

CHAPTER 6

MONEY SUPPLY AND BANK CREDIT

6.1 Money supply with the public and aggregate monetary resources recorded an increase of 17.1 per cent and 21.2 per cent respectively during the financial year 1976-77 till March 25, 1977. The rate of increase in money supply with the public in 1976-77 was significantly higher than the rate of increase in the preceding two years—11.3 per cent in 1975-76 and 6.9 per cent in 1974-75. It was even higher than the rate of increase in money supply of 15.4 per cent in 1973-74 and 15.9 per cent in 1972-73.

6.2 The financing by the banking system of food and fertiliser stocks and additions to foreign exchange assets of the banking sector led to an increase of 11.3 per cent in money supply during 1975-76. The increase in money supply was, however, consistent with an increase in national income by over 8 per cent in 1975-76. In 1976-77, while the financing by the banking system of growing food stocks continued, there was an intensification of fresh accretions to foreign exchange assets. The record growth in money supply during the year was also due to increase in credit requirements for rising industrial production, priority sectors, sick mills and growth in inventories of industrial products which were faced with demand recession

such as steel, fertilisers, coal, engineering goods, chemicals, cement, paper and textiles.

6.3 Such an increase in money supply in 1976-77 when the rate of growth in national income was appreciably lower than in 1975-76 was a cause for concern. Monetary and credit policy aimed, therefore, at mitigating the inflationary potential of the money supply expansion. This was sought to be achieved by impounding a larger proportion of reserve money to neutralise the banks' ability to create credit, by enforcing greater discipline regarding refinancing from the Reserve Bank and by deploying a whole panoply of selective credit controls. The lack of success due to the strength of the basic expansionary forces in the economy can be gauged from the fact that in spite of a restrictive policy, money supply expansion of the order mentioned above took place.

6.4 The long-term declining trend in the proportion of currency to money supply since the 60s was more or less halted in 1976-77. Currency with the public recorded a disproportionately large increase of Rs. 1154 crores till March 25, 1977. The currency component of money supply thus declined only marginally as shown in the table below.

TABLE 6.1
Variations in money supply and monetary resources

	Currency with the public	Deposit money	Money supply with the public	Monetary resources	(Rs. crores)
1970-71	366 (9.1)	356 (14.5)	723 (11.2)	1244 (13.2)	61.0
1971-72	434 (9.9)	510 (18.2)	945 (13.1)	1665 (15.6)	59.3
1972-73	640 (13.3)	651 (19.6)	1291 (15.9)	2181 (17.7)	57.9
1973-74	887 (16.2)	561 (14.1)	1448 (15.4)	2510 (17.3)	58.4
1974-75	29 (0.5)	719 (15.9)	748 (6.9)	1870 (11.0)	54.9
1975-76	361 (5.7)	955 (18.2)	1316 (11.3)	2843 (15.1)	52.1
1976-77 (Upto 25-3-77)	1154 (17.1)	1061 (17.1)	2215 (17.1)	4596 (21.2)	52.1
1975-76 (Upto 26-3-76)	360 (5.6)	775 (14.8)	1135 (9.8)	2650 (14.0)	52.8

NOTE : Figures in brackets indicate percentage variations.

Factors affecting money supply

6.5 During the financial year 1976-77, net bank credit to Government increased by Rs. 431 crores (4.1 per cent) till March 25, 1977 as compared to an increase of Rs. 580 crores (6.1 per cent) during the corresponding period of the previous year. While commercial banks' credit to Government recorded a lower increase of Rs. 388 crores during the year compared with Rs. 535 crores in the same period last year, the increase in the Reserve Bank's net credit to Government by Rs. 43 crores was almost equal to an increase of Rs. 45 crores during the same period in 1975-76.

6.6 Bank credit to the commercial sector, on the other hand, increased by Rs. 2564 crores (18.6 per cent) during 1976-77 till March 25, 1977 compared with an increase of Rs. 2314 crores (20.5 per cent) in the corresponding period of the previous year. The figures during the two years are not, however, strictly comparable because the financing of stocks of food and imported fertilisers was passed on entirely to the banking system towards the beginning of 1976 as against the earlier practice of meeting a part of these requirements through the budgetary resources. During this period, Reserve Bank's credit to the commercial sector showed a significant increase of Rs. 153 crores as against the increase of Rs. 58 crores during the corresponding period of 1975-76. This was due to the larger accommodation made available by the Reserve Bank to term lending financial institutions since the beginning of 1976-77. Commercial banks' credit to the commercial sector was also high in 1976-77 at Rs. 2412 crores till March 25, 1977 compared to Rs. 2256 crores in the comparable period of the preceding year.

6.7 The most important factor responsible for the higher growth of money supply in 1976-77 was the increase in net foreign exchange assets of the banking sector. They rose by Rs. 1587 crores till March 25, 1977 compared to an increase of Rs. 708 crores during the corresponding period of 1975-76. The net non-

monetary liabilities of the Reserve Bank, an increase of Rs. 982 crores in which had exerted a powerful contractionary influence on money supply in 1975-76, increased by only Rs. 195 crores till March 25, 1977. This was due partly to the repayment after July 1976, of the first instalment of additional wages and part of dearness allowance increases impounded during the two previous years and losses suffered due to fluctuations in exchange rates of world currencies. Time deposits with the banks grew handsomely by Rs. 2381 crores in 1976-77 till March 25, 1977 as compared to an increase of Rs. 1515 crores during the same period of 1975-76. Nevertheless, the total non-monetary liabilities of the banking sector (including time deposits), which act as a contractionary factor in money supply, recorded a lower increase of Rs. 2367 crores in 1976-77 as compared to an increase of Rs. 2490 crores in the corresponding period of 1975-76.

Trends in scheduled commercial banks' data

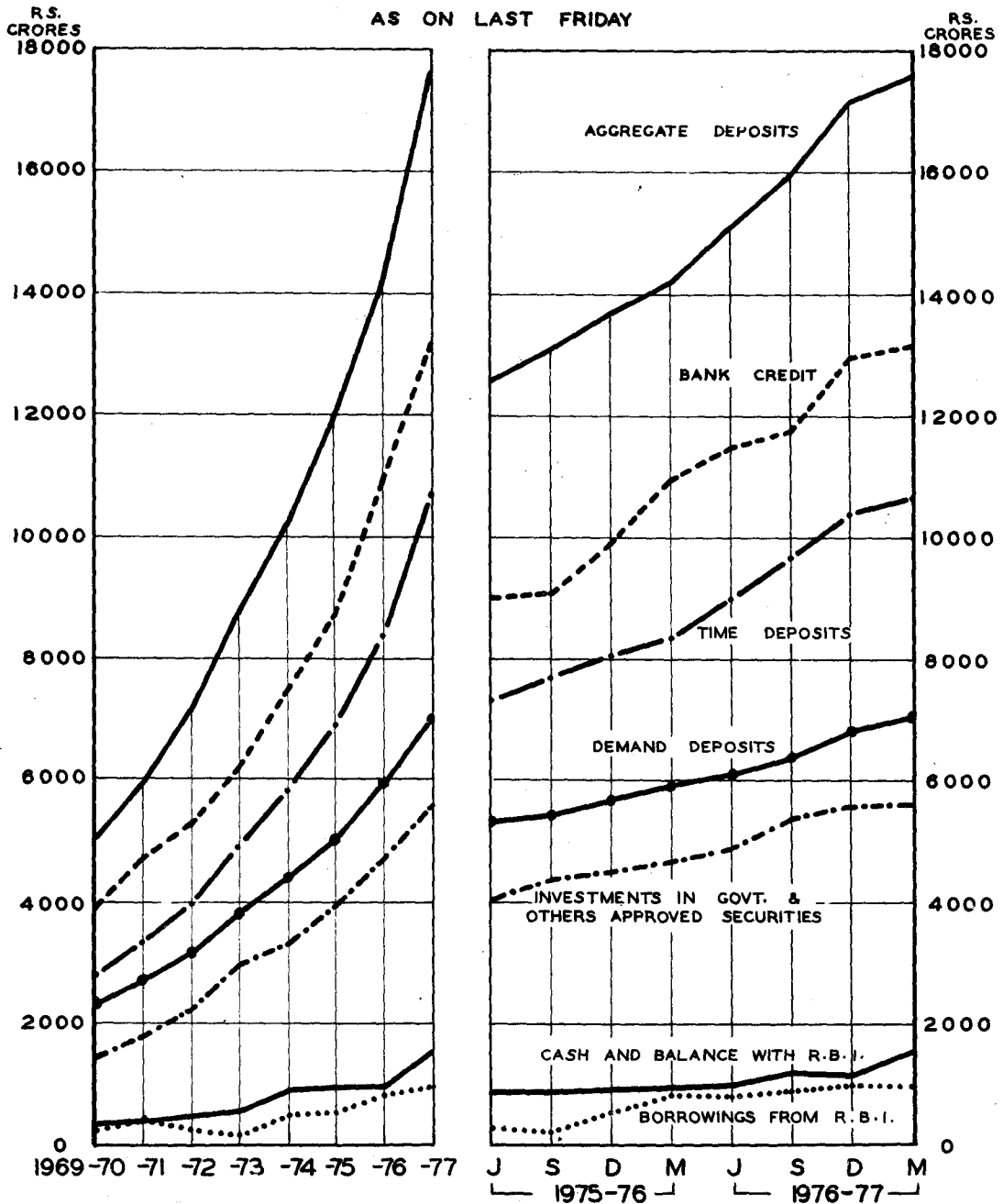
6.8 The up-trend in bank credit, both food and non-food, which began in the busy season of 1975-76 continued in the slack season of 1976 mainly due to the increase in credit requirements of public food procurement operations. Banks also built up their investment portfolio during the 1976 slack season on a significantly larger scale than in the 1975 slack season. However, the record growth of aggregate deposits with banks enabled them to finance the increased credit and investment requirements largely from their own resources.

6.9 During the busy season of 1976-77 (November 1976 to April 1977), the increase in gross bank credit was lower than during the 1975-76 busy season, following a marked deceleration in the growth of advances for food procurement operations. However, the tempo of deposit growth was maintained at a high level. The scheduled commercial banks were thus able to limit their recourse to the Reserve Bank to a much lower level than in the corresponding period of last year. Banks were also able to step up their balances with the Reserve Bank considerably, thus satisfying the increased cash reserve requirements.

SCHEDULED COMMERCIAL BANKS

SELECTED ITEMS

AS ON LAST FRIDAY



MINISTRY OF FINANCE, ECONOMIC DIVISION.

TABLE 6.2
Seasonal variations in scheduled commercial banks' data

	Slack season		Busy season				
	1974	1975	1976	1973-74	1974-75	1975-76	1976-77
1. Bank credit	129	710	1025	1111	935	1764	1097
(a) Food procurement advances	-169	173	489	188	316	874	174
(b) Other advances	298	536	536	923	619	890	923
2. Bills rediscounted under the Bills Rediscounting Scheme	-171	-80	22	244	59	43	22
3. Gross bank credit (1+2)	-42	629	1047	1355	994	1807	1119
4. Aggregate deposits	912	1166	1791	677	784	1270	1777
(a) Demand deposits	298	392	457	407	316	432	721
(b) Time deposits	614	774	1334	270	468	838	1056
5. Borrowings from RBI	-270	-38	83	253	183	628	-304
6. Balances with RBI	92	74	114	-217	110	118	220
7. Cash in hand	25	-31	31	4	31	19	38
8. Investments in Government and other approved securities	472	404	651	157	165	384	629
(a) Govt. securities	349	227	389	73	118	342	583
(b) Other approved securities	123	177	262	84	47	42	46
9. Gross credit-deposit ratio (% at the end of the period)	69.8	71.8	75.8	76.4	73.5	78.0	74.6
10. Gross credit (excluding food credit)—deposit ratio (% at the end of the period)	67.6	66.2	62.9	72.3	68.8	66.8	61.9
11. Investment-deposit ratio (% at the end of the period)	33.8	33.1	33.2	32.2	33.0	32.9	33.5

6.10 With the development of the industrial structure of the economy, the conceptual difference between the conventional slack and busy seasons has tended to be blurred over the last few years. During the financial year 1976-77 (between the last Fridays of March 1976 and March 1977), the expansion in gross bank credit by Rs. 2276 crores was higher as compared to an increase of Rs. 2108 crores during the previous year. While food procurement credit increased by Rs. 669 crores during 1976-77 compared to an increase of Rs. 908 crores in 1975-76, the

increase in non-food gross bank credit by Rs. 1607 crores in 1976-77 was significantly larger than the level of Rs. 1200 crores recorded in 1975-76. Aggregate deposits with scheduled commercial banks, particularly in the form of time deposits, also recorded a highly satisfactory growth with the result that the banks' net balances (deposits net of borrowings) with the Reserve Bank increased by Rs. 370 crores during 1976-77 in contrast to a decline of Rs. 330 crores in 1975-76 as will be seen from the following table.

TABLE 6.3
Scheduled commercial banks : Variations in selected indicators

	(Rs. crores)	
	Variations during	
	1975-76 (Mar. 28, 1975 to Mar. 26, 1976)	1976-77 (Mar. 26, 1976 to Mar. 25, 1977)
1. Aggregate deposits	2328	3402
(a) Demand deposits	854	1124
(b) Time deposits	1474	2278
2. Borrowings from RBI	325	169
3. Cash and balances with RBI 1	4	592
(a) Cash in hand	9	53
(b) Balances with R.B.I.	-5	539
4. Net balances with RBI [3(b)-2]	-330	370
5. Money at call and short notice 1	35	-90
6. Bank credit	2115	2268
7. Bills rediscounted with RBI	-7	8
8. Gross bank credit (6+7)	2108	2276
9. Public food procurement credit	908	669
10. Non-food gross bank credit (8-9)	1200	1607
11. Investments in Government and other approved securities	692	932
(a) Government securities	457	649
(b) Other approved securities	235	283
12. Balances with other banks in current account	-6	18

1. Sign (-) indicates addition to resources with banks.

6.11 Call money rates ruled generally easy during the first five months of 1976-77 due to excess liquidity with banks and other financial institutions. From September 1976, the excess liquidity with the banks was depleted on account of increase in demand for credit, floatation of Government loans and credit restraint measures detailed in the following section. As a consequence, the call money rates were maintained at the ceiling level of 12.5 per cent between the middle of September 1976 and end of March 1977, following stringency in the money market.

Credit Policy Developments

6.12 Though, in general, the emphasis of credit policy continued to be on restraint, a certain amount of flexibility was introduced to meet the requirements of increased economic activity. The maximum rate of interest chargeable by the larger scheduled commercial banks was fixed at 16.5 per cent (including tax on interest income) with effect from March 15, 1976. Advances against commodities subject to selective credit controls were, however, exempted from the ceiling rates of interest. The rate of interest on term loans granted for periods of seven years or more was reduced from 15 per cent to 14 per cent with effect from April 1, 1976.

6.13 In 1976 slack season, the Reserve Bank directed the commercial banks to conduct credit operations in such a way that additional availability of bank credit was related to actual increases in real output and sales. A major change in policy was that with a view to utilising the growing deposits with the banks for the large and essential requirements of public food procurement operations, the formula for refinancing the credit for public food procurement operations by scheduled commercial banks was modified. Under the revised scheme, the Reserve Bank was to provide refinance to the extent of two-thirds of food advances in excess of Rs. 800 crores instead of the entire amount in excess of Rs. 525 crores as before. To have more purposeful and effective credit planning, banks were asked to prepare quarterly credit budgets, instead of the earlier annual credit budget, and the flow of credit among different sectors was to be monitored through a monthly reporting system on sectoral flows of credit.

6.14 The recommendations of the Study Group on Follow-up of Bank Credit set up in 1974 were implemented with flexibility as provided in the scheme. During 1976-77, relaxation of norms for inventories was made in the case of cotton spinning mills, fertiliser factories, paper and engineering industries (including automobiles and ancillaries) due to the emerging situation. Banks were also asked to identify sick industrial

units with the help of the information system devised by the Study Group and to take remedial measures, if possible.

6.15 Selective credit controls were tightened during 1976-77 in the case of raw cotton and kapas, oilseeds and vegetable oils and gur and khandsari in view of the sharp rise in their prices. In the case of raw cotton, as against the previous margins of 25 per cent for textile mills in Bombay and Ahmedabad for stocks of twelve weeks' consumption and 50 per cent for excess stocks, the margins were revised on July 8, 1976 to 25 per cent for stocks of four weeks' consumption and 45 per cent for excess stocks. In the case of parties other than mills, margins were raised from 25 per cent to 45 per cent in respect of new and/or long staple cotton grown in India, from 50 per cent to 60 per cent in respect of other varieties of indigenous cotton and from 40 per cent to 50 per cent for stocks covered by warehouse receipts. The minimum margins for advances against groundnut, rapeseed/mustardseed, castorseed and linseed were raised from 50 per cent to 60 per cent with effect from July 14, 1976. For castor oil and linseed oil, the minimum margin was raised from 60 per cent to 75 per cent. Cottonseed and cottonseed oil were also brought within the purview of selective credit control with minimum margins of 60 per cent and 75 per cent respectively. For vanaspati manufacturers, however, the stipulation of minimum margins for cottonseed oil were not applicable. The minimum margins for advances against gur and khandsari were raised from 50 per cent to 60 per cent for manufacturers and 65 per cent to 75 per cent for others on October 14, 1976. It was also laid down that no further enhancement of credit limits to individual parties should be allowed.

6.16 To curtail the excess liquidity and lendable resources of the banks consequent upon a marked improvement in their deposit resources and in the light of the excessive growth of money supply, the Reserve Bank decided to raise the statutory cash reserve ratio from 4 per cent of the banks' demand and time liabilities to 5 per cent with effect from week beginning September 4, 1976. The minimum cash and liquidity requirements of the banks were thus raised from 37 per cent to 38 per cent of their demand and time liabilities. They were further raised to 39 per cent when the cash reserve ratio was raised to 6 per cent with effect from the week beginning November 13, 1976. Further, the Reserve Bank of India advised the banks on January 13, 1977 to step up the margins on all types of advances against inventories (raw materials, goods-in-process and finished goods) and book debts by 10 percentage points. The enhanced

margins were not applicable in the case of commodities covered by selective credit controls, advances to small-scale industries, export credit, sick units and other preferential sectors in the case of which the minimum lending rate of 12.5 per cent was not applicable. Simultaneously, 10 per cent of the incremental deposits of the banks between January 14, 1977 and April 1, 1977 was impounded by the Reserve Bank.

6.17 However, to avoid an indiscriminate cut or freeze in credit limits and to meet the essential needs of the industry for seasonal requirements or for enhanced production, banks were directed on February 16, 1977 to relax the provision for increasing the margins by 10 per cent in individual cases on merit, to the minimum extent possible. The period of impounding 10 per cent of the incremental deposits with the Reserve Bank was, on the other hand, extended till April 29, 1977* in view of the staggering increase in money supply and the need for continued restraint on lendable resources of scheduled commercial banks. However, banks were not able to comply fully with the statutory and obligatory liquidity requirements till the end of March 1977 on account of stringency in the money market and seasonal and exceptional credit needs.

6.18 The credit policy for the conventional busy season of 1976-77, envisaged a continuation of the accent on monetary restraint and credit discipline. The formula for refinancing of public food procurement credit by the Reserve Bank was further tightened so that only 50 per cent of the food procurement credit above Rs. 1000 crores was made eligible for refinancing by the Reserve Bank with effect from November 1, 1976.

6.19 Other important changes introduced in credit policy during 1976-77 included the advice given by the Reserve Bank to scheduled commercial banks in August 1976 not to insist on cash margins in respect of bid bonds and performance guarantees for exports which were counter-guaranteed by the Export Credit and Guarantee Corporation. To facilitate interest-free credit to exporters under the Duty Draw Back Credit Scheme by commercial banks, the limit of minimum amount to be borrowed by a bank at a time from the Reserve Bank was reduced from Rs. 1 lakh to Rs. 20,000 in June 1976. With a view to bringing about uniformity in the availability of post-shipment credit (other than on deferred payment terms) in respect of exports to all countries, the Reserve Bank directed commercial banks in December 1976 to provide post-

shipment credit upto a maximum period of 128 days instead of 90 days. The ceiling rate of interest of 11.5 per cent per annum was to be charged upto 90 days and a minimum of 12.5 per cent thereafter. It was earlier decided, in July 1976, that for the extended period normal rates of interest but not less than the minimum lending rate should be charged on export credit and that the scheme of penal rates was not applicable during the extended period.

6.20 Based on the recommendations of the Committee on Penal Rates and Service Charges, the Reserve Bank directed all scheduled commercial banks in July 1976 that penal rates of interest on their advances should not exceed 2 per cent over the ceiling rates on advances. All small loans (upto Rs. 5000), advances made under the Differential Interest Rates Scheme and agricultural advances to small and marginal farmers, other direct agricultural loans (excluding plantations) and advances to sick mills were exempted from the levy of penal rates.

6.21 A modified scheme for the issue of rural debentures by approved State sponsored institutions like the State Electricity Boards, the Agro-industries Corporations, Housing Boards (Rural Housing), Co-operative Processing and Marketing Societies etc., was launched on November 12, 1976 to mobilise resources from the rural sector. The salient features of this scheme were that the rate of interest for such debentures would be 12 per cent per annum to make them attractive to individual investors, the maturity period of debentures was 10 years and they were to be sold only to individuals or groups of individuals. Companies and financial institutions which were statutorily or otherwise required to invest a part of their resources in Government and approved securities were prohibited from subscribing to these debentures.

Sectoral deployment of scheduled commercial banks' credit

6.22 According to provisional data available for the year 1976-77, gross non-food credit recorded an increase of Rs. 1667 crores as against an increase of Rs. 1140 crores during the previous year. Of this, Rs. 787 crores or 47 per cent was in respect of priority sectors including small-scale industry, agriculture and other neglected sectors (road and water transport operators, retail trade and small business, professional and self-employed persons and education). Industry accounted for 46 per cent of the increase in non-food credit. The core industries, namely, coal, iron and steel and engineering absorbed more than 60 per cent

*The period has since been extended again till further notice.

of this credit extended to industry. But for the increase in receivables of public sector enterprises from Government departmental undertakings such as Railways and State Electricity Boards and accumulation of large stocks of finished goods with a number of industries, the credit extended to industrial sector would have been considerably lower.

6.23 There was also a sharp increase in credit extended to wholesale trade other than for food procurement operations. This amounted, in all, to Rs. 282 crores, including Rs. 120 crores to Cotton Corporation of India. Credit to the Jute Corporation of India and for stocks of imported fertilisers to the Food Corporation of India also increased during the year.

TABLE 6.4
Sectoral deployment of scheduled commercial banks' credit

	Amount outstanding on last Friday of		Variations during April 1976 to March 1977
	March 1976*	March 1977*	
Gross bank credit	10993	13329	2336
1. Food credit	1521	2190	669
2. Non-food gross bank credit	9472	11139	1667
(i) Industry (total)	6079	6839	760
(ii) Cotton Corporation of India	12	132	120
(iii) Jute Corporation of India	21	30	9
(iv) Wholesale trade (other than (ii) and (iii) above)	753	906	153
(v) Other sectors	2607	3232	625
3. Priority sectors (included in 2 above)	2688	3475	787
(a) Small-scale industry	1181	1402	221
(b) Agriculture	1014	1296	282
(c) Other priority sectors	493	777	284
4. Exports (included in 2 above)	952	1097	145

*Provisional.

6.24 To sum up: the expansion in monetary resources was much faster during 1976-77 than in the preceding year in spite of a relatively low level of net RBI credit to Government. This is because the building up of a food buffer stock and the financing of a substantial growth in industry have coincided with an increase in foreign exchange reserves. The measures taken by the Reserve Bank have not succeeded in limiting the growth of money supply to reasonable levels. The difficulties which banks have experienced in complying with the direc-

tives of the Reserve Bank of India point to the danger which a restriction of credit poses for productive activity.

6.25 The monetary authorities are thus faced with a dilemma. In view of the high order of increase in money supply and monetary resources during 1976-77, every effort has to be made to contain credit expansion in 1977-78 if inflationary pressures are to be avoided. On the other hand, the process of credit restraint cannot be carried to such a point that it tends to hurt production and affect growth.