CHAPTER 7

MONETARY AND CREDIT DEVELOPMENTS

A noteworthy development on the monetary front in 1985-86 has been the lower growth rate in money supply (M_3) compared with 1984-85. Between April, 1985 and January 3, 1986, M_3 grew by 13.3 per cent whereas during the same period in 1984-85 its growth rate was 14.5 per cent. Deceleration in reserve money growth has been a major factor behind this lower growth in M_3. Net Reserve Bank (RBI) credit to the Government, which is the major determinant of reserve money, grew by Rs. 3,186 crores (upto January 3, 1986) compared with Rs. 4,193 crores in the same period of the previous year.

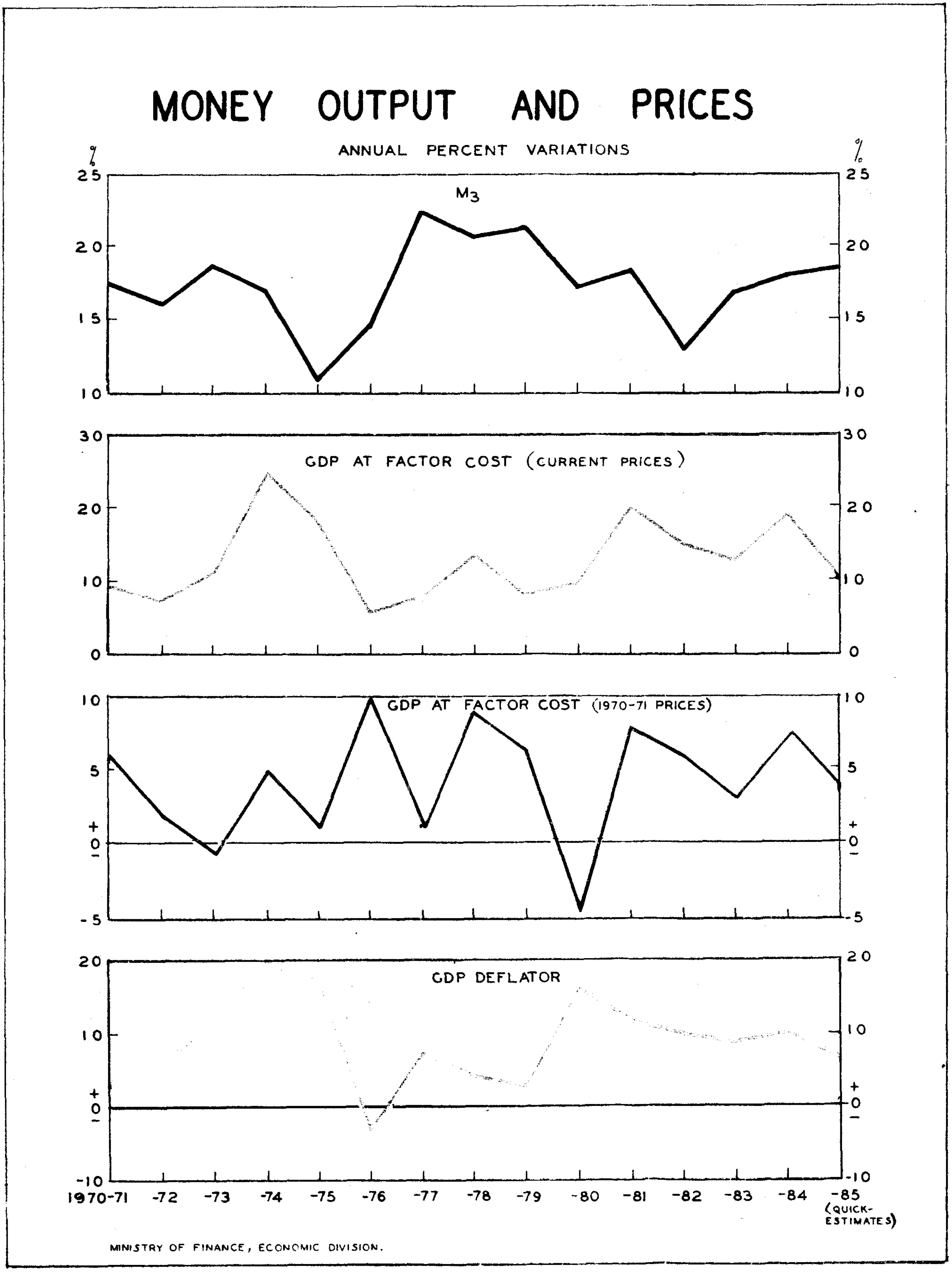
7.2 The Seventh Five-Year Plan envisages mobilisation of resources on a large scale for Plan financing. In order that these resources are raised in a non-inflationary manner, the Plan lays greater emphasis on public savings than borrowings by the Government. Although the Government's reliance on the RBI has diminished in 1985-86, its borrowing from commercial banks has been higher. However, this does not appear to have led to any 'crowding out' of bank credit to the commercial sector. Non-food credit extended by scheduled commercial banks to the commercial sector has, in fact, grown by Rs. 4,629 crores in 1985-86 (April—January 3) in comparison with Rs. 3,886 croses in 1984-85 (April—January 4). This occurred despite a decline in the growth rate of total bank credit to the commercial sector. Nevertheless, careful monitoring of the Government's borrowings from the banks will be required to adhere to the financing package given in the Plan.

Monetary Trends during 1984-85

7.3 A review of the monetary developments during the financial year 1984-85 shows that the expansion in M_3 at 18.9 per cent was slightly higher than the growth of 18.1 per cent in 1983-84. M_1 also grew at a faster rate *i.e.* 19.5 per cent in comparison with the growth of 17 per cent in 1983-84. A component-wise analysis of M_3 shows that currency with the public registered a sharp deceleration as it increased by 15.7 per cent in 1984-85 compared with an expansion of 17.7 per cent durng 1983-84. In contrast, there was a rapid accretion of demand deposits which rose by 23.3 per cent against 15.5 per cent during the previous year. Increase in time deposits, on the other hand, was somewhat lower (18.5 per cent) than the growth (18.9 per cent) in 1983-84. Overall, these growth rates conform to the long term trend of a declining currency to deposit rate which is a reflection of the development and monetisation of the economy.

7.4 Sources of change in M_3 indicate that the main reason for the faster expansion of aggregate monetary resources in 1984-85 was the spurt in net bank credit to the Government amounting to Rs. 9,586 crores compared with the increase of Rs. 5,385 crores in 1983-84. RBI credit to Government expanded by as much as Rs. 7,426 crores (Centre's share being Rs. 6,056 crores) against Rs. 3,987 crores (of which RBI credit to Centre was Rs. 3,949 crores) during 1983-84. Other banks' credit to Government increased by Rs. 2,160 crores which was also higher in comparison with the expansion of Rs. 1,398 crores a year before. Bank credit to commercial sector recorded a lower growth of 16.8 per cent in 1984-85 compared with the increase of 18.7 per cent in the preceding year. The movement in net foreign exchange assets of the banking sector in 1984-85, on the other hand, had a strong expansionary impact on the growth of M_3. Against a decline of Rs. 104 crores in 1983-84, there was a sharp increase of Rs. 1,275 crores in these assets in 1984-85.

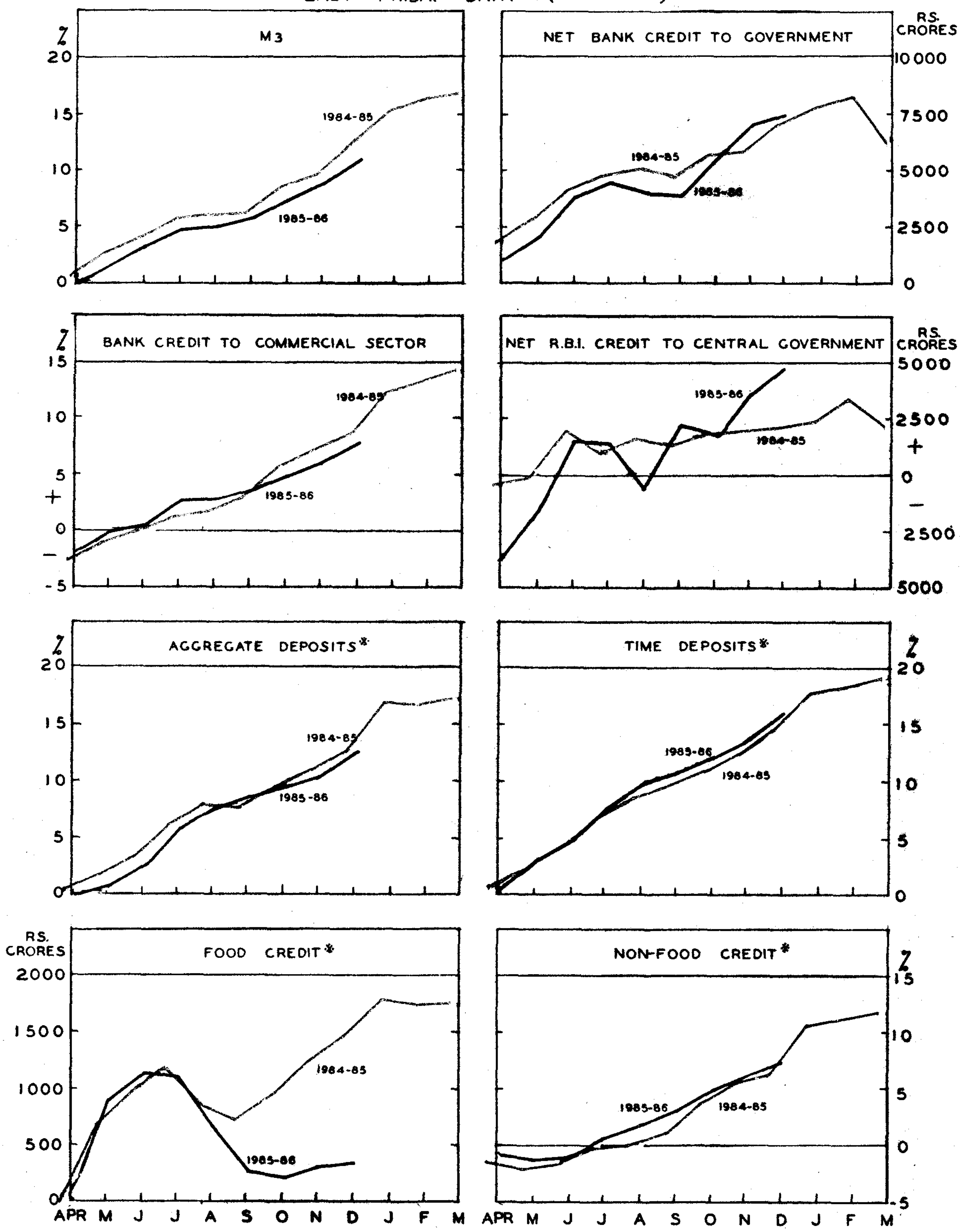
7.5 Scheduled commercial banks' data reflected a marked growth in aggregate deposits of 19.5 per cent during 1984-85 as against 18.3 per cent in the previous year. However, there was some deceleration in the expansion of gross bank credit, which at 17 per cent, was nearly one and a half percentage points lower than the increase of 18.4 per cent recorded during 1983-84. As a consequence of increased procurement of foodgrains and larger buffer stocks, food credit also rose by Rs. 1,489 crores, compared with an increase of Rs. 1,156 crores in 1983-84. Non-food credit, however, registered a noticeably lower growth (14.9 per cent) than the growth (16.5 per cent) recorded in 1983-84. A further break-up of the data available indicates that the incremental credit to the priority sector which was Rs. 2,577 crores in 1983-84 increased to Rs. 3,508 crores in 1984-85.



GMGIPMRND-PLW-469/2/Fin/85-86...Chart I 6

GROWTH IN SELECTED MONETARY INDICATORS

LAST FRIDAY DATA (PROVISIONAL)



MINISTRY OF FINANCE, ECONOMIC DIVISION.

* DATA RELATE TO SCHEDULED COMMERCIAL BANKS

NOTE:- BASE YEAR DATA ARE FOR MARCH 31ST

GMGIPMRND-PLW-469/2/Fin/85-86...Chart 17

TABLE 7.1

Sources of Change in Money Stock

(Rs. crores)

	Variations during			
	1983-84 March 31, to March 31	1984-85* March 31, to March 31	1984-85* March 31 to January 4	1985-86* March 31 to January 3
1	2	3	4	5
I. M_1 (Money Supply with the public) . .	4863 (17.0)	6524 (19.5)	4204 (12.6)	2273 (5.7)
II. M_3 (Aggregate monetary resources) . .	13221 (18.1)	16278 (18.9)	12498 (14.5)	13632 (13.3)
(*i*) Currency with the public . . .	2944 (17.7)	3069 (15.7)	2483 (12.7)	1273 (5.6)
(*ii*) Demand deposits with banks . .	1814 (15.5)	3151 (23.3)	1583 (11.7)	1241 (7.5)
(*iii*) Time deposits with banks . . .	8358 (18.9)	9754 (18.5)	8294 (15.7)	11359 (18.2)
(*iv*) Other deposits with RBI . . .	105	304	138	—241
III. Sources of change in M_3 (1+2+3+4—5)				
1. Net Bank Credit to Government (a+b) .	5385 (15.3)	9586 (23.6)	8898 (21.9)	8162 (16.2)
(*a*) RBI's net credit to Government (i+ii)	3987	7426	4193	3186
(*i*) To Central Government . . .	3949	6056	3282	5504
(*ii*) To State Governments . . .	39	1370	911	—2318
(*b*) Other banks' credit to Government .	1398	2160	4705	4976
2. Bank credit to commercial sector (a+b) . .	9564 (18.7)	10229 (16.8)	7226 (11.9)	7488 (10.6)
(*a*) RBI's credit@ .	455	372	392	314
(*b*) Other banks' credit	9109	9857	6834	7174
3. Net foreign exchange assets of banking sector	—104 (—6.2)	1275 (80.7)	580 (36.7)	—160 (—5.6)
4. Government's currency liabilities to the public .	37 (5.4)	58 (8.1)	16 (2.2)	19 (2.4)
5. Banking sector's net non-monetary liabilities other than time deposits (a+b). . . .	1661 (10.4)	4870 (27.7)	4222 (24.0)	1877 (8.4)
(*a*) Net non-monetary liabilities of RBI .	—763	3311	1953	1316
(*b*) Net non-monetary liabilities of other banks	2424	1559	2269	561

@ Excludes, since the establishment of NABARD, its refinance to banks.

*Provisional

Notes : 1. Figures may not add up to totals because of rounding.

2. Figures in brackets are percentage variations.

3. Reserve Bank data are on the basis of closure of Government accounts.

Monetary Trends during 1985-86

7.6 A major objective of monetary policy during the current financial year, 1985-86, was to curb potential inflationary pressures by ensuring that the growth in M_3 would be lower than in 1984-85. Data available upto January 3, 1986, show that a measure of success has been achieved in this objective, as the expansion in M_3 during the current year at 13.3 per cent was 1.2 per centage points lower than last year's growth of 14.5 per cent. An analysis of the components of M_3 indicates a significantly low growth in currency with the public of 5.6 per cent and in demand deposits with banks of 7.5 per cent during the current year so far, compared with a fairly substantial growth rate in currency with the public of 12.7 per cent and in demand deposits of 11.7 per cent in the preceding year. The growth in time deposits (18.2 per cent) has, however, been higher by 2.5 percentage points in the current year so far over the growth rate of 15.7 per cent in the corresponding period of last year. The net result of these trends is a decline in the currency-deposit and reserve-deposit ratios and, therefore, an increase in the money-multiplier in 1985-86.

7.7 Sources of growth in M_3 reveal that the expansion in net bank credit to Government has been Rs. 8,162 crores upto January 3, 1986, against the increase of Rs. 8,898 crores in the corresponding period of 1984-85. Of this, RBI's credit to Government accounts for an increase of Rs. 3,186 crores compared with the increase of Rs. 4,193 crores in the same period in 1984-85. Whereas net RBI credit to Central Government has increased by Rs. 5,504 crores in the current year (upto January 3, 1986), credit to State Governments has registered a sharp decline of Rs. 2,318 crores. This, however, includes an amount of Rs. 1,628 crores on account of the clearance of States' overdrafts by the Centre on October 1, 1985. Adjusting for this, net RBI credit to Central Government in the current year upto January 3, 1986 would amount to Rs. 3,876 crores compared with Rs. 3,282 crores in the corresponding period of 1984-85. The improvement in the position of the State Governments in the current year is estimated to be Rs. 690 crores against a deterioration of Rs. 911 crores in the same period last year. This is partly a reflection of greater monetary discipline by State Governments in the light of the restrictions on overdrafts from the RBI. In contrast to the low expansion of net RBI credit to Government, other banks' credit to Government in the current year so far has registered a higher increase of Rs. 4,976 crores as against the increase of Rs. 4,705 crores last year. Bank credit to commercial sector, on the other hand, has recorded a growth which is 1.3 percentage points below the rate of expansion during 1984-85 (*i.e.* 10.6 per cent against 11.9 per cent). Foreign exchange assets which had recorded an increase of Rs. 530 crores during 1984-85 (upto January 4) have declined by Rs. 160 crores in the current year so far.

7.8 At the beginning of the year, it was estimated that aggregate deposits of scheduled commercial banks would increase by Rs. 11,500 crores (16.2 per cent) during 1985-86, but by end-September 1985, the trend in deposit growth was higher, and it was anticipated that deposits would grow by Rs. 12,175 crores (16.9 per cent). As against this, the growth in aggregate deposits upto January 3, 1986 has been Rs. 12,147 crores (16.7 per cent) compared with the expansion of Rs. 9,668 crores (15.9 per cent) in the same period last year. Growth in food credit in the first half of 1985-86 was expected to be Rs. 400 crores and non-food credit to be Rs. 1,600 crores, resulting in a total increase of Rs. 2,000 crores in gross bank credit of scheduled commercial banks upto end-September, 1985. Against these estimates, the actual growth in food credit in the first six months of 1985-86 was only Rs. 237 crores, while non-food credit increased by Rs. 1,115 crores. With an increase in the kharif procurement of foodgrains, food credit was originally expected to increase further by about Rs. 1,150 crores by the seasonal peak in December 1985/January 1986 and thereafter it was expected to decline by about Rs. 200 crores by end—March 1986. The actual growth in food credit during the current year upto January 3, 1986 has been only Rs. 525 crores compared with the expansion of Rs. 1,772 crores in the corresponding period last year. As a result of a number of measures taken by the Government to contain the level of foodstocks (for example, increased allocations for anti-poverty programmes, open-market sales and liberal distribution through the Public Distribution System), the net increase in stocks in the current year upto December, 1985 was 2.6 million tonnes compared with an increase of 7.6 million tonnes in the corresponding period last year. Moreover, the food subsidy provided in the 1985-86 budget and the subsequent supplementaries was more than Rs. 500 crores above the 1984-85 level of Rs. 1,100 crores. Non-food credit increased at a rate (10.6 per cent) which was marginally higher than last year (10.3 per cent). As a consequence, gross bank credit has expanded in the current year upto January 3, 1986 by only 10.5 per cent compared with the expansion of 13.5 per cent in the same period last year.

TABLE 7.2

Scheduled Commercial Banks: Variations in Selected Indicators

(Rs. crores)

	Variations duringa@			
	1983-84	1984-85	1984-85 (Upto January 4, 1985*)	1985-86 (Upto January 3, 1986*)
1	2	3	4	5
1. Aggregate deposits (a+b)	9,374	11,839	9,668	12,147
(*a*) Demand Deposits	1,609	2,743	1,512	1,161
(*b*) Time Deposits	7,765	9,096	8,156	10,986
2. Borrowings from RBI.	688	469	655	—1,470
3. Cash in hand and balances with RBI (a+b)	2,771	2,759	1,123	—295
(*a*) Cash in hand	35	127	208	139
(*b*) Balances with RBI	2,736	2,632	915	—434
4. Net balances with RBI [3(b)—2]	2,048	2,163	260	1,036
5. Money at call and short notice	—43	189	47	126
6. Gross Bank Credit (a+b)	6,532	7,148	5,658	5,154
(*a*) Public food procurement credit	1,156	1,489	1,772	525
(*b*) Non-food gross bank credit	5,376	5,659	3,886	4,629
Of which : To priority sector£	2,577*	3,508*	..	..
7. Investments in Government and other approved securities (a+b)	2,862	3,732	5,931	6,661
(*a*) Government securities	1,348	2,087	4,632	4,909
(*b*) Other approved securities	1,514	1,645	1,299	1,752
8. Balances with other banks in current account	133	248	177	27
9. Credit-deposit ratio†	69.2	67.8	67.7	64.1
10. Non-food credit-deposit ratio†	62.4	60.0	59.4	56.9
11. Investment-deposit ratio†	34.9	34.3	38.5	37.3

@ Based on March 31 data.
* Provisional.
.. Not available.
£ Data relate to 50 banks which account for 95 per cent of gross bank credit. Variations are based on last Friday data.
† Percentage at the end of the period.

7.9 The growth in aggregate deposits of banks in the current year has not been matched by a commensurate increase in the demand for credit. Data available upto January 3, 1986 show that the credit-deposit ratio has declined to 64.1 per cent from 67.7 per cent a year ago. The non-food credit-deposit ratio has also come down from 59.4 per cent to 56.9 per cent during the same period. As the gap between the maximum deposit rate 11 per cent) and the maximum lending rate (17.5 per cent) is substantial, a declining credit-deposit ratio would tend to erode the profitability of banks. Banks have also, as a result, substantially reduced their borrowings from the RBI. In contrast to an increase of Rs. 655 crores during April, 1984—January 4, 1985, there has been a sharp decline of Rs. 1,470 crores in their borrowings during the same period in the current year. For meeting the higher statutory liquidity ratio (SLR) requirements, banks appear to have invested a substantial amount of their resources in government and other approved securities, which have increased during April, 1985—January 3, 1986 by Rs. 6,661 crores, compared with the increase of Rs. 5,931 crores in the same period last year. The investment-deposit ratio at 37.3 per cent on January 3, 1986 was, however, lower than that of 38.5 per cent on January 4, 1985.

Reserve Money

7.10 Reserve money represents those liabilities of the RBI and the Government that are deemed to be eligible as reserves to be held by banks for the purpose of deposit money. The ability of the banking system to create deposit money depends on banks' reserves (*i.e.* cash in hand and deposits with the RBI), on the one hand, and the public's preference for currency, on the other. The currency-deposit ratio is an indicator of public's preference for currency at any given point of time. The latter is influenced by a number of factors such as the degree of monetisation in the economy, the expected rate of inflation, the structure of interest rates and shifts in income between the urban and rural areas.

7.11 The ability of the banking system to create deposits also depends on the deposit multiplier which is dependent on the amount of reserves that are required to be maintained, according to the cash reserve ratio stipulations, as balances with the RBI. The growth in banks' balances with the RBI reflects the growth in deposits and the impact of the cash reserve stipulation.

TABLE 7.3

Sources of Change in Reserve Money

(Rs. crores)

	Outstanding as on March 31, 1982	Variations during†				
		1982-83*	1983-84	1984-85 (P)	1984-85 March 31 to January 4(P)	1985-86 March 31 to January 3(P)
1	2	3	4	5	6	7
1. Net RBI Credit to Government	20440	2508 (12.3)	3987 (17.5)	7426 (27.7)	4193 (15.6)	3186 (9.3)
2. RBI credit to banks£	1673	469 (28.0)	746 (36.8)	403 (14.5)	511 (18.4)	—1354 (—42.7)
3. RBI credit to commercial sector@	2044	429 (21.0)	455 (23.6)	372 (15.6)	392 (16.5)	314 (11.4)
4. Net foreign exchange assets of RBI	2706	—977 (—36.1)	—105 (—6.1)	1275 (78.5)	581 (35.8)	—159 (—5.5)
5. Government's currency liabilities to the public	657	25 (3.8)	37 (5.4)	58 (8.1)	16 (2.2)	19 (2.4)
6. Net non-monetary liabilities of RBI	6522	342 (5.2)	—763 (—12.6)	3311 (62.3)	1953 (36.8)	1316 (15.3)
7. Reserve Money (1+2+3+4+5—6)	20998	2112 (10.1)	5883 (25.5)	6223 (21.5)	3740 (12.9)	689 (2.0)

P Provisional
* These disregard changes in components of sources on July 12, 1982 following reclassification of aggregates necessitated by the establishment of NABARD.
† Variations are worked out on the basis of March 31 data after closure of Government accounts.
£ Includes claims on NABARD from 1982-83 onwards.
@ Excludes, since the establishment of NABARD, its refinance to banks.

Notes : 1. Figures in brackets are percentage variations.
2. Figures may not add up to totals because of rounding.

7.12 The growth in reserve money over the last two years has been substantial, though the sources of growth have been quite different in these two years. During 1984-85, reserve money had expanded by as much as 21.5 per cent against an even higher growth of 25.5 per cent in the previous year. The main source of growth in reserve money in 1984-85 was the rapid expansion in net RBI credit to Government by Rs. 7,426 crores (27.7 per cent) compared with an increase of only Rs. 3,987 crores (17.5 per cent) in 1983-84. In addition to this, net foreign exchange assets of the RBI recorded a growth of Rs. 1,275 crores in 1984-85 in sharp contrast to a decline of Rs. 105 crores in the previous year. Counteracting the expansionary effect of the above two factors in 1984-85, RBI's net non-monetary liabilities increased by Rs. 3,311 crores, in contrast to a decline of Rs. 763 crores in 1983-84.

TABLE 7.4

Sectoral Deployment of Gross Bank Credit

(Rs. crores)

On last Friday basis	Variations during			April to September	
	1982-83	1983-84	1984-85	1984*	1985@
I. Gross Bank Credit	5329	5930	7532	2333	2090
	(18.3)	(17.2)	(18.6)	(5.8)	(4.4)
1. Public Food Procurement Credit	837	1058	1643	785	182
2. Gross Non-Food Credit (a+b+c+d)	4492	4872	5889	1548	1908
	(16.6)	(15.5)	(16.2)	(4.3)	(4.5)
(*a*) Priority Sectors (i+ii+iii)	1646	2577	3508	1434	1205
	(15.4)	(20.9)	(23.5)	(9.6)	(6.5)
(*i*) Agriculture	660	869	1513	691	626
	(14.3)	(16.5)	(24.6)	(11.2)	(8.2)
(*ii*) Small Scale Industries	585	961	1161	306	371
	(15.0)	(21.4)	(21.3)	(5.6)	(5.6)
(*iii*) Other Priority Sectors	401	747	834	437	208
	(18.6)	(29.2)	(25.2)	(13.2)	(5.0)
(*b*) Industry (Medium & Large)	2121	1345	1327	—7	570
	(19.0)	(10.1)	(9.1)	(—0.1)	(3.6)
(*c*) Wholesale Trade (Other than food procurement) (i+ii+iii+iv)	155	—10	308	—34	91
	(7.1)	(—0.4)	(13.1)	(—1.5)	(3.4)
(*i*) Cotton Corporation of India	35	—97	—90	—129	—85
	(13.7)	(—33.4)	(—46.6)	(—66.8)	(—82.5)
(*ii*) Food Corporation of India (Fertiliser)	1	—171	—75	—66	—11
	(0.2)	(—41.5)	(—31.1)	(—27.4)	(—6.6
(*iii*) Jute Corporation of India	—41	—25	67	—20	—59
	(—35.7)	(—33.8)	(136.7)	(—40.8)	(—50.9)
(*iv*) Other Trade	160	283	406	181	246
	(11.3)	(17.9)	(21.8)	(9.7)	(10.9)
(*d*) Other Sectors	570	960	746	155	42
	(19.0)	(26.8)	(16.4)	(3.4)	(0.8)
II. Export Credit (included under item 2)	—70	315	301	121	—114
	(—3.9)	(18.3)	(14.7)	(5.9)	(—4.9)
III. Priority Sector advances as percent of net bank credit (including PCs) in the last month of the period	36.8	38.0	39.9	39.7	41.1

*Revised. @ Provisional.

Notes : 1. Data are provisional and relate to 50 scheduled commercial banks which account for about 95 per cent of Gross Bank Credit. Further, these gross bank credit data include bills rediscounted with RBI, IDBI, Exim Bank and other approved financial institutions and participation certificates. Net Bank Credit data are exclusive of bills rediscounted with RBI, IDBI, Exim Bank, and other approved financial institutions.

2. Figures in brackets are percentage variations.

3. PCs = Participation Certificates.

7.13 One of the positive features of the monetary situation during the current financial year (upto January 3, 1986) is the pronounced deceleration in the growth of reserve money (2 per cent) compared with the growth of 12.9 per cent in the same period last year. The main contributory factors to this trend have been : (i) a smaller increase of Rs. 3,186 crores in net RBI credit to Government compared with the increase of Rs. 4,193 crores last year; (ii) a decline in RBI's credit to banks of Rs. 1,354 crores against an increase of Rs. 511 crores during 1984-85 (upto January 4) and (iii) a decline of Rs. 159 crores in net foreign exchange assets of the RBI in contrast to the increase of Rs. 581 crores last year.

Sectoral Deployment of Bank Credit

7.14 Although the regulation of money supply and bank credit is of utmost importance at the aggregate level, the deployment of bank credit to various sectors at the dissaggregate level is of equal significance. The policy of increasing the share of bank lending to certain select sectors[1] on a priority basis to speed up economic development with social equality has gained increasing attention in the last decade. In the Sixth Five-Year Plan, the target for priority sector lending, to be achieved by March 1985, was fixed at 40 per cent of net bank credit. Within this overall target, the following sub-targets were also laid down : (a) at least 15 per cent of total bank credit should be extended as direct finance to agriculture including allied activities and (b) advances to 'weaker' sections of the society (which have been defined to cover small and marginal farmers, landless labourers, tenant farmers, share croppers, artisans, village and cottage industries, beneficiaries of the Integrated Rural Develapment Programme (IRDP), scheduled castes and scheduled tribes and beneficiaries of the Differential Rate of Interest Programme) should reach a level of 25 per cent of the priority sector advances, or ten per cent of the net bank credit outstanding by March,

[1]—These include agriculture, small scale industry, setting up of industrial estates, small road and motor transport operators, retail trade, small bussiness, professional and self-employed persons, education, housing loans to weaker sections and Scheduled Castes/Sccheduled Tribe, and consumption loans.

1985. As against these targets, data available for all public sector banks indicate that the overall target of 40 per cent net bank credit to priority sectors was exceeded by 1.3 percentage points. However, direct advances to agriculture and to weaker sections fell somewhat short of the targets; the former constituted 14.2 per cent of net bank credit as against a 15 per cent target set for March, 1985 and the latter was 9.4 per cent against the target of ten per cent.

7.15 Data on sectoral deployment of gross bank credit for the financial year 1984-85 show that food credit increased by Rs. 1,643 crores compared with a lower growth of Rs. 1,058 crores in 1983-84 and non-food credit expanded by Rs. 5,889 crores (16.2 per cent) in 1984-85 against an increase of Rs. 4,872 crores (15.5 per cent) in the previous year. What was remarkable about the growth in non-food credit in 1984-85 was the substantial growth in the credit extended to the priority sectors which increased by as much as Rs. 3,508 crores (23.5 per cent) against the increase of Rs. 2,577 crores (20.9 per cent) in the previous year. Of the various sub-sectors within the priority sector, credit to agriculture sector registered an increase of 24.6 per cent compared with that of 16.5 per cent during 1983-84.

7.16 Data for the current year upto September, 1985 show a much lower growth in food credit of Rs. 182 crores compared with an increase of Rs. 785 crores in the corresponding period of last year. Credit to the priority sectors has also decelerated, but its share in net bank credit has improved to 41.1 per cent from 39.7 per cent a year ago. (Table 7.4)

Developments in Credit Policy

7.17 Against the background of a rapid expansion in M_3 during 1984-85 there was a need to moderate the growth of liquidity and the pace of reserve money creation in the current financial year. Certain changes were, therefore, made in the credit policy for 1985-86, keeping in view the emerging economic situation and the basic objective of providing financial resources for meeting genuine productive requirements without creating inflationary conditions. From April 1, 1985, the maximum lending rate was reduced from 18 per cent to 17.5 per cent following the abolition of tax on interest income of banks. This downward adjustment was intended to provide relief to a wide spectrum of borrowers, including medium and large industry borrowers, small scale industry borrowers above Rs. 25 lakhs, public sector agencies entrusted with purchase and sale of commodities on commercial basis, and retail borrowers above Rs. 25,000. The lending rates for categories which already had a significant concessional element remained unaltered. The lending rate on pre-shipment credit for specified medium and heavy engineering goods, construction contracts and consultancy services was also reduced from 14.5 per cent to 14 per cent with effect from April 1, 1985.

7.18 With a view to providing resources for vital public sector investment within the framework of the Seventh Plan, without excessive creation of reserve money, the Statutory Liquidity Ratio (SLR) was raised from 36 per cent to 37 per cent in two phases—to 36.5 per cent effective from June 8, 1985 and to 37 per cent effective from July 6, 1985.

7.19 The main objective of the slack season policy of 1985 was to ensure that the credit requirements for the rabi food procurement and other productive activity were fully met without fuelling inflationary expectations. The threshold for food credit over which 100 per cent refinance was available was initially raised from Rs. 4,300 crores to Rs. 4,600 crores with effect from April 5, 1985. Taking into account the overall growth of liquidity and the likely credit requirements in the first half of 1985-86, the threshold for food credit refinance was raised further to Rs. 5,800 crores in three phases (to Rs. 5,000 crores from August 2, 1985, to Rs. 5,400 crores from August 30, 1985 and to Rs. 5,800 crores from September 27, 1985). Banks, however, were to be fully supported by increased refinance limits during the seasonal upswing of food credit in the quarter April-June, 1985. The interest rate on refinance for food credit was raised from ten per cent per annum to 11.5 per cent per annum effective from October 1, 1985. Interest rate on stand-by refinance was also raised from 11 per cent to 12.5 per cent from April 8, 1985.

7.20 With effect from April 8, 1985 scheduled commercial banks were given the freedom to fix interest rates on deposits of maturities of less than one year within the prescribed ceiling of 8 per cent. It was an innovative move and the expectation was that with reasonable rates of interest on such maturities, banks would be able to mobilise hitherto untapped resources and thereby widen their deposit base. A suitable increase in interest rates for shorter maturities was also expected to achieve a better distribution of term-deposits instead of the present highly skewed distribution with concentration around longer maturities at relatively higher costs. The fixed deposit rates prescribed for nine maturity periods were reduced to five and the deposit rate for one year and above but less than two years was raised from eight per cent to 8.5 per cent. The deposit rates for other maturities remained unaltered.

7.21 The above changes, however, did not lead to desired results. Banks started offering the maximum rate of eight per cent even for mautirities of 15 days, as a consequence of which there was a shift of deposits from current accounts and savings accounts to 15-day deposits. In view of these developments, with effect from May 27, 1985 the rate for matuities upto 90 days was restored to the level prevailing prior to April 8, 1985. The rate for matuities of 91 days to less than six months was fixed at 6.5 per cent, and for six months to less than one year at eight per cent.

7.22 Consequent upon the general world-wide decline in interest rates, the RBI reduced the interest rates on deposits under the Foreign Currency Non-Resident (FCNR) Accounts Scheme with effect from August 22, 1985. The reduction was 0.5 percentage point in the case of maturities of two years and above but below three years. In the case of maturities of one year and above but below two years, and for other maturities, the reduction was one percentage point.† The interest rates on Non-Resident External (NRE) Rupee Accounts, however, remained unchanged.

7.23 Following the coming into force of the provisions of Banking Laws (Amendment) Act, 1983 with effect from March 29, 1985 penalties were prescribed for shortfalls in the daily maintenance of SLR by banks. Strict implementation of the provisions of the Act would have meant that apart from the banks facing heavy penalties for the period since March 30, 1985 it could result in a sudden disruption of their vital credit operations. Wth a view to giving some more time to banks to rectify their shortfalls and to ensure continuous flow of credit for meeting the productive needs of the economy, a comprehensive scheme of phased introduction of penalties on SLR shortfalls was announced in July, 1985.

7.24 During the first half of 1985-86, although the growth in M_3 was lower than the increase in the corresponding period of the previous year, the rate of accretion of deposits was somewhat higher. Taking into account the real growth of the economy, the inflation rate, the balance of payments position and the growth of reserve money, it was expected that growth of deposits in the second half of 1985-86 could be larger than estimated. It was, therefore, necessary that despite some moderation in the rate of inflation and in M_3 growth, the cautious stance of credit policy should continue to be maintained in the busy season of 1985-86. At the same time, it was imperative that adequate credit was made available for normal seasonal requirements, particularly for sectors where there was a step up in output, or there was a need for a stimulus. In order to improve the liquidity position of banks, it was, therefore, decided to release, with effect from October 26, 1985, one-third of the cash balances maintained under the additional cash reserve of ten per cent of the incremental net demand and time libilities accruing between January 14, 1977 and October 31, 1980. Since the impounded cash balances amounted to Rs. 1487 crores, an amount of about Rs. 495 crores was released. Furthermore, the SLR on Non-Resident (External) Rupee Accounts (NRE) was reduced from 37 per cent to 25 per cent, with effect from October 26, 1985, thereby reducing the SLR requirement of banks by about Rs. 360 crores. Effective from the same date, the rate of interest payable on eligible cash balances of commercial banks maintained with the RBI over and above the three per cent statutory minimum cash reserve requirement, was raised from ten per cent to 10.5 per cent per annum to enable banks to adequately cover the cost of funds and to increase their reserves. This will increase banks' earnings by about Rs. 45 crores per annum.

7.25 Before November 22, 1985 banks were being provided export refinance at an interest rate of ten per cent per annum and the limits for such refinance were equivalent to 100 per cent of the increase in export credit over the monthly average level of credit in 1983. With effect from November 22, 1985, banks were provided refinance over the monthly average level of 1984. This bringing forward of the base for export refinance is a normal annual feature and although banks' export refinance access was initially reduced (by Rs. 380 crores), the experience in the past has been that access to refinance is quickly regained as banks expand export credit.

7.26 Apart from the above credit control measures, several important changes were also made effective from April 8, 1985 in selective credit controls. Over the years, the procedures had become complex and needed to be rationalised without departing from the central objective of preventing bank credit from being utilised for speculative hoarding of essential commodities. With a view to reducing the burden on banks of monitoring credit utilisation for commodities where there was a stipulation on the level of credit based on certain base years, (which were a decade old), the base period was uniformly brought forward to the three-year period, 1980-81, 1981-82 and 1982-83 (November—October). The structure of minimum margins for commodities was rationalised with a view to reducing the complex and multiple prescriptions and simplifying the operation of controls. Taking into account the regulated operations of roller flour mills

†Effective from February 10, 1986 there has been a further reduction of 0.5 percentage point for maturities of two years and above but less than five years, and of one percentage point for maturitis of five years.

and the comfortable position of public sector stocks of wheat, it was decided in April, 1985 that advances to this industry against wheat would be totally exempt from all the provisions of selective credit control. In view of the distinct improvement in the supply position of wheat, effective from October 26, 1985, all advances against wheat were exempted from selective credit controls. In addition to this, advances to mills against raw cotton and kapas were also exempted from selective credit controls from the same date. The minimum margins against stocks of paddy/rice and of cotton and kapas (per party other than mills) were reduced by 15 percentage points and the multiple prescriptions of margins for oilseeds were rationalised with downward adjustments. The minimum margin against stocks of vegetable oil to processing units was also reduced. The overall exemption limit for advances per borrower against the stocks of commodities covered by selective credit controls was first increased from Rs 5,000 to Rs. 25,000 in April, 1985 and effective from October 26, 1985, it was further raised to Rs. 50,000

Report of the Committee to Review the Working of the Monetary System

7.27 The Report of the Committee to Review the Working of the Monetary System, commonly referred to as the Chakravarty Committee Report, was submitted to the RBI in April, 1985. This Committee was required to provide a comprehensive review of the monetary system and suggest measures for improving the effectiveness of monetary policy. Major areas covered by the Committee are : the objectives of monetary policy; coordination between monetary policy and fiscal policy; regulation of money supply; maintenance of price stability; interest rate policy and utilisation of credit.

7.28 The Committee has emphasised the need to pursue price stability in the broadest sense as the objective of the monetary policy consistent with the other socio-economic goals embodied in the Five-Year Plans. It has recommended that the regulation of money supply (M_3) should be undertaken in a framework of monetary targeting in terms of a range, with feedback and with necessary support from an appropriate interest rate policy. The Committee has pointed out that the major cause of the substantial growth in money supply since 1970 has been the rise in RBI credit to Government. The main reason for the high degree of monetisation of debt is the relatively low yields on Government securities, and the low discount rate on Treasury Bills which has remained unchanged since 1974 at 4.6 per cent per annum. In this connection, the Committee has, *inter alia,* recommended that a proper framework for the regulation of RBI credit to Government should be evolved through coordination between the RBI and the Government. The Committee has recommended that monetisation of debt and the growth in RBI credit to Government should be controlled through a suitable restructuring of yields on Goverment securities and by revising the discount rate on Treasury Bills. These measures would facilitate greater participation in the Government's borrowing programme by the non-bank sector of public and hence reduce the growth in reserve money attributable to RBI credit to Government.

7.29 A change in the definition of budgetary deficit has been suggested by the Committee in order that an economically meaningful and unambiguous measure of the monetary impact of fiscal operations becomes available. Presently, the budgetary deficit of the Central Government essentially takes the form of an increase in Treasury Bills outstanding. This overstates the extent of monetary impact of fiscal operation, in as much as absorption of Treasury Bills by the public is not differentiated from the increase in the holdings of Treasury Bills by the RBI. However, more importantly the budgetary deficit does not presently reflect the support extended by the RBI to the Government's market borowing programme which represents a rise in RBI credit to Government with a corresponding impact on money supply

7.30 In order that credit requirements of productive sectors are adequately met within the overall limits set for monetary expansion, the Committee has recommended that banks should have greater freedom in determining their lending rates. This will also prevent excessive use of credit due to relatively low interest rates. The Committee is of the view that concessional interest rates as a re-distributive device should be used in a very selective manner. As regards interest rates on bank deposits, the Committee has recommended that they should be positive after adjusting for inflation, to encourage small savers. The interest rates should reflect the real cost of long-term loans for industrial projects so that projects which are basically not viable are discouraged.

7.31 The Committee has examined the various aspects of bank credit and made recommendations in regard to credit policies and procedures with a view to facilitating more efficient use of bank credit. It has stressed the importance of providing bank credit in the form of loans and bill finance instead of predominantly in the form of cash credit as at present. It has highlighted the disruptive effect on credit flows arising from tardy payments to suppliers by large public sector and private sector units as also Government and has recommended that interest on delayed payments should be provided for in purchase contracts.

7.32 The Committee is of the view that the problems associated with improving the effectiveness of priority sector lending are principally in the area of organisational re-orientation and effective communication and monitoring. It has emphasised the importance of strengthening the credit delivery system in the area of priority sector lending so that adequate and timely credit is made available to this sector.

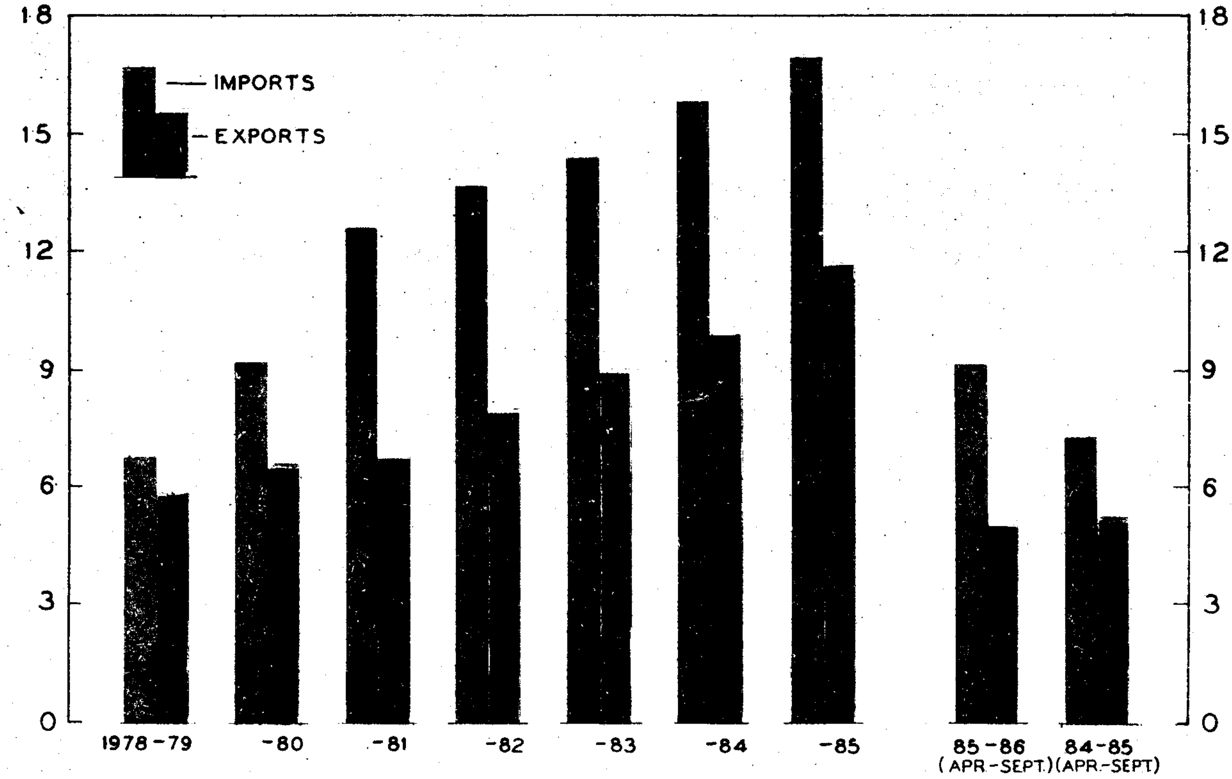
7.33 The recommendations made by the Committee also include those relating to the development of the money market. In the restructured monetary system envisaged by the Committee, the treasury bills market, the call money market, the commercial bills market and the inter-corporate funds market would be expected to play an important role in the allocation of short-term resources with minimum transactions cost and the minimum of delays. Further, according to the Committee, a well organised money market provides an efficient mechanism for the transmission of the impact of monetary regulation to the rest of the economy. Accordingly, the Committee has recommended that the RBI should take measures to develop an efficient money market.

7.34 The recommendations of the Committee are presently under consideration by the RBI and the Government.

7.35 In sum, the monetary trends in the current year so far suggest that the various monetary and credit policy measures taken to control excessive growth of liquidity in the economy have started yielding desired results. Growth in M_3 has been lower than last year by more than one percentage point. Expansion in net RBI credit to Government, which is an approximate indicator of the budgetary deficit of both the Central and State Governments has also been substantially below last year's level. This, however, has been partially offset by a modest increase in investment in Government securities by commercial and cooperative banks. The expansion in bank credit to the commercial sector is expected to pick up further in the coming months with the anticipated seasonal upswing in credit demand. Various credit policy measures announced for the 1985-86 busy season should improve the liquidity position of banks and would facilitate adequate expansion of credit for productive purposes. However, though some success has been achieved in bringing down the inflation rate, the basic stance of monetary policy will have to be cautious in view of the vast resources to be deployed, in both the public and the private sectors, during the Seventh Plan period.

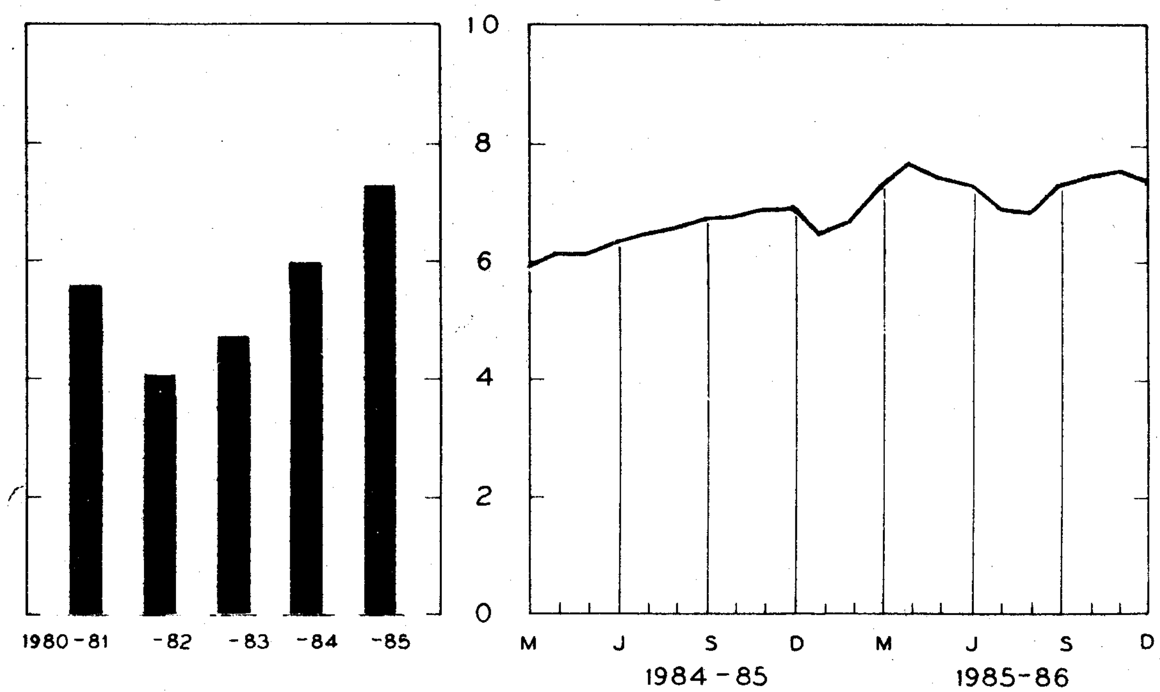
FOREIGN TRADE

RS. IN '000 CRORES



FOREIGN EXCHANGE RESERVES (INCLUDING GOLD & SDRs)

RS. IN '000 CRORES



MINISTRY OF FINANCE, ECONOMIC DIVISION.

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