CHAPTER 6

MONEY, CREDIT AND BANKING

Expansion of Money Supply

6.1 The Indian monetary scene in recent years has been characterised by an unusually large expansion in money supply with the public. The annual rate of growth of money stock increased from 10.8 per cent in 1969-70 to 11.2 per cent in 1970-71. In 1971-72 and 1972-73 there was a further acceleration in the rate of growth of money supply. Thus, whereas in 1971-72 money supply increased by 13.1 percent, in 1972-73 the observed growth rate was 15.9 per cent. During the current financial year, money supply increased by 9.6 per cent between March 31, 1973 and January 25, 1974.

6.2 The strong expansionary impact of monetary developments in recent years is also reflected in the behaviour of aggregate monetary resources with the public, consisting of money supply with the public and time deposits. The annual rate of growth of aggregate monetary resources went up from 12.4 per cent in 1969-70 to 17.7 per cent in 1972-73. In the current fiscal year, there was a further expansion of 14.1 per cent until January 25, 1974.

6.3 Although there is no mechanical relationship between the growth of money supply and the behaviour of prices in a short period, it cannot be denied that a sustained increase in money supply far in excess of the rate of growth of real output during the Fourth Plan period has exerted a strong upward pressure on prices. In the first two years of the Plan *i.e.,* 1969-70 and 1970-71, the impact on prices was cushioned by a sizeable growth of real output. However, in 1971-72 and 1972-73 while the growth of money supply accelerated, the rate of growth of real output declined. In the current fiscal year, as a result of a considerable increase in real output, the divergence between the rate of growth of money stock and that of real output is likely to be reduced. However, the divergence is still large and considering also the impact of disproportionate increases in money stock during the last two years, the imbalance between aggregate demand and aggregate output remains.

6.4 In 1969-70, net bank credit to the commercial sector was the most important factor contributing to the expansion of money supply. However, since 1970-71, net bank credit to Government has exercised far more expansionary influence on money supply than net bank credit to commercial sector. Moreover, since 1970-71, the Reserve Bank credit to Government has accounted for a much larger proportion of the increase in net bank credit to Government than net commercial bank credit (to Government). The Reserve Bank credit to Government increased by Rs. 671 crores in 1971-72 and Rs. 784 crores in 1972-73. The corresponding figures for the increase in commercial banks' net lending to Government are Rs. 301 crores and Rs. 523 crores respectively.

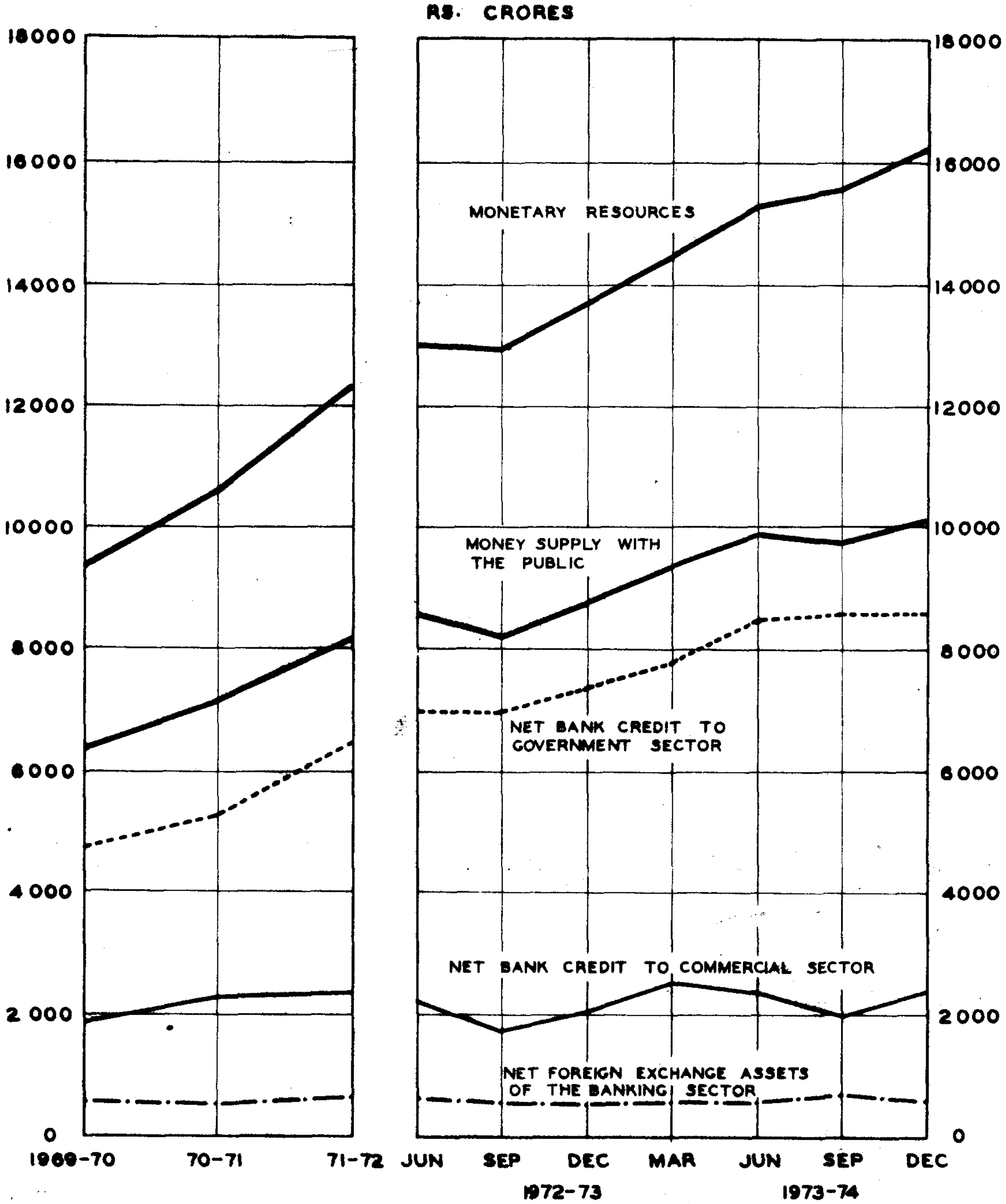
6.5 Judging by the data for the period March 31, 1973 and January 25, 1974, net bank credit to Government is likely to remain a predominant influence on the growth of money supply in the current fiscal year as well. Thus whereas between March 31, 1973 and January 25, 1974 net bank credit to Government increased by Rs. 1032 crores, net bank credit to commercial sector declined by Rs. 171 crores. It should be pointed out, however, that the decline in net bank credit to the commercial sector was not due to any fall in commercial banks' credit (in fact it rose much faster in 1973-74 than in 1972-73), but due to a larger expansion in time deposits with banks. Further, it is worth noting that as compared to 1972-73, net Reserve Bank credit to Government in the current fiscal year has assumed a much larger role than net commercial bank credit to Government. During the period March 31, 1973 and January 25, 1974, net Reserve Bank credit to Government increased by Rs. 816 crores, and commercial banks' net lending to Government went up by Rs. 216 crores. This is to be compared with an increase of Rs. 480 crores in net Reserve Bank credit to Government and of Rs. 594 crores in net commercial banks' lending to Government during the corresponding period of 1972-73.

6.6 Commercial banks' lending to Government takes the form of investments in Government securities, including treasury bills. The fact that despite a substantial increase in deposits, commercial banks' investments in Government securities increased much less in the current year as compared to the previous year, may be partly due to impounding by the Reserve Bank in 1973 of a part of commercial banks' deposits (through an increase of 4 percentage points in the statutory cash reserve ratio). In the absence of this impounding, it is likely that a part of the immobilised bank reserves may have been invested by banks in Government securities. This has to be borne in mind in interpreting the monetary data as well as the figures of budget deficit for 1973-74.

6.7 The events of 1973 also cast some doubt on the validity of the usual economic distinction between commercial bank and Reserve Bank credit to Government. To the extent that impounding of banks' deposits and commercial banks' investments in Government securities are substitutable, it is arguable whether there is much difference in the monetary impact of a Government expenditure financed by borrowings from the Reserve Bank as against commercial banks' investments in Government securities.

MONEY SUPPLY WITH THE PUBLIC AND MONETARY RESOURCES

(AS ON LAST FRIDAY)



MINISTRY OF FINANCE, ECONOMIC DIVISION.

MGIPND-PLW-367/6/M. of Fin./73-74-550C-Ch.4.

TABLE 6.1

Variations in Money Supply

(Rs. crores)

	1969-70 Mar. 31 to Mar. 31	1970-71 Mar. 31 to Mar. 31	1971-72 Mar. 31 to Mar. 31	1972-73 Mar. 31 to Mar. 31	1972-73 Mar. 31 to Jan. 26*	1973-74 Mar. 31 to Jan. 25*
A. Changes in money supply with the public (a+b) . . .	632	723	945	1,290	632	906
(a) Currency with the public	336	367	434	639	276	526
(b) Deposit money with the public	295	357	510	651	356	380
B. Principal factors affecting variations in money supply:						
1. Net Bank credit to Government (a+b) . . .	108	515	972	1,308	1074	1032
(a) Reserve Bank of India credit to Government . .	13	331	671†	784	480	816
(b) Banks' holdings of Government securities . . .	96	183	301	523	594	216
2. Net Bank credit to commercial sector (a+b) . . .	344	347	76	258	—329	—171
(a) Reserve Bank of India credit to commercial sector .	7	51	100	33	—24	169
(b) Banks' net credit to commercial sector (i-ii). . .	337,	296	—25	226	—305	—340
(i) Banks' advances and holdings of private securities	740	818	695	1,116	561	804
(ii) Banks' time deposits	403	521	720	890	866	1,144
3. Net foreign exchange assets of the R.B.I.** . . .	270	—48	78	—39	—74	—44

* Provisional.

† Excludes book adjustments of the order of Rs. 175 crores.

** Variations in net foreign exchange assets of the Reserve Bank of India represent variations in the Bank's holdings of foreign exchange (i.e., gold and foreign exchange) net of variations in the Bank's non-monetary foreign exchange liabilities (i.e., transactions with the International Monetary Fund).

Note:— The magnitude of the Reserve Bank of India's credit to Governmet in the above table represents the changes in the indebtedness of the Government to the Reserve Bank of India. The accounts for the fiscal year are, however, completely adjusted only some days following the end of the fiscal year. Also, the magnitude indicated above includes items such as changes in the rupee coins and long-term rupee securities. For these reasons, the Reserve Bank of India's credit to the Government shown here differs from the deficit shown in the budgetary documents.

In retrospect, it appears that the relative inflationary impact of Government spending cannot always be properly assessed by making a distinction between borrowing from the commercial banks as against borrowing from the Reserve Bank. For a sound anti-inflationary policy, it is essential that Government investment in excess of Government savings ought to be matched by excess of private savings over private investment. The manner in which excess private savings are transferred to the public sector is of much less significance for the control of inflation than is sometimes assumed in discussions of monetary policy.

Seasonal Variations in Credit

6.8 The 1972-73 busy season witnessed a very substantial expansion in bank credit to the commercial sector. Between end October, 1972 and end April, 1973, total bank credit increased by Rs. 878 crores or by 16.7 per cent, as against an increase of Rs. 355 crores or by 7.3 per cent in 1971-72 busy season. The increase in bank credit in the 1972-73 busy season was almost entirely on account of purposes other than for food procurement since advances for food procurement increased only by Rs. 6 crores. In 1971-72 busy season as well, credit for purposes other than food procurement accounted for the entire increase in total bank credit as advances for food procurement had in fact declined by Rs. 71 crores.

6.9 During the first half of the 1972-73 busy season (November, 1972—January, 1973), the increase in bank credit was moderate at Rs. 338 crores as compared to an increase of Rs. 267 crores during the corresponding period of 1971-72 busy season. However, between February and April 1973, there was a sharp spurt and bank credit expanded by Rs. 540 crores as compared to Rs. 88 crores recorded in the corresponding period of 1972.

6.10 The fact that, despite a sharp decline in kharif output in 1972 and a deceleration of the growth of industrial production since the closing months of 1972, bank credit recorded a significant expansion in the early months of 1973 indicates a build up of inventories with the help of bank credit. However, a part of the increase in credit was undoubtedly on account of higher raw material prices.

6.11 The commercial banks were able to satisfy the additional demand for credit with only a marginal recourse to the Reserve Bank. Thus, their borrowings from the Reserve Bank increased only by Rs. 18 crores in 1972-73 busy season as compared to Rs. 4 crores in the preceding busy season. This was due to the fact that banks' deposits during the 1972-73 busy season increased by the record amount of Rs. 780 crores (or by 9.8 per cent). (During the 1971-72 busy season, bank deposits had increased by Rs. 624 crores or by 9.4 per cent.) The highly comfortable resource position of the banks was reflected in the fact that the credit-deposit ratio at 70.4 per cent at the end of the 1972-73 busy season, after rising by 4.2 percentage points since the beginning of the season, was only a shade lower than at the end of the 1971-72 busy season. The bulk of additional resources represented by deposit accretions were utilised by banks for increasing the volume of credit to the commercial sector. Scheduled commercial banks' investments in Government and other approved securities in the 1972-73 busy season increased only marginally (by Rs. 6 crores as compared to an increase of Rs. 241 crores in the 1971-72 busy season). In consequence, the investment-deposit ratio which stood at 36.3 per cent at the beginning of the season declined to 33.2 per cent at the end of the busy season. There was also a noticeable shift in banks' preference from Government securities to other approved securities; investments in the former showed a decline of Rs. 87 crores while investments in the latter went up by Rs. 93 crores (compared to an increase of Rs. 144 crores in Government securities and Rs. 97 crores in other approved securities in the 1971-72 busy season).

6.12 The comfortable liquidity position of the commercial banks during the 1972-73 busy season is also evident from the movements in the inter-bank call rate. After fluctuating between 3.5 to 4 per cent until mid-February, 1973, the inter-bank call rate touched the peak of 7.5 per cent on February 21, 1973. But this was still lower than the peak level of 9.75 per cent reached in the preceding busy season.

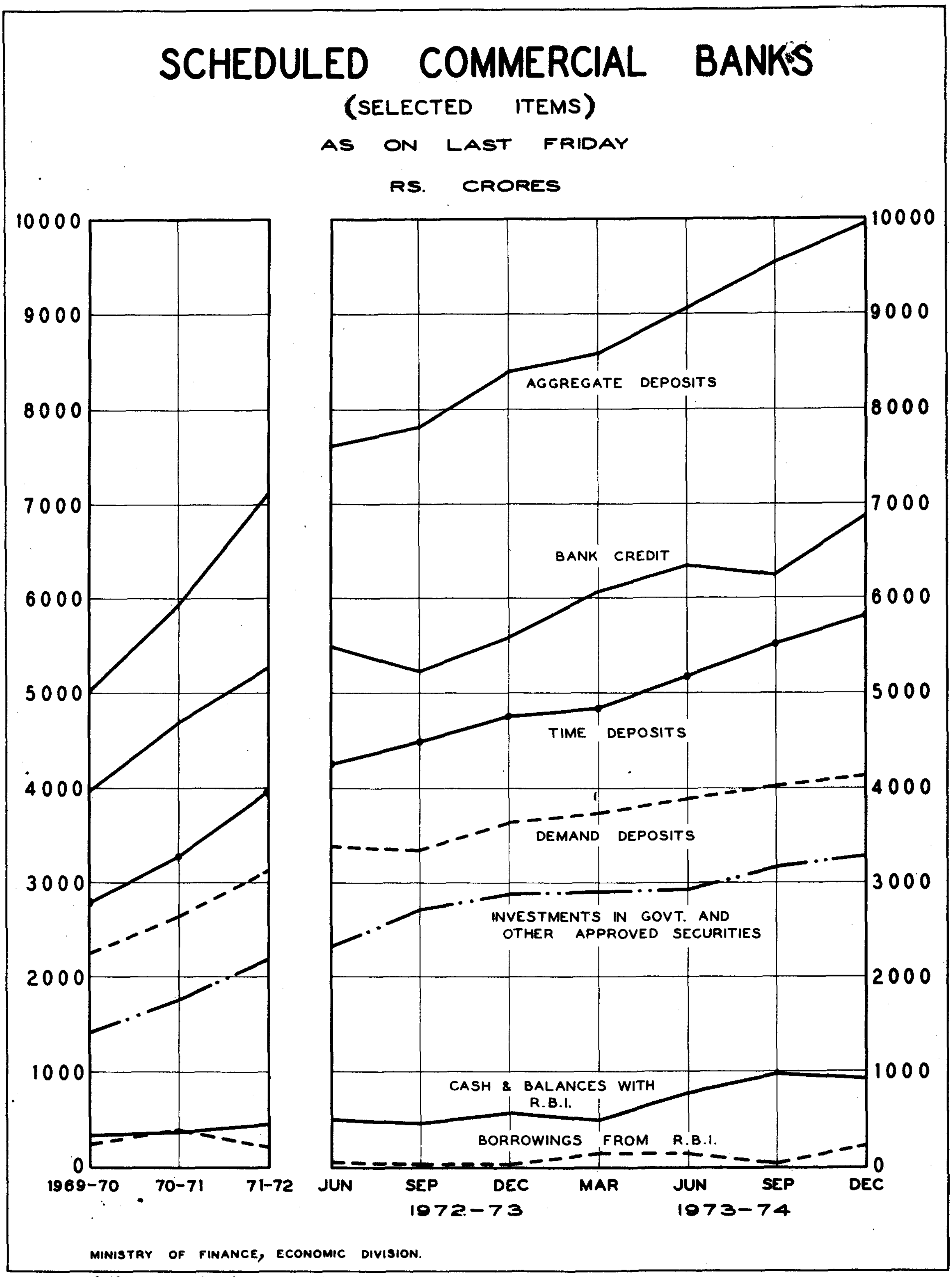
6.13 A notable feature of bank credit in recent years has been the contra-seasonal expansion of credit in the so-called slack season. Thus, the distinction between the busy season and the slack season now lies not so much in the fact that the latter witnesses an absolute contraction in credit but rather in a lower (though positive) rate of growth of credit in the slack season as compared to the busy season. It is of course to be expected that as industrialisation progresses, the traditional distinction between the busy and slack reason will get more and more blurred.

6.14 The 1973 slack season recorded a significant expansion of bank credit by Rs. 265 crores (as compared to an increase of Rs. 67 crores in the 1972 slack season). The entire expansion in credit during the 1973 slack season was on account of non-food advances which increased by Rs. 326 crores. Food procurement advances, on the other hand, declined by Rs. 61 crores. The major part of the increase in bank credit took place after September 7, 1973; and between that date and end October, 1973, non-food advances increased by Rs. 322 crores as against Rs. 100 crores in the corresponding period of the preceding slack season, thereby indicating an earlier start of the 1973-74 busy season.

6.15 Bank deposits increased by Rs. 886 crores (or by 10.2 per cent) during the 1973 slack season as compared to an increase of Rs. 705 crores (or 9.7 per cent) in the 1972 slack season. As a result, notwithstanding a much faster expansion of bank credit during the 1973 slack season, the credit-deposit ratio at the end of the season at 66.6 per cent was only marginally higher than a year earlier.

6.16 Consequence to the Reserve Bank's decision to raise the statutory cash reserve ratio from 3 per cent to 7 per cent in stages, banks' cash balances, including balances with the Reserve Bank, showed a sharp increase of Rs. 460 crores in the 1973 slack season as compared to an increase of Rs. 51 crores in the slack season of 1972. Despite this impounding, bank credit went up significantly during the 1973 slack season. This was no doubt facilitated by the rapid growth of bank deposits. Besides, contrary to the well-established past trend of a net decline in commercial banks' borrowings from the Reserve Bank in the slack season, these borrowings increased by Rs. 56 crores in the 1973 slack season (as against a decline of Rs. 16 crores in the preceding slack season). In addition, there was reduced interest on the part of banks in investments in Government and other approved securities. The observed increase in banks' investments in these securities at Rs. 262 crores in the 1973 slack season was much smaller than the increase of Rs. 618 crores registered in the 1972 slack season. As a result, the investment-deposit ratio declined from 36.3 per cent at the end of October 1972 to 32.8 per cent at the end of October 1973.

6.17 During the current busy season so far (October 26, 1973 to January 25, 1974), bank credit expanded by Rs. 590 crores as compared to the expansion of Rs. 338 crores in the corresponding period of the 1972-73 busy season. Credit for food procurement operations increased by Rs. 143 crores as against a decline of Rs. 89 crores in the corresponding period of the last busy season. In addition, there was also an increase in non-food credit at Rs. 447 crores which was more than the increase of Rs. 427 crores recorded in the corresponding period of the last busy season. The accretion to aggregate bank deposits at Rs. 490 crores during the period end October, 1973 to end January, 1974 was more than the increase of Rs. 377 crores recorded in the same period of the preceding busy season. Even then, in order to meet the increased requirements of credit, banks had to resort to borrowing from the Reserve Bank on a substantial scale which went up by Rs. 149 crores whereas there was no such borrowing during the corresponding period of the last busy season. Banks have also availed of a significant volume of rediscounting facilities from the Reserve Bank under the New Bill Market Scheme. As on January 25, 1974, such rediscounting totalled Rs. 114 crores in the current busy season.


SCHEDULED COMMERCIAL BANKS
(SELECTED ITEMS)
AS ON LAST FRIDAY
RS. CRORES
AGGREGATE DEPOSITS
BANK CREDIT
TIME DEPOSITS
DEMAND DEPOSITS
INVESTMENTS IN GOVT. AND OTHER APPROVED SECURITIES
CASH & BALANCES WITH R.B.I.
BORROWINGS FROM R.B.I.
0
1000
2000
3000
4000
5000
6000
7000
8000
9000
10000
1969-70
70-71
71-72
JUN
SEP
DEC
MAR
JUN
SEP
DEC
1972-73
1973-74
MINISTRY OF FINANCE, ECONOMIC DIVISION.

6.18 The current busy season has witnessed a further expansion of money supply with the public. Thus the observed increase of Rs. 407 crores in money supply with the public during the period end October, 1973 to end January, 1974 was marginally lower than the increase of Rs. 442 crores in the same period of the last busy season. Net bank credit to the commercial sector has played a more significant role in the expansion of money supply during the current busy season than in the corresponding period of the last busy season. Thus, net bank credit to the commercial sector went up by Rs. 359 crores as compared to an increase of only Rs. 234 crores in the same period of 1972-73 busy season. At the same time, net bank credit to Government rose by only Rs. 58 crores as compared to an increase of Rs. 267 crores in the same period in the previous busy season. This was the net result of a small increase of Rs. 3 crores in Reserve Bank credit to Government and an increase of Rs. 55 crores in commercial banks' investments which was in direct contrast to the movement in these variables in the last busy season. The larger decline in the net foreign exchange assets of the banking system during the current busy season (Rs. 56 crores as against a decline of only Rs. 2 crores in the corresponding period of the 1972-73 busy season) has also helped to moderate the expansion of money supply.

TABLE 6.2

Seasonal Variations in Scheduled Commercial Banks' Data

(Rs. crores)

	Salck Season			Busy Season				
	1971	1972	1973*	1970-71	1971-72	1972-73*	1972-73 (Oct. 27, to Jan. 26)*	1973-74 (Oct. 26, to Jan. 25)*
1. Total Bank Credit	163	67	265	394	355	878	338	590
of which:								
(a) Food Procurement Advances	156	—1	—61	70	—71	6	—89	143
(b) Other Advances	7	69	326	324	426	872	427	447
2. Aggregate Deposits	624	705	886	435	624	780	377	490
(a) Demand Deposits	202	262	274	190	310	325	121	195
(b) Time Deposits	422	443	612	245	314	455	256	295
3. Investments in Government and other approved securities	254	618	262	115	241	6	—67	133
(a) Government securities	209	519	173	39	144	—87	—	55
(b) Other approved securities	45	99	89	76	97	93	67	78
4. Borrowings from the Reserve Bank of India	—172	—16	56	40	4	18	—	149

*Provisional.

Note. The slack season is from May to October and the busy season is from November to April.

Development in Credit Policy

6.19 In view of the severe inflationary pressures in the economy in recent years, the Reserve Bank of India has sought to pursue a fairly restrictive credit policy, consistent with the need to maximise production. Reference was made in the last year's Economic Survey to the raising in 1972 of the minimum net liquidity ratio, relevant for banks' borrowings from the Reserve Bank, from 34 to 36 per cent. Along with this measure, which was designed to raise the cost of refinancing and thereby discourage commercial banks' recourse to the Reserve Bank, the statutory liquidity requirement of scheduled commercial banks was also raised from 29 to 30 per cent so as to reduce the availability of resources to banks for lending to the commercial sector. Selective credit controls were also tightened to restrain bank advances against foodgrains and vegetable oils and oilseeds and credit limits were stipulated on a party-wise instead of bank-wise basis. This measure made it obligatory on the part of banks to get clearance from the Reserve Bank not only on proposals for advancing loans to new parties but also for increasing credit availability to existing parties. In order to discourage banks from indulging in interest-rate cutting competition in order to attract big customers, the Reserve Bank made it incumbent on banks to obtain its prior permission for transfer of accounts of Rs. 25 lakhs and above from one bank to another.

6.20 In view of the unusually large increase in noon-food bank credit in January-March 1973, as revealed by the mid-term review of credit policy for the 1972-73 busy season, the Reserve Bank considered it necessary to make the policy somewhat more restrictive. Along with some minor adjustments in deposit rates, with effect from April 1, 1973, the Reserve Bank sought to further discourage banks' recourse to it by raising the net liquidity ratio from 36 to 37 per cent. However, the maximum penal rate of interest on borrowings from the Reserve Bank was reduced from 15 per cent to 12 per cent. In view of the increasing reliance of various public sector and quasi-Government undertakings, such as Electricity Boards, on commercial banks, advances to such units, which were hitherto exempt from prior authorisation by the Reserve Bank under the Credit Authorisation Scheme, were brought under the scheme. Prior authorisation in respect of advances to all public sector undertakings was made obligatory for all working capital loans totalling Rs. 3 crores and above, and for term loans of Rs. 1 crore and above. In addition, before providing loans to State Governments for their commercial/financial requirements, including those for food procurement, banks were asked to ensure that the approval of the Government of India was obtained by the concerned State Governments under Article 293(3) of the Constitution. However, in order to facilitate food procurement, the refinancing facility for such advances was further liberalised by permitting banks to draw one-half, as against the then existing limit of one-third, of incremental credit over the level of last Friday of October 1972, in addition to 10 per cent of the outstanding level of such credit on that date.

6.21 In the background of continued strong upsurge of inflationary pressures and large expansion in bank credit during the busy season 1972-73, the Reserve Bank undertook several additional measures in the slack season of 1973, designed to curtail the use of its resources by banks for expansion of credit. Thus, the Bank Rate was raised by one percentage point to 7 per cent effective May 31, 1973. To reinforce the restrictive effect of higher Bank Rate, the minimum net liquidity ratio was raised from 37 per cent to 39 per cent effective from June 29, 1973 and the rate of interest to be charged on borrowings from the Reserve Bank was raised from 7 per cent to 8 per cent for a fall of one percentage point or fraction thereof in the net liquidity ratio below 39 per cent; thereafter for every fall of one percentage point or fraction thereof in the net liquidity ratio, the rate of interest would increase by 1 per cent until the maximum of 12 per cent was reached. The net liquidity ratio was further raised to 40 per cent from September 8, 1973. Since the minimum net liquidity ratio was higher than the statutory liquidity requirement, banks seeking financial assistance from the Reserve Bank had perforce to invest a higher proportion of their funds in the prescribed assets. In order to add to the effectiveness of the NLR mechanism, the Reserve Bank also withdrew the concessionary refinance entitlement at Bank Rate or below from July 13, 1973 with the exception only of (a) a limited amount of refinancing of export credit and (b) refinancing of amounts lent to primary credit societies and farmers' service societies. Borrowings against these entitlements, however, impaired the net liquidity ratio, thereby increasing the cost of further borrowing.

6.22 Concurrently with changes in the net liquidity ratio, the Reserve Bank revised the interest rates charged on certain categories of refinance available to banks accordingly. Thus, the minimum rate charged under the Bills Rediscounting Scheme was increased to 8 per cent from June, 1973. The interest rate for refinance against export credit was raised from 4.5 per cent to 5.5 per cent up to an amount equal to 10 per cent of the annual average of export credit in the previous calender year irrespective of a bank's net liquidity radio. The rates of interest charged by the Reserve Bank on advances to State cooperative banks were also adjusted in line with the new Bank Rate.

6.23 The Reserve Bank also brought into operation in 1973 the power conferred on it to vary the cash reserve ratio to be maintained with it by every scheduled commercial bank. This ratio was initially raised from the then existing (minimum) level of 3 per cent to 5 per cent of a bank's total demand and time liabilities from June 29, 1973. There was a further increase in two stages; by 1 percentage point to 6 per cent with effect from September 8, 1973 and further to 7 per cent from September 22, 1973 for a period of one year. The banks would be paid interest at the rate of 4.75 per cent per annum on additional reserves maintained by them with the Reserve Bank over and above the level of 3 per cent. The deployment of the technique of variable cash reserve ratio immobilised slightly over Rs. 400 crores of commercial banks' resources by the end of September 1973.

6.24 With a view to imparting greater discipline in the use of credit, a minimum lendig rate of 10 per cent was prescribed for all bank lendings from June 1,1973 with only a few exemptions namely, (a) advances covered by the Credit Guarantee Scheme; (b) advances against exports; (c) loans to primary cooperative societies; (d) loans for public sector food procurement, storage and distribution; and (e) loans under the Differential Interest Rates Scheme.

6.25 With the takeover of wholesale trade in wheat by Government, advances to wholesale traders in wheat were completely banned. In addition, banks operating in the main wheat producing States were advised on May 15, 1973 to undertake a special review of credit limits exceeding Rs. 20,000 against wheat to private parties so as to ensure that these limits were cancelled in the case of wholesale traders and appropriately fixed in the case of licensed retail traders. Restrictions, earlier imposed, on credit made available by banks to jute mills for holding of stocks were withdrawn, and with the larger availability of raw jute, scheduled commercial banks operating in the Eastern region were allowed from October 31, 1973 to finance inventories of raw jute with jute mills on merit up to a maximum of 4 months' consumption and finished goods equivalent to 6 weeks' sales.

6.26 As pointed out earlier, notwithstanding the greater use of the NLR mechanism and impounding of a part of bank deposits, the slack season of 1973 did not witness the usual seasonal return flow of credit, and in fact there was an unusually large expansion in bank credit in the months of September and October. It is clear that in a situation where bank deposits are increasing rapidly, the NLR mechanism can have an extremely limited effect on the banks' ability and willingness to expand credit, as ultimately, any measure to restrict access of commercial banks to the Reserve Bank can be effective only to the extent that banks cannot finance additional credit out of their own resources. This is equally true of the technique of variable cash reserve ratio unless this ratio is adjusted frequently.

6.27 It is perhaps in recognition of this fact that the Reserve Bank decided on November 16, 1973 to indicate quantitative limits for the expansion of bank credit to the commercial sector (excluding advances for food procurement) during the busy season of 1973-74. Thus, commercial banks were informed that on account of acute inflationary pressures in the economy, credit expansion in sectors other than food procurement in the conventional busy season (end-October to end-April) of 1973-74 should not exceed Rs. 400 to 450 crores. The Reserve Bank also announced that if banks resource position improved to a point so as to threaten an expansion of credit beyond this ceiling, further measures, such as impounding of additional deposits, would be taken. In order to ensure that credit to the commercial sector did not expand unduly at the cost of banks' investments in Government securities, the statutory liquidity requirement was raised from 30 to 32 per cent with effect from December 8, 1973. Banks were also informed that hereafter, recourse to refinance by the Reserve Bank should not be regarded as automatic even within the ambit of net liquidity ratio system and the maximum rate chargeable for such borrowings was increased from 12 to 15 per cent. In addition, banks were told on November 30, 1973 that ordinarily borrowings from the Reserve Bank would not exceed the following ceilings :—

(a) 1.5 per cent of a bank's total demand and time liabilities as on September 28, 1973 for the period between December 8, 1973 and January 11, 1974;

(b) 2 per cent of a bank's total demand and time liabilities as on September 28, 1973 for the period between January 12, 1974 and April 5, 1974; and

(c) 1 per cent of a bank's total demand and time liabilities as on September 28, 1973 for the period between April 6 and May 31, 1974.

This meant that scheduled commercial banks' borrowings from the Reserve Bank (inclusive of refinance entitlements for export credit, lending to primary co-operatives and farmers' service societies and for advances granted for public food procurement operations), could not ordinarily exceed Rs. 143 crores between December 8, 1973 and January 11, 1974; Rs. 191 crores between January 12 and April 5, 1974; and Rs. 95 crores between April 6 and May 31, 1974.

6.28 In addition to these measures, the Reserve Bank raised the minimum lending rate chargeable by banks from 10 per cent to 11 per cent, effective December 1, 1973. Earlier on November 16, 1973 the Bank announced that exemption from the minimum lending rate would be restricted only to individual small-scale industrial units with limits from a bank totalling less than Rs. 2 lakhs and individual agricultural borrowers with limits not exceeding Rs. 50,000. The restrictions imposed on small-scale industries have since been rescinded and commercial banks were also advised not to apply the norms relating to margins on advances laid down in respect of units covered by the Credit Guarantee Scheme. In the case of exports, while the maximum rate chargeable on deferred payment terms was retained at 6 per cent, for all other export credits the rate was increased from 7 to 8 per cent.

6.29 The busy season credit policy also contained certain modifications in the selective credit controls. The minimum lending rate for commodities covered by these controls was raised in most cases from 12 per cent to 13 per cent and the peak level of credit admissible in respect of all commodities covered under the scheme with the exception of sugar, gur and khandsari was linked to three preceding years i.e., 1970-71 to 1972-73 instead of three preceding seasons. In view of the takeover of wholesale trade in rice by the Assam Government, advances to traders against paddy/rice were banned except to dealers in paddy/rice authorised by the State Government. Advances against imported cotton and imported oilseeds/oils, which were exempt from the scheme of selective credit controls, as also advances against finished goods and stocks in process of cotton textiles including yarn and fabrics and yarn made out of man-made fibres, were brought within the purview of the scheme. Margins were increased in respect of processing units and for traders a margin of 40 per cent was stipulated along with a minimum lending rate of 13 per cent. The minimum margin on advances to the sugar industry was raised from 10 per cent to 15 per cent for levy sugar and from 15 per cent to 25 per cent for free sale sugar. The minimum rate of interest on advances to sugar mills against free sale sugar not released from factories was fixed at 12 per cent and the rate on advances against free sale sugar released would be 13 per cent. Certain reductions in margins in respect of castorseed/linseed were also made as an export promotion measure.

6.30 Despite these measures, credit expansion in the first few months of the current busy season has been quite fast. In the process, banks' liquidity has been under strain. The Reserve Bank has continued to operate its policy with due flexibility so as to ensure that genuine credit needs for production are adequately met. It has thus allowed banks short-term discretionary refinance when this has been required. Further, on January 11, 1974, the Reserve Bank announced its decision to exempt export credit from the quantitative ceiling on credit expansion and also to provide increased refinance facilities for export credit. Thus, the expansion in export credit over the average level of such credit during the period January—September 1973 will henceforward not be included in the aggregate non-food credit ceiling fixed earlier. On a rough basis, this involves an increase of Rs. 100 crores in the overall credit ceiling for the busy season announced earlier. Banks will also be provided with increased refinance facilities on a discretionary basis after a review of their performance in export sector and the sectoral deployment of credit. Such refinance assistance, though linked to export credit, would no doubt enable banks to meet the genuine demand for credit on a somewhat more liberal basis than before.

6.31 What will be the likely expansion of bank credit to the non-food commercial sector during the current busy season is difficult to assess at the present stage. The fact that non-food credit expanded by Rs. 447 crores between end-October, 1973 and end-January, 1974 indicates that utmost vigilance will be needed in the coming months in order to contain the expansion of credit within the overall ceiling fixed for the busy season. The experience of the preceding four years suggests not only that the period January to April usually witnesses a sizeable expansion of credit, but also that the increase during this period is often larger than during end-October to end-December. Thus, if the genuine needs of credit are to be met without upsetting the aggregate ceiling, there will have to be considerable redeployment of outstanding credit. In recognition of this fact, the Reserve Bank advised banks on January 11, 1974 to undertake a careful review of all recent drawings of substantial amounts and to recall funds where there was evidence that money had been drawn in advance of immediate needs. Banks were also asked to ensure that the return flow of substantial funds made available by them in December 1973 for making tax payments was accelerated. The experience of the current busy season has highlighted the need for a well thought out sectoral deployment of credit especially in the context of an overall quantitative restriction on credit expansion. Following the directions and guidelines given by the Reserve Bank, there should be greater effort on the part of individual banks to formulate appropriate credit plans at micro level in order to translate the policies fully into meaningful action. With such follow-up efforts on the part of banks, it should be possible to ensure that essential sectors of the economy are not denied their legitimate credit requirements, within the overall quantitative ceiling of credit expansion.

Credit Policy : Some Limitations

6.32 The foregoing review of credit policy since November 1972 brings out the inherent difficulties that arise in successful implementation of a restrictive credit policy when accompanied by increased Government expenditure. Increased Government outlays financed by budgetary deficits directly add to the pressure of domestic demand and also increase the liquidity of the economy. When business firms expect prices to rise significantly, an increase in the cost of bank credit, brought about either by an increase in minimum lending rate or by higher cost of refinance provided to commercial banks by the Reserve Bank, cannot by itself exercise a strong restraining influence on the demand for bank credit. In any case, in so far as budget deficits inflate the growth of bank deposits, restrictions on refinance facilities are unlikely to be very successful in reducing banks' incentive and ability to expand credit. Mopping up of additional deposits with banks by increasing the statutory cash reserve ratio or the statutory liquidity requirement offers considerable potentialities for restricting the expansion of bank credit. However, a progressive increase in either of the two, unaccompanied by a suitable upward revision in the interest rates payable either on impounded reserves or on Government securities, is likely to greatly affect the profits of commercial banks. Although profitability of commercial banks can never be an overriding consideration in the conduct of monetary policy, one cannot be indifferent to a sustained decline in bank profits associated with a particular technique of monetary control. In theory, quantitative selective controls appear very attractive. However, apart from their inherent administrative complexity, their effectiveness in controlling prices of sensitive agricultural commodities like foodgrains, vegetable oils, and raw coton is limited by the fact that, thanks to a progressive tightening of the structure of selective credit controls in recent years, bank credit now does not play a very significant role in financing private trading activities in many of these commodities. Simultaneously, with the progressive expansion of the role of the public sector trading agencies whose activities have to be financed with the help of bank credit, the scope for a flexible operation of credit policy without affecting the growth of productive sectors also gets diminished.