CHAPTER X.

SUMMARY OF FINDINGS AND CONCLUSIONS.

We now sum up the findings and conclusions of the foregoing chapters. The method is to present a broad summary in a manner that may help to have a unified treatment of the nature operation and effectiveness of monetary management in India over the period 1951-66.

(1) 'Revival' of monetary policy in the post-war years is partly attributable to extensive scholarly work on the theoretical and empirical planes done in the - U.S.A. and elsewhere and partly to the innovations and sophistication built up in the instruments of monetary control by the Central Banks the world over. In the underdeveloped countries rethinking on the role of monetary policy has perhaps emanated from - or has to emanate from - the need to have an optimum combination of various methods of 'Savings-investment' technology.

Although it might seem making a facile generalisation, the point need be emphasised that monetary policy in the underdeveloped countries would aim at - affecting the saving-investment process rather than be concerned with only 'quantitative' management of money. This does not amount to relegating the 'Quantity' aspect of monetary policy in the background but it does emphasise discretionary management as against the 'rule' hypothesis.

(2) The issue of relevance of either the Quantity theory or the Portfolio balance approaches has thus to

be resolved, on the one hand by accepting that the aim should be to have a 'defined' versus 'undefined' performance system and on the other hand, by accepting that the channels through which monetary policy exerts its influence are many and varied. The outcome then is that monetary authorities in underdeveloped countries should design their policy on the basis of a set of interrelated data. Too much harping on credit planning or sectoral allocation of bank credit (though these exercises are useful in themselves) does not meet full way the total requirements of monetary policy-making.

A 'monistic' approach based on either 'Quantity theory' or 'Portfolio balance', therefore, is not considered useful for problems of monetary policy in the underdeveloped countries.

(3) Monetary policy in underdeveloped countries has to contend with constraints on policy in the form of 'velocity', 'trade credit' and 'non-bank financial intermediaries' in addition to a few more constraints like the non-monetised sector; higher currency ratio in total money supply; seasonality in banking operations and a dual money market which are inherent in the nature of such economies.

According to one study, short-run variations in income velocity of money in India (1950-51 to 1962-63) have either reinforced attenuated or altogether -

counteracted the effect of changes in money supply on effective demand. Larger resort to trade credit in underdeveloped countries represents gaps in the credit system let alone its effect as frustrator of monetary policy. Non-bank financial companies now brought under regulation of the Reserve Bank of India made a dent into the deposit mobilization business of scheduled banks in that the percentage ratio of deposits with the former to the latter rose from 7.05 in 1962 to 9.61 in 1966 (end of March).

The goal of monetary policy in underdeveloped countries may be stated as "Growth objective in relation to its employment aspect and price level path". It may be assumed that growth leads to employment-creation (since it is not a fully employed economy) though monetary policy may affect employment creation more positively through provision of concessionary finance or institutional developments. No firm conclusions have been reached in regard to growth process and its price level path. Inflation may mobilize resources either via income redistribution (Keynesian approach) or through tax on real cash balances (quantity theory approach) but the benefit of resource mobilization has to be traded off against the costs entailed in wastes of resources in terms of shortening of the payments period and holding of inventories in place of money balances.

Since the process of real accumulation is accompanied by financial accumulation, structural efficiency of the banking (financial) system should be another goal of monetary policy in the underdeveloped countries. Recognition of this aspect by the developed countries (the Federal Government in the U.S.A. has very recently constituted "President's Commission on Financial Structure and Regulation"), should serve as a timely reminder to the underdeveloped countries. The labours of the Banking Commission in India would go a long way in determining the course and efficiency of monetary policy in - India.

The avowed policy goal of 'controlled expansion' put forth by the Reserve Bank of India bears simple logic and has popular appeal. On closer examination, it is seen that the policy goal does not provide any meaningful guideline for policy making and may have injected a sense of complacency in designing the - policy. The term provides less than a rational hypothesisation of the policy goal for monetary authorities in underdeveloped countries.

(4) The Reserve Bank of India has largely fulfilled its role in regard to the promotional and - regulatory aspects of the organised banking system. The Indian monetary system has remained more stable and more diversified during the three Five Year Plans.

The 'unorganised sector' in the financial system continued however, to remain a drag on effective operation of monetary policy and the 'co-operatives' designed to serve as vital links in the chain of substitution encircling the rural and urban - sectors have subsisted on heavy support from the Central Bank.

(5) There was a doubling in the Bank Rate (from 3 per cent to 6 per cent) between 1951 and 1966.

Date of change	Rate after change (per cent)	Period elapsing between this and the earlier change.
November, 1951	3½	16 years
May, 1957	4	66 months.
January, 1963	4½	67 months.
September, 1964	5	20 months.
February, 1965	6	5 months.

The November, 1951 change was a timely action (though somewhat delayed) and the period of quiescence (66 months) between this and the next May, 1957 change was justified in view of falling prices and rising - national income of the First Plan period. The May, - 1957 change was a rise necessitated by a limping - official Bank Rate and a higher effective rate of lending. The change in Bank Rate in January, 1963 again after a lapse of 67 months (as in previous case) was not due to a period of quiescence. The larger lapse of time was made good by the introduction of the system of graded lending rates which lasted till September, 1964. The September, 1964 rise in Bank rate (after a lapse of 20 months) came with the introduction of the Net liquidity ratio - method which rationalised the system of graded lending rates. This rise was followed by a full one - percentage point rise after a lapse of 5 months. The Reserve Bank had thus followed a steady path of monetary control in wielding its Bank Rate policy. Thus while we are not justified in laying a charge of - timid behaviour on the part of the Reserve Bank because Bank Rate variations were infrequent, we have to concede the charge that the Bank remained lukewarm towards its responsibility as an agent of 'change' first by failing to evolve a rational interest rate policy and second by paying inadequate attention to the structural dimension of its Bank Rate policy - namely the Bill Market Scheme.

(6) Open market operations have been given primacy among 'general' instruments of control but in the underdeveloped countries their use as a control measure is precluded by the 'fiscal' burden the policy has to bear in addition to the environmental constraint of 'narrow' market for government securities.

Open market operations in India serve as a channel of seasonal finance but the Reserve Bank policy has succeeded in keeping under check the destabilizing effects that this function may - involve. Central Bank holding of government securities in India is twice as large as that of the Federal Reserve Banks in U.S.A., while the percentage share of individuals in U.S.A. is fifteen times that in India. The maturity distribution of 'investments' by scheduled banks has shown trend towards predominance of the 'shorts' over the 'longs'. The percentage ratio of securities maturing 'within 5 years'to those maturing 'between 5 and 10 years' rose from 54.8 in 1951 to 320.9 in 1966. It remained above 50 per cent during all these except two years. There has been a decline in the ratio of investments to deposits from 34.5 per cent (average for the First Plan years) to 28.7 per cent (average for the Third Plan years). One of the reasons for this is the widening of the differential between rates on 'advances' and 'investments' from its 1953 level of + 3.2 to + 5.1 in 1966. The ratio of 'net free reserves' to total deposits of scheduled banks remained below - 2 per cent for most of the years 1951-66. In view of the shortening of the maturity distribution of investments by banks and the possibility of some operation of the locking-in effect monetary authorities need not get scarred in pursuing a realistic interest rate policy.

In contrast to the 'narrowness' of securities markets in the underdeveloped countries may be cited the contention that in the developed countries 'limitless marketability' renders the market too good. The truth is that in the case of both the groups of countries there is holding to maturity and there are some marketable assets (the "small savings" securities in India for instance) which may provide liquidity without participation by the Central Bank so that pursuance of an active interest rate policy does not seem that much destabilizing as may be supposed.

The use of variable reserve requirements in India is limited to upward revision. In using this measure in March, 1960 (and abandoning it in January, 1961) the Reserve Bank was perhaps reading too much in the situation and was guided more, in this instance, by the ambivalent policy goal of 'controlled - expansion'.

Scheduled banks in India are subjected to lower cash reserve ratios as compared to those prevalent in some of the developed and underdeveloped countries. Optimum level of reserve requirements is not easily defined but in view of the fact that the high currency ratio in total money supply keeps the value of the 'money multiplier' low and in view of the needs for 'banking expansion', use of reserve requirements variations is of limited significance in India - although its use as an emergency measure remains important.

(7) Selective controls seem to have greater appeal for tackling situations of distortions in relative prices and imbalances in specific sectors, which may emerge from programmes of planned economic development. In India, they have been used to - "prevent speculative hoarding of commodities like foodgrains and essential raw materials". Fixation of margin requirements and ceilings on advances on these commodities over the years 1956-66 have shown continuance of the controls in a larger measure and have failed to meet the 'Sayers Criterion' (as we have termed it) of 'sharp effects' and 'early relaxation'. The ratio of scheduled bank advances - against foodgrains remained within 2 to 7 per cent of total commodity advances and this may be pointed out as futility of the measures. If we relate the ratio of bank credit (brought under the purview of selective controls) to total national expenditure pertaining to that category of bank credit and if the ratio turns out higher we may justify the use of the controls. The percentage ratio of bank advances against consumer credit to total personal consumer expenditure in the U.S.A. was 6.1, as against the ratio of bank advances against 'composite food group' to total private consumer expenditure being

of the order of 0.79 in India during the year 1960. Keeping in view the limitations inherent in such a comparison, it may be said that the area of influence of selective controls is quantitatively much smaller in India but having regard to the impact that foodgrains prices would have on material - well-being of individuals in a subsistence economy, the use of selective measures would have justification. If we measure the impact of the controls on prices of foodgrains and other commodities in India, the outcome is not encouraging however, and we have to grant these control measures a sort of 'status value' rather than a place of "control measures with marked effectiveness".

In view however, of the fact that selective controls had (and may have to) meet the counteracting demands of expansion of banking and warehousing facilities and such other claims that may be made from time to time, it would constitute a rational policy to use more of moral suasion than has been done hitherto. Concentration of the banking system and the prestigious status of the Reserve Bank - together with the need to bring the co-operative banking sector under purview of such regulations are factors favouring the use of moral suasion.

(8) There is agreement that interest rate is an important financial variable to be acted upon by -

Central banks and the experience of post-war years bears testimony to this. The pre-war skepticism about insensitivity of investment to interest rates has given way to somewhat dependable negative relation between the two and so about the positive interest elasticity of savings also.

Bank rate variations in India had transmitted their effects on other market rates of interest and this augurs well for pursuance of an active interest rate policy.

Granting the proposition that monetary policy, in the underdeveloped countries, works by affecting the saving-investment process, the assets structure of savings becomes relevant. The household sector contributed between 2/3 and 3/4 of total savings in the Indian economy during 1951-66, and there has been veering away from the holding of 'physical' to 'financial' assets by this sector; the percentage ratio of the former to the latter having declined from 2050 in 1950-51 to 53 in 1965-66. Among the financial assets held by the household sector 'bank deposits and currency' which were 49.4 per cent of the total in 1955-56 increased to 59.3 per cent in 1965-66. There was relative decline from 21.2 to 10.5 in the percentage share of 'claims on government and corporate sector', and a rise in the share of 'contractual savings' like "Provident funds and -

insurance".

Taking net savings of the household sector in the form of the 'currency and bank deposits' the ratio of the latter to the former which was 4.5 (average) during the First Plan rose to 86.3 (average) during the Third Plan. The relative - gain of bank deposits is attributable not to very attractive interest rates on them but due to their being one of the few savings media available in the underdeveloped countries. From this point of view, a rise in the interest level should coax out - further savings in form of bank deposits. The structure of some interest rates in India shows that during the period 1951-66 annual growth rates of the short term and long term rates have been such that the differential has somewhat narrowed down. This is attributed to strained liquidity position of banks consequent upon their failure to mobilize deposits and the low rates on government securities made possible by a 'captive' market. The annual growth rate has been the highest in case of bank deposits (12 months) but this is to be ascribed to the very low level of this rate in 1950-51 rather than due to realistic interest rate policy. A comparison of variations in rate on bank deposits vis-a-vis (i) rate on bank loans and (ii) return on investments by banks shows that the percentage ratio of rate on bank deposits to bank loan rate increased from 20.3 in 1953 to 45.5 in 1966. Both, rates on deposits and on advances being subject to inter-bank agreement and official regulation, it has been observed that during the non-agreement years (1953-58) the ratio showed larger variation; during the interrgnum (1959 and 1960) characterised by agreement without intervention, the ratio showed a decline but from 1961 to 1966 there was again rise in the ratio. Determination of rates under free market forces is, therefore, to be recommended with regulation in specific cases in case of anamolies in the structure (such as the rate on 12 months deposits remaining lower than those on 3 months deposits).

The percentage ratio of rate on bank deposits to return on investments on the other hand showed a continuous rise over the years. If the assumption is granted that banks were not made to hold securities in a captive market and, therefore, their earnings would have remained higher and that these were passed on to the average depositor (competition would ensure this), then the average depositor may be said to have been subjected to an implicit tax. Alternatively if the earnings were utilized for banking expansion the policy exercised a check on financial development.

Interest rate policy in India has remained excessively preoccupied with the allocative aspects of bank finance taking supply side of savings as given. The pre-war and immediate post-war policy of low rates has been far extended to periods of growing economies.

With rates being determined according to free play of economic forces a levelling up in the rate of interest by the monetary authorities might lead to a rise in lending rates by banks (though with cost consciousness and with increasing returns to scale the hike in lending rates may remain lower). The obsession with monetary authorities about higher lending rates leading to over-borrowing at the discount window should give way to the more rational consideration about financial discipline that may ensure higher interest rates. What is more, monetary authorities in India have now evolved the method of meeting such over-borrowing through the Net liquidity ratio technique. There is thus a case for evolving a realistic interest rate policy. Such a policy has to be both rational and purposive. To meet the former aspect of policy there is case for levelling up the rates of interest in the organised sector consistent with a capital-scarce and high-consumption economy. No particular numerical level need obviously be suggested here, but the advantages of larger volume of savings and financial discipline are both apparent and must be given a fair trial. The policy may remain purposive through provision of finance at low or high rates in specific sectors and should remain flexible also.

(9) A realistic interest rate policy has to be formulated with due regard to the question of structural efficiency of the banking system. In the Indian context there is on the one hand the issue of integration within the organised set-up - the commercial, co-operative and post office savings banks - and between the 'organised' and 'unorganised' sectors. The issue of size in the banking unit which on, a priori reasoning, suggests treating banks as public utilities on account of their being subject to increasing returns to scale has to be now understood, in the context of a nationalised set-up, in terms of expansion of the system and induction of financial innovations, - together with the responsiveness of the system to monetary control.

In sum, it seems, Bank Rate would continue to have its primacy in the armoury of monetary controls with the Reserve Bank of India. The Bank should have a better mix of moral suasion and other - measures of selective controls than has been done hitherto. Preoccupation with rather excessive and ineffective use of selective controls is a reflex action of the ambivalent policy goal of 'controlled expansion' which may be better eschewed as the 'keynote of monetary policy' in India. While 'quantitative' management of money would necessarily remain one of the constituents of policy making, incorporation of a rational purposive and flexible interest rate policy as another constituent seems overdue.

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