CHAPTER IV

RBI CREDIT TO OTHER SECTORS AND RESERVE MONEYM

A look at the sources of RM in recent years show that RBI's net credit to Government is the principle source of change in reserve money. The other important sources are :

[i]	RBI credit to Banks	[RBCB]
[ii]	RBI credit to Commercial Sector, and	[RBCC]
[iii]	RBI Credit to Foreign Sector	[RBCF]
	(All in Net)	

I. Reserve Bank Credit to Banks :

One important source of change in RM is the Reserve Bank Credit to Commercial and co-operative banks. In recent years, it has tended to be excessive resulting into very sharp rise in RM which in turn resulted into increase in money supply sharply.

The RBI, provides credit to banks in the following two forms :

[a] as advance against the security of government securities usance bills, or promissiory notes, and

[b] through the purchase or rediscounting of bills.

The RBI lend to banks partly in fulfilment of the traditional Central Banking functions and partly for promoting certain new policy objectives. Being the Central bank of the country it provides the "Lender of the last resort" facility and supplies the busy season finance to the banks. To achieve new policy objectives, it provides refinance facilities and rediscontunting under its Bills rediscounting scheme [of November 1970].

It should be noted that unlike RBI's classificaton of credit to banks in terms of "ultimate borrower's" criteria, we feel that classification by substituting it in terms of immediate borrowers criteria would be more appropriate. This in our view has strong bearing on monetary analysis.

With the nationalization of major banks, strengthening of non-nationalized banks through amalgamation and liquidation, close supervision and inspection of banks by the RBI, strengthening the paid-up capital requirement of banks, deposit insurance, development of sound banking habits of the public, development of banking sector, etc. the Indian banking system has been made very sound for all practical purposes. A continuous fall in currency deposit ratio clearly shows the marked shift in the asset preferences of the public in favour of bank deposits and the ratio has acquired relative stability. [Refer Annexure - 6]

As against this , the trend in RBI credit to Banks show that their dependence on RBI is increasing year after year, even though they have become sound enough. It is a paradoxical situation that with the decreasing importance of "the lender of last resort" function, the RBI has been converted more and more into "the lender of regular resort".[1]

The RBI lends to Banks to enable them to provide "busy season" finance to the economy. There are two methods whereby the RBI can meet the busy season expansion in the demand for funds. The methods are [i] open market operation [ii] increased lending to banks. The open market sales of government securities is not really open to the RBI, as it does not have an active market. Therefore, RBI resorts to lending to banks. Here, also, RBI does not enjoy the power of having control over the amount of its lending; infact, it merely specifies the terms on which advances are to be made, and hence it loosses control over RM creation and in the course RM becomes endogenous.

In order to acheive the promotional objective, the RBI uses its lending power to banks to [i] influence their credit allocation, and [ii] develop a sound bill market in India. To attain these objectives, the RBI has offered borrowing facilities to banks at concesssional rates. This combines two things [a] the volume of loans, decided largely by banks, and [b] an interest rate subsidy. Though, subsidy is an inducement factor for influencing the allocation of credit and hence does not matter much from the RM point of view, but certainly, the volume of credit and that to be determined by the banks, certainly comes in the way of RBI, in having control over RM.

Keeping all these factors in mind, let us analyse the behaviour of RBI credit to banks in relation to total RM.

Table 4.1 Trend in RBI Credit to Banks (Rs. Crore)

Year	RBI Credi to Banks	RM	Relative Share in RM	Change in RBI Credit to Banks	Trend Growth Rate	
1970-71	675	4814	0.14			
1971-72	531	5380	0.098	-144		
1972-73	460	6015	0.076	-71		
1973-74	726	7260	0.1	266		
1974-75	914	7387	0.124	188	9.93	
1975-76	1258	7732	0.163	344		
1976-77	1404	9798	0.143	146		
1977-78	926	10941	0.085	-478		
1978-79	1117	14083	0.079	191		
1979-80	1227	16465	0.075	110		
1980-81	1264	18788	0.067	37		12.31
1981-82	1722	20463	0.084	458		
1982-83	2024	23110	0.087	302		
1983-84	2585	28824	0.089	561		
1984-85	2803	31477	0.089	218	17.17	
1985-86	2285	37858	0.06	-518		
1986-87	2689	44813	0.06	404		
1987-88	3929	53296	0.074	1240		
1988-89	6324	62377	0.101	2395		
1989-90	7472	77591	0.096	1148		

Based on Annexure - 3.
RBI Credit to Banks : RBI Credit to Commercial and Co-operative Banks + NABARD.

Total credit to Commercial and State Co-operative banks taken together[2] in absolute terms, it seems that there is significant rise the RBI credit to Banks. It went up from Rs.675 crores in 1971 to Rs.1264 crores in 1981 and further to Rs. 7472 crores in the year 1989-90. [Table 4.1]

Based on the annual variation in RBCB and RM, it seems that the two are positively related as expected. The influence of change in RBCB over change in RM can be estimated though the following relationship.

$$\Delta RM = f\ [\ \Delta RBCB] \quad \ldots. \quad \ldots \quad \ldots \quad \ldots \quad ..[4.I]$$

The estimated result is as under on the basis of data given in the Annexure - 7.

$$\Delta RM = \underset{\substack{(2.47)\\ \text{t-value}}}{2219.127} + \underset{\substack{(3.125)\\ \text{t-value}}}{3.826}\ \Delta RBCB$$

$$R^2 = .364 \qquad DW = 1.29$$

The above estimated equation reveals that unitary change in RBCB on annual variation basis can bring about 3.82 units annual variation in RM which is quite high.

Over these years, the share of Reserve Bank credit to Banks in relation to total RM has fallen from 14.Ø percent in year 197Ø-71 to 9.63% in the year 1984-9Ø (Table 4.1). On year to year basis, though the relative share has remained relatively low and steady at less than 1Ø%, except for the years 1974-75 & 76, during which it was more than 1Ø% of the total RM. From the above analysis, it seems that to check the volume of RM, RBI has laid heavy restrictions on the credit to banks. For almost last 13 years i.e. from 1978 to 199Ø, RBI could restrict the share to around 8 percent of the total RM. Certainly, the move of the RBI was in support of its credit policy to check the money supply in order to restrict the inflationery situation in the country mainly experienced during seventies.

II. Reserve Bank's Credit To Commercial Sector :

At the outset, let us be very clear that RBI does not provide any credit directly to the commercial sector. Credit given to this sector by the RBI is chanelised through other financial institutions mainly Commerical & State Co-operative banks, or development banks. Now a days, Central banks of most of the countries, over and above the traditional Central banking functions perform a variety of developmental and promotional functions too. The RBI has also followed the same line. In this new role, the RBI has helped in the establishment and development of many new specialised financing agencies, called development banks. This meant not only initial subscription to the share capital of some of these institutions by the RBI, but also regular provision of funds to them through loans and advances, and subscription to their bonds/debentures for financing their lending operations. This has resulted in the creation of additional source of increase in RM.

Reserve Bank's credit to Commerical Sector is the aggregate of :

[i] Reserve Bank's investments in shares and bonds of financial institutions;

[ii] Loans and advances to financial institutions such as Industrial Development Bank of India, Agricultural Refinance and Devlopment Corporation etc; and internal bills purchased and discounted.

Table 4.2 RBI Credit to Commercial Sector and Reserve Money Variation. (Rs. Crore)

Year	RBI Credi to Commercia Sector	Relative Share in RM	Change in RBI Credi to Commercial Sector	Trend Growth Rate	
1970-71	125	0.026			
1971-72	232	0.043	107		
1972-73	265	0.044	33		
1973-74	562	0.077	297		
1974-75	652	0.088	90	25.66	
1975-76	721	0.093	69		
1976-77	898	0.092	177		
1977-78	954	0.087	56		
1978-79	1250	0.089	296		
1979-80	1547	0.094	297		17.36
1980-81	1703	0.091	156		
1981-82	1909	0.093	206		
1982-83	1925	0.083	16		
1983-84	2376	0.082	451		
1984-85	2765	0.088	389	14.02	
1985-86	3066	0.081	301		
1986-87	3429	0.077	363		
1987-88	3806	0.071	377		
1988-89	4950	0.079	1144		
1989-90	6349	0.082	1399		

Based on Annexure - 3.

RBI Credit to Commercial Sector has grown at the rate of 17.36 per cent per annum on an average during 1970-71 to 1989-90 as per Table 4.2. More specially, the growth rate was more rapid during the first decade i.e. 1970-71 to 1979-80, as compared to the second decade 1980-81 to 1989-90. During 1971 to 1980, the growth rate of RBI credit to Commercial Sector was 25.66%, where as during 1981-90 it went down to 14.01%. It was mainly due to the establishment of many new development banks and their early stage of development. During the last decade, the relative share of RBI credit to Commercial Sector remained very steady around 8 to 9 per cent of the total RM for fairly long period [between 1975 to 1990]. Though, in the early years [1970-71 to 1975-76], it rose continously from 2.59 percent in 1970-71 to 8.82 per cent in 1974-75.

No doubt, the establishment and the development of more and more developemnt banks would help in the economic development, as they provide long term and middle term financial assistance to Commerical Sector. What is undesirable is their dependence on the RBI for the support of their activities. The reason is that after 1974, RBI credit to Commercial Sector [by way of its support to development banks] seems to be an important source of change in RM,[5,6] and hence its wider influence on money supply.

In order to examine the above contention we have estimated the responsiveness of RM to RBCC on annual change basis, with the help of following relationship :

$$\Delta RM = f [\Delta RBCC] \quad .... \quad .... \quad .... \quad .... \quad ..[4.II]$$

The estimated results supports the belief that RBCC is an important source of change in RM. As the estimated equation states that unitary change in RBCC on annual change basis brings about 9.579 units change in RM on annual change basis.

$$\Delta RM = \underset{\substack{(1.17) \\ \text{t-value}}}{692.34} + \underset{\substack{(7.78) \\ \text{t-value}}}{9.58} \; \Delta RBCC$$

$$R^2 = .78 \qquad DW = 1.77$$

That implies the annual variation in RBCB and RBCC have a significantly strong influence over the annual variation in RM.

One very important point which is worth noting is that RBI makes credit available to Commerical Sector out of its accumulated surpluses, therefore it may not affect the RM, which is true in accounting sense. But, the fact is that, all Reserve Bank's Credit is financed partly from its monetary liabilities and partly from the net non monetary liabilities. As well, if a large part of net non-monetary liabilities the RBI uses for its credit to Commerical Sector, then it would be left with no or very little of its own surpluses to meet other sectors credit requirements.

The problem of resources available to development banks to perform their development banking role to facilitate the Commerical Sector must be squarely faced. They must not depend for long on the RBI for funds, instead they must build-up their capacity to raise funds on their own in the market. Fortunately, though of late, they have realised the need of the time as some of the development banks have started attracting public funds to meet their requirements. Hence, we can expect that the preseure of credit to Commerical Sector on the RBI will be eased, which in turn will help the RBI to have more control over RM or to allocate funds to other sectors of the economy.

If we combine the RBI's Credit to Banks and Commercial Sector [RBCBC] we come accross certain interesting results [Table - 4.3].

Table 4.3 Relative Changes in RBI Credit to Banks and Commercial Sectors with Relation to its NNML
(Rs. Crore)

Year	RBI Credit to Banks and Commercia Sector *	Relative Share in RM	Net Non Monetary Liabiliti of RBI	Change in RBI Credit to Commercial Sector	Change in NNML
1970-71	800	0.166	714		
1971-72	763	0.142	1091	-37	377
1972-73	725	0.121	1219	-38	128
1973-74	1288	0.177	1437	563	218
1974-75	1566	0.212	1670	278	233
1975-76	1979	0.256	2577	413	907
1976-77	2302	0.235	3433	323	856
1977-78	1880	0.172	3708	-422	275
1978-79	2367	0.168	3735	487	27
1979-80	2774	0.168	3930	407	195
1980-81	2967	0.158	4741	193	811
1981-82	3631	0.177	6166	664	1425
1982-83	3949	0.171	5565	318	-601
1983-84	4961	0.172	5105	1012	-460
1984-85	5568	0.177	7686	607	2581
1985-86	5351	0.141	10677	-217	2991
1986-87	6118	0.137	12860	767	2183
1987-88	7735	0.145	13879	1617	1019
1988-89	11274	0.181	16294	3539	2415
1989-90	13821	0.178	17536	2547	1242

Based on Annexure - 3.
* RBI Credit to Banks and Commercial Sector
= RBI Credit to Commercial and Co-operative Banks + RBI Credit to Commercial Sectors

The combined share of RBCB and RBCC [RBCBC] in total RM was low and has remained more or less constant around 16 to 17 percent of the total RM except for the years 1975-76 & 1977 during which, it crossed the 20 per cent mark. The average growth rate in RBCBC during the period was 14.21 per cent per annum on trend basis. Moreover the combined annual growth rate during the first and second decade have shown a very high consistency. Hence it is not responsible for major variation in RM.

To investigate the joint responsiveness of RBCB and RBCC [RBCB + RBCC = RBCBC], we have used the following relationship :

$$RM = f\,[\,RBCBC] \quad \ldots\ldots\ldots\ldots\ldots\ldots [4.III]$$

It is evident from the estimated equation that combined influence of Reserve Bank credit to banks and to commercial sector is relatively less on the annual variation in RM, as compared to their individual influence.

$$RM = \underset{\substack{(1.77)\\ \text{t-value}}}{1399} + \underset{\substack{(4.79)\\ \text{t-value}}}{3.247}\ RBCBC$$

$$R^2 = .57 \qquad DW = 1.67$$

As well, the total credit granted by the RBI to Commerical Sectors and Banks, when related with the net non monetary liability [NNML] of the the RBI, it was observed that RBI credit to both the sectors remained fairly stable and it hardly exceeded the amount that Reserve Bank could draw from its net non monetary liabilities. This makes it evident that large part of changes in RM can not be attributed to the change in the RBI credit to both, Banks and Commericial Sector.

As evident from the following relationship :

RBCBC = f [NNML] ... .[4.IV]

The estimated result is as under on the basis of data given in table 4.3.

$$RBCBC = \underset{\substack{(0.31)\\ \text{t-value}}}{115.15} + \underset{\substack{(14.04)\\ \text{t-value}}}{0.641}\ NNML$$

$$R^2 = 0.916 \qquad DW = 0.85$$

Infact RBCBC was so much restricted that during the period [1971 to 1990] the variation was only about only 0.64 unit per unit change in NNML. Even by comparing the average annual growth rates of NNML and RBCBC, we find that the comparative growth rate of NNML was higher than that of RBCBC, i.e 17.33% in case of NNML and 14.21% in case of RBCBC. Hence, it is clear that RBI's own funds were enough to meet the financial requirements of Banks and Commerical Sectors. But at the same time these sectors have exhausted 64% of the NNML of the RBI and hence RBI was left with a very little of its own resources to meet very large demand of other sectors, viz., credit to government and credit to foreign sector. So, ultimately, to meet governments' and Foreign Sectors' requirement, RBI frequently relied upon the creation of additional RM.

III. Reserve Bank Credit to Foreign sector :

The foreign exchange assets of the RBI less its gold holding represent the Reserve bank credit to the foreign sector[7] [RBCF].

The RBI is the custodian of the country's foreign exchange reserve. It also acts as the controller of all foreign exchange transactions. As a result, it regularly buys and sells foreign exchange against Indian rupees. All such transactions have an ultimate impact on RM. When the RBI buys foreign exchange, it pays for it in terms of its own money and the supply of RM in the economy increases. Where as, when the RBI sells foreign exchange, it receives payments from the buyers of foreign exchange and the supply of RM goes down. As the buying and selling of foreign exchange by RBI goes on round the year, what matters for changes in RM is the difference between the two. Hence, a surplus in the balance of payments increases RM, whereas a deficit in it decreases the supply of RM, other things being the same.

The Reserve Bank credit to foreign sector is not fully under the control of the RBI as it depends on many internal and external factors, hence it has shown a very inconsistent movement. Though the trend growth rate of net foreign exchange reserve of the RBI was 12.45% during 1970-71 to 1989-90, the annual variations were quite high.

Since about the middle of 1975, net foreign exchange reserves of RBI have grown at a rapid rate, which resulted into a larger share of it in total RM. At the end of March 1975, they amounted to Rs.391 crores. By March 1976, they had grown to Rs.1078 crores, a net addition of Rs.678 crores. Then onwards, it had grown continously till 1979-80, when it touched the figures of Rs.5494 crores in March 1980.

Such a rapid accumulation of resources had been due to many reasons, the most important of them being large inflows of private remittances from abroad, large net inflow of external assistance and improvement in balance of trade. Though, from the national economy point of view it is a favourable outcome, but at the same time because of the inability of the RBI to regulate such inflow merely resulted into rise in RM, which inturn resulted into rise in excessive money supply in the country.

After 1980, the net foreign exchange assets balance with RBI have shown a steady decline till 1985. Thereafter, once again it was on rising path, bringing corresponding increase in RM.

The relative share of net foreign exchange assets of the RBI in total RM was 11.17 percent in 1970-71, which went down to 5.29% in 1974-75 and then took a sudden turn and went up to as high as 41.42% of total RM in 1977-78. During 1979, 1980 and 1981, it remained relatively high. Only after 1982, it went down to less than 10% of the total RM through out the remaining period, except for the year 1986-87 when it was 10.25%.

Table 4.4 Net Foreign Exchange Reserves of RBI and RM. (Rs. Crore)

Year	Net Forei Exchange Reserves of RBI	Relative Share in RM	Change in Net Foreign Exchange Reserves of RBI
1970-71	538	0.112	
1971-72	608	0.113	70
1972-73	563	0.094	-45
1973-74	672	0.093	109
1974-75	391	0.053	-281
1975-76	1078	0.139	687
1976-77	2599	0.265	1521
1977-78	4532	0.414	1933
1978-79	5431	0.386	899
1979-80	5494	0.334	63
1980-81	4710	0.251	-784
1981-82	2623	0.128	-2087
1982-83	1729	0.075	-894
1983-84	1624	0.056	-105
1984-85	3044	0.097	1420
1985-86	3343	0.088	299
1986-87	4594	0.103	1251
1987-88	5267	0.099	673
1988-89	5904	0.095	637
1989-90	6068	0.078	164

Based on Annexure - 3.

The above analysis shows that there was considerable variation in the foreign exchange holding of the RBI. It also shows that the year to year fluctuations were much wider and uncertain. In view of this we do not consider it to be an important source of change in RM.

An attempt was made to estimate the influence of change in foreign exchange assets of the RBI holdings on RM, but the estimated parameters were so insignificant statisticaly that we have not incorporated those estiamtes in the final analysis.

NOTES

Ø1. S.B. Gupta : Monetary Planning for India, Oxford University Press [1984] P.136

Ø2. Since July 12, 1982, with the establishment of NABARD, certain assets and liabilities were transferred to NABARD, so RBI claims on NABARD got seperated from RBI's claims on commercial and co-operative bank. But for the consistency purpose we have included it under RBI's claim on Commerical and Co-operative banks for the whole period.

Ø3. S.B. Gupta : Op.cit. P.172.

Ø4. RBI : Currency and Finance [Various issues]

Ø5. S.B. Gupta : Op.cit., P.137

Ø6. A.K. Chakervaarti : Monetary Planning in the Nineties : A System Analysis Approach - Institute for System Studies and Analysis, February 1987.

Ø7. S.B. Gupta : Op.cit., P.78.