CHAPTER 7

MONETARY AND CREDIT DEVELOPMENTS

In 1985-86, the growth in overall liquidity in the economy, as measured by growth in total money supply (M3), was contained at 15.9 per cent. compared with an annual average rise of 18.5 per cent in the preceding two years. However, narrow money (M1), grew by only 10.4 per cent as against the growth of 19.5 per cent in the preceding year. Trends in monetary expansion recorded in the first nine months of the current year indicate a faster expansion of M3 than in 1985-86, with growth (upto January 2, 1987) of 15.7 per cent as compared to an increase of 13.3 per cent in the same period of 1985-86.

7.2 A disturbing element of monetary trends in 1986-87 is the increase of Rs. 5,048 crores (upto January 2, 1987) in the net RBI Credit to Government, as compared to an increase of Rs. 3,186 crores in the same period last year. Net RBI credit to Government is a key determinant of base money (or reserve money) and its growth requires careful monitoring and control. Other banks credit to Government also rose significantly, by 34.5 per cent as against a growth of 31.1 per cent in the corresponding period of 1985-86. This sharp increase in the Government's recourse to the banking system may be largely attributed to increased expenditure following the two supplementary demands for grants voted by Parliament in its monsoon and winter sessions and the effects of implementing the Pay Commission recommendations.

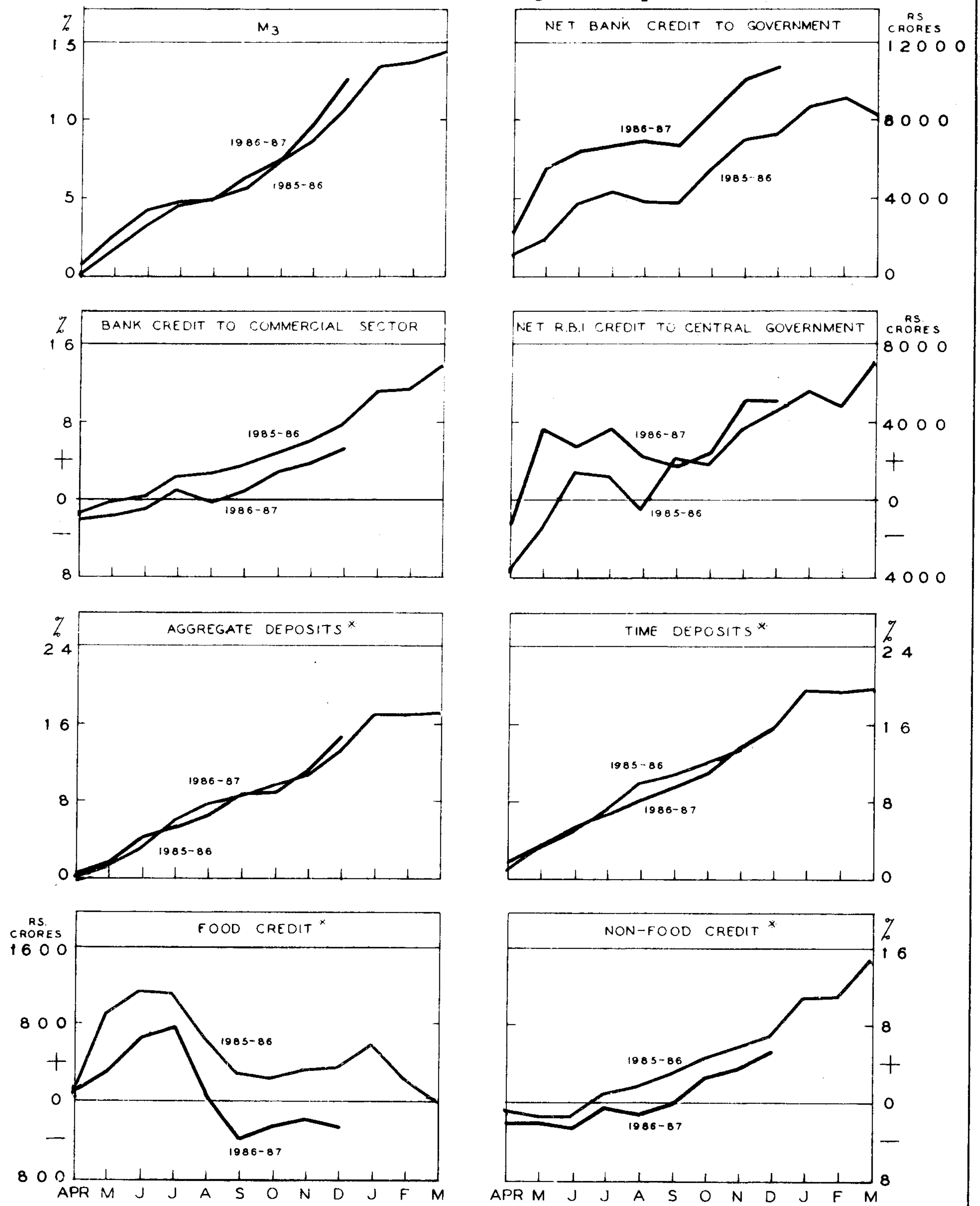
7.3 In the sectoral deployment of bank credit, the target of 40 per cent set for the priority sector was exceeded and stood at 40.8 per cent at the end of March 1986 and at 42.4 per cent at the end of September 1986. In the area of selective credit controls, the process of rationalisation initiated in 1985 was carried further in the current year. More credit flows were allowed where production was expected to rise, or where the demand-supply position was comfortable. The exemption limit of aggregate advances against stocks of commodities covered under selective credit controls was raised to Rs. 1 lakh (from Rs. 50,000) per borrower with a view to helping small producers and dealers. The Credit Authorisation Scheme (CAS), which covers large borrowers, was also modified taking into account the increase over time in the volume and number of transactions under the CAS. In order to boost the country's exports, the interest rates on export credit were lowered by 2.5 percentage points with effect from August 1, 1986. The scope for export refinancing limits of banks was also widened, and care was taken to see that no application for export credit was rejected.

7.4 An important element of macro monetary management in the current year has been the strict enforcement of the Statutory Liquidity Ratio (SLR). Unlike in 1985-86, when the SLR was raised in two stages from 36 to 37 per cent, no change has been effected in SLR in the current year. But the concession of a band of waiver of 4 per cent of the amount of SLR required to be maintained by banks was gradually phased down and wholly eliminated from October 11, 1986.

7.5 The current year also saw the implementation of some of the major recommendations of the Committee to Review the Working of the Monetary System (the Chakravarty Committee). The Committee had emphasized the desirability of developing aggregate monetary targets to help secure acceptable and orderly monetary growth. The Government has, accordingly, carried out on an experimental basis, an exercise to evolve and monitor such targets in consultation with the Reserve Bank of India. The Government had accepted, in principle, the Committee's recommendation that increase in entire RBI credit to the Government should be reflected in the budget in addition to the more narrowly defined figure of budgetary deficit. After further technical examination and in consultation with the Reserve Bank of India, it has now been decided to show the increase in RBI's net credit to the Central Government as a memorandum item in the Budget documents. Following the Committee's recommendation, a new form of 182 days treasury bills are being issued by the RBI, on the basis of monthly auctions, to serve as a short-term instrument with flexible rates which would enable banks to manage their liquidity better and promote the evolution of an active secondary market in short-term instruments. Pursuant to the Committee's recommendations, the yields on long-term Government securities were increased and the maximum maturity reduced.

GROWTH IN SELECTED MONETARY INDICATORS

LAST FRIDAY DATA [PROVISIONAL]

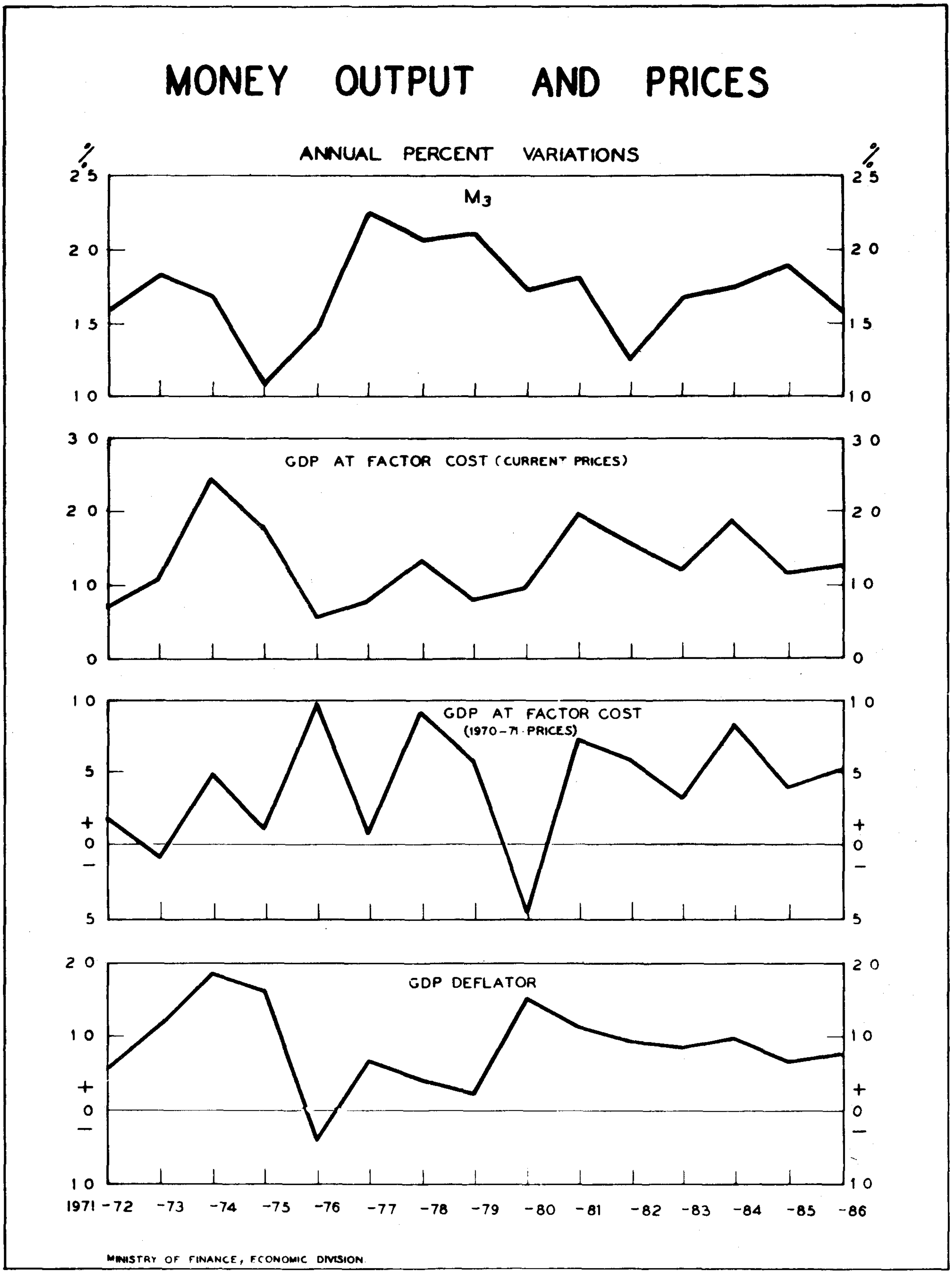


MINISTRY OF FINANCE, ECONOMIC DIVISION.

x DATA RELATE TO SCHEDULED COMMERCIAL BANKS

NOTE :- BASE YEAR DATA FOR MARCH 31 ST.

MGIP/PLU/302/1/FIN/86-87



MGIP/PLU/302/1/FIN/86-87

TABLE 7.1

Sources of change in money stock

(Rs. crores)

	Variations during			
	1984-85 March 31 to March 31	1985-86 March 31 to March 31 P	1985-86 March 31 to January 3, 1986 P	1986-87 March 31 to January 2, 1987 P
I. M1 (Money Supply with the public)	6517	4171	2280	5310
	(19.5)	(10.4)	(5.7)	(12.0)
II. M3 (Aggregate monetary resources)	16268	16313	13642	18578
	(18.9)	(15.9)	(13.3)	(15.7)
(i) Currency with the public	3069	2378	1273	1712
	(15.7)	(10.5)	(5.6)	(6.8)
(ii) Demand deposits with banks	3144	2099	1248	3588
	(23.3)	(12.6)	(7.5)	(19.1)
(iii) Time deposits with banks	9751	12142	11362	13268
	(18.5)	(19.4)	(18.2)	(17.8)
(iv) Other deposits with RBI	304	—306	—241	10
III. Sources of change in M3 (1+2+3+4—5).				
1. Net Bank Credit to Government (a+b)	9586	8093	8162	11825
	(23.6)	(16.1)	(16.2)	(20.3)
(a) RBI's net credit to Government (i+ii)	7426	4442	3186	5048
(i) To Central Government	6056	6468	5504	5262
(ii) To State Governments	1370	—2026	—2318	—214
(b) Other Banks' credit to Government	2160	3651	4976	6777
2. Bank Credit to Commercial Sector (a+b)	10227	11850	7490	7286
	(16.8)	(16.7)	(10.6)	(8.8)
(a) RBI's credit to commercial sector*	372	300	314	365
(b) Other banks' credit to commercial sector	9855	11550	7176	6921
3. Net Foreign Exchange Assets of Banking Sector	1322	841	—159	—47
	(80.3)	(28.3)	(—5.4)	(—1.2)
4. Government's Currency Liabilities to the Public	58	154	19	116
	(8.1)	(19.8)	(2.4)	(12.5)
5. Banking Sector's Net Non-monetary Liabilities other than Time Deposits (a+b)	4925	4625	1870	602
	(27.9)	(20.5)	(8.3)	(2.2)
(a) Net non-monetary liabilities of RBI	3311	2085	1316	1619
(b) Net non-monetary liabilities of other banks	1614	2540	554	—1017

*Excludes, since the establishment of NABARD, its refinances to banks. P=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.

7.6 At the end of December, 1986 the liquidity position of the banks was comfortable and they were well placed to meet the genuine credit requirements during the remainder of the current busy season. However, sizeable increase in Net RBI Credit to the Central Government has the potential for increasing substantially overall liquidity in the economy. In this context, there is a need for continuous monitoring of the situation and for taking expeditious corrective action where deemed necessary.

Monetary Trends during 1985-86

7.7 Monetary expansion in 1985-86 (on 31st March basis) showed a distinct moderation. Narrow money (M1) expanded by 10.4 per cent, nearly one-half of the rate of 19.5 per cent recorded in 1984-85. Broad money or aggregate monetary resources (M3), too, expanded at a perceptibly lower rate of 15.9 per cent compared to 18.9 per cent in the previous year. Component-wise, currency with the public showed a marked deceleration, growing by only 10.5 per cent against 15.7 per cent in 1984-85 and 17.7 per cent in 1983-84. The growth in demand deposits also slowed down considerably to 12.6 per cent from 23.3 per cent in 1984-85. Time deposits, on the other hand, recorded a faster growth—19.4 per cent against 18.5 per cent in 1984-85. Consequently, the ratio of currency to incremental deposits came down to 0.17 from 0.24 in 1984-85 conforming to the long term trend of a declining currency to deposits ratio.

7.8 Source-wise, a slower rate of increase in net foreign exchange assets of the banking sector and a lower order of expansion in net bank credit to Government were the major factors which helped in containing the growth in M3 in 1985-86. Expansion in net bank credit to Government was less pronounced at Rs. 8,093 crores (16.1 per cent) than that of Rs. 9,586 crores (23.6 per cent) in 1984-85, mainly because of the significant improvement in the budgetary position of the States which had reduced their indebtedness to the Reserve Bank by Rs. 2,026 crores (or by Rs. 398 crores if the medium term loan of Rs. 1,628 crores given by the Centre is excluded). Furthermore, the States' investments in treasury bills had also gone up by Rs. 1,377 crores in 1985-86, which in turn had reduced the Centre's reliance on the Reserve Bank. Accruals to net foreign exchange assets of the banking sector were lower at Rs. 841 crores as compared to Rs. 1,322 crores in 1984-85. Bank credit to the commercial sector increased by

Rs. 11,850 crores (16.7 per cent) as against Rs. 10,227 crores (16.8 per cent) in 1984-85.

7.9 An analysis of scheduled commercial banks' data shows a deceleration in the rate of growth of aggregate deposits and bank credit. The growth rate of 18.1 per cent in aggregate deposits was lower than 19.5 per cent in 1984-85. This was due entirely to a marked slow-down in the growth of demand deposits which grew at a rate of 12.3 per cent, about one-half of the growth rate of 23.7 per cent in 1984-85. The growth in time deposits, on the other hand, maintained its upward trend and recorded an increase of 19.5 per cent. Gross bank credit expanded at a lower rate of 16 per cent against 17 per cent in 1984-85, the reason being a comparatively smaller expansion of Rs. 293 crores in food credit against Rs. 1,489 crores in 1984-85. Non-food credit, on the other hand, increased substantially by Rs. 7,576 crores (17.4 per cent) compared with the increase of Rs. 5,659 crores (14.9 per cent) in 1984-85.

Monetary Trends during 1986-87

7.10 The trends so far indicate that in the first nine months of 1986-87 (April, 1986—January 2, 1987) M3 recorded a growth of 15.7 per cent, which was higher than 13.3 per cent in the same period of 1985-86. Both currency with the public and demand deposits, which had shown a significant deceleration in 1985-86, registered larger increases contributing to the higher growth rate in M3 during the period. The growth rate of 17.8 per cent in time deposits was, however, lower by 0.4 percentage point than the rate in the similar period of 1985-86.

7.11 Source-wise, the fast pace of acceleration in net bank credit to Government in the current year so far (upto January 2, 1987) has more than neutralised the moderating effect on M3 of slower rate of expansion in bank credit to commercial sector and the relatively smaller decline in net foreign exchange assets of the banking sector. Net bank credit to Government expanded by Rs. 11,825 crores (20.3 per cent) during April, 1986—January 2, 1987 against Rs. 8,162 crores (16.2 per cent) in the corresponding period of 1985-86. Of this increase, RBI's net credit to Government accounted for Rs. 5,048 crores and other banks' credit to Government Rs. 6,777 crores, compared with Rs. 3,186 crores and Rs. 4,976 crores respectively, in the same period of 1985-86. RBI's net credit to Central Government alone increased by Rs. 5,262 crores off-setting the modest decline of Rs. 214 crores in credit to State Governments during April, 1986—January 2, 1987. The decline in indebtedness of State Governments to RBI both in the current and previous year has to be seen in the context of the Central Government's medium term loans of Rs. 1,628 crores to State Governments and the regulation of overdrafts by RBI. Bank credit to commercial sector, on the other hand, recorded a lower order of expansion of Rs. 7,286 crores (8.8 per cent) compared to Rs. 7,490 crores (10.6 per cent) in the similar period of 1985-86. Net foreign exchange assets of the banking sector witnessed only a small decline of Rs. 47 crores, as compared to Rs. 159 crores in the same period of 1985-86.

TABLE 7.2

Scheduled Commercial Banks : Variations in Selected Indicators

(Rs. crores)

	Variations During@			
	1984-85	1985-86	1985-86 (upto January 3, 1986)*	1986-87 (upto January 2, 1987)*
1	2	3	4	5
1. Aggregate Deposits (a+b) . . .	11839	13133	12147	16356
(a) Demand Deposits .	2743	1756	1161	3398
(b) Time Deposits .	9096	11377	10986	12958
2. Borrowings from RBI	469	—943	—1470	—620
3. Cash in hand and balances with RBI (a+b) . . .	2759	864	—295	1451
(a) Cash in hand . .	127	231	139	4
(b) Balances with RBI .	2632	633	—434	1447
4. Net balances with RBI [3(b)—2] . . .	2163	1576	1036	2067
5. Money at call and short notice . . .	189	—67	126	367
6. Gross Bank Credit (a+b) . . .	7148	7869	5154	4999
(a) Public food procurement credit . .	1489	293	525	—104
(b) Non-food bank credit	5659	7576	4629	5103
of which : to priority sector £ .	3510	3157	..	..
7. Investment in Government and other approved securities (a+b) .	3732	5666	6661	8606
(a) Government securities	2087	3549	4909	6704
(b) Other approved securities . . .	1645	2117	1752	1902
8. Balances with other banks in current account	248	418	27	—421
9. Credit-deposit ratio†	67.8	66.6	64.1	60.8
10. Non-food credit-deposit ratio† . . .	60.0	59.7	56.9	55.1
11. Investment—deposit ratio† . . .	34.3	35.7	37.3	38.4

@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

7.12 Selected indicators pertaining to scheduled commercial banks' financial operations are given in Table 7.2. Aggregate deposits were expected, according to the working estimates of RBI drawn up, keeping in view the desired objective of a slowdown in the overall growth of liquidity, to increase by Rs. 15,000 crores (17.6 per cent) in 1986-87. As against this, the growth in aggregate deposits till January 2, 1987 worked out to Rs. 16,356 crores (19.1 per cent) compared to the expansion of Rs. 12,147 crores (16.7 per cent) in the same period of 1985-86. The movements in bank credit till January 2, 1987, show an absolute decline of Rs. 104 crores in food credit. Non-food credit, however, showed an increase of Rs. 3,105 crores (10.0 per cent) compared with the increase of Rs. 4,629 crores (10.6 per cent) in the same period last year. The decline in food credit in the current year appears to be due to the adequate provisions for food subsidy in the Budget, and its timely release to the Food Corporation of India. The larger expansion in non-food credit could be attributed to the pick-up in industrial production in the later half of the year and the surge in requirements of seasonal industries.

7.13 Consequent upon the lower rate of growth in bank credit, the credit-deposit ratio as on January 2, 1987, declined to 60.8 per cent from 64.1 per cent a year ago. The non-food credit-deposit ratio, too, dropped to 55.1 per cent from 56.9 per cent during the same period. The decline in credit-deposit ratio has implications for the profitability of banks. In view of the comfortable resources position, and the strict enforcement by the RBI of the statutory provision, regarding maintenance of SLR on a daily basis, banks appear to have invested a larger amount in Government and other approved securities, which recorded an increase of Rs. 8,606 crores during the nine months ending January 2, 1987 compared with the rise of Rs. 6,661 crores during the same period last year. As a result, the investment-deposit ratio moved up to 38.4 per cent as on January 2, 1987 compared to 37.3 per cent as on January 3, 1986.

Reserve Money

7.14 The significance of reserve money is in its being the base for monetary expansion. Reserve money is largely influenced by Government's budgetary deficit *via* changes in net Reserve Bank Credit to Government. Much of the concern over the budgetary deficit is, therefore, due to this relationship and the consequent impact on prices. There are also other factors such as RBI Credit to banks and commercial sector, foreign exchange assets of RBI, Government's currency liabilities and the net non-monetary liabilities of RBI which influence reserve money. An analysis of the sources of reserve money shows that RBI's net credit to Government was the principal source of reserve money. Net RBI credit to Government as a proportion of reserve money was 83 per cent at the end of March 1971 and 85 per cent at the end of March 1981; this has now risen to 101 per cent by the end of March 1986.

7.15 The movements in reserve money over the past few years have been erratic. It recorded an expansion of 25.5 per cent in 1983-84, followed by another 21.5 cent growth in 1984-85. Thereafter, the rate of expansion slowed down to 8.3 per cent in 1985-86. It is, however, important to note that the extent of erratic movements is only statistical, based on a point to point comparison. When compared with twelve-monthly average, the growth in reserve money worked out at 19.6 per cent and 17.3 per cent in 1984-85 and 1985-86, respectively. For analytical purposes, it might be more meaningful to consider the average figure. While substantial increases in two components, namely, currency with the public (Rs. 3,069 crores) and banks' deposits with RBI (Rs. 2,686 crores) accounted for the bulk of the expansion of Rs. 6,223 crores in reserve money in 1984-85 on a point to point basis, a much lower growth in banks' deposits with RBI (Rs. 606 crores) together with the deceleration in the growth of currency with the public (Rs. 2,378 crores) contributed to the slow-down in the reserve money expansion in 1985-86. Source-wise, the faster expansion in reserve money in 1984-85 was brought about by the substantial expansion in net RBI credit to Government (Rs. 7,426 crores or 27.7 per cent) and rise in net foreign exchange assets of RBI (Rs. 1,275 crores or 78.5 per cent). In comparison, the lower order of expansion in both net RBI credit to Government (Rs. 4,442 crores or 13.0 per cent) and net foreign exchange assets of RBI (Rs. 841 crores or 29.0 per cent) were responsible for the deceleration in the growth of reserve money in 1985-86.

TABLE 7.3

Sources of Change in Reserve Money

(Rs. crores)

	Outstanding as on March 31 1983	Variations during†				
		1983-84	1984-85	1985-86 (P)	1985-86 March 31 to January 3 (P)	1986-87 March 31 to January 2 (P)
1	2	3	4	5	6	7
1. Net RBI credit to Government	22823	3987 (17.5)	7426 (27.7)	4442 (13.0)	3186 (9.3)	5048 (13.1)
2. RBI credit to banks £	2025	746 (36.8)	403 (14.5)	—712 (—22.4)	—1355 (—42.7)	—686 (—27.9)
3. RBI credit to commercial sector@	1925	455 (23.6)	372 (15.6)	300 (10.9)	314 (11.4)	365 (12.0)
4. Net foreign exchange assets of RBI	1729	—105 (—6.1)	1275 (78.5)	841 (29.0)	—159 (—5.5)	—47 (—1.3)
5. Governments' currency liabilities to the public	682	37 (5.4)	58 (8.1)	154 (19.8)	19 (2.4)	116 (12.5)
6. Net non-monetary liabilities of RBI	6074	—763 (—12.6)	3311 (62.3)	2085 (24.2)	1316 (15.3)	1619 (15.1)
7. Reserve Money (1+2+3+4+5—6)	23110	5883 (25.5)	6223 (21.5)	2940 (8.3)	689 (2.0)	3177 (8.3)

(P)—Provisional.
†—Variations are worked out on the basis of March 31 data after closure of Government accounts.
£—Includes claims on NABARD.
@—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.

7.16 During the current financial year upto January 2, 1987, the growth in reserve money again witnessed an upturn on a point to point basis. It recorded an expansion of Rs. 3,177 crores (8.3 per cent) during this period as compared with a moderate increase of Rs. 689 crores (2.0 per cent) in the similar period of 1985-86. A sizeable increase of Rs. 1,712 crores (6.8 per cent) in currency with the public and of Rs. 1,431 crores (12.6 per cent) in bankers' deposits with RBI accounted for the bulk of the increase in the incremental reserve money. Source-wise, the increase was due mainly to a sharp rise in net RBI credit to Government by Rs. 5,048 crores (13.1 per cent) compared with the increase of Rs. 3,186 crores (9.3 per cent) in the same period of the previous year. Although net RBI credit to Government is highly volatile, the magnitude of its expansion so far during the year indicates pressure on the Central Budget.

Trends in Sectoral Deployment of Credit

7.17 Monetary policy is concerned not only with aggregate supply and demand for liquidity but also with its sectoral disposition in the light of established socio-economic and Plan priorities. The broad pattern of the direction of flow of credit is shown in Table 7.4. The data therein relate to deployment of credit by 50 scheduled commercial banks which account for about 95 per cent of gross bank credit. These show that bank credit to priority sectors constituted 40.8 per cent of net bank credit as on the last Friday of March, 1986 thereby exceeding the target of 40 per cent. Of the increase of Rs. 3,157 crores in credit to priority sectors in 1985-86, agriculture and small scale industries accounted for 44.3 per cent and 38.1 per cent respectively. Other priority sectors, which include weaker sections, small transport operators, self-employed persons and rural artisans, shared the remaining 17.6 per cent of the total credit. Advances to medium and large industries recorded a substantially higher order of expansion of Rs. 3,231 crores (20.3 per cent) than Rs. 1,318 crores (9.0 per cent) in 1984-85, and their share in incremental non-food gross bank credit rose to 43.7 per cent in 1985-86 from 22.4 per cent in the preceding year.

TABLE 7.4

Sectoral Deployment of Gross Bank Credit

(Rs. crores)

On the last Friday basis	Variations During			April to September	
	1983-84	1984-85	1935-86	1985*	1986@
I. Gross Bank Credit	5930 (17.2)	7535 (18.6)	7257 (15.1)	2093 (4.4)	1047 (1.9)
1. Public Food Procurement	1058	1643	—130	190	—48
2. Gross Non-food Credit (a+b+c+d)	4872 (15.5)	5892 (16.2)	7387 (17.5)	1903 (4.5)	1095 (2.2)
(a) Priority Sector (i+ii+iii)	2577 (20.9)	3510 (23.6)	3157 (17.1)	1214 (6.6)	1108 (5.1)
(i) Agriculture	869 (16.5)	1516 (24.7)	1398 (18.3)	629 (8.2)	622 (6.9)
(ii) Small Scale Industry	961 (21.4)	1165 (21.4)	1204 (18.2)	380 (5.7)	314 (4.0)
(iii) Other Priority Sectors	747 (29.2)	829 (25.1)	555 (13.4)	205 (5.0)	172 (3.7)
(b) Industry (Medium and Large)	1345 (10.1)	1318 (9.0)	3231 (20.3)	565 (3.5)	162 (0.8)
(c) Wholesale Trade (other than food procurement) (i+ii+iii+iv)	—10 (—0.4)	306 (13.1)	417 (15.7)	99 (3.7)	—347 (—11.3)
(i) Cotton Corporation of India	—97 (—33.4)	—58 (—30.0)	25 (18.5)	—117 (—86.7)	—45 (—28.1)
(ii) Food Corporation of India (Fertiliser)	—171 (—41.5)	—75 (—31.1)	—25 (—15.1)	—11 (—6.6)	9 (6.4)
(iii) Jute Corporation of India	—25 (—33.8)	67 (136.7)	11 (9.5)	—59 (—50.9)	19 (15.0)
(iv) Other Trade	283 (17.9)	372 (20.0)	406 (18.2)	286 (12.8)	—330 (—12.5)
(d) Other Sectors	960 (26.8)	758 (16.7)	582 (11.0)	25 (0.5)	172 (2.9)
II. Export Credit (included under item 2)	315 (18.3)	294 (14.4)	74 (3.2)	—107 (—4.6)	160 (6.6)
III. Priority Sector Advances as percentage of the Net Bank Credit (including PCs) in the last month of the period	38.0	39.8	40.8	41.1	42.4

*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.

7.18 Data for the current year indicate significant deceleration in expansion of gross non-food credit (2.2 per cent) during the period upto September 1986 as compared with (4.5 per cent) in the same period of 1985. This was due largely to the steep decline in credit to wholesale trade and deceleration in credit to medium and large industries and priority sectors. However, the share of priority sector in net bank credit in September, 1986 improved to 42.4 per cent from 41.1 per cent, a year ago.

Developments in Credit Policy

7.19 In the wake of rapid growth of overall liquidity at an annual average rate of 18.5 per cent in 1983-84 and 1984-85 and the associated increase in inflationary pressures, the focus of the monetary and credit policy in 1985-86 was on moderating this growth to a rate lower than that in the previous two years. At the macro-monetary management level, the Statutory Liquidity Ratio (SLR) was raised in two phases to 37 per cent (from 36 per cent) and the maintenance of SLR on a daily basis was made more stringent by introducing penalties for defaults in SLR. The Cash Reserve Ratio (CRR) was left unchanged at 9 per cent until February 28, 1987 when it was raised to 9.5 per cent. Banks were cautioned that the facility of averaging the cash reserve requirement should not be used to generate large fluctuations in cash balances.

7.20 Further, effective September 14, 1985 an additional 3 per cent interest charge was imposed on the portion of the refinance equivalent to the average CRR shortfalls on each day of the fortnight in which there was a CRR shortfall. The interest rates on term deposits of one year and above under the Foreign Currency Non-Resident Scheme (FCNR) were revised downwards in line with trends in interest rates abroad. On the credit policy front, selective credit controls were further rationalised by granting certain concessions and exemptions but banks were advised to enforce strictly various credit norms so that credit was not utilised for speculative hoardings. The entire approach was thus on gearing up effective implementation of different monetary and credit control instruments so as to moderate overall growth in liquidity without sacrificing genuine credit requirements and liquidity needs of the economy.

7.21 It was a measure of success that the liquidity growth in the economy in 1985-86 was contained at 15.9 per cent, perceptibly lower than the rate of growth of 18.9 per cent in the preceding year. However, in the current year, there have been signs of upward pressure on prices signalling the need for continuation of caution on monetary and credit fronts. In the interest of preserving growth with price stability, it was felt necessary to aim at containing the rate of growth in overall liquidity (M3) to a level below the average for the previous three years. Consistent with this objective, various measures were taken both at macro and sectoral levels which are detailed in the paragraphs that follow.

7.22 An important element of macro monetary management in the current year continued to be the strict enforcement of SLR maintenance by banks. Unlike in 1985-86, no change was effected in SLR but the concession of a band of waiver of 4 per cent of the amount of SLR required to be maintained was gradually reduced by one percentage point each effective July 19, August 16 and September 13; and was eventually extinguished effective October 11, 1986. Further, effective from October 11, 1986, the earlier concession of not imposing the 3 percentage points additional interest charge on refinance from RBI equivalent to SLR default was withdrawn.

7.23 In order to supplement the efforts of banks to meet fully the busy season spurt in credit requirements from their own resources, it was decided by RBI in October, 1986 to release in two equal instalments a sum of Rs. 496 crores being one half of the remaining cash balances impounded earlier under the additional cash reserve ratio of 10 per cent of incremental net demand and time liabilities between January 14, 1977 and October 31, 1980. Accordingly, the first instalment of Rs. 248 crores was released on November 22, 1986. Considering the surge in deposits and the comfortable liquidity position of banks, RBI has postponed the release of the second instalment from January 31, 1987 to March 14, 1987. Furthermore, the Cash Reserve Ratio was raised from 9 per cent to 9.5 per cent with effect from February 28, 1987.

7.24 The regime of differential interest rate structure with respect to different sectors, commodities and users continued during the year. The maximum rate of interest remained unchanged at 17.5 per cent per annum. This rate, however, does not indicate the actual cost of money to the economy as it was applicable mainly to borrowers in large and medium sectors who accounted for a little over one-third of the total outstanding gross bank credit as at the end of September, 1986. Borrowers under priority sectors, anti-poverty programmes, food procurement, export, etc., were charged lower rates of interest. The borrowers under priority sectors accounted for a little over 40 per cent of the outstanding gross bank credit and the interest rates charged to them varied from 4 per cent to 16.5 per cent. Export credit likewise accounted for about 5 per cent of the total outstanding gross bank credit and the rates of interest for this sector varied from 8.65 per cent to 16.5 per cent. Food procurement which accounted for about 10 per cent of the outstanding gross bank credit enjoyed a lower rate of interest of 14 per cent. Thus, contrary to the common belief, the average rate of interest in India was not high, as about two-thirds of lendings by banks were at lower interest rates. Presently, the weighted average lending rate of scheduled commercial banks works out to about 11 per cent per annum.

7.25 The increasing role of Foreign Currency Non-Resident Accounts (FCNR) in overall liquidity of the economy was recognised and in the context of a decline in interest rates abroad, the interest rates on FCNR deposits were reduced on May 5, 1986. The reduction was one percentage point in the case of maturities between one and less than three years and 0.5 percentage point for maturities of three years. It was also specified that effective from that date deposits under FCNR scheme would not be accepted for maturities above three years. Subsequently, the interest rates were lowered again with effect from September 8, 1986. The reduction was 0.5 percentage point in regard to three categories of maturities viz., six months and above but less than one year (from 8 per cent to 7.5 per cent), one year and above but less than two years (from 8.5 per cent to 8 per cent) and two years and above but less than three years (from 9 per cent to 8.5 per cent). In the case of maturities of three years, however, the reduction was one percentage point (from 10 per cent to 9 per cent).

7.26 In the area of sectoral credit management, selective credit control remained as the principal policy instrument. The rationalisation of selective credit controls undertaken in April and October, 1985 was carried further in the current year with a view to making these controls more responsive to commodity balances and development in prices. For commodities where a stipulation existed regarding the level of credit based on the three-year periods 1980-81, 1981-82 and 1982-83 (November-October), the base was brought forward by one year to 1981-82, 1982-83 and 1983-84 with effect from April 4, 1986. This was done to allow more credit flows in keeping with rising output of these commodities. Further, keeping in view the comfortable position in paddy and rice and cotton and kapas and increase in cotton-seed output, all advances against these commodities were exempted from the provisions of selective credit controls. Similarly, the minimum margins on advances against oilseeds and vegetable oils were reduced across-the-board by 15 percentage points. Also, advances against high-yielding and hybrid oilseeds were exempted from all provisions of selective credit controls. All these exemptions|reductions were made effective from April 4, 1986. Besides, the exemption limit of aggregate advances against stocks of commodities covered under selective credit controls was raised from Rs. 50,000 to Rs. 100,000 per borrower with effect from April 4, 1986, with a view to helping small producers and dealers of commodities which still remained subject to selective credit controls.

7.27 The Credit Authorisation Scheme (CAS) is another important tool of sectoral credit management. Taking into account the increase over time in the volume and number of transactions under the CAS, the following changes were made with effect from April 4, 1986 :

— the cut-off point for CAS working capital limits was raised to Rs. 6 crores from Rs. 4 crores. This measure would reduce the number of working capital limits at present covered by CAS by almost one third.

— the cut-off point for working capital limits for manufacturer|trader exporters was raised to a uniform Rs. 7 crores against the differential cut-off points hitherto of Rs. 5 crores for manufacturer exporters and Rs. 4 crores for trader exporters.

— the cut-off point for cases of working capital limits which banks hitherto have to report for post-sanction scrutiny was raised from Rs. 1 crore to Rs. 2 crores. Moreover, the discretionary powers of banks to sanction *ad hoc* additional limits was enlarged.

— the eligibility criteria for the Fast Track facility was modified marginally to provide for greater flexibility in the use of this facility. The modifications related to norms for inventories and receivables and quarterly returns.

7.28 Export credit continued to receive careful attention in the scheme of sectoral credit management. Hitherto, the structure of pre-shipment credit was characterised by a multiplicity of interest rates differentiated with reference to specified commodities. It was desirable to rationalise this structure by prescribing uniform interest rates for all commodities and allowing variations to occur according to periods of credit sanctioned. With this end in view, the interest rates for pre-shipment credit for all commodities were realigned with effect from March 1, 1986 : 12 per cent for credit upto 180 days; 14 per cent for credit beyond 180 days but upto 270 days; and not exceeding 16.5 per cent for credit beyond 270 days. As a further measure aimed at boosting export efforts the interest rates on export credit were lowered by 2.5 percentage points with effect from August 1, 1986. The rate of interest on post-shipment credit was also reduced from 12 per cent to 9.5 per cent. However, the ceiling rate for export credit of not exceeding 16.5 per cent wherever applicable remained unchanged. Effective August 1, 1986 the interest subsidy rate payable to banks under the Export Credit (Interest Subsidy) Scheme, 1986 was enhanced from 1.5 per cent to 3.0 per cent. To ensure that the margin between the effective return to banks (after adjusting for interest subsidy) and the refinance rate remains unimpaired, the interest rate on Reserve Bank's export credit refinance to banks was also reduced from 10 per cent to 9 per cent effective from August 1, 1986.

7.29 Apart from lowering the interest rates, the scope for export refinancing limits of banks was also widened by discontinuing in the current year the practice of bringing forward the base. The banks were thus enabled to get export refinance at 9 per cent per annum within a limit equivalent to 100 per cent of the increase in export credit over the monthly average limit of credit in 1984. Accordingly, the banks' access to this facility would now be Rs. 200 crores more than what it would have been in the event the base had been brought forward. To supplement these efforts aimed at making export credit available at ease, the RBI requested banks to adopt effective procedures for dealing expeditiously with any alleged denial of credit to exporters. In particular, care was to be taken to see that no application for export credit was rejected by a competent authority without the approval of the next higher authority.

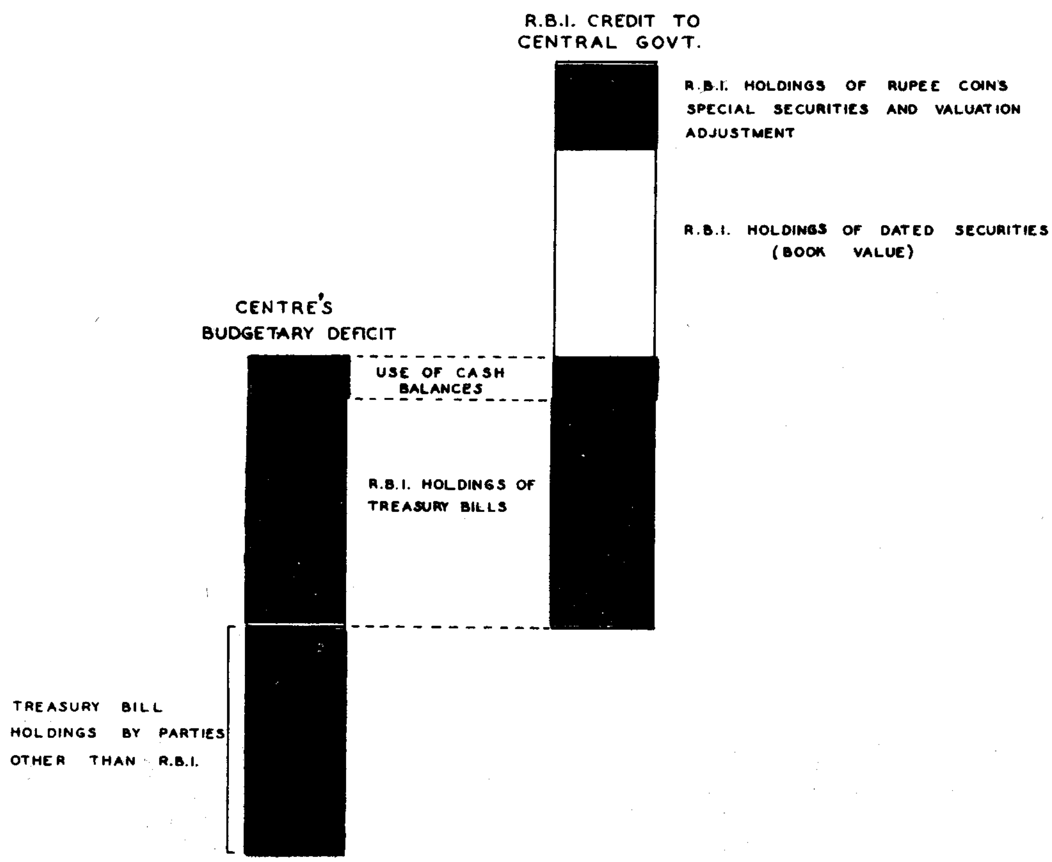
7.30 With a view to providing easier access to the discretionary refinance facility, all licensed scheduled commercial banks are being permitted to draw discretionary refinance upto an amount equivalent to 0.5 per cent of their average deposits in 1985-86 for a period not exceeding 14 days without prior sanction by the Reserve Bank; the interest rate charged will continue to be 14 per cent per annum.

Follow-up Action on the Recommendations of the Committee to Review the Working of the Monetary System

7.31 The Committee to Review the Working of the Monetary System (Chakravarty Committee) had observed that the budgetary deficit as defined at present does not reveal the full extent of the Government's reliance on Reserve Bank Credit. This results mainly from the exclusion of Reserve Bank's holdings of dated securities from the present concept of the Centre's budgetary deficit. To the extent treasury bills are held outside the Reserve Bank, the present concept tends to overstate the monetary impact of fiscal operations. The Committee had accordingly recommended a modification in the present concept of the budgetary deficit to include the entire RBI credit to the Government. This recommendation has been accepted, in principle, by the Government and steps have been taken to work out the modalities of effecting the change in consultation with the Reserve Bank of India. However, it was noticed that *ex ante* there were several problems in the estimation of the RBI credit to Government, particularly when the Budget of the next fiscal year is under preparation in the months of January/February every year and it is necessary to have as firm an estimate of the deficit as possible at the R.E. stage. On an analysis of the past data of variations in the net RBI credit to Central Government, it was found that there was no stable and predictable relationship in the credit extended by the RBI to Central Government in a full year with that of the first nine months of that year. Transactions in treasury bills and the long-dated securities by parties other than the RBI have shown wide swings during the course of a fiscal year. In fact, the week to week fluctuation in the holdings of treasury bills by the banks, has been particularly pronounced. It was against this background that the Reserve Bank has been urging the banks to desist from triggering such wide fluctuations. In the case of long-dated securities, the factors causing fluctuations were variations in the liquid assets of banks, as also the transactions in securities by the financial institutions under the buy-back arrangement, especially by those institutions which keep their accounts exclusively with the Reserve Bank of India.

7.32 In addition to the absorption by RBI of dated securities floated under the market borrowing programme, the RBI credit to the Central Government includes rupee coins and special securities issued by the Central Government to the Reserve Bank for borrowings against collections under the Compulsory

RELATIONSHIP BETWEEN CENTRE'S BUDGETARY DEFICIT AND R.B.I. CREDIT TO CENTRAL GOVERNMENT



MINISTRY OF FINANCE, ECONOMIC DIVISION.

MGIP/PLU/302/1/FIN/86-87

Deposit (I.T. Payers) Scheme, and for payment of charges on drawings from the IMF. There are also disparate practices in regard to the valuation of treasury bills, and dated securities, which in the monetary data are on the basis of Reserve Bank's book value (that is, purchase price), whereas in the fiscal accounts, the transactions are recorded on the basis of the face value of securities. These different methods of recording the transactions by the Government and the Reserve Bank result in an asymmetry in the fiscal and the montetary data.

7.33 In view of the technical problems in achieving a one to one correspondence in the fiscal and monetary accounts, it has now been decided to show the RBI's net credit to Central Government as a memorandum item in the Budget documents. As part of measures to remove the noise in the data series on the new definition of the budgetary deficit, banks have been advised to eschew volatile movements in their holdings of treasury bills. The RBI has decided to levy, with effect from November 21, 1986, an additional fee on early rediscounting of 91 days' treasury bills within 14 days of their purchase. Beyond the fourteenth day, no such fee would be levied.

7.34 The Chakravarty Committee had laid stress on the desirability of developing monetary targets at the aggregative level for securing an acceptable and orderly pattern of monetary growth. The range of the monetary targets needs to be determined in the light of a number of considerations, including expectations regarding the growth in output, the rate of increase in prices and the income elasticity of demand for money. It was also pointed out by the Committee that targets so derived for the year, might need to be revised upwards or downwards during the year to accommodate the impact of developments in the real sector of the economy. The Committee, accordingly, recommended for the setting of overall monetary targets with feed back which enables changes in the targets to be made in the light of emerging trends in output and prices. The recommendation of the Committee has since been accepted by the Government and an exercise to develop operationally meaningful targets and monitor them on an experimental basis has been carried out in consultation with the Reserve Bank of India.

7.35 In developing this exercise, several technical problems connected with the choice of candidate variables, volatility of those variables and their seasonal variations were required to be resolved. The choice of variables is necessarily influenced by the fundamental objective of controlling aggregate fiscal and monetary outcomes and the feasibility of predicting the full year's outcome on the basis of current information. On the basis of these criteria, three monetary variables, namely, Aggregate Monetary Resources (M3), Net Reserve Bank Credit to Central Government (NRCCG), and Net Bank Credit to Government (NBCG) have been selected for early warning signals with respect to growth of overall liquidity in the economy. NRCCG is a key component of the stock of reserve money and although volatile, research has indicated that the changes in NRCCG may have been the single most important explanation of year to year changes in money supply in the economy. NBCG has the virtue of including the full recourse to bank borrowing by Government and being less volatile than NRCCG, it provides a better indicator of within year trends. M3, on the other hand, is the appropriate indicator of the degree of overall liquidity in the economy as it exerts a substantial influence on the rate of inflation in the economy. The problem of volatility in these variables, particularly NRCCG, and the efforts required to reduce these have been discussed earlier.

7.36 The Chakravarty Committee has recognised the need for exploring new financial instruments which could provide alternative avenues for short-term investments for which an active secondary market could develop in future. Specifically, the Committee had recommended that treasury bills should be developed as a monetary instrument with flexible rates which would enable banks to better manage their short-term liquidity. Following this, with effect from November 28, 1986 treasury bills of 182 days' maturity are being issued. These bills would be issued on a monthly auction basis, and unlike the 91-days' treasury bills, the rate of discount and the corresponding issue price of these bills would be flexible and determined through the auctions subject to there being a reserve price. However, these bills are not being provided rediscounting facilities with the RBI. The new treasury bills are available for purchase to any resident in India including individuals, firms, companies, corporate bodies and institutions, but State Governments and Provident Funds are precluded from participating in the auctions. These bills are treated as approved investments by banks for SLR purposes and are also eligible as collateral for borrowing under the Reserve Bank's stand-by refinance facility. The RBI has appointed a Working Group to examine the possibilities of enlarging the scope of the money market and to recommend specific measures for evolving other suitable money market instruments. The

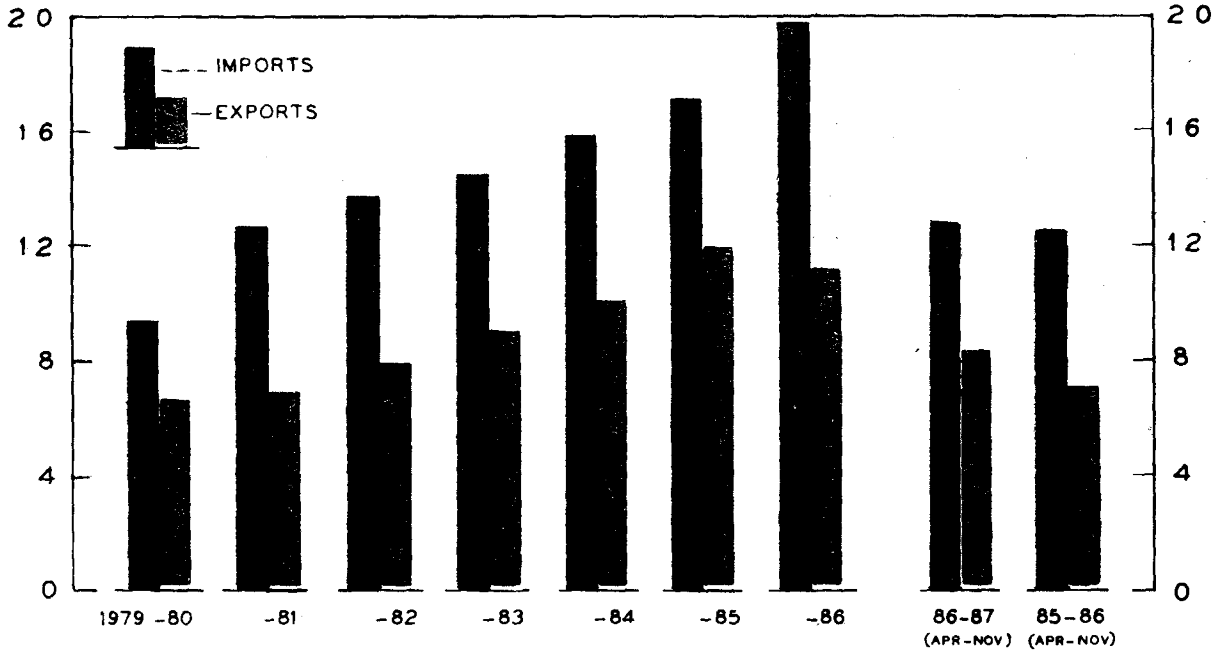
Working Group's terms of reference *inter alia* include the pattern of money market interest rates, whether these rates should be administered or market determined. The Working Group has recently submitted its Report to the Reserve Bank.

7.37 The Chakravarty Committee had recommended an upward revision of yields on Government securities coupled with a shortening of maturities to attract funds from the capital market. In recent years, Government has been increasing the yield on Government securities, and the maximum interest rate now is 11.5 per cent. As a further measure, the maximum maturity for floatations of dated securities in the financial year 1986-87 was reduced to 20 years.

7.38 With a view to providing a forum at which co-ordinated views on financial flows in the economy could be formulated to promote development of requisite policies, the Reserve Bank appointed in June 1986, a National Finance and Credit Council. The Council will have the following objectives : (a) to take an overall view of the flow of finance and credit, both short-term and long-term for industry, agriculture and trade; (b) to coordinate policies relating to the flow of short-term and long-term credit; and (c) to consider developments in capital and money markets with a view to enhancing their role and efficiency.

FOREIGN TRADE

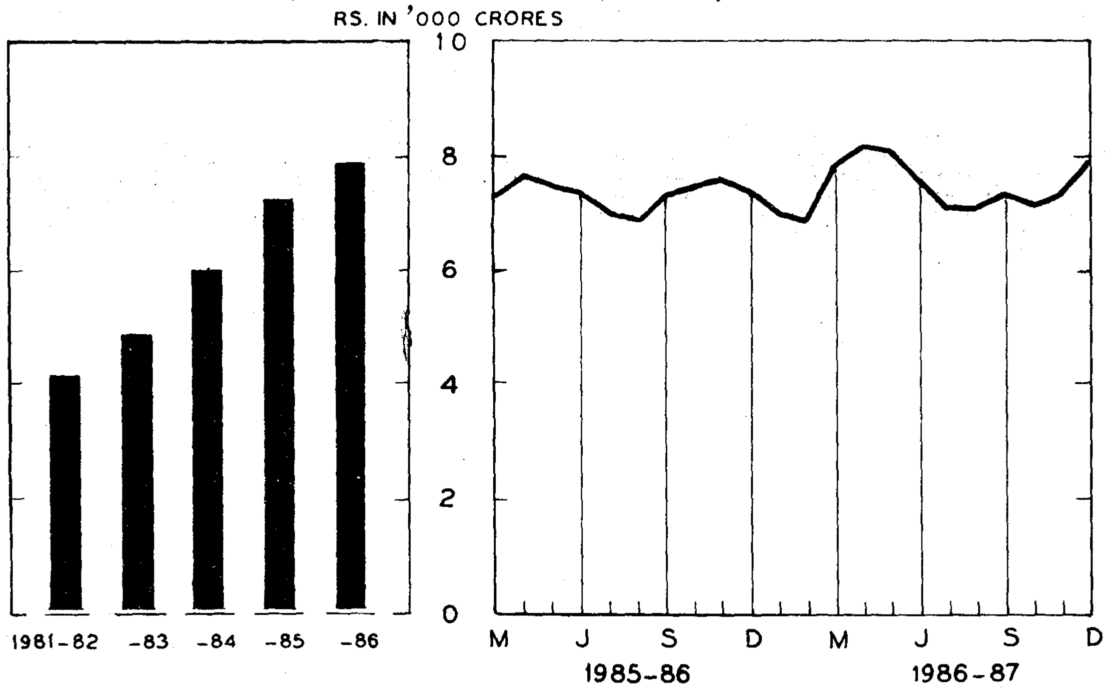
RS. IN '000 CRORES



FOREIGN EXCHANGE RESERVES

(INCLUDING GOLD & SDRs)

RS. IN '000 CRORES



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