CHAPTER 6

MONETARY TRENDS AND CREDIT POLICY

6.1 In the sphere of monetary policy, the current year was characterised by a considerable slowing down in expansion of money supply, an increase in the entire structure of interest rates and a more effective restraint on growth of bank credit, thus helping to keep the growth of demand within the economy under check. Although there is no precise correlation between the rate of growth of money supply and prices, the exercise of greater monetary discipline thus far in 1974-75 has helped to reduce the strength of inflationary forces operating in the economy.

6.2 The growth of money supply went up steeply in the period covered by the Fourth Plan. After 1971-72, the gap between the growth rate of real national income and of money supply with the public widened considerably. From an average of 8.6 per cent in the two years, 1967-68 to 1968-69, the money supply increased by 10.8 per cent in 1969-70 and by 11.2 per cent in 1970-71. In 1971-72, an increase of money supply by 13.1 per cent was accompanied by a steep fall in national income growth, from 4.9 per cent in 1970-71 to 1.4 per cent in 1971-72. There was a further increase in money supply by 15.9 per cent in 1972-73 when the rate of growth of national income was negative. In 1973-74, the rate of increase in money supply was still 15.3 per cent but this was accompanied by a moderate improvement in growth of 3.1 per cent in national income. In 1974-75 so far, the rate of increase in money supply was 4.3 per cent between March 31, 1974 and January 17, 1975 as compared with the increase of 9.4 per cent in the corresponding period of the previous year. This signifies a visible reduction in the rate of growth of money supply even though it has been accompanied by expectations of almost no growth in the economy in the current year. The trend in the rate of growth of monetary resources, which includes money supply with the public and time deposits, has also been similar to that of money supply. In the current financial year up to January 17, 1975, the expansion of aggregate monetary resources was 8.6 per cent compared to 13.9 per cent in the corresponding period of the previous year.

6.3 Since 1961-62, the proportion of currency in total money supply has shown a declining trend. From 72.2 per cent at the end of 1961-62, the percentage of currency to money supply with the public came down to an average level of 62.1 per cent in the three years, 1968-69 to 1970-71 and further declined to an average of 58.5 per cent in the subsequent three years, 1971-72 to 1973-74. As on January 17, 1975, the percentage of currency to money supply came down to 55.7 per cent as compared to 58.0 per cent a year ago. There has been an absolute decline of Rs. 34 crores (0.5 per cent) in currency with the public during the current financial year till January 17, 1975 in contrast to an increase of Rs. 518 crores (9.5 per cent) during the corresponding period in the previous year. The progressive decline in the ratio of currency to money supply over the last few years has resulted in raising the value of money multiplier and this has increased the magnitude of expansionary impulses associated with any given level of deficit financing.

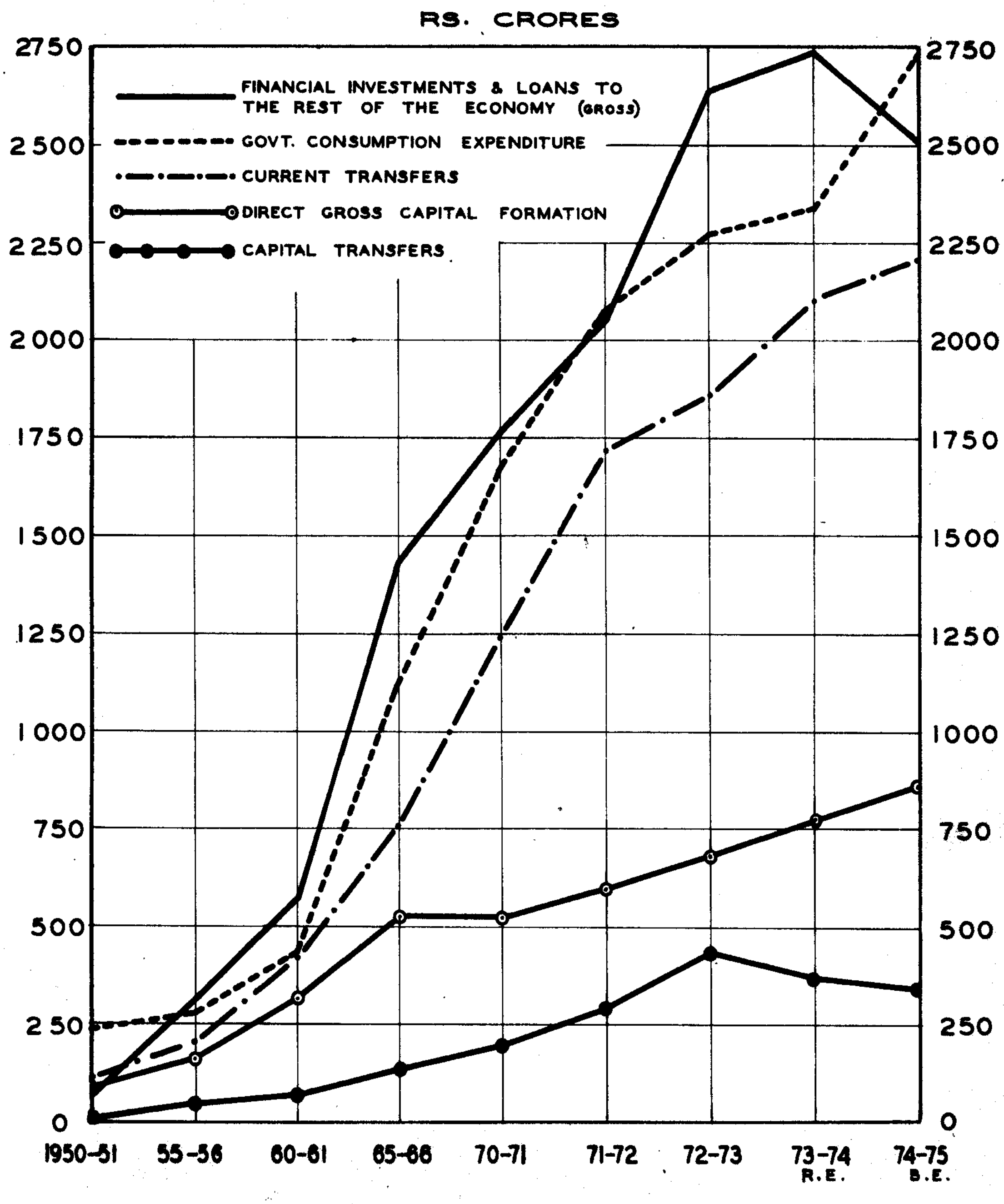
TABLE 6.1

Growth in money supply and monetary resources

Year (end of the period)	Increase in money supply with the public		Increase in monetary resources		Currency as percentage of money supply
	Rs. crores	Percentage	Rs. crores	Percentage	
1961-62	188	6.6	295	7.4	72.2
1968-69	437	8.1	854	11.4	63.1
1969-70	632	10.8	1035	12.4	62.1
1970-71	723	11.2	1244	13.2	61.0
1971-72	945	13.1	1665	15.6	59.3
1972-73	1291	15.9	2178	17.7	57.9
1973-74	1446	15.3	2506	17.3	58.4
1974-75 (Till Jan. 17, 1975)	468	4.3	1464	8.6	55.7
1973-74 (Till Jan. 18, 1974)	887	9.4	2017	13.9	58.0

CENTRAL GOVERNMENT EXPENDITURE

(ECONOMIC CATEGORIES)



MINISTRY OF FINANCE, ECONOMIC DIVISION.

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Factors Affecting Money Supply

6.4 In 1971-72 and 1972-73, the increase in net bank credit to Government was mainly responsible for the increase in money supply. In 1973-74, the increase of 22.0 per cent in bank credit to commercial sector was the most important factor which contributed to the increase in money supply, even though there were also considerable additions to foreign exchange assets of the banking sector and to net bank credit to Government. During 1974-75 so far (till January 17, 1975), the decline in the rate of growth of money supply was made possible mainly by a slow down in the expansion of bank credit to commercial sector. The slow down in the rate of growth in net bank credit to Government also helped to moderate the expansion of money supply in the current year.

6.5 Another important factor which has contributed to the recent decline in the pace of expansion of money supply is the sizeable fall in net foreign exchange assets of the banking sector. The increase in Government's net currency liability representing rupee notes, rupee coins and small coins with the public, has also been lower in 1974-75 so far compared to last year. However, the contractionary effect of the non-monetary liabilities which include time deposits of the banking sector was lower in the current financial year compared to the previous year.

6.6 The increase in net Reserve Bank of India credit to Government (Centre and States) has amounted to Rs. 627 crores during the current financial year (March 31, 1974 to January 17, 1975) as compared to an increase of Rs. 821 crores in the corresponding period of the previous year. The net R.B.I. credit to Central Government increased by Rs. 617 crores and to State Governments by Rs. 10 crores during the current financial year so far (till January 17, 1975) as compared to the increases of Rs. 754 crores and Rs. 67 crores for the Central and State Governments respectively in the corresponding period of the previous year. Restraints on budgetary expenditure have contributed to the lower rate of growth in net R.B.I. credit to Government. Net R.B.I. credit to State Governments has shown a smaller increase in the current financial year due mainly to higher devolution of funds from the Central Government in terms of the Award of the Sixth Finance Commission and increase in the States' resource mobilisation efforts.

6.7 With the increase in the statutory liquidity ratios of the scheduled commercial banks, details of which are given later in this chapter, the increase in commercial banks' credit to Government in the form of investments in Government securities (including treasury bills) has amounted to Rs. 438 crores in the current financial year till January 17, 1975 which is considerably more than the level of Rs. 210 crores in the corresponding period of the previous year. It is thus obvious that the overall contraction in the rate of growth of bank credit to Government has been due entirely to a decline in the rate of growth of R.B.I. credit to Government.

6.8 The increase in bank credit to commercial sector of Rs. 915 crores or 9.8 per cent till January 17, 1975 in the financial year 1974-75 has been markedly lower than the increase of Rs. 1362 crores or 17.7 per cent in the corresponding period of the previous year. Till July 1974, bank credit to commercial sector was showing a higher rate of increase; the increase during the first four months of 1974-75 (April to July) was Rs. 563 crores compared to an increase of Rs. 69 crores in the corresponding months of 1973-74. As a result of a package of credit control measures introduced in July 1974, which are discussed later on, bank credit to commercial sector showed an increase of Rs. 352 crores since the last Friday of July, 1974 till January 17, 1975 as compared to an increase of Rs. 1293 crores in the corresponding period of the previous year. An important factor responsible for the decline in the rate of growth of bank credit to commercial sector during 1974-75 so far, has been the steep decline in R.B.I. credit in the form of bills rediscounted under the new bill market scheme, after July 1974. There was also a deceleration in the rate of growth in other banks' credit to commercial sector since July 1974.

Seasonal Variations in Bank Credit

6.9 During the busy season of 1973-74, scheduled commercial banks' credit expanded by a record figure of Rs. 1109 crores, including Rs. 188 crores by way of food procurement advances and Rs. 921 crores of other advances. In addition, bills rediscounted under the new bill market scheme increased by Rs. 244 crores against an increase of only Rs. 19 crores in the busy season of 1972-73. Thus, the gross credit (including bills rediscounted) increased by as much as Rs. 1353 crores (20.7 per cent) during the busy season of 1973-74 compared to Rs. 916 crores (17.4 per cent) in the busy season of 1972-73. On the other hand, the growth of aggregate deposits of scheduled commercial banks decelerated to Rs. 670 crores (6.9 per cent) in the busy season of 1973-74 compared to Rs. 811 crores (10.2 per cent) in the busy season of 1972-73. In particular, time deposits showed a much smaller rate of increase of Rs. 266 crores (4.7 per cent) in the busy season of 1973-74 compared to Rs. 476 crores (10.5 per cent) in the busy season of 1972-73. The step up in the rate of growth of bank credit and slower rate of increase in bank deposits, particularly in the later half of the busy season i.e., from January, 1974 onwards, coupled with the enlargement in banks' investments in Government securities, necessitated a steep increase (Rs. 253 crores) in commercial banks' borrowings from R.B.I. and a decline of Rs. 217 crores in the banks' cash balances with R.B.I. during the busy season of 1973-74.

6.10 The liquidity position of scheduled commercial banks thus became tight during the busy season of 1973-74 due to slower rate of growth of bank deposits, monetary measures taken by the R.B.I. which called upon the banks to increase their investments in

Government and other approved securities and the spurt in demand for bank credit arising from hike in domestic and international prices, energy crisis and higher demand for credit from priority sectors, export credit and requirements of public sector enterprises.

6.11 The uptrend in bank credit continued in the first half of the 1974 slack season (May to July) when bank credit expanded by Rs. 240 crores compared to an increase of Rs. 117 crores during the corresponding period of the 1973 slack season. Advances for food procurement showed a lower order of increase of Rs. 58 crores during this period as compared to an increase of Rs. 98 crores in the corresponding period of 1973. However, bills rediscounted declined by Rs. 35 crores in the first half of the 1974 slack season compared to a smaller decline of Rs. 10 crores in the corresponding period of the 1973 slack season.

6.12 Consequent to credit restraint measures taken in July, 1974, scheduled commercial banks' credit declined in absolute terms by Rs. 147 crores between the last Fridays of July and October, 1974—the later half of the 1974 slack season—in contrast to an increase of Rs. 229 crores in the corresponding period of last year. Advances for food pdocurement declined by Rs. 227 crores during the later half of the 1974 slack season against a smaller decline of Rs. 156 crores during the corresponding period of the previous slack season. Bills rediscounted also showed a marked decline of Rs. 136 crores whereas in the corresponding period of the 1973 slack season there was an increase of Rs. 25 crores in bills rediscounted.

6.13 Thus, during the 1974 slack season as a whole, gross bank credit of the scheduled commercial banks declined by Rs. 78 crores (including a decline of Rs. 171 crores in bills rediscounted) compared to an increase of Rs. 361 crores in the slack season of 1973. Advances for food procurement declined significantly by Rs. 169 crores during the slack season of 1974 compared to a decline of Rs. 58 crores in the slack season of 1973. Gross bank credit, including bills rediscounted but excluding advances for food procurement, increased by Rs. 91 crores during the slack season of 1974 compared to an increase of Rs. 419 crores in the slack season of 1973.

6.14 The deceleration in the rate of growth of bank deposits, which started in the busy season of 1973-74, continued during the slack season of 1974. The overall deposit growth of Rs. 880 crores or 8.5 per cent during the 1974 slack season was lower than the growth in bank deposits of Rs. 899 crores or 10.3 per cent in the slack season of 1973. The rate of increase in time deposits declined appreciably from 12.9 per cent in the slack season of 1973 to 9.5 per cent in the slack season of 1974; the rate of increase in demand deposits of 7.2 per cent in the slack season of 1974 was still higher than the rate of increase of 6.7 per cent in the 1973 slack season.

6.15. The increase in interest rates offered on term deposits towards the end of July 1974, on top of the general increase in interest rates on savings and term deposits from April 1, 1974, did not result in increasing the rate of growth in aggregate deposits, although there was a marked shift from demand deposits to time deposits after July 1974. During the latter half of the 1974 slack season, while time deposits increased by Rs. 292 crores demand deposits declined by Rs. 2 crores.

6.16. During the current busy season so far (October 25, 1974 to January 17, 1975), scheduled commercial banks' credit has expanded by Rs. 372 crores as compared to the expansion of Rs. 518 crores in the corresponding period of the previous year. Credit for food procurement has declined by Rs. 37 crores in contrast to an increase of Rs. 136 crores in the corresponding period of the last busy season. The non-food credit has thus increased by Rs. 409 crores in the current busy season till January 17, 1975 compared to an increase of Rs. 382 crores in the corresponding period last year. There has been an acceleration in the pace of expansion of bank credit since mid-December 1974. If this tendency persists, expansion of non-food bank credit during the current busy season may exceed the unduly large increase that took place in the last busy season. As such, the situation needs to be kept under close observation.

6.17. Accretion to bank deposits at Rs. 411 crores during the period end October 1974 to January 17, 1975 is also about the same as that of Rs. 422 crores recorded in the corresponding period of the previous busy season. The deposit growth rate has generally improved since the third week of December, 1974.

6.18. Since the beginning of the current financial year, aggregate deposits of the scheduled commercial banks have shown an increase of Rs. 1446 crores or 14.2 per cent (till January 17, 1975) compared to an increase of Rs. 1480 crores or 17.2 per cent during the corresponding period in the previous year. The increase in interest rates on term deposits in July, 1974 has led to a shift in asset preferences of the depositors towards time deposits to some extent. It also appears that the availability of more attractive interest rates on company deposits have induced some depositors to switch over from bank deposits to company deposits.

6.19. Expansion of money supply of Rs. 320 crores (2.9 per cent) during the current busy season (October 25, 1974 to January 17, 1975) has been lower than the increase of Rs. 387 crores (3.9 per cent) in the same period of the last busy season. The increase in bank credit to commercial sector amounted to Rs. 538 crores as compared to Rs. 845 crores in the corresponding period of the last busy season. Net bank credit to Government has increased by Rs. 260 crores between October 25, 1974 and January 17, 1975 compared to an increase of Rs. 43 crores in the same period of the previous busy season. The contractionary effect of the decline in net foreign exchange assets of the banking sector has gone up to Rs. 204 crores in the current busy season so far compared to Rs. 76 crores over the same period in the previous year.

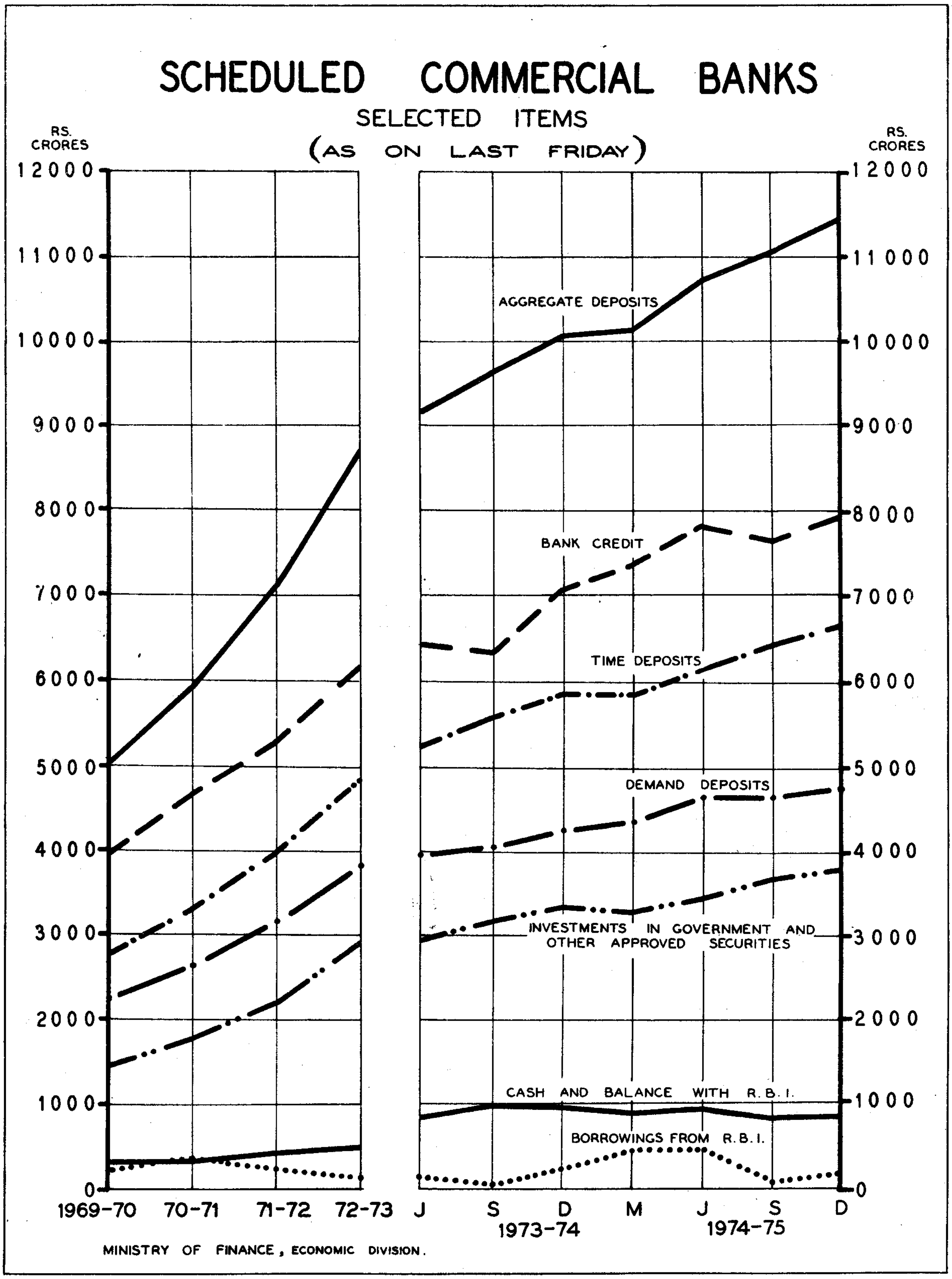

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TABLE 6.2

Seasonal variations in scheduled commercial banks' data

(Rs. crores)

	Slack season			Busy season				
	1972	1973	1974	1971-72	1972-73	1973-74	1973-74 (Oct. 26 to Jan.18)	1974-75 (Oct. 25 to Jan. 17)
1. Bank Credit Of which :	67	346	93	355	897	1109	518	372
(a) Food procurement advances	—1	—58	—169	—71	6	188	136	—37
(b) Other advances	68	404	262	426	891	921	382	409
2. Bills rediscounted under the new bill market scheme	—10	15	—171	—3	19	244	107	60
3. Aggregate deposits	705	899	880	624	811	670	422	411
(a) Demand deposits	262	252	316	310	335	404	195	144
(b) Time deposits	433	647	564	314	476	266	227	267
4. Borrowings from RBI	—16	56	—270	4	17	253	211	16
5. Deposits with RBI	30	419	92	14	40	—217	38	—92
6. Investments in Govt. and other approved securities	620	282	439	239	4	157	109	89
(a) Government securities	519	187	326	144	—89	73	35	47
(b) Other approved securities	101	95	113	95	93	84	74	42
7. Credit-deposit ratio (end of the period)	66.2	67.3	68.8	71.7	70.3	73.7	69.7	69.5
8. Investment-deposit ratio (end of the period)	36.3	32.9	33.6	31.3	33.0	32.2	32.6	33.2

6.20 Investment-deposit ratio of banks at 33.2 per cent on January 17, 1975 was higher by 0.6 percentage point compared to 32.6 per cent a year ago. The credit-deposit ratio at 69.5 per cent on January 17, 1975 is slightly lower than 69.7 per cent a year ago reflecting a marginal improvement in the banks' liquidity position so far.

6.21. Conditions in the money market indicated a relative easiness after July 10, 1974. The call money rate at Bombay which was ruling steady at the ceiling level of 15 per cent from December 14, 1973 till July 10, 1974, fluctuated widely thereafter. It touched the low level of 10 per cent on September 13, 1974 and again on November 8, 1974 and December 8, 1974, and in between, it fluctuated between 10 per cent and 15 per cent which is the ceiling under the inter-bank agreement reached on 14th December, 1973. Since October, 1974 call money rate was generally higher compared to last year but in the first week of November, the first month of the 1974-75 busy season, the rate was lower by 2-3 percentage points compared to the corresponding week of the previous year. However, as the busy season gathered momentum in the middle of December, 1974, the call money rate was maintained at the maximum permissible limit of 15 per cent between December 16, 1974 and January 3, 1975.

Developments in Credit Policy

6.22. As reported in the last year's *Economic Survey*, a number of measures were undertaken in 1973-74 to reduce the lendable resources of the commercial banks. These included an increase in statutory and net liquidity ratios and increase in statutory cash reserve to be kept with the Reserve Bank. In addition, there was an upward adjustment in lending rates. In the busy season of 1973-74 a ceiling on credit expansion was attempted for the first time. However, in the context of developments such as the energy crisis and the consequent demand from oil companies, the enhanced requirements of exports and other priority sectors and public sector undertakings, an attempt to adhere to the ceiling would have had adverse effects on the economy.

6.23. Keeping in view the lower order of deposit growth and a large expansion in credit in the previous busy season and in pursuance of the need for reducing the rate of increase in bank credit and of money supply, the Reserve Bank directed that during the slack season period of 1974-75, the banks should restrict credit expansion to 33 to 35 per cent of their aggregate deposit accretion. Since the additional cash reserve requirements of 2 per cent introduced in June, 1973 expired on June 28, 1974, the minimum of statutory liquidity requirements, under Section 24 of the Banking Regulation Act, was raised from 32 per cent of total demand and time liabilities to 33 per cent with effect from July 1, 1974. Another 2 per cent of statutory cash reserve requirements introduced in September 1973 for a period of one year were, however, further renewed in September, 1974. In order to facilitate more orderly planning of credit expansion in the 1974-75 busy season, banks were also directed that in planning their operations, they should keep maximum credit expansion for the year as a whole to 63 to 65 per cent of their deposit accretion which would result in credit-deposit ratio of around 71 per cent at the end of April 1975 as against the credit-deposit ratio of 73.7 per cent at the end of April 1974. While continuing the emphasis on provision of refinance to banks on a discretionary basis, banks were directed to bring down the sanctioned bill rediscount limits to about 40 per cent of the level existing in April 1974 by the end of the slack season. In terms of this directive, the outstanding level of bills rediscounted was to be brought down from Rs. 279 crores at the end of April 1974 to a level of Rs. 100—110 crores by the end of October, 1974. In addition, in order to further rationalise the structure of interest rates, the maximum rate of interest on export credit was increased from 8 to 9 per cent per annum in the case of exports other than on deferred payments and from 6 to 7 per cent in the case of exports on deferred payments. The interest rate on food procurement credit was also raised from 8.5 per cent to 9 per cent.

6.24. The objectives of the 1974 slack season policy were more than achieved. The incremental credit-deposit ratio during the slack season was restricted to about 11 per cent, partly on account of larger decline in food procurement advances. Scheduled commercial banks' borrowings from Reserve Bank also declined by Rs. 270 crores and bills rediscounted stood at the level of Rs. 108 crores by the end of the slack season. The overfulfilment of the targets was however, partly due to a package of monetary measures taken on July 22, 1974 to raise the cost of credit steeply.

6.25. With effect from April 1, 1974, the rates of interest on deposits with banks were revised upwards ranging from 0.25 to 1.0 percentage point for various categories of deposits. In the case of savings deposits, the increase was by one percentage point. Simultaneously, the interest payable by the Reserve Bank on additional deposits maintained by commercial banks under Section 42(1) of the Reserve Bank of India Act was raised from 4.75 per cent to 5.25 per cent. On July 22, 1974, when the Reserve Bank announced the increase in the Bank rate from 7 per cent to an all time high of 9 per cent, the minimum lending rate of the banks was raised to 12.5 per cent from 11 per cent, to which level it had been raised from 10 per cent on December 1, 1973. The concessional rate of interest charged on export credit was also raised from 9 per cent to 10.5 per cent in respect of packing credit and that on food procurement credit from 9 to 11 per cent in the case of Food Corporation of India and from 9 to 12 per cent in the case of State Governments/Agencies. The minimum lending rates on advances against commodities covered under selective credit control measures were also raised by 2 percentage points. In the supplementary budget presented on July 31, 1974, gross interest earned by scheduled banks on loans and advances was subject to a tax of 7 per cent, which would have led to a further increase of upto one per cent in banks' lending rates. Simultaneously, rates of interest on fixed deposits of commercial banks were raised so that the maximum rate of interest payable on deposits of over 5 years was raised from 8 per cent to 10 per cent.

6.26. With effect from August 1, 1974, the rate of interest on food procurement credit to Food Corporation of India was further raised from 11 to 12 per cent. Subsequently, effective from September 25, 1974, the maximum rate of interest on export packing credit was raised from 10.5 to 11.5 per cent and on deferred payments credit from 7 to 8 per cent.

6.27. On October 29, 1974, the Reserve Bank announced the credit policy for the 1974-75 busy season. The policy calls for a continuing restraint on credit creation while, at the same time, providing for greater selectivity in the deployment of credit for "sustaining investment, augmenting production and facilitating better distribution of essential commodities". The order of priorities indicated are agriculture, exports, small scale industries, particularly those producing inputs for 'core' sector and wage goods industries, manufacturing units in the public sector and core industries in the private sector, mainly those producing fertilisers, pesticides and other needs of agriculture and those engaged in the production of goods needed for mass consumption (such as controlled varieties of cloth, edible oils and sugar). In order to enable banks to meet the genuine requirements of additional credit during the busy season, the minimum statutory balances which the scheduled banks are required to keep with the Reserve Bank were reduced from 5 per cent to 4 per cent of the total demand and time liabilities. the reduction was 0.5 per cent w.e.f. December 14, 1974, and a further 0.5 per cent w.e.f. December 28, 1974. As a result, about Rs. 120 crores of additional loanable resources became available to banks by the end of December, 1974. The minimum net liquidity ratio was reduced from 40 per cent to 39 per cent w.e.f. December 28, 1974, the maximum rate chargeable for refinancing remaining unchanged at 18 per cent. The banks' ordinary recourse to the Reserve Bank for refinance at the Bank rate would continue to be limited to one per cent of their demand and time liabilities as on September 27, 1974. In addition, when the overall level of advances for food procurement exceed Rs. 300 crores, an amount equal to 50 per cent of the excess provided by each particular bank would be refinanced by the Reserve Bank. When the overall level of public food procurement exceed Rs. 450 crores, the full amount of the excess would be refinanced. Any further excess to refinance would be strictly at the discretion of the Reserve Bank.

6.28. On account of the continued strength of inflationary pressures in the economy, the credit policy for the 1974-75 busy season envisages the continuation of selective credit controls on commodities which are subject to speculative tendencies. Moreover, as hitherto, banks will be required to keep down the financing of Multani Hundis and such other financial transactions. However, since bank credit does not play a predominent role in financing trade in many agricultural commodities, slective credit controls can at best have only a marginal influence in stabilising their prices.

6.29. In order to provide an additional source of finance to the commercial sector, the Reserve Bank introduced in November 1970 a new Bill Market Scheme. Since until the 1973-74 busy season industry did not experience any shortage of credit, the bill market mechanism was not extensively used. However, when stricter credit limits were set in the 1973-74 busy season, the new bill market scheme provided a readily available mechanism for securing additional credit. During the busy season of 1973-74, there was a significant increase of Rs. 244 crores in the bills rediscounted by the Reserve Bank. As a measure of stricter credit control, the Reserve Bank, as part of its credit policy of the 1974 slack seaon, asked banks to bring down sanctioned rediscount bill limits by the end of October 1974 to 40 per cent of the level outstanding in April 1974. With effect from June 18, 1974, the minimum rate of discount in respect of bills tendered by drawees for discount by scheduled commercial banks was raised from 9.5 per cent to 11 per cent but the rate of discount in respect of bills discounted at the instance of drawers remained unchanged at 9.5 per cent. It was stipulated that the rate of interest on drawee bills should be on par with the rate of interest on the cash credit accommodation extended to the same borrower. This was done to avoid the buyers obtaining credit cheaper than under the cash credit system for inventory purchase. When the minimum lending rate was increased to 12.5 per cent in July, 1974, the rate of interest on drawees' and drawers' bills was increased to 12.5 per cent and 11 per cent respectively. The return flow of funds under the bill market scheme was quite satisfactory during the slack season.

6.30 The financial accommodation provided by the banking system against bills under the new bill market scheme is an improvement over the normal cash credit by the banks in view of its shorter maturity period and improved supervision by the Reserve Bank. The new bill market scheme is designed to impart flexibility to the money market by evening out liquidity within the banking system. Thus for the current busy season, the Reserve Bank has made it clear that in view of the advantage that the bill financing has over the system of cash credit for purposes of regulating the end uses of credit, flow of Reserve Bank funds through the new bill market scheme would be encouraged in preference to assistance through refinance. A basic rediscount quota would be available to each bank equivalent to 10 per cent of its total inland bills purchased and discounted as on September 27, 1974. This accommodation amounting to about Rs. 100 crores would be made available to the banks at the Bank rate. Additional limits would be made available at the discretion of the Reserve Bank at a rediscount rate ranging from 10 per cent to 15 per cent.

6.31. Since November 1965, the Reserve Bank has been keeping a watch on the cash credit and other facilities granted by banks to large borrowers under the Credit Authorisation Scheme. Export packing credit was brought within the purview of the Credit Authorisation Scheme in July 1974. The Credit Authorisation Scheme, however, is designed to approve limits equivalent to the requirements of borrowers at peak levels and actual drawals related to immediate needs are supervised by the internal control system of banks. In order to ensure better supervision of larger accounts, the Reserve Bank in July 1974 asked each bank to scrutinise the accounts of their fifty biggest borrowers and ensure that there was proper utilisation of credit. A study group was also set up to examine various aspects relating to follow up and supervision by banks of the end use of credit extended by them. Arising from the interim report of the study group the Reserve Bank issued guidelines to banks on November 8, 1974 in respect of advances against inventories in the form of raw materials, finished goods and receivables for selected ten major industries, which should be applied to both the existing and new borrowers in the public and private sectors. As a result of the report of another study group appointed to suggest measures for coordination and cooperation among banks in respect of multiple financing, the Reserve Bank issued guidelines to banks to extend credit facilities on a participation basis. The principal provision of these guidelines issued on August 8, 1974 is that wherever the credit limits to any one borrower in the public and private sectors (including Electricity Boards) was in excess of 1.5 per cent of a bank's total deposits, credit should be extended through a joint participation/consortium basis.

6.32. Unlike the previous busy season, the Reserve Bank has not indicated any quantitative ceiling on the credit expansion during the current busy season. The objectives of preventing an excessive expansion of credit and of ensuring its proper end use are sought to be achieved by discussions with the individual banks, which are ultimately responsible for allocations of credit to individual borrowers in terms of the broad priorities indicated by the Reserve Bank. Since financial asistance provided by the Reserve Bank to commercial banks is as expansionary as deficit financing, scarce bank credit has to be deployed cautiously and with flexibility so as to ensure that excessive inventory build up is halted and credit needs of essential production are adequately met. At the same time, it is inevitable that given the need for restraint on credit expansion, demand for credit by every borrower from the banks cannot be met. The purpose of the credit control will be defeated if the potential borrowers do not use the credit for the designated purposes and delay the repayment of borrowed funds. There is a need for more effective arrangements to increase the commercial banks' supervision over their large borrowers.

Deployment of Bank Credit

6.33. Since nationalisation of commercial banks, there has been a considerable increase in the expansion of bank credit to priority and neglected sectors, namely, agriculture, exports, small scale industries, road and water transport operators, retail and small business, professional and self-employed persons and education. The percentage of advances by public sector banks to agriculture and other neglected sectors has increased from 14.9 per cent of the total outstanding advances in June, 1969 to 25.7 per cent in June, 1974. Similarly, the percentage of bank credit for exports to total bank credit increased from 6.8 per cent in June 1969 to 10.3 per cent in June 1974. During the busy season of 1973-74, the expansion of bank credit for public food procurement, exports, priority sectors, and public sector undertakings accounted for 72.1 per cent of the total increase in bank credit, the balance of 27.9 per cent having been deployed for residual sector which includes large and medium scale industry and wholesale trade in the private sector. Inclusive of bills rediscounted, the bank credit to the residual sector accounted for 41 per cent of the increase in gross credit during the busy season of 1973-74 as compared to 64 per cent in the busy season of 1972-73. In the slack season of 1974, while there was an absolute decline in bank credit for food procurement and exports, the bank credit to

TABLE 6.3

Deployment of Bank Credit

(Rs. crores)

	Slack season		Busy season	
	1973	1974	1972-73	1973-74
1. Public food procurement	— 58	— 169	+ 6	+ 188
2. Exports	+ 69	— 86	+ 114	+ 214
3. Priority sectors Of which :	+ 155	+ 144	+ 122	+ 273
Small scale industries	+ 49	+ 103	+ 82	+ 161
4. Public sector undertakings	+ 146	+ 83	+ 86	+ 125
5. Residual sector (large & medium scale industries and wholesale trade in the private sector)	+ 34	+ 121	+ 569	+ 309
6. Total bank credit	+ 346	+ 93	+ 897	+1109
7. Bills rediscounted with RBI	+ 15	— 171	+ 19	+ 244
8. Gross bank credit (6+7)	+ 361	— 78	+ 916	+1353

priority sectors and public sector undertakings continued to grow. There was also an increase of Rs. 121 crores in bank credit (excluding bills rediscounted) to the residual sector in the slack season of 1974 compared to an increase of only Rs. 34 crores in the slack season of 1973.

6.34 The decline in export credit in the 1974 slack season has been attributed to faster turn-round of funds. However, there have been complaints from exporters that banks were not according due priority to export credit which it is hoped will be corrected in terms of the current busy season policy. The large expansion in bank credit to public sector enterprises represents an increasing level of output. However, in part, expansion of bank credit to some public sector enterprises was necessitated by difficulties faced by them in collecting their dues from State Governments. To that extent, expansion of bank credit to the public sector undertakings constitutes a substitute for overdrafts by the State Governments. Among the priority sectors, the small scale industry seems to have been the greatest beneficiary. In the interest of proper deployment of credit, it is essential to distinguish between small industry producing wage goods or goods otherwise considered vital for the economy and that part of industry which caters to less essential needs. The data on sectoral allocations also bring out the fact that the residual sector, consisting of large scale industry and trade in the private sector have had to face much tighter financial discipline than ever before. This has helped to weaken the inflationary psychology.

Credit Policy, Stability and Growth

6.35. The foregoing account clearly brings out the determined efforts made by the monetary authorities to reduce the rate of growth of bank credit in the current year. In combination with greater fiscal discipline displayed by the Central and State Governments in 1974-75, there has been a visible reduction in the rate of growth of money supply. As a result, there seems to have been some reduction in the pressure of excess demand in the economy. However, considering the fact that the overall growth rate of the economy in 1974-75 is likely to be insignificant, the current rate of growth of money supply is still indicative of a continuing imbalance in aggregate demand and supply.

6.36. During the earlier part of the year, a distinguished group of economists came out with a plan to immobilise about 25 per cent of the existing money supply as a means of effecting a sharp reduction in prices. With current incomes of households remaining unaffected initially, the implied liquidity squeeze in the Economists' proposal would have had no significant effect on household spending particularly if the immobilised currency notes and bank deposits represent past savings. As regards business firms, there is no doubt that an immobilisation of a part of their deposits, unaccompanied by any reduction in their current liabilities, could give rise to a severe liquidity squeeze, forcing them to reduce their inventories. Insofar as their existing stock of inventories was in exces of their normal requirements of production, a reduction in inventories would accentuate downward pressure on prices, without affecting output. However, the effects of the squeeze would vary from industry to industry, depending on the size of inventory holdings in relation to output, and there is no reason to believe that more essential sectors of the economy would escape unhurt. As a result, a decline in industrial production could not be ruled out. Such a decline need not persist if prices of industrial inputs declined in the wake of reduced demand for them. However, this could happen only to prices of industrial materials of agricultural origin since these alone were likely to be very sensitive to changes in demand and supply. Prices of imported raw materials and of other domestic materials whose prices are administratively controlled (steel, cement and coal) are unlikely to fall and, as a result, a reduction in inventories would most probably lead to a decline in their production (or to a forced piling up of inventories with producers). Thus, a serious dislocation of industrial activity might become unavoidable. It is obvious that the inflationary excesses of last two years cannot be corrected without a certain degree of dislocation. However, in view of the various market imperfections and structural rigidities, a sudden large liquidity squeeze could add significantly to unutilised capacity and unemployment in industry. The fact that an inflationary rise in prices is not associated with an increase in output does not warrant the conclusion that a sudden sharp fall in prices can be engineered through an indiscriminate credit squeeze without affecting industrial output. This is not to deny that a firm control of growth of money supply must form an essential ingredient of an effective anti-inflationary package. However, given the inherent complexity of economic processes, a safer method of gaining control would be to operate on increments to money supply. This is precisely what the Government have done in the current year.

6.37 More recently, certain sections of industry have been arguing that the credit policy had become unduly restrictive and that it would land the economy into a major recession. Judging by the trend of industrial output thus far in the current year and comparing it to the behaviour of industrial production in the corresponding period of the previous year, one does not get the impression that there has been a general slackening of the rate of growth. In fact, the industrial growth rate in 1974-75 is likely to be higher than that of 1973-74. It is, of course, true that there is considerable excess capacity in our industrial system. However, this phenomenon is basically due to continued shortages of certain critical inputs and this situation cannot be remedied through an increase in demand, facilitated by a more rapid expansion of bank credit. Indeed, any attempt to liberalise provision of credit on a large scale will strengthen the basic inflationary forces, which are still very strong, without ensuring any compensatory increase in real output. The general acceptance of the argument that every industry is entitled to higher credit limits in proportion to increase in prices would imply that we have almost given up hopes for stabilising the price level. While credit needs of industries producing mass consumer goods and of sectors such as export have to be fully met so as to facilitate increased production, the overall emphasis must still be on restraint.

6.38. Recently, there has been considerable discussion of the increasing diversion of loanable funds to companies in the form of deposits. However, precise details of the magnitude of company deposits are not available. It is no doubt true that these deposits provide industry with funds which are not only cheaper than bank credit but are also not subject to social control. As such, company deposits reduce somewhat the effectiveness of credit controls. In order to plug this loophole, the Reserve Bank has recently directed that non-banking companies in the corporate sector accepting deposits in the form of unsecured loans should bring them down from the present ceiling of 25 per cent of their paid-up capital and free reserves, net of accumulated losses, to 15 per cent by the end of December, 1975.

6.39. The deceleration of deposit growth rate in the current year indicates that in a regime of rapidly rising prices, a mild increase in interest rates is not effective in inducing people to hold more of their savings in financial assets. Ways and means have to be found to reverse this tendency. At the same time, unorthodox proposals for indexation are also not a practical proposition in an economy where inflationary pressures are basically due to sluggishness of agricultural output and a deterioration in our terms of trade. Our best hope is still to deal with inflation by striking at its roots.