link between the real and financial sectors. The real sector is concerned with the transformation of productive resources. The financial sector is concerned with the lending and borrowing of funds. Funds are used in buying and selling of real output. In a free financial system, the rate of interest is the main lever determining the flow of funds that are borrowed and lent. The domain of the financial sector is constituted by the exchange of funds. In a freely competitive financial system, market forces determine the rate of
interest. The interest rate is an equilibrating variable which brings equality between the aggregate demands for and the supply of funds to the various sectors of the economy. Since interest rate is a price for loanable funds, like all prices, it performs an allocative and distributive function in the financial market.

Interest plays a dynamic role in shaping the economy. In ancient India the importance of interest and rate of interest were considered, as discussed in *Kautilya’s Arthashastra*. In modern economy, interest rates are important tools by which economic development is affected. Interest rate influences the various economic variables at macro and micro levels, such as savings and instruments, individual choice of financial assets, costing and choice of investment projects and techniques (capital-intensive Vs labour-intensive), used portfolio management by the financial institutions. The objectives and targets of economic development are influenced by the changes in the rates of interest. The determination of interest rate at the international level affects the economy of the country and its internal interest rates. The financial liberalization hypothesis holds that allowing the market determination of real interest rates would mobilize savings and increase deposits. Analytically speaking, interest rates can exert potential influence in the crucial areas, such as the level and composition of savings, the investment activity, and the aggregate demand. As such, interest rate policy plays a critical role in the development process.

There is a special relationship between economic development and interest rate because the determination of interest rate depends upon the economic forces of demand for money and supply of money. Interest rate policy
is an important dimension of monetary policy. Basically, it exerts its influence on the demand for credit through the cost of borrowing. The role of interest rate is significantly widened when it is recognized as an instrument of more effective mobilization of savings and as a rationing device for its efficient allocation among alternative forms of investment. The dynamism and impact of the rate of interest in the development process of the Indian economy and its role in the monetary policy framework are clearly mentioned in the Chakravarthy Committee Report (1985). The report envisages a role of interest rate policy which is supportive for the control of money supply. For the demand management “a suitable interest rate policy should be evolved as a monetary management tool in addition to monetary target”. Indeed, monetary policy cannot be devoid of an interest rate policy. It must concern itself with both the control of money and interest rates.

The financial system/infrastructure comprises financial institutions, instruments on moneymarkets as well as capital markets. Its major role is to channelize funds from the household sector to the deficit (or investing) sectors. After the adoption of liberalization policy in the country since 1991, the market rates of interest have been playing an important role in determining the interest rates and interest rates have been fixed in keeping in view the market force in recent years.

3.D.2 Objectives of Interest Rate Policy in India

The interest rate policy in India has evolved in a regulatory framework of planning. The interest rate policy is so designed that interest rates play only a
passive role as a rationing device for the allocation of scarce productive resources between alternative investments and sectors. This allocative role is assumed by the government as its major responsibility which is carried on at its own discretion and arbitrariness through an administrated structure of interest rates and a credit policy directed towards selective lending such as priority sector lending. The interest rate policy in India has been designed to serve the following purposes:

1. To facilitate government’s borrowings at lower rates, thereby to minimizing the burden of domestic public debt,

2. To fabricate a financial framework for growth with equity and stability,

3. To encourage productive activities in the priority sectors through lending at preferential/concessional rates,

4. To assist the weaker section by supplying back credit at lower rates,

5. To increase the level of investments,

6. To minimize financial costs,

7. To mobilize savings of household sector in the form financial assets,

8. To check inflation by using interest rates as a regulatory device of monetary policy for demand management.

The interest rate policy has a profound impact on the structure of interest rates in the country. The structure and behaviour of interest rates and their functional relationship as well as linkage are of vital importance to the economic development as they crucially determine the process of mobilization of savings and the allocation to the different sectors of the economy. Each sector or area of
economic activity is typically influenced by a single specifically relevant interest rate in the whole set of the interest rate structure in the country’s financial system. For the effective operation of monetary policy, therefore, it is essential that the monetary authorities should deal with such strategic rate which appears to be the key to the savings and investment activity.

Different rates of interest are charged on different types of loans by different institutions. The rate of interest is generally determined by economic forces of demand for and supply of capital in the country. The central bank of a country tries to regulate the interest rates. In India, there is a vast variation in interest rates in the organised and unorganized sectors of the country. The interest regulation is applicable in the organized sector of the economy. Interest rates are determined independently in the unorganized market.

The economic history of our country reveals that there were three levels of interest rates after 1950. Free interest rate regime existed during 1950 to 1960. The Reserve Bank of India emerged as regulator, and a regime of regulation of interest rates prevailed during 1961 to 1985. After 1985 and from the decade of the 1990’s, the regime of decontrolled interest rates continued. It is also found at present. Thus various rates of interest existed in our country and there have been two categories of interest, namely administrated or regulated interest rates and market-oriented rates of interest.

3.D.3 Administered or Regulated Interest Rates

The administered or regulated interest rate is that rate which is determined by the authority. The authority determining such rate of interest takes into
consideration the supply side of the capital. This rate of interest is also called regulated or controlled interest rate which is not affected by the economic forces of demand and regulated by the Reserve Bank of India. Globalization and liberalization have brought down the administered and regulated rates of interest and they are moving towards market-oriented rates of interest.

3.D.4 Market-Oriented Rate of Interest

Liberalization and globalization after the economic reforms in 1991 have widened our economy and it has become an internalized economy. The speed of flow of funds has increased on the international level. Market rates of interest are those rates which are determined by the free economic forces of demand and supply in the market. These rates of interest are affected by the activities in the market.

3.D.5 Levels of Interest Rate in Indian Economy

The Indian financial system in the pre-reform period essentially catered to the needs of planned development in a mixed economy framework where the public sector played a dominant role in economic activity. The complex structure of administered interest rate, guided by social concern, resulted in cross-subsidisation. These not only distorted the interest rate mechanism, but also adversely affected the viability and profitability of banks by the end of the 1980’s. The financial sector reforms initiated in India create an enabling environment for the banks to overcome constraints like administered structure of interest rates, high levels of pre-emption in the form of reserve requirements, and credit allocation to certain sectors. Interest rate deregulation has been an
important component of the reform process and has imparted greater efficiency to resource allocation.

The effectiveness of monetary policy to bring down the nominal interest rate will depend on the impact that this policy will have on inflation expectations and on the perception of uncertainty in the economy. The nominal interest rate comprises three elements: (1) the real rate of interest, (2) inflation expectation, and (3) a discount factor for uncertainties. The real interest rate is influenced by several long-term factors such as savings and investment balance in the economy and the rate of return on capital. In a closed economy, the real interest rate is equal to the real rate of growth. The real rate of interest will have to be substantially higher in the developing economies which seek to maintain a high savings rate and which aim at growing at more than 6 to 7 per cent per annum, which is typically the situation in India. In developing economies, high rate interest may be due to market imperfections and due to high intermediation costs. Improved efficiency can reduce the spread between the deposit rate and lending rate and bring the lending rate in closer alignment with fundamental factors, while the interest rate may be adjusted upwards or downwards depending on the nature and extent of output gap and inflation gap. The level also requires to be maintained at an appropriate level consonant with the real rate of growth of the economy and most importantly, real interest rate should be kept at a level necessary to generate savings and investment that are needed to support repaid economic growth.
The presence of administered interest rates even in segments of a financial system could hold back appropriate adjustments in the real rate as a sequel to change in the policy rates. The impervious behaviour of financial market rates could act as the source of nominal rigidities in the economy. This brings changes in the long-term real rates in the financial market but not in the desired direction, posing challenges to the effectiveness of monetary policy even in the market-based system. Therefore, it is not only the changes in real rates but also the direction of change following changes in the policy rates that are important for the effectiveness of monetary policy\textsuperscript{137}.

**Conclusion**

The art of good management of interest policy works through the process of conjectural variation in which the authorities and the market test each other out. Any upward or downward movement of interest rate should be small, and large jolts should be avoided. In the Indian context, we have all along had large movements ostensibly on the ground that the market would only respond to large changes\textsuperscript{138}.
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