CHAPTER 7

MONETARY AND CREDIT DEVELOPMENTS

A striking feature of monetary developments during the year has been the deceleration in the growth in money supply despite pressure on Government expenditure. The expansion in net Bank Credit to Government has also been slower than in the previous year. The sharp reduction in food credit *pari passu* with a large drawdown in foodgrains stocks provided room for expansion of other credit without affecting the overall monetary balance.

7.2 Early in the current year, the Statutory Liquidity Ratio (SLR) was raised from 37 to 37.5 per cent, effective from April 25, 1987, to facilitate the financing of plan expenditure without excessive creation of reserve money. Following the advent of drought, and as part of the overall strategy of aggregate demand management, the Cash Reserve Ratio (CRR) was raised from 9.5 per cent to 10 per cent effective from October 24, 1987. The SLR was also increased from 37.5 per cent to 38 per cent, effective January 2, 1988. While selective credit controls had been relaxed early in the financial year in view of positive price-output development, they were reimposed/tightened between July and October, 1987 in the case of oilseeds, vegetable oils, paddy/rice, "other foodgrains" (except wheat), cotton and kapas to combat inflationary pressures in sensitive commodities.

7.3 In July, 1987, the Credit Authorisation Scheme (CAS) was liberalized to allow for greater access to credit to meet genuine demands in production sectors without the prior sanction of the Reserve Bank. Banks were also advised to extend liberal credit facility to drought-affected farmers for second sowing or fodder cultivation as also facilities for credit rescheduling with a view to enabling them to prepare for rabi cultivation. The higher export credit refinance limits were also made available in the current year, as the base for determining export credit limit was not brought forward.

7.4 The most noteworthy feature in the evolution of sectoral credit patterns during the year was the sharp decline in food credit (by 38.9 per cent upto January 15, 1988) reflecting the policy of drawing down food stocks to augment supplies through the Public Distribution System. During this period non-food commercial credit increased by Rs. 5,944 crores as compared to Rs. 5,180 crores in the same period of 1986-87. These trends reflected the concern of monetary authorities to meet genuine credit needs of production and trade through appropriate expansion in non-food bank credit.

7.5 Effective April 1, 1987, important changes were made in the structure of interest rates of banks and postal deposits, bank credit as well as on other major financial instruments. The objectives guiding these changes were to reduce the overall cost of money in the economy and impart greater flexibility to interest rate policy.

7.6 The Working Group on Money Market, which was set up last year by the Reserve Bank to examine the possibilities of enlarging the scope of the money market and recommend specific measures for evolving other suitable money market instruments, submitted its report on January 13, 1987. The Reserve Bank has taken action to implement some of the major recommendations of the Group.

Monetary Trends during 1986-87

7.7 During 1986-87 both narrow money (M_1) and broad money (M_3) recorded faster growth than in 1985-86 (on 31st March basis). While the increase in M_1 was of the order of 16.8 per cent as compared to the increase of 10.5 per cent in 1985-86, the acceleration in the growth of M_3 was comparatively modest, from 15.9 per cent in 1985-86 to 18.6 per cent in 1986-87. The growth rate of time deposits was about the same (19.4 per cent and 19.6 per cent in the two respective periods). Among other components of M_3, currency with the public expanded by 13.3 per cent as against 10.5 per cent in the preceding year, but the growth in demand deposits was fairly substantial at 21.7 per cent as compared with the modest growth of 12.6 per cent recorded in 1985-86.

7.8 Among the sources of change in M_3, the sizeable expansion in net bank credit to Government was the leading contributory factor behind the acceleration in the growth rate of M_3 in 1986-87. Net Bank Credit to Government grew by Rs. 13,699 crores (23.5 per cent) as compared to an increase of Rs. 8,093 crores (16.1 per cent) in 1985-86, both on account of the increase in net RBI credit as well as other banks' credit to Government. In this context, it may be noted that more attractive coupon rate on Government securities, and stricter enforcement of SLR requirements on a daily basis by banks resulted in the sharp rise in banks' holdings of Government securities during 1986-87. As regards the net Reserve Bank credit to Central Government, the increase of Rs. 7,091 crores in 1986-87 was much larger than the increase of Rs. 4,561 crores (excluding Rs. 1,628 crores of medium-term loans given to States to clear their overdrafts with the RBI) recorded in 1985-86, mainly reflecting the sharp increase in the Centre's budgetary deficit in that year. As regards States, the net RBI credit to them expanded by Rs. 516 crores in 1986-87, which was in sharp contrast to a decline of Rs. 119 crores in the preceding year. Adjusted for Rs. 1,628 crores of medium-term loan given by the Centre to the States to clear their over-drafts with the RBI, the decline in net RBI credit to State Governments in 1985-86 was Rs. 1,747 crores. The increase in net foreign exchange assets of the banking sector was somewhat larger in absolute terms at Rs. 881 crores (22.8 per cent) as compared to the increase of Rs. 737 crores (23.5 per cent) in 1985-86. The growth rate in bank credit to the commercial sector decelerated to 14.4 per cent (Rs. 11,926 crores) from 16.7 per cent (Rs. 11,850 crores) in 1985-86.

TABLE 7.1

Sources of Change in Money Stock

(Rs. crores)

	Variations during			
	1985-86 March 31 to March 31	1986-87 March 31 to March 31	1986-87 March 31 to January 16 P	1987-88 March 31 to January 15 P
1	2	3	4	5
I. M_1 (Money supply with the public)	4,180 (10.5)	7,420 (16.8)	5,086 (11.5)	5,311 (10.3)
II. M_3 (Aggregate monetary resources)	16,322 (15.9)	22,030 (18.6)	18,574 (15.7)	20,395 (14.5)
(i) Currency with the public	2,387 (10.5)	3,323 (13.3)	2,562 (10.2)	3,974 (14.0)
(ii) Demand deposits with banks	2,099 (12.6)	4,077 (21.7)	2,672 (14.3)	1,370 (6.0)
(iii) Time deposits with banks	12,142 (19.4)	14,610 (19.6)	13,488 (18.1)	15,084 (16.9)
(iv) 'Other' deposits with RBI	—306	20	—148	—33
III. Sources of change in M_3(1+2+3+4—5)				
1. Net Bank Credit to Government (a+b)	8,093 (16.1)	13,699 (23.5)	12,852 (22.0)	11,991 (16.6)
(a) RBI's net credit to Government (i+ii)	4,442	7,607	6,997	6,761
(i) To Central Government	6,189	7,091	7,472	7,553
(ii) To State Governments	—1,747	516	—475	—792
(b) Other banks' credit to Government	3,651	6,092	5,855	5,230
2. Bank credit to commercial sector (a+b)	11,850 (16.7)	11,926 (14.4)	6,920 (8.4)	6,708 (7.1)
(a) RBI's credit to commercial sector*	300	342	356	413
(b) Other banks' credit to commercial sector	11,550	11,584	6,564	6,295
3. Net Foreign Exchange Assets of banking sector	737 (23.5)	881 (22.8)	—111 (—2.9)	—59 (—1.2)
4. Government's Currency Liabilities to the public	163 (21.0)	252 (26.8)	122 (13.0)	94 (7.9)
5. Banking sector's Net non-monetary Liabilities other than Time Deposits (a+b)	4,521 (19.9)	4,728 (17.3)	1,209 (4.4)	—1,661 (—5.2)
(a) Net non-monetary liabilities of RBI	2,085	2,737	1,535	100
(b) Net non-monetary liabilities of other banks (residual).	2,436	1,991	—326	—1,761

P=Provisional.

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

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.

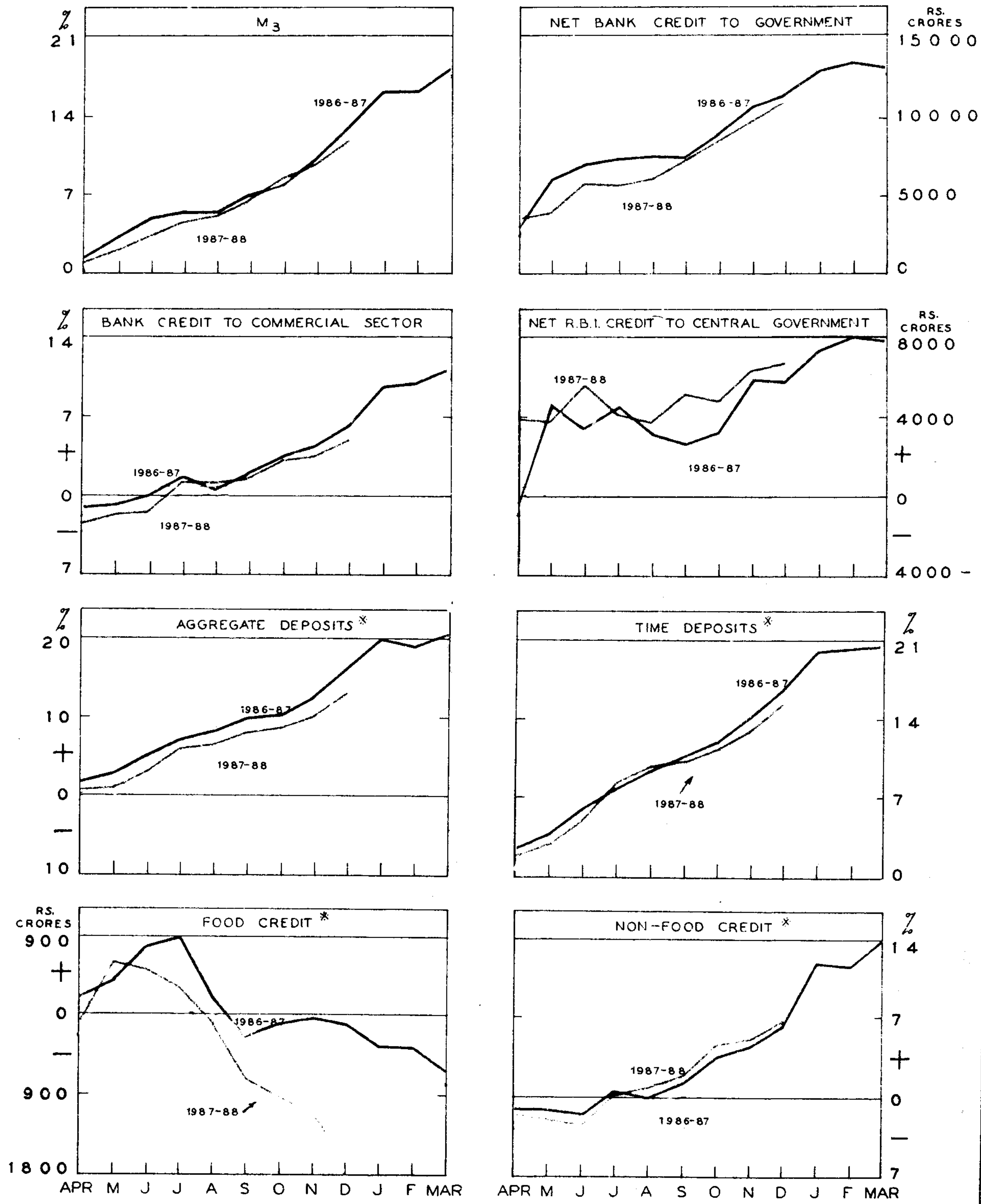
7.9 The scheduled commercial banks' data show that their aggregate deposits had risen by 20.1 per cent in 1986-87, which was 2 percentage points more than the increase of 18.1 per cent recorded in 1985-86. This was due to a marked acceleration in the growth of demand deposits in 1986-87 to 22.6 per cent from 12.2 per cent in 1985-86. The growth in time deposits, however, remained unchanged at 19.5 per cent. The rate of expansion in gross bank credit, on the other hand, decelerated to 13.5 per cent from 16 per cent in 1985-86, the main reason being a return flow of food credit of Rs. 1,295 crores into the banking system, following the grant of a loan of Rs. 1,200 crores by the Central Government to the Food Corporation of India (FCI) for the maintenance of buffer stocks of foodgrains. Non-food credit, however, increased by 17.6 per cent in 1986-87 which was marginally higher than the increase of 17.4 per cent recorded in the preceding year.

Monetary Trends during 1987-88

7.10 In the current year so far, (i.e. upto January 15, 1988) the growth in broad money (M_3) has been slightly lower (14.5 per cent) than the growth of 15.7

GROWTH IN SELECTED MONETARY INDICATORS

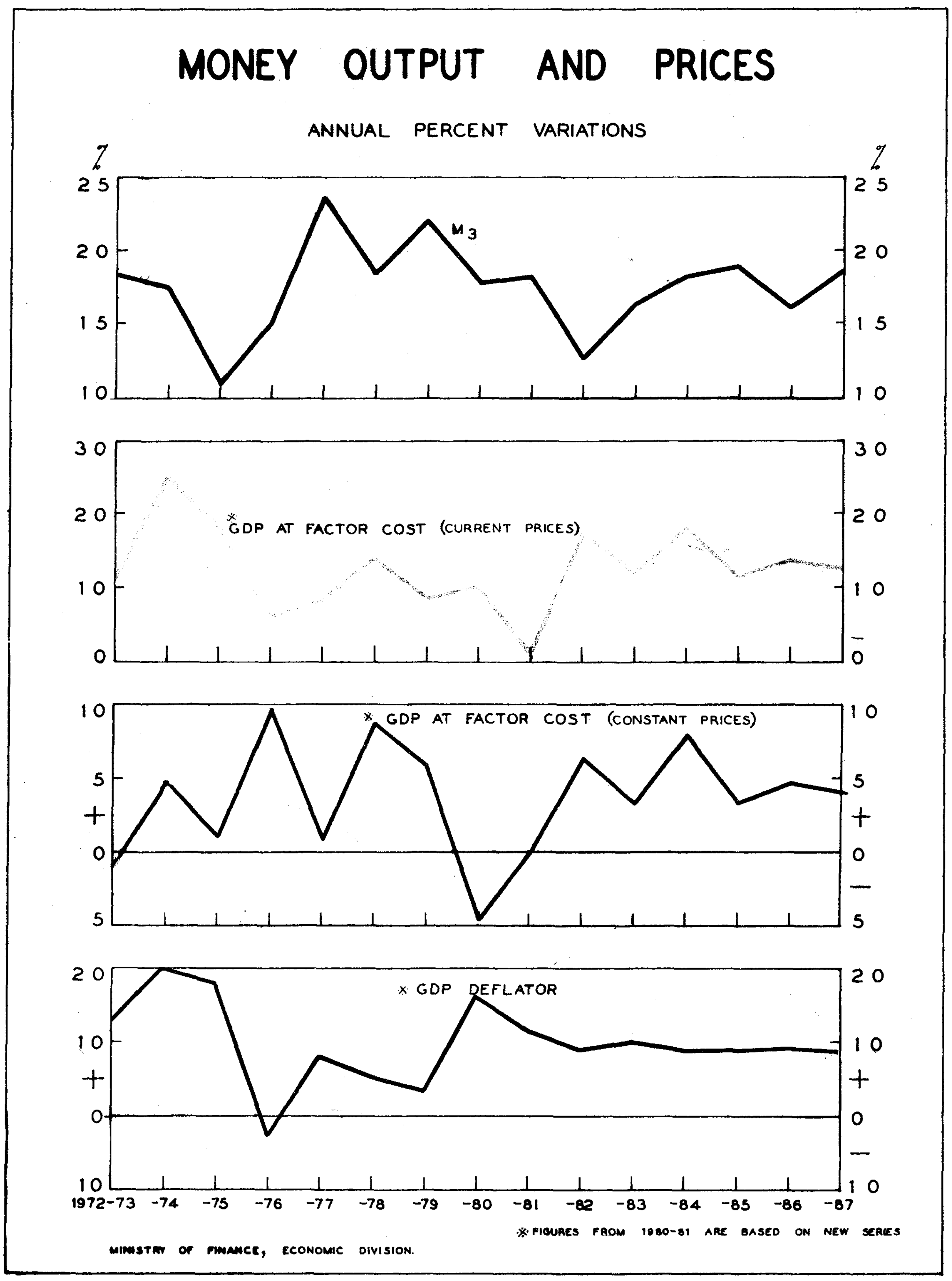
LAST FRIDAY DATA [PROVISIONAL]



MINISTRY OF FINANCE, ECONOMIC DIVISION

* DATA RELATE TO SCHEDULED COMMERCIAL BANKS
NOTE:- BASE YEAR DATA FOR MARCH 31 ST.

MGIP(PLU)MRND-668/1/F/87-88



MGIP(PLU)MRND-668/1/F/87-88

per cent in the corresponding period of 1986-87, though in absolute terms the expansion was larger. Component-wise, currency with the public rose at a higher rate of 14.0 per cent as against a rise of 10.2 per cent in 1986-87. On the other hand, time deposits recorded a growth rate of 16.9 per cent, which was somewhat lower than the increase of 18.1 per cent in 1986-87 (upto January 16, 1987). As regards demand deposits, there was a steep deceleration in its growth during the current financial year so far, the growth rate working out to only 6.0 per cent as against 14.3 per cent in the comparable period of 1986-87. The deceleration in the growth rate of demand deposits is apparently due to portfolio management being resorted to by the banks in the form of providing buy-back arrangements to the holders of Government securities.

7.11 The main factor responsible for a slightly lower rate of expansion in M_3 this year so far (upto January 15, 1988) is the relatively modest growth of 16.6 per cent (Rs. 11,991 crores) in net bank credit to Government against the increase of 22.0 per cent (Rs. 12,852 crores) in the corresponding period of 1986-87. The other factor moderating growth of M_3 in 1987-88, so far, has been the slower increase in bank credit to the commercial sector (7.1 per cent as against 8.4 per cent in 1986-87), due in large part to the sharp decline in food credit, resulting from the draw-down in food-stocks. However, the decline in net foreign exchange assets this year has so far been lower at Rs. 59 crores, as against the decline of Rs. 111 crores in the corresponding period of 1986-87. In other words, the moderating effect of declining foreign assets on M_3 growth has been lower this year so far relative to the same period of the previous year.

7.12 The lower increase in net bank credit to Government this year so far has been due to a comparatively smaller expansion in both the net Reserve Bank credit and other banks' credit to Government. The expansion in net RBI credit at Rs. 6,761 crores so far compares favourably with that of Rs. 6,997 crores between March 31, 1986 and January 16,1987. The increase in other banks' credit to Government was much lower at Rs. 5,230 crores in relation to the increase of Rs. 5,855 crores in 1986-87. While State Governments paid back to the Reserve Bank Rs. 792 crores of credit during March 31, 1987 and January 15, 1988, the Centre's indebtedness to Reserve Bank increased by Rs. 7,553 crores, which was marginally higher than the increase of Rs. 7,472 crores in the same period of 1986-87.

7.13 Selected indicators pertaining to scheduled commercial banks' financial operations are presented in Table 7.2. Their aggregate deposits have grown by 15.0 per cent between March 31, 1987 and January 15, 1988 as against 18.3 per cent in the comparable period of 1986-87. This lower rate of expansion in aggregate deposits is basically due to the substantially smaller rise of 5.4 per cent in demand deposits in the current year as against 15.4 per cent in the last year (upto January 16, 1987). Time deposits have also shown a lower expansion of 17.2 per cent this year as compared to 18.9 per cent last year. Total bank credit has also recorded a modest growth of 6.4 per cent relative to the growth of 8.0 per cent recorded in the same period last year. Because of the severe drought conditions this year, food procurement has been lower and the release of food stocks through the Public Distribution System has been stepped up, resulting in a sharp decline of Rs. 1,791 crores in food credit between March 31, 1987 and January 15, 1988, as compared to a decline of Rs. 596 crores in the same p d last year. The rate of expansion in non-food credit has also been a shade lower at 9.9 per cent in the current year so far, compared to the rise of 10.1 per cent in the same period of 1986-87 though there was a small rise in absolute terms.

TABLE 7.2

Scheduled Commercial Banks : Variations in Selected Indicators

(Rupees crores)

	Variations during@			
	1985-86	1986-87	1986-87 Upto January 16, 1987*	1987-88 Upto January 15, 1988*
1	2	3	4	5
1. Aggregate Deposits (a + b) . .	+13133	+17228	+15651	+15407
(*a*) Demand Deposits	+1756	+3640	+2478	+1069
(*b*) Time Deposits .	+11377	+13588	+13173	+14338
2. Borrowings from R.B.I. . . .	—943	+348	—315	—14
3. Cash in hand and balances with R.B.I. (a + b) . .	+864	+3231	+3040	+3761
(*a*) Cash in hand .	+231	+24	—53	+65
(*b*) Balances with R.B.I. . .	+633	+3207	+3093	+3696
4. Net balances with R.B.I. [3 (b) — 2] .	+1576	+2859	+3408	+3710
5. Money at call and short notice . .	—67	+1725	+671	—950
6. Gross Bank Credit (a + b) . .	+7869	+7706	+4584	+4153
(*a*) Public food procurement credit	+293	—1295	—596	—1791

1	2	3	4	5
(*b*) Non-food bank credit . .	+7576	9001	+5180	+5944
Of which :				
to priority sector£	+3157	+3493	..	..
7. Investments in Government and other approved securities (a + b) . .	+5666	+8276	+7736	+7292
(*a*) Government securities .	+3549	+5984	+5783	+5153
(*b*) Other approved securities . .	+2117	+2292	+1953	+2139
8. Balances with other banks in current account . .	+418	—369	—632	—22
9. Credit-deposit ratio†	66.6	62.9	60.8	58.2
10. Non-food credit-deposit ratio† .	59.7	58.4	55.6	55.8
11. Investment-deposit ratio† . . .	35.7	37.8	37.8	39.0

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

7.14 As a result of relatively lower growth in bank credit, the credit-deposit ratio on January 15, 1988 has declined to 58.2 per cent from 60.8 per cent prevailing a year ago. The non-food credit-deposit ratio remains unchanged at around 56 per cent. Investment-deposit ratio has increased from 37.8 per cent to 39.0 per cent during this period.

Reserve Money

7.15 According to the Chakravarty Committee, a fairly stable and strong relationship is found between the reserve money and the money stock (M_3), especially if reserve money is adjusted for changes in cash-reserve ratio. Net RBI credit to Government, which is the most important source of reserve money and which is basically influenced by the budgetary deficit of the Central and State Governments constituted 83 per cent of the total reserve money at the end of March 1971. It has been almost continuously rising since then and as on 31st March 1987, the ratio stood at 103.3 per cent.

TABLE 7.3
Sources of Change in Reserve Money

	Out-standing as on Mar. 31, 1984 (Rs. crores)	Variations during+									
		1984-85		1985-86		1986-87		1986-87 March 31 to Jan. 16, 1987 P		1987-88 March 31 to Jan. 15, 1988 P	
		Rs. crs.	Per-cent	Rs. crs.	Per-cent	Rs. crs.	Per-cent	Rs. crs.	Per-cent	Rs. crs.	Per-cent
1	2	3	4	5	6	7	8	9	10	11	12
1. Net RBI credit to Govt. .	26,810	7,426	27.7	4,442	13.0	7,607	19.7	6,997	18.1	6,761	14.6
2. RBI credit to banks£ . .	2,771	403	14.5	—712	—22.4	298	12.1	—382	—15.5	612	22.2
3. RBI credit to commercial sector*	2,380	372	15.6	300	10.9	342	11.2	356	11.7	413	12.2
4. Net foreign exchange assets of RBI	1,624	1,275	78.5	841	29.0	881	23.6	—111	—3.0	—59	—1.3
5. Government's currency liabilities to the public . . .	719	58	8.1	163	21.0	252	26.8	122	13.0	94	7.9
6. Net non-monetary liabilities of RBI	5,311	3,311	62.3	2,085	24.2	2,737	25.6	1,535	14.3	100	0.7
7. Reserve Money (1+2+3+4+5—6) .	28,993	6,223	21.5	2,949	8.4	6,643	17.4	5,447	14.3	7,721	17.2

+ = Variations are worked out on the basis of March 31 data after closure of Government accounts.
P = Provisional
£ = Includes claims on NABARD.
* = Excludes, since the establishment of NABARD, its refinance to banks.
Note : Figures may not add up to totals because of rounding.

7.16 Reserve money recorded a rise of 17.4 per cent in 1986-87 (on 31st March basis) as against the increase of only 8.4 per cent in 1985-86. Source-wise, a larger expansion in net RBI credit to Government in 1986-87 (Rs. 7,607 crores) than in 1985-86 (Rs. 4,442 crores) was the main contributory factor to the higher growth in reserve money. Movements in RBI credit to banks also aggravated the growth in reserve money. In sharp contrast to a decline of Rs. 712 crores in 1985-86, RBI credit to banks recorded an increase of Rs. 298 crores in 1986-87. Component-wise, a large growth in currency held by the public (13.3 per cent increase in 1986-87, as against 10.5 per cent in 1985-86), as well as in the banks' deposits with the Reserve Bank (28.5 per cent and 5.6 per cent increase in the two periods respectively) mainly explain the faster growth in reserve money in 1986-87.

7.17 In the current year so far (i.e. between March 31, 1987 and January 15, 1988), reserve money has recorded a faster growth of 17.2 per cent compared to 14.3 per cent increase in the same period last year. Among the main factors contributing to this higher growth are : (i) expansion in RBI credit to banks in sharp contrast to a substantial decline in the same period last year; (ii) a lower decline in RBI's foreign exchange assets in comparison with last year; and (iii) a negligible growth in the non-monetary liabilities of RBI (0.7 per cent as against 14.3 per cent last year). However, the net RBI credit to Government in the current year so far has recorded an increase of 14.6 per cent (Rs. 6,761 crores) which is lower than the increase of 18.1 per cent (Rs. 6,997 crores) in the corresponding period of 1986-87.

Trends in Sectoral Deployment of Credit

7.18 Apart from regulating the overall level of credit in the economy, the objective of credit policy is to promote an effective use of credit and also to enlarge the spectrum of borrowers covered by bank credit keeping in view the national priorities laid down from time to time. One important criterion in this regard is the share of the priority sector in the total net bank credit at a given point of time. Table 7.4 presents the broad sectoral pattern of the incremental credit deployed by 50 scheduled commercial banks, which account for about 95 per cent of the total gross bank credit. The latest available data indicate that credit to priority sector, which constituted 40.8 per cent of the total net bank credit at the end of 1985-86 and had increased to 42.2 per cent by the end of 1986-87 moved up further to 44.0 per cent by end of September, 1987. This compares with the national target of 40 per cent. In 1986-87, the credit to the priority sector had risen by Rs. 3,493 crores, of which Rs. 1,530 crores (44 per cent) was accounted for by agriculture and Rs. 1,287 crores (36.8 per cent) by small scale industries. The other priority sectors, such as the weaker sections, small transport operators, rural artisans and self-employed persons claimed nearly a fifth of the increase in the total credit to the priority sector. A striking feature of the sectoral deployment of credit during 1986-87 was almost no growth in bank credit to the wholesale trade (other than food procurement), whereas a year earlier, this sector had recorded a growth of 15.7 per cent. The growth in bank credit to medium and large industries also decelerated from 16.8 per cent in 1985-86 to 15.7 per cent in 1986-87. However, the expansion in export credit was substantial (Rs. 737 crores) in 1986-87 as against the increase of Rs. 294 crores in 1984-85 and only Rs. 74 crores in 1985-86. It may be recalled that in 1986-87 uniform rates of interest on pre-shipment credit for all commodities for export came to replace the earlier varying rates according to commodities. As a measure for boosting exports,

TABLE 7.4

Sectoral Deployment of Gross Bank Credit

On the last Friday basis	Variations during									
	1984-85		1985-86		1986-87		April-Sept. 1986		April-Sept. 1987	
	Rs. crores	Per cent	Rs. crores	Per cent	Rs. crores	Per cent	Rs. crores	Per cent	Rs. crores	Per cent
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)
I. Gross Bank Credit	7535	18.6	7257	15.1	7330	13.3	1050	1.9	1569	2.5
1. Public Food Procurement	1643	..	—130	..	—431	..	—65	..	—1380	..
2. Gross Non-food Credit (a+b+c+d)	5892	16.2	7387	17.5	7761	15.6	1115	2.2	2949	5.1
(a) Priority Sector (i+ii+iii)	3510	23.6	3157	17.1	3493	16.2	1112	5.2	1544	6.2
(i) Agriculture	1516	24.7	1398	18.3	1530	16.9	618	6.8	648	6.1
(ii) Small Scale Industry	1165	21.4	1204	18.2	1287	16.5	313	4.0	525	5.8
(iii) Other Priority Sectors	829	25.1	555	13.4	676	14.4	181	3.9	371	6.9
(b) Industry (Medium and Large)	1318	9.0	2683	16.8	2930	15.7	198	1.1	1019	4.7
(c) Wholesale Trade (Other than food procurement) (i+ii+iii+iv)	306	13.1	417	15.7	6	0.2	—346	—11.3	—37	—1.2
(i) Cotton Corporation of India	—58	—30.0	25	18.5	—51	—31.9	—45	—28.1	—109	—100.0
(ii) Food Corporation of India (Fertiliser)	—75	—31.1	—25	—15.1	8	5.7	9	6.4	10	6.7
(iii) Jute Corporation of India	67	136.7	11	9.5	71	55.9	19	15.0	—31	—15.7
(iv) Other Trade	372	20.0	406	18.2	—22	—0.8	—329	—12.5	93	3.6
(d) Other Sectors	758	16.7	1130	21.3	1332	20.7	151	2.4	423	5.5
II. Export Credit (Included under item 2)	294	14.6	74	3.2	737	30.6	160	6.6	346	11.0
Priority Sector Advances as percentage of the Net Bank Credit (including PCs) in the last month of the period		39.8		40.8		42.2		42.2		44.0

Notes : 1. Data are provisional and relate to 50 scheduled commercial banks which account for about 95 per cent of the bank credit. 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. PCs—Participation Certificates.

interest rates on export credit were lowered by 2.5 percentage points with effect from August 1, 1986. While the interest subsidy available to the banks was doubled from 1.5 per cent to 3 per cent, interest rate on Reserve Bank's export refinance was reduced from 10 to 9 per cent.

7.19 For the current year, the data for sectoral deployment of credit are available only upto September, 1987. Apart from the share of the priority sector, as stated earlier, registering an increase during this period another important feature was the continued expansion in export credit (11.0 per cent compared to 6.6 per cent in the first half year of 1986-87), which was in keeping with the policy objective of export promotion.

Developments in Credit Policy

7.20 Controlled monetary expansion continued to be the central theme of credit policy in the current year keeping in view the important role of money and credit in a developing economy such as ours. On the demand side, money supply creates liquid assets and generates demand for goods and services. Though there is no one to one correspondence between changes in money supply and the price level, it has been observed by the Chakravarty Committee that variations in money supply find reflection in the price level over a period of time, if expansion in money supply becomes disproportionate to real output growth. On the supply side, however, money plays an important role as credit (financial input) for production and if credit expansion is unduly restrained, it may have adverse consequences on production. Increasing monetisation of the economy also calls for some monetary and credit expansion.

7.21 The note of caution against the growth of excessive liquidity was struck at the beginning of the year when the Statutory Liquidity Ratio (SLR) was raised from 37 per cent to 37.5 per cent, effective from April 25, 1987. The upward revision in SLR was aimed at providing resources for public sector investment without excessive creation of reserve money. Earlier, effective from February 28, 1987, the Cash Reserve Ratio (CRR) on banks' net demand and time liabilities [excluding Foreign Currency (Non-Resident) (FCNR) Accounts and Non-Resident (External) (NRE) Rupee Accounts] had been raised from 9.0 per cent to 9.5 per cent. Moreover, the decision for release of the second instalment equivalent to Rs. 248 crores of impounded cash balances of scheduled commercial banks through incremental CRR between January 14, 1977 and October 31, 1980 was rescinded in March 1987. The CRR applicable on FCNR deposit liabilities was also raised from 3 per cent to 9.5 per cent, effective from May 23, 1987.

7.22 To impart flexibility in interest rate policy as also to reduce the cost of money, both lending and deposit rates were revised from April 1, 1987 (this is discussed in a separate Section elsewhere in this Chapter).

7.23 During the early part of the year, the process of rationalisation of selective credit controls was carried further and the minimum margins in respect of "other foodgrains", pulses, released stocks of sugar, gur and khandsari were redued by 15 percentage points, effective from April 1, 1987. For commodities in respect of which there was a stipulation on the level of credit based on the three-year period 1981-82 to 1983-84 (November-October), the base was brought forward to 1982-83, 1983-84 and 1984-85, also from April 1, 1987.

7.24 After an exhaustive review of the Credit Authorisation Scheme (CAS), the Reserve Bank, in July 1987, decided that parties who broadly comply with the prescribed discipline should be treated differently from those who do not. Accordingly, banks were permitted to release the entire amount of additional limits sanctioned by their Board of Directors without prior approval of the Reserve Bank in respect of parties who comply with the requirements of CAS relating to (i) method of lending; (ii) information system; and (iii) inventory/receivable norms. Further, for parties who conform to the requirements (i) and (ii), banks will have the discretion of relaxing the norms upto 20 per cent of the standard norms/past trends and such cases also need not be referred to the Reserve Bank for prior approval of enhanced credit limits. These and other decisions are expected to reduce the number of CAS cases to be referred to the Reserve Bank by about 35 per cent. Where cases have still to be referred to the Reserve Bank, the existing limit for temporary accommodation by banks upto three months has been raised substantially, *i.e.*, upto not exceeding 25 per cent of the existing packing credit limits and 10 per cent of the existing working capital (other than packing credit) limits, subject to an overall ceiling of Rs. 4 crores as against Rs. 2 crores hitherto. In addition to these discretionary powers, banks are permitted to sanction a separate additional inland bill limit for a period not exceeding 3 months upto an amount equivalent to 10 per cent of the existing bill limit, subject to a ceiling of Rs. 2 crores, as against Rs. 1 crore permitted since April 1, 1987.

7.25 Revised instructions were issued to banks for ensuring closer co-ordination between them and the financial institutions in dealing with sick industrial units with a view to expediting decisions on measures for their rehabilitation and their implementation.

Fresh guidelines were issued to strengthen lending under consortium arrangements which provide for automaticity about the selection of the lead bank under multiple financing arrangements and envisage a pivotal role to be played by the lead bank. While "Single Window Concept" which was initiated last year for rupee loans only, came to be extended to cover the opening of letters of credit for foreign currency loans as well, the matter of extending this concept for lending under consortium arrangements is being examined.

7.26 Following the drought in the current year, in August, 1987 the Reserve Bank advised the banks to provide financial assistance to the affected farmers/persons on a priority basis in order to enable them to undertake a second sowing, raise an alternative short duration crop or fodder cultivation. The banks were further advised to allow conversion of short-term loans into medium-term loans as also to reshedule investment credit in case of a complete loss of crops. In addition, banks were to provide loans for minor irrigation and setting up of fair price shops. The limit of consumption loans to small and marginal farmers and other weaker sections of the society was doubled from Rs. 250 to Rs. 500. The banks were also advised that in case a bank faces temporary resources constraint in extending assistance to affected persons, it may approach Reserve Bank of India for accommodation under the existing refinance facilities.

7.27 The banks were further advised in September, 1987 that in the case of farmers affected by drought for three or more years in sucession, they may defer, on merits of each case, recovery of the amounts falling due on account of principal and interest in the current year (July 1987-June 1988) for a period of 2 years or till the next normal year, whichever is earlier. Besides, banks should not charge penal interest in these cases nor should they compound the interest on dues postponed. Banks should also ensure that in the case of short-term loans the total interest payable by small and marginal farmers does not exceed the principal amount. Banks have also been advised that the lead bank machinery in the concerned districts should be activated and immediate meetings of the District Consultative Committee (DCC) should be held. The progress in implementing the action plan should be monitored closely by the standing committee by holding special mid-month meetings. This is to be reviewed by the DCC. In all the affected States, the nature of assistance to be extended to the affected persons would also be discussed on an urgent basis by the State Level Bankers Committee. Regional Managers of the banks have to pay special attention and oversee the performance of each of the branches under their control in rendering assistance on the basis of the agreed programme allotted to them. They should be able to visit all the bank branches in the affected areas and review the progress and provide necessary guidance.

7.28 In October, 1987 banks were advised to charge a rate of interest of 10 per cent on short-term loans upto Rs. 5,000 each in case of farmers who have suffered three or more consecutive droughts/floods and whose loans have been converted/rescheduled. This rate is applicable for each of the years converted/rescheduled in 1987-88 and to be repaid in future years as per the instalments fixed, within due dates.

TABLE 7.5

Minimum Margins on Bank Advances Against Stocks of Commodities covered under Selective Credit Controls

(Percentages)

Commodities	Effective April 1, 1987			Effective October 19, 1987		
	Against stocks		Against warehouse receipts	Against stocks		Against warehouse receipts
	Processing units/mills	Others		Processing units/mills	Others	
1. Paddy/rice .	X	X	X	45	60	45
2. Other foodgrains (other than paddy/rice and wheat)	30	45	30	45	60	45
3. Pulses . .	30	45	30	45	60	45
4. Oilseeds :						
(a) Groundnut, rapeseed/mustard seed, linseed, castorseed and all imported oilseeds .	30	45	30	45	60	45
(b) Cottonseed	X	X	X	45	60	45
5. Vegetable oils :						
(a) Groundnut oil, rapeseed/mustard oil, linseed oil, castor oil, vanaspati and imported vegetable oils .	30*	60	45	45*	75	60
(b) Cottonseed Oil . .	X	X	X	45*	75	60
6. Cotton and Kapas	X	X	X	X	45	30
7. Sugar :						
(a) Buffer .	0	—	—	0	—	—
(b) Unreleased stocks .	17.5	—	—	17.5	—	—
(c) Released .	60	60	45	60	60	45
8. Gur and Khandsari . .	30	60	45	30	60	45

X : Completely exempt from all the stipulations of Selective Credit Controls.

* : Applicable to registered oil mills and vanaspati manufacturers.

— : Not applicable.

7.29 After a review of price-output developments, selective credit controls on a number of sensitive commodities were tightened with a view to preventing the use of bank credit for speculative purposes. The minimum margins on bank advances against the stocks of oilseeds and vegetable oils (including vanaspati) were raised from July 15, 1987 and all advances against paddy/rice, and raw cotton and kapas which were exempted from selective credit controls, were brought under selective credit controls, effective from August 17, 1987. A minimum margin of 30 per cent was fixed for bank advances against paddy/rice in the case of mills/processing units and against were-house receipts and 45 per cent in the case of 'others'. Margins on bank advances against all varieties of cotton and kapas were fixed at 30 per cent against warehouse receipts and 45 per cent in respect of 'others'. Mills, however, remained exempt from these controls. In addition to margin stipulations, credit ceilings were also imposed at the same time. Bank advances against oilseeds and vegetable oils were placed under a ceiling equivalent to 85 per cent (as against 100 per cent earlier) of the peak level of credit maintained by any party in any of the three years i.e., 1982-83, 1983-84 and 1984-85 (October-November). Similar ceiling for advances against paddy/rice and advances against cotton and kapas was fixed at 100 per cent. Banks were advised by the Reserve Bank in the third week of September, 1987 to exercise a greater caution while providing credit against turmeric and other condiments, like chillies. A further tightening of credit controls was effected in October, 1987 when the minimum margins in respect of paddy/rice, pulses and "other foodgrains" (excluding paddy/rice and wheat) were raised across the board by 15 percentage points. Cash credit to the sugar industry was limited to the last season's level, and the advances to wholesale and retail outlets under the fair price distribution system continued to be exempt from selective credit controls. Table 7.5 indicates the existing margins on advances against the commodities subject to selective credit controls.

7.30 The busy season credit policy for 1987-88 (announced on October 17, 1987) stressed the need for preventing excessive monetary expansion and for containing inflationary pressures, while at the same time fully meeting the credit requirements of agriculture, industry and exports. To achieve the former, the Cash Reserve Ratio (CRR) was raised from 9.5 per cent to 100 per cent of net demand and time liabilities with effect from October 24, 1987. The CRR in respect of NRE and FCNR Accounts was, however, unchanged. Banks which attain an overall CRR of 15 per cent (including the incremental CRR) are by law, not required to maintain a higher ratio.

7.31 In the field of export refinance, as a part of the busy season policy package it was decided not to bring forward the base for determining the level of such refinance. This means that the banks would continue to be provided refinance equivalent to 100 per cent of the increase in export credit over monthly average level of the year 1984. This implies that export refinance limits are Rs. 430 crores higher than the level of such limits if the base had been brought forward to the average monthly level of export credit for the year 1986.

7.32 An assessment of monetary and credit trends towards the end of 1987 revealed that there would continue to be some excess liquidity even after the seasonal credit requirements of the busy season are fully met. With a view to moderating the growth of liquidity without affecting the credit requirements necessary to support output, the SLR for scheduled commercial banks was raised from 37.5 per cent to 38 per cent on net demand and time liabilities, with effect from January 2, 1988. However, the SLR remained unchanged at 25 per cent for both Non-Resident (External) Rupee Accounts and Foreign Currency (Non-Resident) Accounts.

Structure of Interest Rates

7.33 While reviewing the level and structure of interest rates, the Chakravarty Committee had emphasised that in the present stage of development of the Indian money and capital markets, a fair degree of regulation of interest rates was required for an orderly mobilisation of financial savings for purposes of economic development as also for the viability of the operations of the banks. Even so, the Committee felt the need for modifications in the "administered" interest rate system so that the Government as a major borrower can raise substantial resources for plan investment in schemes/projects of rural development and infrastructural facilities with long gestation periods and the banks can also mobilise adequate financial savings from small savers, in particular, by offering them attractive real return on their deposits.

7.34 It may be recalled that in 1986-87 the interest rate structure was left untouched, except that in keeping with falling interest rates abroad, interest rates on Foreign Currency (Non-Resident) Accounts (FCNR) Accounts were reduced and that in order to promote exports, interest rates on both export credit and export refinance were revised downwards. In the current year, however, changes were made, effective from April 1, 1987 in the structure of interest rates with a view to reducing the cost of money and imparting flexibility to interest rate policy. The reduction in lending rates provided relief to many categories of borrowers for whom the interest rates had been raised sharply earlier. All lending rates of scheduled commercial banks prescribed at levels above 15 per cent were reduced by 1 percentage point, which will benefit agriculture, certain public sector procurement agencies and industry, including small industry. The maximum deposit rate was reduced from 11 per cent to 10 per cent and this was made applicable to deposits with a maturity of two years and above. Interest rate on deposits of one year and above but less than 2 years was consequently adjusted and raised from 8.5 per cent to 9.0 per cent. Thus, the shortening of the maturity structure should facilitate easier adjustment of bank interest rates in response to changing circumstances. Earlier, substantial deposits were for fixed three and five year terms, which introduced an element of rigidity in the structure of lending and deposit rates.

7.35 Changes were also made in the interest rates applicable to other financial instruments. The maximum interest rate payable on issues of convertible and non-convertible debentures, company deposits, and public sector bonds as well as the interest rates on National Savings Certificates were reduced by one percentage point. The maturity period of Indira Vikas Patra was extended to 5½ years from 5 years, implying thereby a reduction in yield from 14.9 per cent to 13.4 per cent per annum. In the case of Post Office Time Deposits, the reduction from 11.5 per cent to 11.0 per cent, was effected only in the case of five year deposits.

7.36 As regards FCNR Accounts, in line with the interest rate changes abroad the Reserve Bank effected changes from time to time-on April 7, May 25, October 12, November 30, 1987 and again on February 8, 1988. The interest rates on those deposits are kept at levels attractive for Non-Resident Indians to place deposits under the scheme. The interest rate on Non-Resident (External) Rupee (NRE) Accounts was revised only in respect of the maturity of 6 months and above but less than one year on October 12, 1987.

7.37 The comparative structure of interest rate for some important categories prior to and from April 1, 1987 is given in Table 7.6.

Working Group on Money Market

7.38 In the last year's Economic Survey, a reference was made to the setting up of a Working Group by the Reserve Bank to examine the possibilities of

TABLE 7.6

Structure of Interest Rates : Some Selected Categories

(Percent per annum)

	Prior to April 1, 1987	From April 1, 1987
I. Scheduled Commercial Banks Deposits :		
(i) One year and above but less than two years	8.5	9.0
(ii) Two years and above but less than three years	9.0	
(iii) Three years and above but less than five years	10.0	10.0@
(iv) Five years and above	11.0	
II. Non-Resident (External) Rupee Accounts		
(i) 6 months and above but less than one year	8.0	8.5
(ii) One year and above but less than two years	10.5	10.5
(iii) Two years and above but less than three years	11.0	11.0 £
(iv) Three years and above but less than five years	12.0	12.0
(v) Five years and above	13.0	13.0
III. Foreign Currency (Non-Resident) Accounts		
(i) 6 months and above but less than one year	8.5	7.5
(ii) One year and above but less than two years	10.0	8.5 *
(iii) Two years and above but less than three years	10.5	9.25
(iv) Three years only	11.0	9.5
IV. Other Financial Instruments		
(i) Convertible debentures	13.5	12.5
(ii) Non-Convertible debentures	15.0	14.0
V. Post Office Saving Schemes		
(i) One year time deposits	9.5	9.5
(ii) Two year time deposits	10.0	10.0
(iii) Three year time deposits	10.5	10.5
(iv) Five year time deposits	11.5	11.0
(v) Five year recurring deposits	11.5	11.0
(vi) National Savings Certificates (VI & VII Issues)	12.0	11.0
VI. Bank Advances (Ceiling Rate)	17.5	16.5

@Rate applicable on deposits with a maturity of 2 years and above.

£Effective from October 12, 1987.

*Effective from February 8, 1988.

enlarging the scope of the money market and to recommend specific measures for evolving other suitable money market instruments. This Working Group which was chaired by Shri N. Vaghul submitted its Report in January, 1987. It has made several recommendations for activation and development of the money market. Some of the important recommendations include : (i) measures to improve the operation of the call money market; (ii) development of the bills rediscounting market with a view to facilitating the emergence of a genuine bill culture in the country; (iii) introduction of a short-term commercial paper; (iv) development of an active secondary market for Government paper, especially a "182 days Tresury Bill" Refinance Facility; (v) seting up of a Finance House to deal in short-term money market instruments; and (vi) encouraging banks and private non-bank financial institutions to provide factoring services. The Group also recommended that there should be continuing development and refinement of money market instruments, and each new instrument coming into the market must be specifically approved by the Reserve Bank.

7.39 Following detailed consultations with banks and financial institutions, the Reserve Bank has taken several steps during the current year to implement the recommendations of the Working Group. Some of these are :

— In order to make bill financing attractive to borrowers, from April 1, 1987, the effective interest rate on bill discounting for categories subject to the maximum lending rate has been fixed at a rate one percentage point lower than the maximum lending rate i.e., at a level equivalent to effective interest rate of 15.5 per cent.

— The ceiling on the bill rediscounting rate has been raised from 11.5 per cent to 12.5 per cent in order to attract additional funds into rediscount market.

— Access to bill rediscounting market has been increased by selectively increasing the number of participants in the market.

— Measures taken to promote bill financing include :—

(i) only 75 per cent of the eligible receivables of all parties subject to the Credit Authorisation Scheme (CAS) would be taken into account for financing with effect from April 1, 1988; (ii) banks have been given the discretion to sanction additional ad-hoc inland bill limits to all parties subject to CAS; and (iii) it has been stipulated that all parties subject to CAS should attain a ratio of bill acceptance to credit purchases of 25 per cent by April 1, 1988.

— With a view to imparting greater liquidity to banks' holding of 182 days Treasury Bill, a "182 Days Treasury Bill" Refinance Facility has been introduced.

— A decision has been taken to set up a Finance House jointly by the Reserve Bank of India, public sector banks and the financial institutions. Its modalities are being worked out.

Follow up on the recommendations of the Committee to Review the Working of the Monetary System

7.40 As already discussed in the Economic Survey 1986-87, the Committee to Review the Working of the Monetary System (Chakravarty Committee) felt that the present definition of the budgetary deficit did not fully reflect the Government's reliance on the net Reserve Bank credit in a particular year, since Reserve Bank's holding of dated securities were not taken into consideration in this definition. The Committee, therefore, suggested a modification of the present concept to include the entire increase in net RBI credit to Government in a given year. This recommendation was considered by Government and accepted, in principle, in the Budget speech of 1986-87. It was then stated that the modalities for effecting the change will be worked out in consultation with the Reserve Bank. The technical issues involved in estimation of the change in net Reserve Bank credit to Central Government were considered in depth, and, as reported in last year's Survey, it was found that there were several problems in estimating the increaseed in net Reserve Bank credit to Central Government for the current as well as the ensuing financial year, especially at the time of the preparation of the Budget in January/February. These difficulties result from (a) wide swings in the transactions in long dated securities by parties other than the Reserve Bank, because of the buy-back arrangements in such securities, particularly by those institutions which keep their accounts exclusively with the Reserve Bank, and (b) pronounced volatility in the holdings of treasury bills by the

States and the banks, depending upon variations in the liquid assets. Besides, the disparate practices in regard to the valuation of the treasury bills and the dated securities (by purchase price by RBI and the face value by the Government) contribute to the incompatibility of fiscal data with the monetary data.

7.41 Keeping in view the above technical problems in achieving one to one correspondence between the fiscal and the monetary accounts, as mentioned in the last year's Survey, a decision was taken to show the increase in net RBI credit to the Central Government as a memorandum item. This decision was implemented in the 1987-88 Central Budget documents by showing the actual increase in net RBI credit to Central Government for 1985-86, the Revised Estimates(RE) for this aggregate for 1986-87 and the Budget Estimates (BE) for 1987-88. It can be seen from the 1987-88 Budget documents that whereas for actuals 1985-86 and (RE) 1986-87 the increase in net RBI credit to Central Government differed from the budgetary deficit according to the established concept, with regard to (BE) 1987-88 they were shown as identical (i.e. Rs. 5,688 crores). This was done as a matter of convenience only because of the intrinsic difficulties, noted above, in estimating, before the start of the fiscal year, the anticipated variation in net RBI Credit to Central Government over the fiscal year for reasons other than the Government's need for such credit. Net RBI Credit to Central Government during the course of the fiscal year can fluctuate widely depending upon transactions of the State Governments, banks and others in respect of Central Government instruments. Even the holding of these securities by the Reserve Bank depends upon the timing of the floatation of market securities during the course of the year. Quite often the Reserve Bank subscribes substantially to the issue, and then unloads securities in the market over a period of time.

7.42 The experience during 1987-88 in regard to the behaviour of net Reserve Bank Credit to Central Government has confirmed that there are severe operational difficulties in estimating this variable for the year as a whole because of absence of any underlying trend in month to month fluctuations. Swings in the holdings of treasury bills by the State Governments have been particularly sharp. At the start of the current fiscal year, the States' total holdings of treasury bills were Rs. 1,268 crores, which had come down to Rs. 661 crores by end July, 1987. But thereafter, in one single month, they had risen to as high a figure as Rs. 2,179 crores. In the subsequent two months, i.e. by end October, 1987, their holdings of treasury bills again came down to Rs. 772 crores. Some measures have already been taken to reduce sharp fluctuations from week to week in the net Reserve Bank credit to Central Government. Volatility of the commercial banks' holdings of treasury bills has been substantially reduced. Further action may be necessary to reduce the volatility in the holdings of other parties.

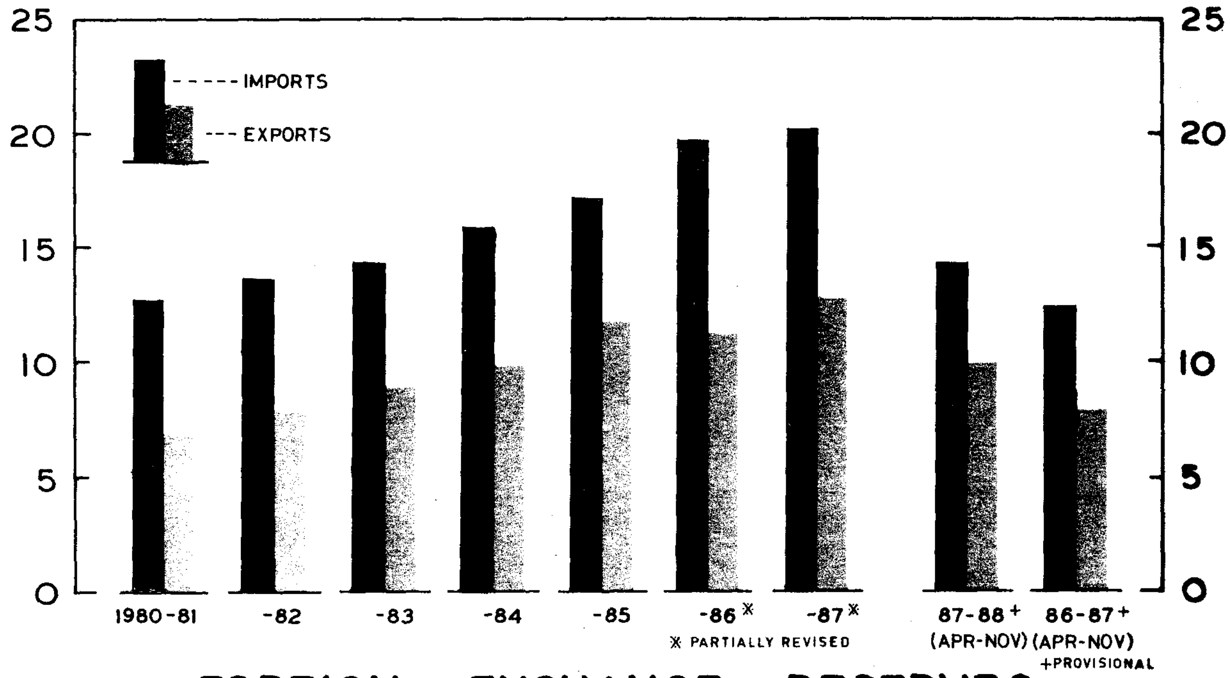
7.43 Following the Chakravarty Committee's recommendation, and its acceptance, in principle, by the Government, regarding the setting of monetary targets at the aggregative level, the exercise to develop operationally meaningful targets and monitor them is being done in the Ministry of Finance on an experimental basis in consultation with the Reserve Bank of India. These targets are subject to revision upwards or downwards during the year to accommodate the impact of developments in the real sector of the economy, such as the one we faced during the current year. Last year's Economic Survey had elaborated the several technical problems that came in the way of developing this exercise and the criteria applied in selecting three monetary variables, namely, Aggregate Monetary Resources (M3), Net Reserve Bank Credit to Central Government (NRCCG), and Net Bank Credit to Government (NBCG), for early warning signals.

7.44 The exercise for setting the monetary targets is taken up immediately after the presentation of the Central Budget, when the two vital inputs necessary for the exercise, namely, the magnitude of the Centre's budgetary deficit as well as the level of its market borrowing programme become available. Estimates are made of credit requirements of the commercial sector. Requirements of food credit is based on the likely movements in the level of food stocks held by the public sector, while the increase in non-food credit is calculated on the expected growth in industrial output and movement in prices of industrial raw materials and final products. A view is also taken of the balance of payments position in order to determine the likely change in the net foreign exchange assets of the banking sector (net of repayment to IMF under the Extended Fund Facility).

7.45 It may be noted that since this exercise is done before the start of the fiscal year, it becomes imperative to effect suitable changes in the targets towards the end of May in the light of the availability of RBI data for March 31, after the closure of Government accounts, and of the partially revised data of the commercial banks on the last Friday of March basis. The exercise is still in an experimental stage. It has been found that while broad projections of M_3 and aggregate deposits and credit growth can be undertaken with a certain degree of confidence, the estimates of various other variables, such as change in net bank credit to Government, is fraught with several technical problems because of transactions in Central Government securities (including the treasury bills) by certain parties other than the Reserve Bank. There are also several uncertain factors. The behaviour of the monsoon becomes known only towards the end of August, and at times, there are substantial additional expenditure proposals later in the year, such as occurred last year when the Fourth Pay Commission's recommendations were implemented.

FOREIGN TRADE

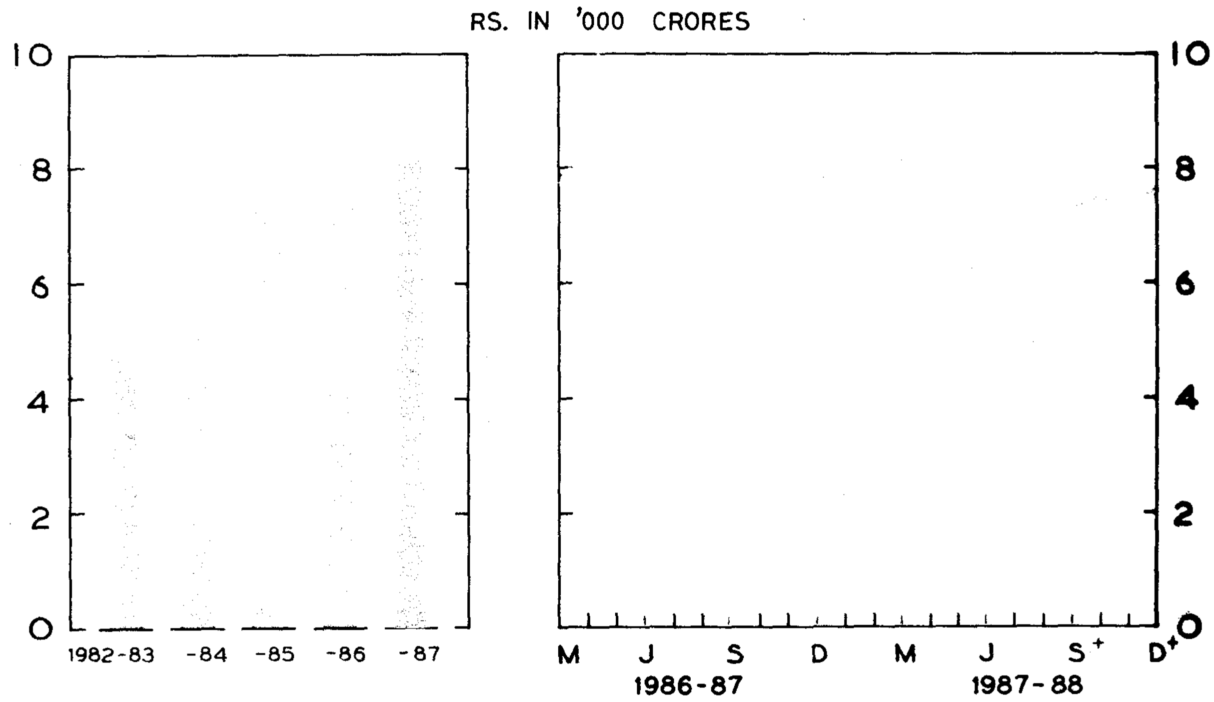
RS. IN '000 CRORES



FOREIGN EXCHANGE RESERVES

(INCLUDING GOLD & SDRs)

RS. IN '000 CRORES



MINISTRY OF FINANCE, ECONOMIC DIVISION.

+ PROVISIONAL

MGIP(PLW)MRND-868/1/F/87-88