MIDS Working Paper No. 222

India’s Monetary Policy in a Political Context (1835-2003) RBI and the Quest for Autonomy

TCA Srinivasa-Raghavan
Visiting Fellow
Madras Institute of Development Studies

June 2016

Madras Institute of Development Studies

MIDS Working Paper No. 222, June 2016

India's Monetary Policy in a Political Context (1835-2003)
RBI and the Quest for Autonomy

by TCA Srinivasa-Raghavan

Rs.25.00

Madras Institute of Development Studies
79, Second Main Road, Gandhi Nagar
Adyar, Chennai 600 020
Tel.: 2441 1574/2589/2295/9771
Fax : 91-44-24910872
pub@mids.ac.in
http://www.mids.ac.in

India's Monetary Policy in a Political Context (1835-2003) RBI and the Quest for Autonomy

TCA Srinivasa-Raghavan*

Abstract

This paper examines the factors that have influenced monetary policy in the country. It highlights the political factors that have influenced monetary policy providing a fresh perspective on the relationship between the RBI and the government. The paper shows how the one area in which the RBI has more-or-less failed is in ensuring rapid monetary transmission, although this failure is not for want of trying. While the RBI has managed to achieve some autonomy, on many key variables, the political needs prevail.

Introduction

This paper is an informal account of the factors that have influenced monetary policy. It builds on recent research that has focused on the politics of India's monetary policy. Goyal (2011) is more by way of a history and has only oblique references to politics. Ray (2011) is a description of the formal relationship between the RBI and the government and thus, politics. This paper focuses largely on the political factors that have influenced monetary policy. In that sense it provides a fresh perspective on the relationship between the RBI and the government.

The paper is essentially chronological in its description of monetary policy in India since the 19th century. It traces the factors that influenced British policy, namely, to retain a competitive advantage for British exports to India through the manipulation of interest rates and exchange rates. It then describes post-Independence monetary policy, which falls into three phases.

---

* Visiting Fellow, MIDS

Acknowledgements: My grateful thanks to Dr Shashanka Bhide, Director of the Madras Institute of Development Studies, for having given me the opportunity to write this paper. My thanks also to the various friends in the economics profession, RBI and journalists discussions with whom over the years have formed the conclusions expressed in this paper.

The first phase was 1947-70 when the government paid some heed to the RBI which was in charge of monetary policy; the second phase is 1971-92 when for all practical purposes the RBI became in the words of one former finance minister, ‘a subordinate department’ of the finance ministry; and the third phase is 1992 onwards when, thanks to the reforms of 1991, monetary policy was given some autonomous space by the government and the RBI became less of a subordinate department.

The paper shows how the one area in which the RBI has more-or-less failed is in ensuring rapid monetary transmission. But that has not been for the want of trying. The government has been an unshakeable obstacle in this regard because of its control of banking. Rescuing Indian banking from the government to ensure non-political monetary policy remains a major challenge. In the final analysis despite the ups and downs that have mostly involved the egos of ministers and governors the overall outcome has been satisfactory for the economy. There has been a great deal of learning.

***

The beginnings

By 1820 the East India Company had gained control of much of India after defeating the Marathas. It was severely constrained by the diverse coinage in existence. It therefore decided to unify the money and introduced a silver rupee in 1835. From about 1874, the gold price of silver began to fall because of global developments and by 1893 it had fallen by about 40 per cent. In 1893, alarmed by the consequences of both the decline and the volatility, the British government appointed a committee to see what needed to, and what could, be done. It recommended the end of free minting of silver in India in order to control the value of silver. The closing of the mints, followed by a subsequent increase in the exchange rate of the rupee and the unexpected evolution of the gold exchange standard meant a curb on silver imports. This introduced rigidity into the system and local interest rates rose very sharply. The idea was to introduce the gold standard which was eventually done in 1898. A sovereign was fixed at Rs 15 to £1 but the scheme was soon abandoned. Over the next few years, the gold exchange standard slowly came into being. It was based on silver rupees, half rupees and currency notes which were not convertible into gold. But the government made gold available for foreign payments. This was a watershed event in the evolution of the Indian monetary system. The new system sought to maintain parity of the rupee with gold.

Indian business opinion was, however, of the view that the currency mechanism was being used to support and strengthen the London money market to increase the volume of loanable funds in London, to make the London market earn brokerage and commission charges, to help exchange banks in London with loans so as to enable them to purchase and subscribe to non-Indian loans and securities and so on. In 1913, the Indian government decided to set up a commission under Austin Chamberlain to analyze the gold exchange standard which was used for maintaining the exchange rate of the rupee at 1s.4d. There were, of course, no Indians on it.

Eventually, it was agreed to appoint a Royal Commission to analyse the gold exchange standard. It was expected to recommend the scrapping of the gold exchange standard. Amongst its members was an unknown young economist called John Maynard Keynes. It was he who coined the term 'gold exchange standard'. Later he would call gold a barbaric relic. The Commission decided the currency should be coins and notes and that the use of the latter needed to be encouraged. On the matter of establishing a central bank which would take away the monetary function from the Government of India, it maintained a discrete silence except to suggest the setting up of an expert committee. British Indian businesses had a great deal of influence on the Indian government and didn't want an independent agency with its loyalties to England. It merely 'requested' two of its members, John Keynes and Sir Earnest Cable, to draw up a note. Keynes wanted the new bank to be created by merging the three presidency banks, to be called 'the Imperial Bank of India'. It would manage government balances and note issue. 'Supreme Direction' was to be vested in a 'Central Board of three members: the Governor of the bank, the deputy Governor and a representative of the government along with three or more assessors. The gold standard reserve would constitute an ultimate safeguard. The new bank would perform central banking as well as commercial banking functions.

In 1925 Britain returned to the gold standard having gone off it a couple of years before. Yet another committee was appointed under the chairmanship of one Edward Hilton Young. He recommended that the gold bullion standard should be adopted but that gold coins should not be in circulation. But most importantly, he said India should have its own central bank and in January 1927, a bill to that effect was passed. The Reserve Bank of India (RBI) was to come into existence, which it did in 1935. Its task would be to unify the currency and credit policies in India.

Until now, these had tended to go off in all directions. The Reserve Bank took over the management of note issue from the Currency Department of the Government of India. It didn't have much to do because, thanks to the low level of economic activity and the low level of monetisation, the volume of currency in circulation in 1935 was very small.

It can be, and indeed was, asked why it took so long to set up the RBI. In fact, Keynes had suggested that a central monetary authority for India be set up as far back as 1913, observing "if funds are to be attracted from abroad for a short period (say three months) the rate of interest would be high enough to repay the cost of remittance both ways, which, in the case of places so remote from one another as India and London, is considerable. If there were some authority which would create money in India, it would not be necessary for the rate of discount to rise so high." (Keynes 1913).

The inter-war years

Truth be told, the British governments of the time had very many other major worries and India, though important as source of wealth for the Empire, didn't loom large on their horizons. The fact that London's monetary policies made the supply of currency and credit highly inelastic – thus depressing growth – came to be fully appreciated only much later. Indian GDP saw a trend growth rate of 0.93 per cent per year during 1900 to 1947. C D Deshmukh, the first Indian Governor of the Reserve Bank laid the blame squarely on the British insistence on maintaining an exchange rate that was unfavourable to India.

The origins of this problem can be traced back to Hilton Young who had recommended that the Indian rupee be pegged to gold at 1s 6d per rupee, (up from 1s 4d). This rate was accepted in 1927 and led to the vexed rupee-sterling ratio debate that lasted from 1927 to 1939 because this ratio helped British exports to India and inhibited Indian exports, facilitated the transfer of the so-called Home Charges and, finally, it inflated the value of the debt owed to British banks.

The shortfall in exports was offset by the distress sales of gold by farmers in the wake of the steep decline in agricultural prices. In net terms there was massive outflow of gold from India to Britain. The distress sales of gold were sustained by the deflationary policy followed by the government. This consisted of quietly melting down silver coins unaccompanied by a commensurate rise in the paper currency.

Indians protested loudly but were as usual divided. Purshottamdas

Thakurdas wanted the old rate back. If the exchange ratio was maintained at this rate, he felt, the currency authority would deplete India's gold alarmingly. His view was supported by businessmen and many economists. But it was refuted by J.C. Coyajee who had been a member of the commission -- and Dr. B.R. Ambedkar. Thakurdas said the Indian cotton textile industry was depressed because the rupee was overvalued. Coyajee said there was over-production. Gandhiji supported Thakurdas who wrote that "A change to 1s.6d hits the large bulk of the debtor class to the benefit of creditor class. I cannot conceive of any valid or moral reason for a step calculated to give the latter an unearned increment at the expense of the former."

Ambedkar, however, said that reverting to 1s.6d would mean higher prices. "Without increasing the volume of currency," he wrote "we cannot certainly reach 1s.4d in gold. Therefore the complete question is, to my mind, shall we raise our prices from what they are today so that we can go back to 1s.4d? Now I, being a member of the labouring community, feel that falling prices are better". The British, of course, thoroughly approved. They said the Commission was also speaking for labour because real wages would go down if the lower rate was adopted. But all was not quite settled yet. In 1929 India got a new Finance Member of the Viceroy's Council, Sir George Schuster who was soon convinced that it would be best to go back to 1s.4d. He called the higher ratio as his 'worst inheritances and appeared to him indefensible'.

The debate went on for the next 11 years until the start of the Second World War settled it by shifting attention away completely. In the meanwhile, of course, the British had achieved their economic objectives at the expense of Indians. The larger objective was to rebuild British gold reserves; the lesser objective was to keep British factories in business.

By 1938, enormous opposition to this policy had been built up by the Congress and its industrialist friends. The Congress Working Committee asked the provincial Congress ministries to agitate for a lower rate. The British Government of India responded predictably: on 6 June 1938 it said no, the exchange rate will remain as it is. The excuse was that the gold and sterling assets in the RBI which had come into existence on April 1, 1935, and with the Government of India, were worth more than Rs 160 crore. Purshottamdas Thakurdas disagreed but the RBI said there was nothing to worry about. On the contrary, it said, a reversion to pre-war parity would certainly be injurious. It didn't say to whom but it was clear from the fact that the high ratio resulted in the outflow of gold.

The RBI, the first central bank to be set up in the non-White world, has many problems to deal with but none as annoying as its date of birth – All Fools Day, 1935. Despite that, it has nurtured many monetary institutions in India, acted as an all-rounder and, on one brief occasion for about three months during the great crisis of 1991, practically supplanted the Government of India.

The idea of a central bank for India was born out of the need to facilitate the drain of wealth from India to Britain (via banks) in an increasingly complex world of finance. The first time the idea of a central bank for India was mooted was in 1870 by one Ellis, a member of the Viceroy's Executive Council. He suggested the setting up of 'one State Bank for India'. This was to be like the Bank of France which Napoleon had established in 1800. The proposal was renewed in 1884 dropped on the ground that India possessed a sound banking and currency system. After that nothing was heard of it till 1913 when the Chamberlain Commission again brought it up.

Keynes, who piloted the idea, said "The choice lies between a good deal of responsibility without thoroughly satisfactory machinery for the discharge of it and a little more responsibility with such a machinery. The balance of advantage is with the second alternative." But soon the First World War began and the whole project took a back seat. It was another seven years before the idea resurfaced. In 1920 the Imperial Bank Act was passed. It was on the general lines of Keynes' memorandum. In 1925, the Hilton Young Commission recommended that a 'Reserve Bank of India' be set up to discharge central banking functions.

Immediately, a controversy arose as to who would control the RBI when it was set up. Young said the shareholders of the Imperial Bank should control it. The government said no on the ground that it was politically impracticable. Nothing much happened till 1931 when constitutional reforms were being examined. These reforms would result in some financial autonomy to the provincial governments when they were formed as a result of the constitutional reforms. In September 1930 the government in India told the British government a central bank had to be formed before any financial responsibility was transferred to the Indians. The die was pretty much cast then but it would take another four years before the RBI became a reality.

In 1931, the Central Banking Enquiry Committee submitted its report and it too strongly recommended the establishment of the Reserve

Bank at the earliest possible date. "The paramount interests for the country involved in the establishment, within the shortest time possible, of such an independent institution, free from political influence, can hardly be overestimated." In 1933 a White Paper on the new constitutional reform was published. It simply assumed that the RBI would be set up. It also assumed that it would be free from political influence.

Finally, in 1933, the Reserve Bank of India Bill was introduced by the Finance Member of the Viceroy's Council who said "when the direction of public finance is in the hands of a ministry responsible to a popularly elected legislature... it is desirable that the control of currency and credit in the country should be in the hands of an independent authority which can act with continuity." He added that it should be "independent of political influence" meaning Indian politicians should be kept at an arm's length. The Bill was passed in December that year. The RBI would, amongst other things, sell sterling in lieu of gold to protect it and maintain a fixed exchange rate with the sterling. The shares of the RBI would be widely dispersed.

But who would control this new bank? Who would sit on its board? The Indians were against the board being selected by private shareholders. They wanted it to be an agent of the State so that public interest was always kept in view. The government was determined to have its nominees. Politicians wanted the legislature to have say in the selection of the Board and a constitution like charter for it but the Muslims and other minorities opposed it saying all the usual things about safeguards!

In any case all this was of academic interest only because the British had decided to have a shareholders bank like the Bank of England. They thought that private ownership would insulate the RBI from political interference. But it must also not be forgotten that as a creditor country, Britain gained from such independence. It didn't want local politicians being a nuisance.

In the event, the newly minted Reserve Bank was started as a shareholders bank with a capital of Rs 5 crore. It would 'regulate the issue of bank notes and the keeping of the reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage'. Some sops were thrown in to satisfy the politicians but control remained firmly in private British hands and through them, in the hands of the Viceroy's Council. After all, fully half the board members would be appointed by the government. As it turned out, the RBI was accountable to no one and certainly not to the legislature. Successive governments since then have sought to bring it to heel but the RBI has mostly resisted them successfully. There have been only three episodes which have ended badly for the Governors.

The RBI had a clear but hard-to-attain objective: to maintain the external and internal value of money. The instruments available to it were the bank rate, reserve requirements and open market operations. For much of the Second World War, the government had just one objective: stable interest rates. The emphasis was on stability and not on cheapness. So the bank rate was kept at 3 per cent. The RBI Governor John Taylor set out the policy:

> *"To many, monetary control means cheap money and it is often argued both in this country and elsewhere that the better the control the cheaper should be money. This of course is essentially fallacious. The business of the controlling authority…is to do as far as possible what freely operating markets would have done for themselves if they were not being subjected to abnormal stresses beyond their control or their ability to foresee. In the absence of control these would be reflected in violent fluctuations upwards and downwards.…It is obviously advantageous to have machinery to carry out theoretical policies and to do what the market if left to itself in normal circumstances.…Too great a reduction in the effective rate of interest must lead to the drying up of the investing habit in which case the only alternative is inflation…the controlling has to take these factors into consideration".*

As a result, the war was financed by borrowing at the rate of 3 per cent. In 1943, thanks to the Bengal famine, inflation started and there was some pressure, supposedly from the government, to raise interest rates. But the 'independent' RBI opposed the move saying "The results of attempting any enhancement of interest rates at this stage are likely to be embarrassing for those who have so far subscribed to government loans.…Apart from the fact that high interest rates increase the burden of succeeding generations, there is always the possibility of any such increase failing in its immediate effect and defeating its own purpose". And that, as they say, was that.

The first four years of RBI's existence – until the start of the Second World War – were confined to the day-to-day management of money and foreign exchange. The government didn't have much of a borrowing programme in those pre-Keynesian days. It took orders from the Viceroy to help with the war effort. This involved, inter alia, the RBI adjusting monetary and exchange rate policies to suit fiscal policy, which was to borrow a lot. At one point when the RBI demurred there was even a threat to supersede it. And therein lies a tale, the virtual dismissal of the first RBI Governor, Osborne Smith.

At the root of it lay the age old issue: control. Was the RBI Governor going to be a nominal boss while real control lay with the Finance Member of the Viceroy's Council or would he be genuinely autonomous? The irony was that Smith had been appointed, instead of some ICS officer or British banker, precisely to give the impression that the RBI was independent.

Smith had been at sixes and sevens with government policy from the very start. In fact, once after receiving some instructions from the Secretary of State in 1930, he had complained that "anyone would assume that the Imperial (Bank) was a department and a very inconspicuous department of the government." RBI History Volume 1, page 223. These, as we will see later, would turn out to be prophetic words because 27 years later the finance minister of independent India would say exactly that to the then RBI Governor.

In a fit of anger Sir Osborne had also once told the government that "as long as I run the Imperial Bank, I will not be run by London or anywhere else, and further, that I would not tolerate interference with my business." In 1936, he written in a letter that he was "sick to death" of the government's attempt to dominate the RBI.

There were two issues they were quarrelling about: the exchange rate and its consequences and the bank rate. Sir Osborne was implacably opposed to the 1s 6d rate. And he was convinced that it would be deflationary and wanted a lower bank rate. The government view, embodied in the Finance Member, Sir John Grigg, would not budge on the former and was scornful of the latter. Indeed, as has been noted by G Balachandran, the economic historian, Grigg said he would judge pro and anti-British attitudes in India by applying two tests: 'ratio and protection'. He believed that both should favour Britain and anyone who said otherwise was anti-British. Grigg was also very concerned that the RBI Board, far from being a British catspaw, had too many persons who sympathised with the Indian businessmen and the Congress party. When Sir Osborne wanted to appoint A D Shroff, an ICS officer, as deputy Governor, Grigg dismissed the suggestion calling Shroff "a perfectly frightful man and intimate crony" of Sir Osborne.

Not only did Sir Osborne fail both of Grigg's tests, he also opposed the gold drain from India and wanted to impose an export tax on gold, which the government opposed tooth and nail. Overall, the British officers in India regarded him as a colonial who sympathised with the natives and who had to be shown his place, not least for calling the Viceroy a "weak ass". In fact, they had opposed his appointment when it was first suggested by Montague Norman, the Governor of the Bank of England.

Their view of him was also based, at least in part, on the encomiums he received from Indian businessmen. The Indian Merchant Chamber wrote a very critical letter to Grigg, after Sir Osborne's resignation. And just as is happening now, the Congress demanded full disclosure. The government simply remained silent hoping that the controversy would die down, which of course it did. But the episode left a very bad aftertaste, which has persisted till today because no one really knows what happened.

The RBI has, from time to time, rebelled but in the end its independence was best summed up by Dr Y V Reddy who was Governor from 2003 to 2008. Asked about RBI independence he said "We are totally free – within the limits set by the government."

The relationship cannot be described any better than this.

The new governor was James Taylor was Grigg's man. His first task, made clear to him by Grigg, was to bring the RBI Board to heel. It had a lot of Indian businessmen on it and they often took positions that were variance with what John Grigg, the Finance Member of the Viceroy's Council wanted. Grigg, in his autobiography, has summed up the situation accurately. Writing about Taylor he says that when Taylor took over the Board was dominated by 'Hindu' businessmen owing allegiance to the Congress. "This might have had serious consequences. That it did not was due largely to the skill and tact of Sir James Taylor... he showed utmost loyalty to me..."

The first volume of the RBI's official history has been very charitable to Taylor saying he harmonised the interests of the government and the Indians. That is simply not true. It was an unequal relationship in which the government gave way on small things while holding firm on the large issues that directly affected British interests, such as financing and supplying its defence forces. Indian businessmen were unlikely to oppose British policies very much because the Second World War resulted in a huge increase in orders placed by the government. That, in essence, was the unstated deal that Taylor managed to make with the Board.

The war years presented the RBI with two major problems: the increase in sterling balances and inflation. The former was caused by the huge increase in British purchases from India and the latter by the diversion of food to the British army and Britain. Thus, India acquired a lot of foreign exchange in the form of sterling which, in modern parlance, had to be sterilised or kept out of circulation. It also had to produce food for Britain which meant it went short in India. The famine in Bengal in 1943 was a direct result of this policy. But it was preceded by three years of steady increases in food prices. The RBI did make some feeble attempts to raise the interest rate but was told by the government to be quiet as it needed to borrow cheaply. So the interest rate remained at 3 per cent for over a decade and Britain ran up a huge debt to India – which it would not repay in full.

It was also during this period that exchange control was introduced by the government and the RBI put in charge of administering it. This would remain in place for over 55 years, until the end of the century when it was finally abolished by Bimal Jalan when he was Governor. Not having very much else to do during the war, the RBI busied itself with setting up new departments. The banking and the agricultural credit departments were set up during this period. A research department was also started and has distinguished itself since.

In a sense, the RBI used the war years to arm itself with the wherewithal to deal with post-war problems. By 1943, no one had any doubts that the British would leave as it could not possibly pay for the Empire; the only uncertainty was over when.

Taylor died suddenly of a heart attack in 1943 and it decided to hand the job over to an Indian, an ICS officer called C D Deshmukh. Deshmukh had been appointed to the RBI in 1938 to liaise with the government. He was then made deputy Governor in 1940. He went on to become India's finance minister in 1950, a post which he had declined in 1946 in the Interim Government, thus allowing Liaquat Ali Khan of the Muslim League to become finance minister. It was a decision everyone soon regretted.

The government in Delhi tried hard to prevent his appointment. But the majority of the Board stood firm and approved the appointment of Deshmukh. It might be worth noting here that the suggestion to make Lamond the Governor was moved by a Parsi and seconded by a Muslim and an Englishman. But the Hindus won the day by 7:3. In the end, the government proposed a face-saver: the Board would have to accept a Muslim and a European as deputy Governors. The Board decided to agree to this condition – it had no choice really because the government had the veto – but one of its more vocal members, C R Srinivasan, made it clear that "...the powers of the Governor are not sought to be short-circuited by the appointment of a Deputy Governor who possesses more contact and perhaps more confidence of the Government of India."

In short, he said, beware the Trojan horse. For a while, though, Deshmukh was 'advised' by the finance department to consult the Managing Director of the Imperial Bank, Lamond. Deshmukh complied for a while and then stopped saying since there was never any disagreement, there was no need to consult.

Deshmukh played fair and tried his best to balance Indian and British interests but sometimes he lost patience, as when in 1945 he was asked to consult Delhi on some matter before deciding. He told the finance department not to interfere. His letter is sharp: "... I cannot engage to do in subservience to what amounts to a claim to be consulted... I regard it as important... that the independence of the Reserve Bank be preserved ... and I feel constrained to enter a caveat against any semblance of an encroachment on its discretion." Thirty four years later, in 1979, a Special Secretary in the finance ministry called Manmohan Singh would give a sharp rap on the RBI's knuckles for not consulting the government over some issue. Then again, in 1985, a young and brash chief economic advisor called Bimal Jalan would take strong exception to something the RBI did without consulting him.

India contributed a very substantial amount to what was called the 'war effort', not so much via taxation or exports as by lending money to Britain by means of a formula arrived at in 1939. Basically, it meant the RBI would print notes – deficit financing – which would be paid back in pounds. This debt came to be known as Sterling balances – balances because they were not available to India for spending on imports; they remained in Britain as a book entry to be repaid after the War. If Britain had lost, it would have been that much money down the drain because the Germans could hardly be expected to honour British debts.

The consequence for India, where manufacturing output was not growing by much and nor was agricultural output, was severe inflation. Prices nearly doubled between 1939 and 1945. The RBI was helpless as it was required to indulge in deficit financing to finance the war while minimising inflation. Deshmukh's assessment of the price situation is a testimony to central bank obfuscation. "Thus on a comprehensive survey... one arrives at the conclusion that there can be no complete solution to the problem of rising prices in war time if the war effort is to be maintained at its fullest pitch and pace; and such remedial action as is possible... does not lie on monetary lines but... on advice to the government to intensify efforts on the production of food and other necessaries of life..." This theme has echoed down the 70 years since then, namely, don't expect too much from monetary policy.

When prices began to rise sharply after 1942 because of the excess money with the public, the British worked out a nice little squeeze. The government decided that one way of tackling the problem, at least at the psychological level, would be to sell gold and silver. But where would it come from and how much would India pay for it? The answer to the former easy: Britain and the US. The answer to the latter was also easy: it would pay a 75 per cent premium. Much the same thing happened in the case of silver also.

Eventually the sterling balances mounted around 1.3 billion pounds. The British simply decided not to honour their debt to India, at least not in full. Even in that India was lucky. Had Winston Churchill, the main author of the Bengal famine which claimed 3 million lives, been re-elected as prime minister, he would have repudiated the debt. He had said as much. But his successor, Clement Attlee was a more moral person. He agreed to pay the debt but a far reduced amount than the 1.3 billion pounds. But he did agree to compound this perfidy by devaluing the pound by 30 per cent in September 1949. It was, as it happens, the last act of British perfidy in India.

During July-December 1947, the RBI was engaged in sorting out Pakistan's problems. It even acted as its central bank for about a year. The Muslims demanded that Pakistan should appoint a deputy Governor. The Hindus said no because the Governor and deputy Governors did not represent a government but the Board. Similar problems arose in respect of the issue of currency against the Pakistan government's securities. There was a good deal of wrangling because the RBI felt that Pakistan would print away merrily if given a free hand. Eventually a minimum limit of Rs 20 crore and a maximum of Rs 40 crore were fixed. There were dozens of other issues over which the Pakistanis kept making claims and demands. Most of these were based on playing the victim. They were accommodated to a certain extent.

Then there was the question of IMF and World Bank membership. The Muslims said India should sponsor Pakistan. They also wanted the existing quota to the IMF to be divided. The Hindus said it was up to the IMF and the World Bank to decide these things. In the end, the Partition Council decided it would get 17.5 per cent, and only as much gold as it was required to pay to the IMF when it became a member.

Similar wrangling went on in respect of the sterling assets as well. In the end Pakistan got an amount based on a complex formula which pretty much no one understood. Much of all the arguing and bad feeling could have been avoided if Pakistani officials had not started with the assumption that the Indians – Hindus to them – were out to cheat them. The extraordinary thing was that many of them had been colleagues and knew each other well.

Pakistan's unwillingness to honour its commitments extended to the exchange rate as well. Out of sheer generosity, which some thought was misguided, India had agreed to parity between the Indian and Pakistan rupee. This after Pakistan had officially claimed that it had a weaker economy and therefore needed a larger portion of the sterling balances than it was entitled to. In September 1949, as pointed out earlier, India devalued the rupee by 30 per cent after the British had cunningly devalued the pound. Pakistan refused to follow suit. The Indian rupee became Rs 144 to Rs 100 of Pakistan. The RBI was incensed and stopped providing cover for a few weeks. But Nehru put pressure on the RBI which agreed to a rate of nearly Rs 144. India started a mini-trade war against Pakistan which lasted for about a year until Nehru was persuaded to be generous and let bygones be bygones.

In 1949, the RBI was nationalised, thus ending the power of the board, which more-or-less became a rubber stamp. From here on, the government would rule supreme. The record shows that the RBI resisted nationalisation tooth and nail. It told the government that it saw no reason whatsoever why it should be nationalised because the government "already possessed adequate powers to ensure that its wishes were carried out by the RBI". There may come a time when, in keeping with the international trend, it could be nationalised. But that time was not now. It said the case for nationalisation was "weak and inconclusive."

Its protests proved futile. The politicians had their way.

***

New challenges

From about 1950 onwards, the RBI had to undergo a deep change in its personality. From being a supervisor of India's financial sector, such as it was then, it had to become agent of transformation. Nehru, for some reason which no one has ever been able to understand, chose Sir R K Shanmugam Chetty, a businessman from Madras with no particular expertise in the business of running government finances, as his first finance minister. He began deficit financing, over which the RBI would lose control. He also started a restrictive import policy. "The rapid depletion of sterling balances is causing some anxiety to the government," he said and proceeded to divide imports into three categories: free, restricted and prohibited. Over the years the first category almost vanished while the latter two have continued to grow. Thus was import licensing born. It complemented RBI's own exchange controls perfectly.

His successor was John Mathai. He believed that India's main economic problems were inflation and forex shortage. Prices were rising and forex reserves were dwindling, instead of it being the other way round. His warnings didn't have the desired effect. The overall approach to policy was still the old one of economic liberalism. The socialism bug had not yet bitten anyone yet. Then Nehru ordered the setting up of the Planning Commission and Mathai resigned in protest.

Mathai's place was taken by the first Indian Governor of the RBI, Sir Chintaman Deshmukh. He would present six budgets in a row. It was, as it turned out, a benign period. As a contemporary said about him, "he suffered the consequences of good fortune." Prices started to fall as world commodity prices simply plummeted after the War. India began to import large volumes (partly, as John Mathai had admitted, for the much needed customs revenue). Industrial production grew at a healthy rate of 4 four cent and agriculture also picked up. But the forex problem remained stubbornly in place. Not one seemed very bothered and the commerce minister, T T Krishnamachari had convinced Nehru that large-scale imports would lead to quick growth. Nehru trusted TTK and Indians had a good time for those five years from 1950 to 1955.

Meanwhile, planning for industrial development was in the air. The private secctor had pretty much thrown up its hands. So the overall belief was that the government has to lead the way with investment. But where would the forex to finance the plans come from and would prices remain stable? No one quite knew. In the end, a political decision was taken in

1956 at the Aavadi Congress where the notion of 'commanding heights of the economy' was floated. India would have a planned economy with five year plans which would be based on import substitution. It would adopt the capital intensive path to growth. And in all this the State would be dominant while the RBI played a supporting role. The resulting Industrial Policy Resolution of 1956 completely neutered private industry in India. Over the next decade, state control of industry gradually increased.

During all this, the RBI stood by stoically, coping and managing as best as it could. It had to manage inflation and reserves and it did so quite creditably -- until the Second Plan came along when it ran full tilt into conflict with the government. But the upheavals of the twentry years between 1950 and 1970 would change it forever, from being a mere manager of the monetary system to an active parrticipant in the development effort. It was asked to get off its high pedestal and wade in, as it were, into the messy work of getting a whole country going. It did, in a rather ill-tempered sort of way to begin with and then with more grace and cooperation.

Between 1951 and 1957, the only significant thing of note was the departure from the policy followed since 1935 – of keeping the bank rate steady at 3 per cent. But alarmed by the possibility of inflation, in November 1951, it was raised to 3.5 per cent and resulted in the commerical banks increasing their lending rate to 4 per cent. The RBI also decided to stop buying government securities, after the government had agrred that it could do so. This, too, was a major departure from the previous 15 years.

There was one new thing, however, that the RBI ventured into, an area no other central bank had, or has: rural credit. The first All India Rural Credit Survey was carried out in 1951 and 1952 and published in 1953. The RBI Act of 1934 had enjoined it to expand credit to agriculture because India was so predominantly agricultural. But the British had no particular preference for this – certainly not as much as indpendent India would have – and little effort was expended on expanding bank credit to farmers. Why bother when they could not repay?

A key issue was deficit financing in the latter half of the 1950s. The RBI was being asked to simply print notes to make up for the difference between the government's revenue and expenditure. It was known that this could cause inflation, about which the RBI constantly worried but it was critical to the successs of the Second Plan. And thereby hangs an extraordinary tale, told by the irrepressible B K Nehru. It also shows how casually and informally policy could be made in those days, with just a phone call between friends. The RBI's official history has called it 'somnambulent' policy making, at least on the part of the RBI.

Money being always short, B K Nehru says that sometime in 1956 he phoned the RBI Governor and suggested that the RBI might want to issue ad hoc treasury bills to the tune of Rs 50 crore at the end each Friday and Rs 4 crore at the end of each day. This way the government would always have money and never be broke. These bills had been in existence since 1920 and were issued from time to time. They were meant to let the government tide over temporary cash difficulties, a sort of special overdraft from the issuer of currency to its consumer.

What was new about the 1956 'understanding' was that they would become a source of permanent, cheap finance, at 4.6 per cent, to the government. As Y V Reddy who was a deputy Governor of the RBI in 1997 explained "Ad hoc Treasury Bills emerged as a mode of financing Central Government's deficit in mid-1950's… it was mutually agreed between Central Government and RBI that a minimum cash balance of Rs 50 crore on Fridays and Rs 4 crore on other days would be held by the Central Government. To adhere to this administrative arrangement, it was agreed that RBI would replenish government's cash balances by creation of ad hoc Treasury Bills in favour of the Reserve Bank. These… were meant to be temporary (but) gained a permanent as well as a cumulative character. Indeed, they became an attractive source of financing government expenditures since it was available at an interest rate pegged at 4.6 per cent per annum since 1974, i.e., actually at a negative real interest rate."

The RBI's major dilemma after 1958 was how to control both monetary andd aggregate demand. With the government determined not to follow pre-Keynesian policies of balanced budgets and such like, the RBI could only come with administrative solutions, such as introducing rationing in the monetary sector. The immediate results were beneficial because both inflation and the foreign exchange shortages came under control. But administrative solutions are adddictive and, within a short period, the Indian economy's rudder was taken over by bureaucrats in the RBI and the Finance Ministry. If anything moved, they trussed it.

No better example of this can be found the system of selective credit controls that the RBI introduced. It had no option. After all, it had agreed to lend the government whatever it needed, via the ad hoc treasury bills and that, by definition, was inflationary. Thus was born the system of funding the least productive parts of the economy at the expense of the more productive ones.

It didn't work. Even a RBI study in 1957, conducted at the instance of D R Gadgil who regarded the controls as an abominaiton, showed the controls didn't work because the market always found a way around them. The study then came to an extraordinary conclusion: don't restrict credit to just a few businesses; restrict to everyone! "… to act in advance and… as much as possible through restriction of credit generally than through a maze of separate, specific directives which are got around."

By 1988, the Indian economy would have as many as 235 different interest rates. It was the financial equivalent of the old bureaucratic saying, 'show me the man and I will show you the rule.' Here it was 'Show me the business and we will invent a rate'. Discretion thus replaced the market.

In the 1960s, the RBI had to do a lot of things, from financing the central and the state governments to ensuring that inflation remained low; from making sure that everyone got at least some bank credit to supervising the banks who were lending the money; and from prudently managing India's external finances to making sure that there was enough money to pay for necessary imports, which included arms. It was a veritable series of rope tricks that the RBI was required to perform and, on balance, it did so by becoming a part and parcel of the state appartus for managing demand by managing the supply of credit and its price in a wat that left the private sector on the fringes while placing the public sector at the centre of its efforts.

From about 1963 onwards when George Woods took over from Eugene Black as the head of the World Bank, there had been pressure, this time to devalue the rupee. Once again the RBI resisted and was able to convince the government that there was no need. It found unexpected support from the British who told the Americans that India wasn't manufacturing enough to be able to export, and so there was no need to devalue!

Things dragged on like this until 1965. By the middle of that year it became clear to everyone, even the government and the RBI, that there was no option but to devalue. The only question left to be decided was when and by how much. But before a final decision could be taken, Prime

Minister Shastri died of a heart atack in Tashkent in january 1966 and it was left to his successor, Indira Gandhi to bite the bullet – which she did personally when she visited Washington in March 1966. There is a hint in Volume Two of the RBI history that she haggled over the exact extent and finally agreed to Rs 7.50 to the dollar or 36 per cent beating the American/IMF/World Bank demand down from 42 per cent or Rs 10 to the dollar. She did not, however, inform her finance minister, Sachin Chaudhury about what she had agreed to until May. The decision was announced in June and predictably, the government came in for severe criticism. As it turned out the devaluation was 'failure' in that exports did not increase significantly and the US did not deliver the aid it promised.

***

'A subordinate department'

In 1969, Indira Gandhi nationalised the banks and in 1971, she became the Supreme Ruler of India. The RBI was collateral damage. It more-or-less formally lost its power to set interest rates. True, it had never been fully independent in this regard – the bank rate was kept at 3 per cent from 1935 to 1952 even though the RBI had wanted to increase it from time to time. But after bank nationalisation and the resulting dominance of the finance ministry over the banking system, the RBI lost control of what these days is called the transmission mechanism also. Indeed, such was the disempowerment of the RBI that when it's Board met a few days after the nationalisation on July 23, no records were kept of the discussion. The whole meeting was described in a single line: "There was a brief discussion on the implications of the bank nationalisation ordinance." When the Board met again on July 30, L K Jha told the members that "...the RBI will continue to be responsible for monetary policy and ensuring compliance... by the nationalised banks." But this would soon be proved wrong.

A connected issue, which has been re-echoing now for a few years, was of setting up a body that would control these 14 banks. It was, in a sense, the idea of a holding company but not in the corporate sense. Within a few days of it being suggested in Parliament, it was ruled out because no one really knew what it would entail. Nor did anyone know what to do next. The political purpose had been served and the commercial aspect would be left as is for some time. The banks would now take their orders from the government, not the RBI whose wards they were supposed to be by law.

All that the RBI would do for the next two decades was to exhort them and inspect them but without much power to penalise them. Resources transfer in the country would now happen via the banking system and progressive taxation, which also acquired a new life with the marginal tax rate reaching 97 per cent in 1973 and staying over 90 per cent through the 1970s.

Throughout the 1970s, when emphasis shifted from monetary policy to banking expansion, arguments between the RBI and the finance ministry went on interminably over strategy and detail. There was constant tinkering as each Governor and each finance secretary tried to leave his mark. While both were agreed on what needed to be done, there was constant friction over how it was to be done. The RBI claimed expertise. The government claimed necessity. The RBI grumbled about interference. The government said the RBI was conservative and old fashioned. The RBI said its approach was the best for the public interest. The government asked which public the RBI was talking about. Lengthy, learned and polite letters, written on the ubiquitous Remington typewriters, were exchanged between North Block and the RBI. Most of them can be found in the RBI's archives in Pune. Some got destroyed in a fire in 1973 in one of RBI's offices in Mumbai.

If the British had wanted India's monetary policies to support their economy, the government in the 1970s and 1980s wanted the RBI to support its anti-poverty programmes which included subsidies. Now that the control of banking had passed into political hands, the central problem of such control came up: to whom to lend and how much? The votes were in the rural areas but profits came from lending to industry. And now there was a third claimant for bank funds as well, by far the largest and most powerful: the government itself. Not only did it want huge amounts, it also wanted them cheaply. It was exactly the same problem that the RBI had faced when it was a private bank just before and during the Second World War. Once again, all that the RBI could do was to collaborate while doing its best to minimise the damage.

The RBI likes to think of what it did with regard to money in the years between 1970 and 1996 as 'monetary policy.' In reality, however, it was nothing more than an exercise in credit rationing because there simply wasn't enough to go around. There were too many claimants and there was too little by way of deposits. And, of course, inflation was a major problem. It lurked just around the corner throughout the 1970s.

Had government expenditure gone out of control as it did in the latter half of the 1980s, inflation would have been even harder to control.

In fact, the story of the 1970s, apart from the expansion of banking, is the story of very successful inflation control between 1974 and 1979. In both cases two supply shocks – oil and agriculture – had thrown everything out of gear and the government had to resort to extraordinary measures to depress demand. In 1974, alarmed at the enormous political protests over inflation the government impounded increments on salaries for a period two years, saying it would all be paid back in instalments with interest. It also froze dividends and introduced a compulsory deposit scheme. The impact was dramatic and within a year inflation had slowed; within two years, it had turned negative. Low inflation would last till the middle of 1979 when a massive drought and the second oil shock would launch a 30-month bout of inflation that at one point reached 27 per cent.

Monetary policy as we know it today had little to do with it. As such, nor did the RBI, which busied itself with credit policy, or more accurately, credit rationing. As can well be imagined, the main purpose of credit rationing was to make sure that credit reached those who "needed it most", that is, for what the government and the RBI agreed on were 'productive purposes'. But productivity acquired a new meaning: productive now meant productive for the Congress party. Productivity was implicitly defined in terms of the votes gained, or at least not lost. That is, in a very large measure, credit policy was guided by first catering to its political component and only after that had been taken care of, even if only cosmetically, providing credit to industry. And even the latter was viewed in terms of social rather than economic usefulness. The Communist approach to the economy acquired a virtually unshakeable hold on the way the economy was viewed.

The RBI didn't like this. Its official history recounts in dreary detail the wrangling between the finance ministry and the RBI over credit rationing. Detailed notes and letters were exchanged over small issues about the extent and the timing. But nowhere in the official view was there any room for challenging the received orthodoxy that it would be the government, and not the RBI, that would define the flow and direction of credit. The RBI did try from time to time but was usually slapped down and asked to behave. One of the worst culprits in this aspect was none other than Manmohan Singh. Some excerpts involving him are quoted below:

"On May 22, 1975 Manmohan Singh arrived in Bombay and bluntly informed the Bank's top executives that the government felt that there could have been 'prior consultation' with them before announcing the credit policy on May 8. Sen Gupta and Hazari responded that there was no intention to bypass the government, and that in any case, there was no change in the stance of policy. Manmohan Singh utilised the opportunity to discuss the projection made by the Bank of a little less than 10 per cent increase in money supply during 1975-76 as against the actual increase of only 6 per cent in 1974-75. He also said that he thought the projected growth rate in money supply was on the high side. Hazari and Krishnaswamy explained that it was a preliminary projection on the basis of available indicators at that time and was a 'rough estimate' of the situation that took into account the 'plausible level' of the factors affecting money supply. But the objective remained the same as before, namely, to keep the growth rate of money as low as feasible. In other words, the estimate of about 10 per cent growth should not be treated in any sense as a 'target'. They also doubted whether all the favourable circumstances that helped to achieve 6 per cent money supply growth in the previous year would be repeated in the ongoing year."

"On April 29, Krishnaswamy apprised Manmohan Singh over the phone of the measures proposed to be announced at the Governor's meeting with bankers on May 7. The latter shot back that the 'Secretary desired that such matters from the Reserve Bank should be in writing'. A chastened Krishnaswamy, duly wrote to Manmohan Singh on April 30 setting out the proposed measures. The government did not react to the letter, implying that they had no serious objections to the proposed measures. This episode was a rude reminder that the Bank's policies could be formulated only with government's concurrence."

"The chief economic adviser, Manmohan Singh, pointedly told the Bank "government would like the Reserve Bank to examine the matter on a most urgent basis for such action as it is considered appropriate in the direction of tightening credit against cotton". R M Honavar, economic adviser also wrote to Krishnaswamy on what he called the government's 'decision' that in order to keep a check on the prices of raw cotton, the earlier relaxation on margins for credit for holding stocks of cotton should be withdrawn immediately, if not already done. The Bank issued a directive to the banks on July 08, 1976, raising the margins on raw cotton."

"Earlier, Manmohan Singh had written to Krishnaswamy that as the FCI could not repay about Rs 250 crore to the government, and as the Budget for 1976-77 took credit for this amount, the Bank could

arrange to provide FCI additional credit of Rs 250 crores. He felt that an 'exaggerated picture' of the budgetary deficit would be conveyed in the revised estimates for 1976-77 in the event of the FCI's failure to honour its commitment. Krishnaswamy thought it fit to pass on the letter to J.C. Luther, newly, appointed as deputy Governor, who was widely regarded as having gained the confidence of the Governor. The needful was done."

The 1970s ended very badly. Inflation shot up at one point to 27 per cent; the forex reserves dwindled to alarmingly low levels; 1979 became the worst drought year in a century; and political instability came back with a vengeance with there being only a caretaker government from July 1979 to January 1980.

Indira Gandhi came back as Prime Minister in January 1980 and almost immediately she agreed to approach the IMF for a loan under the Extended Fund Facility (EFF) which is a soft loan window of the IMF with a longer repayment period of three or four years for countries that have run into a balance of payments problem because of what the IMF calls 'structural weaknesses'. The loan comes with strings attached, the most important of which is that the borrower must give up its old policies of state control.

From the IMF's point of view this was "walk into my parlour situation" because it had been trying since 1966 to get India to change its statist policies, to no avail. From India's point of view, the loan was needed so that it would be able to buy Mirage fighter aircraft from France. The US knew what India was up to and tried to block it. But eventually India managed to get the approval of the IMF board. To do so, it made several commitments about 'structural reform'. Its letter to the IMF was leaked to the Hindu. Just who leaked it is not known but there are various theories, (including one that the Hindu's correspondent there, a Brahmin, befriended the Brahmin cook of a Brahmin official).

There was the usual political storm, led by the Left but nothing came of it. Indira Gandhi stood firm domestically and agreed to do as bidden by the IMF. But in her usual way she wriggled out of the commitments. Not just that. She also declined the last tranche due in 1983 because the next year was an election year and she could not afford the strict fiscal discipline that India had been made to observe since 1982. In actual fact, there was a lot of fiscal subterfuge. India also carefully hid its actual level of reserves. The result was that it ended up with the Mirage fighters and the IMF didn't quite get what it wanted. For that it would have to wait till a really big balance of payments crisis hit India in 1991.

But in 1981, the emphasis was containing inflation, which meant a very tight monetary policy, stringent credit policies and targeting, if not achieving, a lower revenue deficit which had surfaced after a very long time in 1980. The RBI, under Patel who knew about the secret negotiation with the IMF, really tightened the monetary screws, raising the CRR and the bank rate. The SLR was also raised to 35 per cent. By September 1981 however it was clear that these measures were not working and in October that year, Patel tightened money even further by raising the CRR from 7 to 8 per cent in the busy season. He was told by many not to be so severe but he went ahead anyway to make sure that the IMF's ceiling on money supply growth was met. It was, in February 1982. Indeed to meet the IMF's requirements on expenditure ceilings, the government was even forced to ask public sector companies to deposit their excess cash in the treasury instead of leaving it in the banks because deposit growth in the first half of 1981 had been very high, leading to higher-than-needed credit growth.

The RBI's official history says that the government had decided to undertake structural reform even before being told by the IMF to do so. But another theory is that it decided to at least pretend that it was doing so because it badly wanted that EFF loan to be able to use its own foreign exchange for the Mirages. Since there is no clarity on the subject and all the main dramatis personae have preferred to keep quiet, we will have to leave it at that. Suffice it to say that the fiscal stringency of the years 1980-84 led to an opposite reaction from the next government, led by Indira Gandhi's son, Rajiv. Between 1985 and 1988, the fiscal situation went from good to very bad and then to extremely bad by 1990. The 1980s ended with another major crisis.

The EFF episode provides a perfect example of close and deep cooperation between the RBI and the government, not least because the Governor understood the imperatives better than anyone else. Even so, there was a small spat, this time between the RBI and the Planning Commission. The issue was how the EFF money was to be shown in the Budget. The Planning Commission said the IMF money was a 'real' resource and should be allocated by it; the RBI disagreed and said the money could not be used for increasing the size of the Sixth Plan. It was right because all that had happened was that dollars had replaced an equivalent amount of rupees and as such there was no net effect on the Budget. There were fewer rupees now and more borrowed dollars, that's all. The finance ministry, in a rare show of support, sided with the

RBI and India was thus saved some embarrassment when the tine came to repay the loan.

The 1980s can be divided into two neat halves: when fiscal conservatism combined with old fashioned credit management by the RBI from 1980 to 1985; and when fiscal irresponsibility combined with an assertive RBI trying to bring monetary policy back to centre stage because it felt that the government was creating far too much money via the infamous ad hoc treasury bills. These, as was mentioned earlier, were a virtual license to the government to print as many notes as it wanted to make up the gap between revenue and expenditure. It was classic deficit financing and Dr Singh wants to at least curb it, if not put a complete end to it.

The first half is really much of muchness with the 1960s and 1970s and therefore quite boring. Nothing new happened. But in one of those five years, Manmohan Singh, as Governor, asked Professor Sukhomoy Chakravarti to head a committee that would provide a roadmap to fashion a new place for monetary policy. Dr Singh had taken over the Governorship in early 1982 and very soon thereafter, in an interview he gave to T N Ninan of India Today, he spelt out his views on the direction that the economy needed to take. It was towards greater liberalisation of the industrial sector and a more active role for monetary policy. While the former had clear political implications that the politicians understood, the latter was well beyond them. Cleverly, Dr Singh focused on that. The Chakravarty Committee's report, which in reality was authored by Dr C Rangarajan who was a deputy Governor then, gave the blueprint for monetary policy for the foreseeable future. He had very firm support from his boss, the Governor who had been drumming away on the theme.

He told the Maharashtra Economic Development Council in late 1982 that the government should not borrow too much from the RBI to finance public expenditure. "If we take seriously the objective of accelerated growth in a regime of reasonable price stability and viable balance of payments we cannot assume that the resources which are not mobilized can somehow be made available through expansion of RBI credit. Unless it is clearly understood, monetary policy cannot be expected to operate smoothly and effectively. Here lies both a challenge as well as an opportunity."

The same point was made by his successor, R N Malhotra, who had come after a three eyar stint as finance secretary, three years later.

Even the finance minister, VP Singh, agreed though perhaps not quite understanding what he was saying. He said fiscal deficits could increase money supply and called for more coordination between fiscal policy and monetary policy to make sure that money supply did not increase too much. In all likelihood, he was reading out a speech prepared by his chief economic adviser who he would later appoint as finance secretary when he became prime minister in December 1989.

The Report of the Committee to Review the Working of the Monetary System, to give the Chakravarty Committee its full name had this to say:

> *"A feasible approach to evolving a policy framework for ensuring the desired rate of growth of government expenditure as well as the desired rate of growth of reserve money supply involves a certain degree of coordination between government and the Reserve Bank in evolving and implementing agreed policies. Such coordination is essential and also feasible. The experience of the last fifteen years has shown that when occasion demands government has played even a dominant role in containing inflationary pressures. In normal times, however, its major preoccupation in the economic field is to play the role of a large entrepreneur in the country...Both government and the Reserve Bank would thus be required to show due concern for the achievement of price stability objective which must underlie government actions aimed at raising output levels and Reserve Bank's actions relating to the control of expansion in reserve money and money supply."*

In simple English that meant the RBI should keep a strict watch on the government's borrowings, especially the part that led to notes being printed without any corresponding output resulting. This led in 1985 to a highly hopeful document called the Long-Term Fiscal Policy which asked for rule-based fiscal and financial policies instead of the usual discretionary, case-by-case method. It showed how naive its usually politically very savvy author, Bimal Jalan, who was the chief economic advisor then, was. He seemed to have not heard what his minister, V P Singh, was on record as saying that "...deficit financing per se is not bad."

V P Singh regarded deficit financing as a legitimate budgetary source. This was the view that had been espoused by L K Jha also in his book in 1981 called Economic Strategy for India in the 1980s. According to the Economic Times of December 12, 1985 V P Singh had 'declared that the Indian economy had enough cushion to absorb substantially higher deficit financing than what the "traditional economic theories and analysis would permit". "The most important thing," he is reported as having said, "is that it should not fuel inflation. The Government could control inflation because of the comfortable food stocks and the prudent management of the incremental growth in money supply". The finance minister went on in this strain. "Had I listened to those who advocated a smaller deficit, the economic activity including the Government's anti-poverty measures and public sector investments would have suffered. Let those theories and analysts come and explain where they went wrong".

Two years later, V P Singh had been sent out of the finance ministry by Rajiv Gandhi, food stocks had fallen after a major drought in 1987 and, despite the RBI's efforts, money supply had zoomed. When he became prime minister in 1990 with Bimal Jalan his finance secretary, they had to cope with the looming crisis. Their successors, as we shall see, had to cope with their sins of omission and commission.

In the meantime though, taking advantage of the new naivette in the government, the RBI was forging ahead – or so it thought. It had persuaded the government to accept monetary targets as well as a wider definition of budgetary deficit. This meant it would have to include what it was borrowing from the RBI while showing the deficit. This came to be called net RBI credit to government and became a very important guide to the health of government finances. But a few years later the government thought it fit to give up this neat little indicator. It said it was not wise to tell the world beforehand how much it would borrow via note printing by the RBI!

In the 1980s, the RBI became something of a maiden aunt who constantly chastens and chides children. Its target was the government which went from fiscal dourness in the first half to extreme exuberance in the second. 1984 being an election year, the government had taken its foot off the expenditure pedal that two years of IMF austerity had forced on it. Manmohan Singh, as ever worried, wrote a warning letter to the finance secretary, P.K. Kaul. "Given the imperative need for containing inflation rate, moderation in the pace of monetary expansion is a necessary concomitant of a viable overall financial strategy".

He pointed out that the government was trying to hide the real deficit by issuing 'special securities'. Overall, he warned, the higher deficit would lead to higher liquidity through the printing of notes, euphemistically called 'reserve money'. Add to that the deficit of the

State Governments and Manmohan Singh said the combination would be "explosive" -- even if revenue and expenditure flows were in accordance with the budget estimates. In short, he said, stop it. And knowing that the government wouldn't cease and desist, he assured the finance secretary that the RBI would ensure that it would limit commercial bank credit so that inflationary expectations were not aroused. "A copy of this well-reasoned letter was also forwarded to P.C. Alexander, Principal Secretary to the Prime Minister", says the RBI's official history.

Kaul wrote back to Manmohan Singh saying relax we know all this and we have decided to cut back on the Sixth Plan expenditures. "Performance of this nature does reflect the keenness of the Government to maintain financial discipline and to readily take measures that would ensure this." Then he told the RBI to get real. "However, you would agree with me that it is equally important to ensure that urgent development requirements of the country are met as far as feasible. A too narrow and restrictive view would have serious repercussions on the long-term potential of the economy. As you know, our defence requirements are also increasing and obviously, there can be no compromise on this. This year's budget has tried to strike a balance between these pressing commitments and the need to contain the budget deficit."

On October 31 1984, Indira Gandhi was assassinated by two of her Sikh bodyguards who had been deeply upset by the government's assault on and capture of the Golden Temple in Amritsar in June that year. The general election of November 1984, as result of the sympathy created by Mrs Gandhi's brutal killing, returned the Congress to power with a record majority. It won 415 of the 544 seats in Parliament. Rajiv Gandhi had been sworn in as prime minister on the evening of October 31 itself and he now became the master of all he surveyed.

The new boys had arrived in force, right across the government. Suddenly, the RBI still under an older generation, found itself out of sync with the government. All the cooperation of the previous three decades evaporated. Both the finance ministry and the PMO had time neither for the Planning Commission (which the prime minister famously described as 'a bunch of jokers') and the RBI. For them the RBI was just a tiresome aunt who nagged all the time.

Matters reached such a pass that in January 1989 the Governor, R N Malhotra had to complain to the finance minister directly. "Monetary policy has to ensure the twin objectives of maintaining reasonable price stability and meeting the genuine credit requirements necessary to support the growth of output. The large and recurring Government budget deficits have been contributing to strong monetary expansion and over time, there has been serious erosion in the effectiveness of monetary policy instruments. In the context of the large budget deficits it is difficult to control monetary expansion which, in turn, contributes to inflation."

But by now the government was in election mode. Malhotra's desperate plea went completely unheeded even after he had pointed to the large current account deficit in the balance of payments. The official history quotes him as saying that the current account deficit "has considerably increased our external indebtedness and sharply raised the debt-service ratio. A reduction in the current account deficit which is urgently needed, would, however, put pressure on both money supply and prices. Under the circumstances, a substantial moderation of the fiscal deficit has become inescapable."

The overall consequence of the government's post-1988 fiscal policies was that the RBI had been shown its place. Its job was to accept political imperatives and conduct monetary policy accordingly. The result was that it had to severely limit commercial credit and prepare itself for paying off the increasing amounts of short term debt that the government was accumulating in order to finance the imports of essentials to keep inflation under control. The birds would to come home to roost in 1990 and 1991.

But as often happens in such cases, the experience of the 1980s resulted in the government realising, in the 1990s, that the time had come to stop treating the RBI as a bore and pay attention to it. The RBI's time was coming, although no one knew how and when at the time.

The RBI had to deal with three uncooperative and unreasonable governments throughout the 1980s. Differences of opinion between it and the government had always been there, and sometimes they had been very sharp indeed. But the 1980s were qualitatively different. The first sign of this came in 1983 when the government literally ordered the RBI to give permission to the Bank of Credit and Commerce International (BCCI) to open a branch in Bombay.

It had been trying ever since it had been allowed to a representative office but the RBI, worried about its ownership – it was owned by a Pakistani whose credentials were not fully known – had been saying no. But it kept trying. As the Governor who succeeded I G Patel, Manmohan

Singh also said no. But this time he found that the bank had acquired a powerful ally in the form of the finance minister, Pranab Mukherjee. Annoyed by the RBI's persistent refusal, he let it be known that he would take away the RBI's licensing powers. Manmohan Singh, when he heard of this, wrote a strong page-and-a- half letter to Mukherjee, who remained adamant. Things then took a turn for the worse.

According to one very senior RBI insider, Manmohan Singh responded with fury. He wrote out his resignation and flew down to Delhi. He went to meet Mrs Gandhi -- who persuaded him to stay on and do as bidden. The reasons she gave him (to let BCCI open a branch) must have been very strong indeed because he went back and had the licence issued. That, as it would turn out, was the first of several threats to resign Manmohan Singh would issue over the next 30 years, only to not act on the threat. It was interesting how national interest and self-interest could coincide when he wanted them to.

A few years later, in 1991, the bank went bust and Manmohan Singh had to face a lot of questions in Parliament. But he stonewalled them all. So unless either he or Pranab Mukherjee decides to explain why the BCCI was given the licence, the mystery will remain forever because nothing was ever committed to paper.

The country was ready for change and whether it was Rajiv in 1984 or Modi three decades later in 2014, the optimism was the same. The RBI, usually not given to adventure, didn't prove to be an exception. Even R N Malhotra, an IAS officer of the 1951 batch who had seen it all, and done quite a lot of it, was swayed by the freshness in the air. So he did what needed to be done: he allowed the banks to set their own interest rates on deposits. Or, as the RBI's official history more demurely puts it. "In April 1985 the Reserve Bank decided to try a new experiment. It allowed banks to determine the maturity structure of their liabilities, and accordingly, with effect from April8, 1985 banks were given the discretion to fix interest rates on deposits of maturities of less than one year with in a ceiling of 8 percent."

It wasn't all that a wild-cat of an idea, as the chief economic advisor would make it out to be. It was based both on a need – of getting the banks to finance more of the Seventh Plan – and an expectation of sensible behaviour from the banks. Malhotra also thought that the banks would kee in mind the match between rates offered and the time for which the deposit was being taken, that is, higher returns on shorter deposits and vice versa.

But after 16 years of asking the government and the RBI even when they wanted to blow their noses, the banks simply didn't know how to handle the new freedom. Some of them started offering 8 percent even for 15 days and this led every bank to do the same. In a way, the savings bank deposits became a current account rate and the current accounts started getting depleted. The finance ministry blew a fuse. By the end of May the status quo ante before April 8 had been restored. The RBI retired hurt and sulking to its tent. Everyone drew the wrong lesson: that the banks were simply not ready for managing their own affairs which was not quite the case. Had they been allowed some time, they would have got back near to the old normal within a few months.

Truth be told, as a very senior RBI officer said, the finance ministry, especially the chief economic adviser, was most upset that he had not been consulted.

The utterly unorthodox banking policies that followed nationalisation had slowly led to the realisation that things had to change. Manmohan Singh led the effort from his position as Governor. The Seventh Plan was to start in 1985 and the question he asked was: what will be the banks' role in it? After all, they were the central financial intermediaries with a huge branch network now. But he also added that they had to finance anti-poverty programmes. To do this, said Dr Singh, the banks would have to modernise. The RBI would oversee these programmes.

The government agreed. But as always there were divergent views on how to get it done. The government wanted to use the banks as instruments of politics and had, since 1976, successfully created a multi-agency system for rural credit; the RBI knew that political subversion of banking was inevitable up to a point but was very unhappy over the extent to which the banking system was subverted after 1987, when Rajiv Gandhi started facing enormous political difficulties. Between then and 1990, the banks became captive sources of the two governments that ran India for furthering political ends. Handouts and debt waivers became common and targeted lending became the new mantra. Corruption flourished. The RBI could only bleat helplessly from the sidelines at being ignored and made irrelevant as the banking regulator.

Interestingly, Bimal Jalan who would become the RBI Governor in 1997 was in charge of banking for some of the time during this period. He resisted the government's raiding of the banks and for his pains, was sidelined by his minister, Janardan Pujari. He had also been protesting against the government's fiscal excesses. In 1988, he was quietly sent off to the World Bank.

Worried at the way the government was using the banking system – by deciding both the price of loans and where the loans would go and how much – the RBI decided to see if it could import some sense. In 1986 the BIS published the Cross Report, the first ever to be written on financial stability by the Bank of International Settlements (BIS) which focused on the safety and soundness of the broad financial system and payments mechanism. It decided to strengthen supervision, payments and settlements and capital adequacy norms. This meant emphasising banks' profitability. Its efforts eventually bore fruit but not before extensive damage had been done to the system. In fairness, though, very hesitant reforms started under Malhotra's watch. One of the most important things that was done was to reform the interest rate structure at the short end by reducing the over 225 rates -- to around 25! That's how the government ran the banks.

Money is like water. It flows. And that's exactly what happened after 1970 when the government and the RBI unleashed a Pol Pot like wave of financial repression. A whole host of firms dealing in money sprang up. They ranged from hire-purchase finance, housing finance, investment, loan, mutual benefit financial and residuary financial companies, convertible chit funds, money circulation schemes and what have you. These NBFCs basically offered a much higher rate of interest, sometimes as high as 15 per cent. The government and RBI grandly called them non-bank finance and tried to regulate them, to not much avail.

The RBI wanted to kill them and it did, eventually. In the meantime it had to deal with them and it did so with a deep frown and heavy hand. Basically, it did its best to ensure that they did not take in deposits from the public that contravened the regulations, which were not very sensible. The first major step was the Chit Fund Act of 1983 which was to be administered by the State Governments. It was a fairly ridiculous legislation and could not be implemented. Failing to make much headway, in 1987 the RBI tried again, this time to control the leasing companies, this time because they were taking advantage of lax income recognition standards which allowed backloading of depreciation.

It went on like this till 1997, when the RBI finally delivered the coup de grace saying the NBFCs could take only very small deposits. No one was fooled that the entire effort had been aimed at protecting the inefficient and sometimes corrupt public sector banks. Informally, the RBI officials knew that the success of the NBFCs was because of the excessive regulation of the banking; but they could not say so openly and tried their best to make the best of a bad situation. These efforts at supervision and prudential were not confined to the NBFC's though. Throughout the 1980s the RBI went on tightening to supervision and prudential norms. Some of them ran contrary to each other and some created completely unnecessary problems for the banks and the financial sector generally.

The overall result was the creation of a banking system that lost virtually lost all flexibility. What is remarkable is the massive change in attitude that came about at the RBI when compared with the pre-nationalisation era. Then the RBI kept commercial considerations at the forefront of its regulatory efforts; after 1970, it gradually became what TTK had accused it of being – a subordinate office of the finance ministry not just in the sense that it would have to take orders from it but more importantly, in that it adopted bureaucratic practices of issuing circulars – thousands of them – that laid down precisely what to do in each situation.

The problem was that the RBI could not anticipate every situation that might arise and in the end it all became a game of filling loopholes in loopholes. It is not a very glorious chapter in the RBI's long and distinguished history.

One of the major criticisms of the Rajiv Gandhi government was that it had shrunk the size of budgetary support to the Seventh Plan. A fairly large part of it was to be financed from non-budgetary sources ie the market. These ideas had come from the IMF-World Bank trained officers in the finance ministry and the PMO. A period of experimentation began in which the public sector was encouraged to borrow from the market via bonds many of which offered generous tax benefits. The banks became willing partners in what was to follow because they were quick to spot a perfectly legal business opportunity.

One of the ways devised was the portfolio management scheme. In return for large deposits, usually upwards of Rs 100 crore, some of the larger banks started 'selling' public sector bonds to the depositor higher interest rates. The sale was for a limited period, at the end of which the banks would "buy back" the bonds. This sounded simple enough except there was a problem: the bonds stayed with the banks which meant they had merely taken deposits at higher interest rates which they were not allowed to do by the RBI. These funds were not subject to the Cash Reserve Ratio (CRR) and Statutory Liquidity Ratio (SLR) which together resulted in an impounding of 45 per cent. That is, the government did not get its share of new deposits. These bonds were usually tax free ones but they had been cornered by the public sector banks and the government had been cut out of the action. It was neat little dodge in which some ministers saw an opportunity because it was they who decided which banks to deposit the money of the public sector company in their charge.

But it wasn't only the government that was getting annoyed. The RBI was also feeling slighted because even though its inspections had revealed that this was going on no action had been taken against the guilty banks. Banks which had been more law-abiding had also begun to complain that they were being left out. The dilemma, however, was nothing illegal was being done. Some banks had simply been very clever. In the end the RBI fell back on its established practice: it issued a number of circulars clucking over the practice and asked the banks to be careful. It did not put a stop to the buy-back clause which lay at the root of the trouble. The circulars were ignored and the number of such transactions kept increasing.

Finally, worried but still unable to do anything about it, the RBI took it up with the finance ministry which, under S Venkitaramanan who was the finance secretary said no to the terminating the scheme. He said he knew what the dodge was but wanted the RBI to force the banks to go by the rules. After that the RBI simply decided to accept the situation and make the best of it by ensuring that things didn't get totally out of hand. One of the little stratagems it adopted was to quietly tip off the press which ran a number of stories against the scheme. It was only in April 1988 that the RBI was finally able to wind up the scheme by prohibiting banks from buy-back arrangements in Government and other approved securities with non-bank clients.

As must be evident, it all had to do with the price of money. Not only was the tussle between the government over who should control it but also how much it should be. The government wanted cheap funds and that was that. The RBI lent to the government for 91 days at 4.6 per cent. The rates on government bonds were between 5 to 9 per cent, depending on maturities. It was a fixed match. (One finance minister, as we shall see, tried to align these rates to the market in 2001 and lost his job as a result. He was made foreign minister).

The idea that the market could determine it by a simple interplay of demand and supply was not considered to be a serious option. Indeed, even now India has several interest rates, 90 per cent of which are fixed by the government for political reasons. Sometimes the precise level was fixed; at other times there were ceilings. There are preferential interest rates for specific groups or sectors. It was as low as 4 per cent to small farmers, small businesses and small borrowers. This was called Differential Rate of Interest Scheme. Deposit rates were between 8-11 per cent. The overall consequence was that deposit rates fluctuated widely depending on inflation levels. Worse still, the private sector faced rates of well over 15 percent and usually 18 per cent.

Under the influence of the new advice in the PMO and the finance ministry, the government wanted to shift the investment balance in favour of the private sector. Towards this end, it decided that interest rates should be brought down. The RBI concurred fully and when the government asked for a 'note on the subject of the cost of money' it did so with some alacrity. The man who wrote the note was S S Tarapore, one of the best officers the RBI has ever had. His note "Interest Rates in the Banking System", is a classic and it laid the foundations for what was to come – albeit very slowly. Tarapore concluded that any meaningful cuts in the lending rates could happen only if deposit rates were also reduced. But this was both a political and an economic hot potato. How could deposits rates be cut when so many people depend on incomes from fixed deposits and if deposits rate were nevertheless cut, what would happen to deposit mobilisation by banks?

The only way out was for the government to let go of interest rates. It was willing, but not enough. It needed the high reserve requirements so that it could borrow cheaply. The whole issue was as simple as that: politics V economics. Nevertheless, there was a major overhaul of short term rates based on another note that Tarapore had written, called "A Review of Interest Rates". This paper outlined the framework for a general reduction in the interest rate structure. Volume 4 of the RBI's history says the Governor told the Chief Economic Adviser, Bimal Jalan, who was pushing for a two per cent cut across the board that "If the aim was to achieve a reduction in the cost of money in the economy, it would be necessary to reduce the structure of interest rates not only in the banking sector, but also the interest rates on a large number of other financial saving instruments and, further, that an across-the-board two percentage point reduction in deposit and lending rates would seriously jeopardize the profitability of the banking system. It would also affect the mobilization of savings in the organized sector." This view was accepted by the government. The alternative was adjustments in the structure of interest rates and maturity structure of bank deposits. In the end, between 1987 and 1990 this is what was done. It was reform, but in homeopathic doses.

This, however, was not the full or even nearly full measure of the problem with interest rates. The spread of 3.5 per cent seemed to be high but was in fact not because the operational costs were so high. There were all kinds of problems, mostly caused by the political use of banks and banking that could not be easily surmounted. These included the large number of small deposits and borrowal accounts, earnings of branches in rural and semi-urban areas, low recoveries of agricultural loans, bankrupt companies, and last but not least, the increasing wage bill.

The RBI was once again asked to prepare a note which it did arguing that the high spread of 3.5 per cent was because the income due from loans was simply not coming in. The RBI also said, though not quite as honestly, that it was unfair to compare India's public sector, politically driven banking system with the West's private and commercially driven banks. But recognising the need to reduce the spreads the RBI said they could be reduced by between 0.25 and 0.5 per cent over four years – that is over the term of the Rajiv government – provided politics was kept out of banking.

It wanted a drastic lowering of overheads in the form number of employees and the expenditure on them, better loan recovery and getting money back from the so-called sick units. The Governor told the finance ministry financial viability of banks was of "fundamental importance", and that "Should a conflict arise between ensuring such viability and the objective of reducing the spread, the former should take precedence over the latter". The government thought it over for nearly six months and finally said ok and effective from April 1, 1987, there was a reduction in deposit and lending rates by one percent or more depending on the category. Even so, the prime lending rate remained at or above 17 per cent. Many other interest rates were reduced by the government but the provident rate was left unchanged. This was only fair because the provident fund had been built out impounded incomes. Everyone has to put at least 8.33 per cent of their incomes into it. With decadal inflation generally around 7-8 per cent, any reduction would have become just a refundable tax.

***

Change begins

Change is never completely smooth, especially in the relations between the institutions of governance and the government itself. The former are designed to keep governments in check and governments don't like that. During the 15 years that Indira Gandhi was prime minister, she sought to control every single institution. This resulted in a mindset amongst the officials that they had to be obeyed. But when the same officials went on post-retirement assignments, they found the boot to be on the other foot.

The consequence was persistent friction not least because the new incumbents in government were junior to the retired officials, sometimes by several years, or even a couple of decades. In those days, however, the number such institutions were limited. It was only after the 1991 reforms that they proliferated. But the ones that were there were several decades old and set in their ways. The RBI was the oldest amongst them and the most set in its ways. In consequence, it came into frequent conflict with the finance ministry.

We have already seen how Manmohan Singh as Governor clashed with Pranab Mukherjee, the finance minister, over the BCCI affair. During the Rajiv Gandhi period (1985-89) and the V P Singh year of 1990, the tensions became more intense, not least because the finance ministry, at least in the RBI's view, was being dominated by a bunch of buccaneers and whippersnappers. Two of them, in divine retribution, would eventually go on to become Governors and take orders from juniors.

During Rajiv Gandhi's years as prime minister, the RBI Governor was R N Malhotra who had joined the IAS in 1951. He had been finance secretary before he went to the RBI after retirement. He understood government finances and political imperatives better than anyone else in the government in those days. But he was distinctly old-school who, if he had had his way, would have preferred the budget deficit to be zero or thereabouts. It was he who steered India's finances through the IMF EFF loan years of 1982-84. He understood what L K Jha had been advocating about resorting to deficit financing to boost the growth rate but the limits he had in mind were far lower than the ones the new finance secretary, S Venkitaramanan did. He also believed, rightly, that the banks were the RBI's responsibility by law and the finance ministry (read politicians) had to be kept away from them. But the new banking secretary, Bimal Jalan, was in his mid-40s then and impatient. He regarded the RBI as a nuisance, just as two decades later Montek Singh Ahluwalia would when the Governors defied the government, leaving it helpless and fuming.

The RBI-government confrontation, always low-key, always polite but always intense and vicious during the Rajiv era was mostly about fiscal policy and banking. The RBI insisted, as another Governor would during 2012 and 2013 that fiscal policy should not weaken the effectiveness of monetary and credit policy. On both occasions, it was ignored with very unfortunate consequences for the economy. Indeed, the first time, it left India bankrupt.

In the 1980s the problem with the deficits started even while Manmohan Singh was the Governor. The government wanted to spend more in 1984 which was a election year and asked the RBI to increase the SLR by 2 percentage points. But Manmohan Singh wouldn't agree He wrote to P K Kaul, who was finance secretary that "A situation would be reached whereby inadequate availability of credit for working capital needs would severely affect the utilization of available capacities, thereby accentuating inflationary pressures in the economy."

But Kaul and his chief economic advisor Bimal Jalan could not go empty handed to the government and in the end they bargained for a 1 per cent increase in September. Manmohan Singh reminded them this was not what had been agreed to. The Special Secretary to the Prime Minister, Arjun Sen Gupta waded in now saying that he had no idea that the RBI and the Finance Ministry had agreed to limit M3 growth to 14 per cent. He did, however, side with Manmohan Singh in agreeing that inflation would get a fillip if the government was allowed to borrow more.

What happened subsequently has not been recorded anywhere but Manmohan Singh, gave in and agreed to increase the SLR by 1 per cent. But he wrote a long note for the file justifying why he climbed down.

In 1986, the new finance secretary S Venkitaramanan who would, in 1991, come to the recsue of the country as RBI Governor, looked around and found two possible sources for augmenting government revenue. One was the traditional one of imposing a higher SLR which would make the RBI give the government cheap loans; the other was the RBI's profits. Malhotra, in a long and patronising note, said no to both. Malhotra's arguement against a higher SLR was that it would fuel inflation and that in his view it would leave less for the banks to lend out to medium and large industry which had large investment plans and working capital needs.

As to transferring RBI profits, he wrote that they were 'different' from the normal profits of other public sector companies. Anyway, he said, they were notional. Adding salt to the cut, he said even if he transferred the profits, it would be identical to increasing RBI credit to government. He also said that higher transfers would impact the economy adversely that it should not consider this "as an avenue for augmenting resources."

To top it all off, Malhotra decided to brief the prime minister directly who called off the meeting at the last minute forcing Malhotra to say it all to the finance minister and Deputy Chairman, Planning Commission. Venkitaramanan fumed at the homily and a furious spat broke out. Eventually the government won. (In 2015, the RBI transferred almost Rs 60,000 crore of these 'notional' profits to the government). But the last word had not been heard on the subject. Venkitaramanan raked it up again in 1988.

1987 had been a disastrous year for the economy and for Rajiv personally. There had been a massive drought, necessitating large scale imports of sugar and edible oils which had a large weight in the food basket. These imports had been financed by short term borrowings which had begun to shoot up sharply. Politically, Rajiv's original team had come apart. Arun Nehru, Arun Singh and V P Singh, three of his closest political allies, had gone out of the government. The Bofors scandal had broken out and Rajiv was personally accused of taking bribes. A couple of state elections had been lost. In short, he was in deep and serious trouble. The government needed lots of money, far more than it was getting as revenue. The Annual Plans had to be financed, if nothing else.

The government's grouse was that profits being transferred annually had remained at Rs 210 crore ever since the start. It saw no reason why the RBI, which was owned by the government, should hold on to its profits which, it said, anyway were generated because of the sovereign function of seignorage. Indeed, Venkitaramanan went so far as to tell the RBI that he wanted half the profits. Malhotra again refused. The RBI just could not afford it, he said because its (agency) costs had gone up and income had gone down. He added some other reasons as well. As to a fixed percentage transfer of gross profits, he was adamant that it was a terrible idea because it would seriously reduce the allocations to the statutory funds. But Venkitaramanan was nothing if not clever. He borrowed from NRIs and transferred the liability to the RBI. The result was the same as if what he had suggested in the first place had been done. There matters rested till December 1990 when Venkitaramanan became the RBI Governor. One of the first things he did was to reverse Malhotra's stand. The RBI transferred Rs 350 crore immediately and Rs. 1,500 crore for 1991-92.

Malhotra warned the government and the prime minister in early 1987 – before the latter's political problems had begun to acquire any seriousness – that money supply growth was getting to be too high and that this is not what had been agreed upon between the RBI and the government the previous year. 1986-87 had seen a huge growth in money supply of 19 per cent pass on but it was necessary now to restrict money supply growth to around 16 per cent. The main reason for the massive increase, Malhotra reminded the prime minister, was the increase in bank credit to government. The only solution was to rein in the budget deficits by impounding more cash from the banks via a higher CRR.

Everyone agreed that this had to be done but just two days before it was announced the finance ministry told the RBI not to do it because it would send out the 'wrong signals'. Malhotra, who had to postpone the credit policy meeting, then wrote back with some irritation that not only had the finance minister agreed to the increase in both the CRR and the SLR by 0.5 per cent, he had also urged Malhotra to be quick about it. He also said there was no question of any wrong signal being given. The economy could not afford excess liquidity sloshing about and pushing the price level up. The government agreed but with a notable lack of enthusiasm.

On the whole, it would probably be right to say that the RBI managed the price situation fairly well through the 1980s. The average annual GDP growth during the decade was around 5.2 per cent and average inflation was 7 per cent. But for the drought of 1987, the two would probably have been equal and perhaps inflation would have been lower. The average was made possible only because of the very tight money policy of 1980-85. The IMF discipline was mainly responsible for this happy turn of events. But the moment it disappeared, the government went on a spending spree that, while helping raise the growth rate from an average of 3.5 between 1951-81 to over 5 per cent in the 1980s, embedded inflationary potential in the economy that persists to date.

In today's vocabulary a 'new normal' for inflation came into being, up from around 3 per cent till the 1980s to 6 per cent since then. It was the standard price for growth.

Since 1947, there hasn't been a single set of five years when India has not been beset by worries on the balance of payments. With metronomic precision it begins and ends each decade with a foreign exchange crisis. On cue, India began and ended the 1980s with a severe balance of payments problem. On both occasions, in 1980 and 1990, it turned up at the IMF for help. The same thing had happened in the 1950s, 1960s and the 1970s. The same thing would happen in the 1990s and the first decade of the 2000s, albeit without IMF loans.

It's the RBI's job to manage the exchange rate. It does so by buying or selling dollars (or other currencies) as the occasion demands. How it did this in the 1970s has been described above. But in the 1980s, the world had changed, most notably in that, thanks to the flood of dollars and the resulting financial de-regulation in the West, exchange rate volatility had become nuisance of immense consequence of countries and companies. So the RBI did what the rest of the world's central banks were doing: it became more active in the forex market but, being Indian, it did so within some peculiar limitations devised by it and the finance ministry as a free floating currency was quite out of the question. It still is.

The policy issue was posed quite simply but very hard to answer and execute: what should be the target for the exchange rate? Newspaper pundits were never very sure what rate India was targeting – the real effective exchange rate (REER) or the nominal exchange rate (NEER). The former took into account inflation which the latter didn't. Given that exports had to be supported, India chose the REER which meant a surreptitious depreciation of the rupee of around 30 per cent. All this was done within that secret basket of currencies whose ingredients only about half a dozen people knew for sure. The term transparency was completely alien to the policymakers of the time, at least in the bureaucracy.

A far bigger problem was of managing external debt. This grew and grew because the current account deficit – the difference between revenue from exports and expenditure on imports – kept widening. The gap was financed by borrowing from commercial sources, not the IMF because the IMF held governments to account fiscally while the commercial lenders were content to get paid back in time. Long-term debt, defined as debt that has to be paid back only after 365 days went from less than Rs 15,000 crore in 1980 to almost Rs 70,000 crore by the end of March 1989. But this hid a dangerous truth: short term debt, which was hidden by the government as trade credit, was not shown to the country as debt at all! It was only in 1990 that the country would discover how much it owed as short term debt. It would stupefy everyone.

But that was not all. If you take a loan, interest has to be paid. So whereas these payments were kept below 15 per cent of export earnings till 1985, they shot up to almost 25 per cent by the end of the 1980s. Worse, interest payments on non-residents' deposits were not included as a part of debt service payments. And all this while, repayments to the IMF had bunched up and peaked in 1988. With exports not picking up, at least in the measure needed, the situation was becoming grimmer by the week.

The IMF knew that India was headed for trouble and, in March 1988, Michael Camdessus, the Managing Director, when he was taken by Venkitaramanan to meet Rajiv Gandhi, offered a standby arrangement. Rajiv heard him out but decided not to avail of it. Elections, he told a very senior officer of the PMO later, were due later that year and why give another stick to the opposition to beat him with?

As it turned out, the 1988 monsoon turned out to be excellent and the economy became buoyant. Inflation decelerated and industrial growth revived. Rajiv's political advisers told him to go the full term and not hold the election that year. So what happened was he neither took the IMF's standby arrangement nor did he hold the general election. Instead, he went on a spending spree in the Budget of 1989. That Budget came on top of the 1988 one which had already decided to throw fiscal caution to the winds. Rajiv Gandhi, under tremendous pressure politically, had decided on large government handouts to all potential vote banks. The budget deficit ballooned by more than Rs 2,000 crore. 1989 was an election year and for 1989-90 the deficit had climbed to Rs 11,750 crore. Such a huge fiscal deficit combined with a growing current account deficit was a certain recipe for disaster.

It came in 1991, after the minority government of V P Singh which succeeded Rajiv Gandhi's Congress government, had botched up the management of the economy even more comprehensively. Inflation was at around 15 per cent; the budget deficit for 1990 had gone to well over

Rs 11,000 crore; the current account deficit was close to 4 per cent of GDP and short term creditors had become restive and had begun to take their money out. When 1990 ended, foreign exchange reserves were down just $1.1 billion. India was dramatically broke.

The Rajiv Gandhi era was summed up best by two eminent economists from Oxford University. It was devastating assessment. In their classic book on India's various economic crises since 1964 called India: Macroeconomics and Political Economy 1964-91, Vijay Joshi and IMD Little wrote about the period 1985-90 that:

> *"The current account deficit could have been reduced without cutting public investment only by raising public (particularly government) saving. A different and competing hypothesis is that the current account deficit determined the public deficit rather than the other way round. But until August 1990 there were no unexpected adverse external shocks driving current account deficits. Fiscal complacency was doubtless partly induced by the ease of foreign borrowing, which made it possible to finance large current account deficits. But that surely counts as a policy mistake. De facto, the public deficit may have been the passive element but in appraising policy the right conclusion to draw must be that it should not have been passive. Policymakers were taken in by the apparent ease of commercial foreign borrowing despite the obvious lessons to be drawn from the experience of countries in Latin America... (there was) no excuse for virtual inaction over half a decade."*

What was the RBI able to do about it? Precious little. It protested, cajoled, and even threatened the finance ministry. But in the end the finance secretaries of the period – three or four in all – ignored it because they had the prime minister's backing. The reasons were political. For the first half of his term, he was focused on growth and so ran up deficits because he had been told that the conservative fiscal policies of the past had held back growth. And in the second half he was focused initially on survival and from mid-1988 onwards on re-election. He regarded warnings about the fiscal deficit, even from his own government, as a nuisance. Indeed, when Bimal Jalan who was the chief economic advisor and banking secretary he wrote a long note in 1988 explaining the errant ways of the government. The extraordinary thing was when that Jalan became finance secretary during 1990 he did exactly the same thing: he ignored the RBI. Letter after letter from the Governor about deficit and the coming crisis went unacknowledged.

The two most important factors that led to India's bankruptcy and near-default in 1991 were political impatience and bureaucratic opportunism. The officials could have stood firm over a number of issues cited above but chose not to do so. Rajiv was not a strong person and in all likelihood, if the finance secretaries had stood alongside the RBI he would have agreed to whatever the RBI was prescribing. Instead the bureaucrats told him they would take care of everything. The RBI's official history conveniently ignores this aspect because between 1985 and 1992, two successive finance secretaries – Malhotra and Venkitaramanan – became Governors.

***

Crash!

By about September 1990, the world was beginning to get jittery about India's ability to repay its debts. The credit rating agencies were frowning and muttering and the government decided that they should be comforted with some soothing words. Y V Reddy, a joint secretary in the finance ministry (who would go on to become a highly successful Governor of the RBI 13 years later) and a deputy Governor of the RBI, C Rangarajan who would become Governor in 1992, were asked to go and sing the lullaby to Standard & Poor (S&P) in New York. They did what they could, but wasn't enough because what they told S&P missed the point. They told the credit rating agency that India was a politically stable country. But nothing could hide the fact that the government of the day was unstable. Sure enough, within three months, the government had fallen.

There was one finance secretary during this period in 1989 who did his best to restrain Rajiv Gandhi: Gopi Arora. A highly intellectual person, who was also very suspicious of the West, he repeatedly advised Rajiv to at least go to the IMF if not cut back expenditure. But even he was unable to counter Rajiv's logic that he would do everything he was being asked to do after the general election.

Such was the obsession with secrecy that no one really knew exactly how much foreign exchange reserves India had in the 1980s. At least two billion dollars were kept by the public sector banks as undisclosed reserves in their overseas branches. Only five or six people knew about them: the Governor of the RBI, a deputy Governor, the finance secretary, the chief economic adviser and the joint secretary in charge of external finance. Rajiv Gandhi finished off even this money because he didn't want to go to the IMF.

What is not known generally is that owing to definitional problems not all of the money India had was available to the RBI as reserves. This was because it invested some money in the State Bank of India's overseas branches and the SBI had run through even this money! It had borrowed over $2 billion for oil imports and even that was finished. By December 1990, the SBI in New York barely had enough to meet the minimum balance required by the Federal Reserve of New York.

Rajiv had assumed that he would win because he had been told that he could not lose as many as 143 seats. He lost 222 seats. Twelve years earlier, his mother had been told the same thing and had lost. In his place came the minority government of V P Singh – and political and economic disaster.

The next 18 months were one of huge flux. There were four prime ministers in quick succession between November 1989 and July 1991: Rajiv Gandhi, V P Singh, Chandrashekar, and Narasimha Rao. Naturally, each had his own finance minister and each finance minister had his own finance secretary -- who brought along his own economic adviser. That was not all: the RBI saw two Governors, both prima donnas, having been finance secretaries earlier.

The RBI could only stand by and watch. India, as noted earlier, had always been short of foreign exchange and so a very restrictive policy had been in place since 1955. Foreign exchange was rationed by the government on the basis of what it thought was in the national interest. So, all earnings from exports, as well as capital receipts, were commandeered by it. There also a bureaucratic mechanism to fix the exchange rate which was secret. Nor did the government tell the country how much foreign exchange it had. It was stupid system thought up by bureaucrats who thought only they knew best. It was bound to fail one day and it did when the economy became too big to be handled with such barriers.

As the previous chapter noted, an impatient, well-meaning, and politically challenged prime minister during 1985-90 adopted policies to raise India's growth rate without much bothering about the consequences. An opportunistic bureaucracy fed his needs and fears with policies that it knew would end in disaster. But it thought it could defy the permanent laws of economics and the economic power of the US. So when Rajiv Gandhi demitted office in November 1989, the new finance minister, an honest but simple man, unversed in such matters, admitted publically that the chest was empty. He received a severe scolding from everyone for saying so but the fact remained: he was right. India was indeed broke. It had run out of fiscal room at home and its reserves were down to a level that could finance no more than two and a half months of imports. The economy was slowly grinding to a halt to counter which the government came up with a silly nostrum: there is ground for concern but not panic.

For the next 12 months that would become the leitmotif of the government which succeeded the Congress government. Looking back, it seems a little panic would not have been amiss. To repeat the quote at the end of the last chapter, taken from India: Macroeconomics and Political Economy 1964-91 by Vijay Joshi and IMD Little:

> *"...Fiscal complacency was doubtless partly induced by the ease of foreign borrowing, which made it possible to finance large current account deficits. But that surely counts as a policy mistake... the right conclusion to draw must be that.. policymakers were taken in by the apparent ease of commercial foreign borrowing despite the obvious lessons to be drawn from the experience of countries in Latin America... (there was) no excuse for virtual inaction over half a decade."*

The finance ministry started by fooling the country about the looming foreign exchange crisis and ended up fooling itself. It asked the public sector companies and banks to borrow abroad and this money was used for general balance of payments support. The NRIs were also targeted for loans on a large scale. The State Bank of India borrowed most heavily. But these loans had to be rolled over frequently and the level of short-term credit went up.

When the crisis struck, the government had no clue about how much short term debt had been incurred by Indian entities. Exactly the same thing would happen in 1997 during the Asian crisis when the governments of the Tigers of East Asia would be caught short in a similar way. What was truly astonishing was that the government had no idea how much its main banking arm, the State Bank of India had borrowed. Then there was the problem of data. The commerce ministry had one set of data and the RBI had another. The former's data was designed to hide the value of arms purchases but the latter's revealed everything. So while the finance ministry – and within it, only a few officers, knew things were not all right, even they didn't know quite by how much. There watchword became 'cause for concern, not panic' when it should have been the other way around: cause for panic, not just concern.

By the second half of 1990, when the Gulf War resulted in a very sharp increase in oil prices, the real dimensions of the problem surfaced. The double whammy was that not only did the trade deficit double from around $35 million to almost $70 million workers' remittances from the Gulf also fell off sharply. To make matters even worse, international accommodation for turning over loans became harder. Recourse to short-term credit in 1989 was almost $2 billion. The next year it had fallen to less than $650 million. By the end of 1990, short-term credits in the form of bankers' acceptances and six-month credits which had been available at 0.25 per cent above LIBOR shot up to 0.65 per cent above it and further to 1.25 per cent above by May. By June India was borrowing at 2 per cent above LIBOR. Overall, as Volume 4 for the RBI's official history notes the consequence by early 1991 was that "foreign exchange reserves ...declined from $3.11 billion at the end of August 1990 to $896 million on January 16, 1991." That was less than a billion dollars, enough to finance not even a month's imports.

The NRIs, supposed to be friends in need even now, voted with their feet. What they lent was actually short term debt. During April-June 1991, they took out almost a billion dollars. The rate at which they were taking out their money came down from July onwards but it was not till January 1992, when India had announced a massive package of structural reform, that the outflow was reversed.

The RBI was helpless in all this. It tried to persuade the government to be less cavalier in its policies, to no avail at all. Its pleas fell on deaf ears, the ear in question being that of the various finance secretaries who were busy pleasing their respective prime ministers. Rajiv Gandhi ignored all warnings.

This was not a bad strategy to follow in normal times except that in 1990 the times were anything but normal. It was the year of the perfect storm: severe political uncertainty at home, a near-bankrupt treasury and global turmoil after Saddam Hussein invaded Kuwait. By the end of the year the V P Singh government would be gone and so would Malhotra because the new prime minister wanted someone else as Governor.

Ironically, that man, S Venkitaramanan, was the very one who as finance secretary during 1987-89 had led India down the path to fiscal disaster; he would now have to rescue it from debt default. Between January and July 1991, having to work with a government that lasted all of five months, and a highly ideological and inexperienced team of officials at the finance ministry, he prevented India from being officially declared bankrupt. It was a virtuoso performance which has not been sufficiently recognised. Even the RBI's official history glosses over those six months when India lived from hand to mouth and had to even physically ship its gold off to the Bank of England before it got a loan to pay its bills. The British need not have sought physical possession but they did. That gold is still lying in the vaults of Bank of England, not because it belongs to it but because India decided that the British could and should pay for its safekeeping! Those six months were perhaps the RBI's finest hour.

The use of gold reserves to raise foreign exchange during May-June 1991 was one of the most radical and pragmatic actions of the Chandra Shekhar government. It is doubtful if a mainstream party like the Congress or the BJP would have done the same. In April India had raised borrowed $200 million from the Union Bank of Switzerland through a sale (with a repurchase option) of twenty tonnes of gold confiscated from smugglers. In July it shipped forty-seven tonnes of gold to the Bank of England in order to raise another $405 million. In separate actions Germany loaned $60 million – it too was broke after the reunification with East Germany -- and Japan which was flush with funds gave $300 million. But, as Yashwant Sinha who was finance minister for those six months found, it made India sing for its supper. Indeed, when he went to Tokyo to plead for help, the Japanese finance minister neatly dodged him by giving him all of 30 seconds on his way out for another meeting!

Eventually, there was no option left but to mortgage gold. But there was a wrangle. Should the RBI use its gold? Would that not suggest that the situation was worse than what the government was willing to admit? But then what use was the gold if it could not be used. In the end, time ran out and there was no choice left. The gold was mortgaged to the Bank of England.

The story does not end there. It turned out that India did not have the internationally accepted type of boxes to send the gold. So a frantic SOS was sent to the Bank of England which then loaned India the boxes. The gold was sent over four or five days and one day, the van carrying it broke down near Tardeo. Then a journalist found out and his proprietor had to be contacted to keep the story from going into print. It did, however, in the Bombay edition of that paper.

The time for action had been the first half of 1990 which Bimal Jalan, who was finance secretary, was unable to push through. He has later justified it saying the political climate was not right. Indeed, he did not take a proposal to the Cabinet to go to the IMF. By July 1990, when the BJP decided to take on the government it was supporting from 'outside', it was too late. The second half an unprecedented bleeding of reserves and the finance ministry at last began to act. In September it sought an IMF standby loan.

In October it agreed with the RBI to impose a cash margin of 50 per cent on all imports except capital goods. But even these could be imported only if some foreigner was providing the credit. No money would go out from India for it. But that, as it happens, was about all that the V P Singh government did. It fell in December under its own contradictions and the successor government, comprising a rump of MPs, supported from 'outside' by the Congress, imposed a surcharge of 25 per cent on petro-products. Domestic gas was exempted. Auxiliary customs duties were increased.

In March Venkitaramanan told the government that the banks were not being able to raise short term loans in the international market. In fact, the SBI was borrowing around $2 billion in the overnight market which was the most expensive money. The SBI in New York was taking money out from its branches in London, Paris and Frankfurt because some international commercial banks had stopped lending to it. RBI had transferred $250 million to SBI New York and about $80 million to UCO Bank. But this wasn't going to be enough.

On January 23, 1991, India negotiated with the IMF for drawals under its compensatory Contingency Financing Facility to the extent of around SDRs 800 million to be drawn in tranches. The RBI favoured restricting imports through credit control. The cash margin on imports was increased to 133.3 per cent in March 1991 and 200 per cent in April. In May, the RBI imposed a 25 per cent surcharge on interest on bank credit for imports. In short, India all but stopped importing because there was no money to pay for them. The economy began grinding to a halt. Much later, when the final figures came in for GDP growth that year, they would be a paltry 1.1 per cent. And even that was because of a good monsoon. Industry had more-or-less stopped producing.

But import compression was just one side of the picture. India still needed to earn and borrow more dollars.

As the saying goes, when the going got tough, the NRIs got going and there was, as Ross Perot said in a different context, a 'giant sucking sound'. The drain from the foreign currency non-resident (FCNR) deposits went from $59 million a month during October-December 1990 to $76 million in January-March 1991 and $310 million in April-June. Not just this: the fact that devaluation was inevitable and the fear that India could default led to both longer leads in the payments for imports and lags in payments for exports.

India had been squeezed till its pips were squeaking so loudly that at one point it was even considering, if only briefly, to sell its properties in New York, London and Tokyo to raise money. But good sense prevailed. At one point, a well-known international businessman turned up and said he would arrange for a few billion dollars in return for which India would, over the next five years, give him all of its export earnings. At another time a European bank said it would do the same. There were, however, several offers from less than kosher sources which despite the political pressure to accept them, were turned down. Officials of the finance ministry, meanwhile, were phoning potential lenders in Europe and elsewhere for help. No one would take their calls or even return them. That's how dire the situation was when the government was saying, ad nauseum, 'cause for concern but not panic'.

But the fact was that India had been a hair's breath away from default and the Government of India was literally running from pillar to post looking for dollars. None were forthcoming.

***

Genuine but slow reform

A new minority Congress government headed, for the first time since 1965 by someone not from the Nehru family, took over on June 24, 1991. Prime Minister P V Narasimha Rao was sworn in and he brought along with him Manmohan Singh as his finance minister, who a few months later, brought in Montek Singh Ahluwalia as his finance secretary. According to the former's daughter, they had a father-son relationship.

The first thing Rao did, or had to do, whatever his beliefs about its efficacy, was to devalue the rupee. Had the rupee's value been adjusted gradually, such a big fall in its external value could have been avoided. Indeed, the RBI had been doing the opposite since 1987 because the government's fiscal foolishness had made imports necessary and it didn't want to make them more expensive by devaluing the rupee. So the RBI had 'stabilised' the natural fall in the rupee's external value since 1987.

The devaluation was done in two steps -- on July 1 to "test the waters" and again on July 3 because what had been done on July 1 was not enough. Overall, the rupee was devalued by 17.38 per cent against the pound sterling. The Rs-dollar rate was fixed at 26. To counteract an inflationary impact of more costly imports the Bank Rate -- the rate at which it lends to commercial banks -- term deposit rates and the lending rate for large borrowers were increased to prevent higher borrowing. During that month, India transformed itself from an almost closed economy to an almost open one. The decision was to give the 'animal spirits' of private business – to use Manmohan Singh's words – a chance. Industrial licensing for all except 18 industries was abolished; investment caps on large industrial houses were removed; only six industries remained exclusively in the public sector; access to foreign technology was liberalised; import licensing was virtually abolished; import duties were sharply reduced; and exporters could open foreign currency accounts. Customs duties and excise duties both were cut, direct taxes rationalised and foreign investment given an unmistakable invitation. The general tenor and approach was thus remarkably similar to independent India's first budget of November 1947.

This was not short of a revolution and there was loud cheering from everyone. But was it new? All this had been in the works since the late 1980s except that as always politics had prevented sensible economic action. It is worth adding here that the management of the Indian economy passed into the hands of a bunch of right wing economists: Montek singh Ahluwalia, Rakesh Mohan, Arvind Virmani, Ashok Desai, Raja Chelliah, and C Rangarajan, who was appointed RBI Governor. In 1993, Shankar Acharya joined as chief economic advisor. They brought in the Market/IMF/World Bank philosophy in full measure.

That philosophy later came to be known as the Washington Consensus in which the government stepped back from the production of goods and services and focused on public goods like law and order, justice, health and education. The Left was left howling at the moon. But not for long because its sympathisers in the Congress party now moved in to slow down the reforms that had been proposed in the July budget. They felt that the political cost of even a slightly more market oriented economy would be defeat in the next general election – which is what in fact happened even though meaningful reform stopped in 1994. From there onwards, it would be 'reform by stealth'. The liberalisation of trade and investment, of the financial sector reform, privatisation, and agreeing not to monetise deficits etc -- were politically costless.

In 1991, however, the main budgetary cuts were made on capital investment and expenditure on health, education, defence -- and subsidies. But because of strong resistance within the Congress party, the latter were soon restored. Singh was bitterly criticized in cabinet for his fertilizer subsidy policy and, much to his humiliation and anger, Narasimha Rao instructed him to restore it. Recently he disclosed that he had resigned over the issue but his resignation was not accepted. Not surprisingly, the rest of the Rao government's tenure failed to achieve what Singh had been brought in to do, namely, restore fiscal order. In 1991, the intention was to take the fiscal deficit back to the 1970s level, around four per cent of GDP. But in 1996, after five years in office it was still running at over 5.5 per cent of GDP.

In 1991, howeever, there was a more delicate task to be performed, namely, to get the internattional financial community to accept that India had once again become creditworthy. This wasn't going to be easy and it needed the full throated support of the IMF. India obtained it by borrowing $5 billion from it and agreering to its terms and conditions.

The scale of change in the 1990s decade was similar to what had happened to India between 1955 and 1965 – everything changed. Mindsets, attitudes, modus operandi, international relations, people, partners, politics, everything changed. Indeed, so comprehensive was the change that the 90s decade has become a benchmark for the subsequent decades. All comparisons are referenced to it. The 1990s, despite the persistent political uncertainties of the decade, saw the Indian economy come of age. This was especially true of the financial side of the economy. The entire effort was led by the RBI which finally got lucky in that it had three governors who were on the same page as the finance ministry. They had the usual little differences of opinion over tactics and sometimes even strategies. But as far as the overall direction was concerned, they agreed fully. The governors were also lucky that the finance ministers didn't interfere as much as they used to in the earlier decades. This left the RBI to focus on putting in place sturdy systems to regulate the financial markets. SEBI had not yet grown into the regulator it has become now and the RBI, because of its age and experience, was very much the elder brother.

In May Rangarajan announced what has come to be known as the 'Big Bang' Monetary Policy of 1997. The pity is that it has been largely forgotten, even by the RBI's official historians. Its key feature was the RBI empowering the banks by moving away from micro to macro regulation. Henceforth, the RBI would lay down the broad guidelines and principles and the banks would be free to do pretty much as they wished within those parameters. Rangarajan was also clear that it would have to be market forces that determined the way banks conducted their operations.

Basically, they were given much greater freedom, at least from the RBI if not the government. At the front of Rangarajan's mind was the need for a bank rate to emerge. This is the rate at which banks lend to each other. It is the base price of money in an economy. India used to have one until the government eliminated it in the 1970s. Central banks, via open market open operations – buying and selling of government bonds – have huge influence on the price of money as expressed by the bank rate. All advanced economies have it and Rangarajan wanted to move in that direction too. He also used the occasion to alter the nature of the foreign exchange market because of the greater integration with global markets that was being envisaged. He told the market participants the same thing he had said to the banks: no more micro management.

The RBI played a crucial role in the 1990s. There was a fundamental change in the relationship between the government and the RBI. From 1991 onwards, it became a full, if slightly junior, partner of the finance ministry instead of being what in North India is called a jhamoora or a sidekick. Three successive finance ministers treated the RBI as a professional body instead of, as TTK had called it, a 'subordinate office of the government'. It didn't become independent in the way the term is sometimes defined by western economists so that political considerations ceased to be its concern. But it did become the *primus inter pares* amongst regulators of whom many were to follow to supervise the many new markets that were beginning to take slowly root. Between 1991 and 2004, when UPA I came to power with the peculiar demands it made on the exchequer because of Sonia Gandhi and her National Advisory Council, not to mention the finance minister, P Chidambaram, the RBI was as independent as any legislation for independence was going to make it. But from about mid-2005 onwards, the relationship slowly started to deteriorate.

There were two major factors that contributed to the healthier relationship: the finance ministers and the key officials of the finance ministry who, as economists, had a better understanding of the RBI's role in the economy. The ministers were happy to let it take the blame, much as under the UPA the government was happy to let the Supreme Court do the politically unpopular work. But in the 1990s, it was different. Singh who became finance minister in July 1991 had been RBI governor between 1982 and 1985 and had worked closely with C Rangarajan as his deputy governor who was appointed governor in December 1992. They were both economists and had very similar views about the direction the economy needed to take. Later when Singh became prime minister he would appoint Rangarajan as the head his economic advisory council. Other than Montek Singh Ahluwalia, he was the only person Singh trusted fully. The relationship between Singh and Rangarajan's predecessor, Venkitaramanan was less cordial but they worked in perfect unison for the 18 months between July 1991 and December 1992 when Venkitaramanan demitted office.

The officials, on their part, needed the RBI's technical expertise in an increasingly complex economy as it began to integrate with the world economy. The finance ministry, whose economists came from the Indian Economic Service – barring a few honorable exceptions – were simply not up to the task. Indeed, it would not be too far from truth to say that the technical skills of even the top economist officials of the finance ministry had rusted. They were primarily bureaucrats with a superior understanding of economics than mere IAS bureaucrats who learnt on the job and flew by the seat of their pants. Their World Bank and IMF training told them the destination and which direction to take; but they didn't know how to get there.

For that they needed the RBI. From here onwards, the story gets a little tedious as the RBI, over the next few years, initiated and executed one reform after another in the financial sector. The typical modus operandi was to set up an expert committee which already broadly knew what it was supposed to recommend. Once its report was in the RBI would set about implementing the recommendations. Almost always the sequencing of these reforms became the main issue and such differences as arose between the government and the RBI, it was over this. The overall effect was to slow things down, sometimes a lot and sometimes only a little. But the direction was unambiguous: removal of government controls on the financial sector.

The RBI's first task was to fix the external payments arrangements and it came up with some highly innovative ideas that worked very well while they were in use which, as it turned out, was not for very long. At the peak of the forex crisis the Liberalised Exchange Rate Management

System (LERMS) was recommended by an expert committee of the RBI which had been constituted on oral instructions from the Governor to keep everything quiet. Its existence was known only to a few. It was originally called NERA (the New Exchange Rate Arrangement) to rhyme with FERA. LERMS was incorporated in the Report of the Balance of Payments Group but in the hurry to come out with a solution before the Budget, its origins remain obscure because everything was off the record except for the final report. There were no minutes circulated of the meetings to avoid their getting into wrong hands. LERMS was introduced on March 1, 1992. It worked for a year and on March 1, 1993 the unified exchange rate system was introduced. It has been working since then.

In August 1994, the rupee made convertible on the current account. India thus became compliant with Article VIII of the Articles of Agreement of the IMF, which was a huge change. The results were dramatic. In 1993-94 there was an unprecedented inflow of foreign capital and a sharp improvement in the current account of the balance of payments. Suddenly, it became a problem of dealing with plenty. The stock market also witnessed a massive boom comprising a large increase in turnover increases in share prices.

From a macroeconomic viewpoint, possibly the most important change that happened was the delinking of the budget deficit from monetisation. Basically, this meant the RBI would stop printing notes to finance the excess of government expenditure over revenue. This practice had been in followed since 1955 and stopping it was one of the most fundamental reforms of the period. Henceforth the RBI would have much greater flexibility in monetary management. The union budget for 1994-95, had announced that there would be a limit on resort to RBI for ad hoc Treasury Bills by the Central Government. This was formalized by an agreement between the government of India and the RBI which was signed on September 9, 1994.

The last three years of the 90s also saw the replacement of the horrible Foreign Exchange Regulations Act (FERA) by the Foreign Exchange Management Act (FEMA). The RBI was consulted in the drafting of the law and this new thinking was very different from the one that had led to FERA in the 1970s. This was that it was no sin to hold foreign exchange and that as long as no crimes were committed in acquiring it, the new law should be benign towards external transactions. Eventually this view was accepted and the new law has turned to be a huge success because it is flexible and not rigid like FERA was.

Of all the different things that the RBI has to do, perhaps the worst, or at any rate the most difficult, one is that it has to manage the government's borrowing which is copious, excessive, causes the most damage because it is put, ultimately, to wasteful use. The RBI is enjoined by the law to do so. No other task that it performs engages its attention as much as this, or as fully. Nothing worries it more. There is nothing else over which it and the government wrangle more; and there is nothing else about which it is able to do less. There is no other subject which has led to a governor being, for all practical purposes, sacked. There is no escape. Even if it wanted to hand it over to some other agency which it doesn't, it can't unless the law is changed. It is stuck with something it can neither swallow nor spit out. It is a cross that the RBI has to bear.

Governments didn't always use to borrow. In fact, they were considered virtuous only if they didn't, and balanced their budgets by spending only as much as they earned from taxes. A government that lived beyond its means soon got its just desserts.

One of the great reforms of the 1990s undertaken by C Rangararajan was the ending of this practice. Many other reforms of the government debt market were initiated following the report submitted by M Narasimham in 1992. The idea was to move away from a system that, by allowing the government to borrow at less than 4.6 per cent – a rate which it had fixed – was severely distorting the financial market because no one really knew what the price of money was. In other words, here was a central bank which had only a fuzzy notion of the yield curve.

The first step towards getting a market based yield curve was to start auctioning the debt. This would raise the cost of borrowing for the government but at least India would not be in the financial Stone age. A yield curve is a device which helps calibrate the price of money. It plots the interest rate at a point in time for bonds that mature over different periods. It usually slopes upwards which suggests that a bond gives the borrower best returns early on its life and tapers off towards the end of its life.

But this was the easy part of these reforms because the officers who were manning the finance ministry, given the World Bank/IMF provenance and training, understood the need for this. But it was a different matter altogether to convince politicians to give up the addiction to cheap debt. In that sense, a huge amount of credit goes to the RBI and Rangarajan for phasing out the automatic monetisation of the budget deficit between 1994 and 1997. The government would now have to borrow from the market – such as it was – and not at whatever low rate it wanted. So out went the ad hoc Treasury bills and in came, in their place, the ways and means advances. These latter had been used only for the state governments so far and could, in theory, be stopped if the RBI felt the borrower was becoming too profligate. This was a major victory for the RBI as it introduced a new way of controlling the budget deficits of the government.

By the end of the decade these changes in the way the RBI managed the government's debt had become fully internalised. What was also noteworthy was the speed and smoothness with which the RBI had managed the change. By 2001, it had become a regulator of the money market in the real sense and with that the importance of what it did and what the Governors said had gone up exponentially. The RBI had come of age and there was a fundamental change in its relationship with the government.

One of the questions that needed to be settled was whether or not the government's debt should be managed by a body that was independent of the government and the RBI. This was because until then the agency managing the debt and fixing the interest rate on it was the same and this was not very desirable. So a section of the RBI decided to study what other countries did. It eventually came to the conclusion that it would be a good thing to have an independent debt management office which would be a corporate entity. But nothing came of it because the Governor was not in favour on the grounds that before such a body was created it was necessary for the government to bring down its fiscal deficit which was still running very high at over 6 per cent.

***

Conclusion

The Nineties had started with a major crisis. And they ended with a major one. By a strange coincidence, the man in effective charge on both occasions was Bimal Jalan. In contrast to the way in which he had handled the first crisis as finance secretary – or perhaps because of that – Jalan did a splendid job the second time around as the Governor of the RBI. Indeed, he had to deal with two crises simultaneously.

The first one began a few months before he took over in December 1997 and is known to posterity as the Asian crisis when almost all the countries of East Asia went under; the second one was made entirely by the government in May 1998 when, 24 years after the first test, it exploded India's second nuclear device and India was immediately put under sanctions by the West. Overall, the consequence was extreme turbulence in the financial markets because of the Asian crisis and a sudden dip in India's external trade and finance as a result of the sanctions. There was great apprehension that the balance of payments could once again come under severe pressure.

But this time the RBI was determined not to let the reserves get depleted as suddenly and quickly as they had in 1990 or for the rupee to depreciate hugely and quickly. Foreigners became unwilling to lend to India. So India turned to the Old Faithfuls, the NRIs. A new set of India Development Bonds were floated by the State Bank of India which also bore the exchange risk. In the event, because the rupee remained fairly stable, that risk turned out to be negligible.

Jalan also decided to intervene in the market with uncharacteristic aggression to counter speculation. The cleverness of his actions lay in his decision to intervene, not in the RBI itself buying and selling dollars, but by asking the commercial banks to buy or sell on its behalf. The RBI would not enter the picture at all. The idea was to confuse the market, which, it has to be admitted, was a novel strategy. Jalan argued that he would be able to reduce volatility without committing any particular exchange rate. He succeeded against all expectation, most particularly from within the RBI itself. He had redeemed himself for the pusillanimity and politics of 1990.

The 1990s, despite the persistent political uncertainties of the decade, saw the Indian economy come of age. This was especially true of the financial side of the economy. The entire effort was led by the RBI. Slowly but surely, its image changed from being a passive, fuddy-duddy and boring place to one which was trendy and where things were happening.

Nothing illustrates this better than an episode in mid-1997. There was great political uncertainty over whether the government would fall, and if so when. That meant there might be no finance minister when the annual monetary policy was due to be announced. After some hesitation Rangarajan decided to go ahead and announced what has come to be known as the 'Big Bang' Monetary Policy of 1997. The pity is that it has been forgotten, even by the RBI's official historians.

One episode that pushed the RBI right into the limelight was the famous Goa speech by Deputy Governor Y V Reddy. The RBI thought that the rupee was overvalued. So did the finance minister. But who was going to fix it? In the old days the RBI and the finance ministry would have simply issued a fiat and that would have been that. But these were days when everyone believed that the market should take care of the rate. But the market seemed to be waiting a word from the RBI. The problem was how to nudge the market.

In the event, Reddy, after getting the go ahead from the ministry and the Governor told the Foreign Exchange Dealers' Association that he thought the rupee was over-valued. There was pandemonium. Was the RBI actually saying that the rupee should be depreciated? Was it really telling the markets something? Since when had the Mahavishnu of Mint Road become so garrulous? The prime minister said something and added to the bewilderment. The rupee fell. The outcomes were positive and as S S Tarapore, a former deputy governor pointed out in a newspaper column, it probably helped when the Asian crisis broke a few days later.

There was another tricky issue to be handled. The collapse of the USSR in 1990 had led to major shift in emphasis in India's foreign policy which became more diverse in its approach. But old friends, especially when they supply you the bulk of your defence hardware, can't be dumped. Not just that: when they need help you have to help them out of pure self interest. For India, therefore, Russia (as the former USSR's successor came to be known) was a major problem. Not to put too fine a point on it, it was broke and looked to India for help. India had helped out in 1993 by agreeing to an exchange rate for the worthless rouble at Rs 33 to one rouble. Now, in the mid-1990s, it would be required to help out with dollars that Russia so badly needed. Looking back after nearly two decades it is hard to recall just how intertwined India and Russia were. But it was a four decade old relationship and it would unravel slowly over the next fifteen years.

Over the previous 40 years, the RBI's balance sheet had become a proforma affair, there more to fulfil a statutory obligation rather than be used for macroeconomic management. But now with the onset of globalisation of the financial markets, it had become crucial to bring it in line with international practice and expectations.

Two major problems that had to be resolved related to the level of reserves the RBI would maintain and of what to do with all those useless government securities that cluttered the vaults. The solution to the first problem was found in prescribing a level of reserves that was a fixed percentage of the size of the balance sheet. The solution to the second problem was the logical one – they were, so to speak, marked to market. All that junk suddenly became worth something. By the time the 1990s ended, the RBI had come of age in many respects, not least of which was its success in winning a greater of degree of autonomy.

To conclude, monetary policy during 1875-1947 was an important adjunct of overall British Imperial policy which aimed at retaining a competitive advantage for British exports to India through the manipulation of interest rates and exchange rates. The issue was merely of doing so efficiently and one of the results of that quest for efficiency was the setting up of the Reserve Bank of India which would oversee both the issue of currency and the banking system.

The paper then describes post-Independence monetary policy, which falls into three phases. The first phase was 1947-70 when the government paid some heed to the RBI which was in charge of monetary policy; the second phase is 1971-92 when for all practical purposes the RBI became in the words of one former finance minister, 'a subordinate department' of the finance ministry; and the third phase is 1992 onwards when, thanks to the reforms of 1991, monetary policy was given some autonomous space by the government and the RBI became less of a subordinate department.

The simple point is that the price of money is as much of political significance and the agency that sets that price is not, as economists would have the world believe, a mere economic agent but a very important political one as well. This is true not just of India but of central banks the world over. There may be some differences in the degree of politics that infuses central bank decisions but that is as much a matter of perception as measurement. The RBI has not been an exception to this general rule and, indeed, if anything, it has been amongst the most politicised central banks. And this is true not just after 1971 when Indira Gandhi used it as a key instrument of finance and control over banks – and their lending to the poor at rates determined by the government – but right from the start when the RBI was set up in 1935. Since the end of the 1990s, however, the RBI has managed to wrest some autonomy but mainly over the repo rate and the exchange rate; on all other key variables, the government still decides what should be done depending on its political need.

Bibliography and Select References

- Ahamed, Liaquat, "Lord of Finance: 1929, The Great Depression, and the bankers who broke the world", William Heinemann, London, UK, 2009.
- Bernanke, Ben S., "The Federal Reserve and the Financial Crisis", lectures, Princeton University Press, Princeton USA, 2013.
- Dadabhoy, Bakhtiar K., "Barons of Banking: Glimpses of Indian banking history", Random House India, Noida, India, 2013.
- Ghosh, D.N., "No Regrets", Rupa Publications, New Delhi, India, 2015.
- Goyal, Ashima (2011), "History of Monetary Policy in India since Independence", IGIDR Working Paper No. 2011-018.
- Greenspan, Alan, "The Age of Turbulence: Adventures in a New World", Allen Lane, London, England, 2007.
- Irwin, Neil, "The Alchemists", Headline Business Plus, Noida, India, 2013.
- Ramesh, Jairam, "To the Brink and Back: India's 1991 story", Rupa Publications, New Delhi, India, 2015.
- Ray, Partha, "Monetary Policy", Oxford India Short Introduction, Oxford University Press, New Delhi, India, 2013.
- The Reserve Bank of India History, Volumes 1- 4.
- Vasudevan, A., "Central Banking for Emerging Market Economies: A relook in the context of the global financial crisis", 2nd edition, Academic Foundation, New Delhi, India, 2014.

❑

MIDS Recent Working Papers

221 Gender and Commodity Aesthetics in Tamilnadu,1950-1970
by ***S. Anandhi***

220 Estimating the Economic Value of Ecosystem Services of Pallikaranai Marsh in Chennai City: A Contingent Valuation Approach
by ***L. Venkatachalam***

219 Governance and Development in India: A Review of Studies and Suggestions for Further Research
by ***K. Srinivasan*** and ***M.S. Selvan***

218 Social Theory and Asian Dialogues: Cultivating Planetary Conversations
by ***Ananta Kumar Giri***

217 Water Acquisition for Urban Use from Irrigation Tanks: Can Payment for Ecosystem Services (PES) Produce a Win-Win Outcome?
by ***L. Venkatachalam***

216 Family Planning Programs in India: An Overview and Need for a Revision
by ***K. Srinivasan***

215 With and Beyond Plurality of Standpoints: Sociology and the Sadhana of Multi-Valued Logic and Living
by ***Ananta Kumar Giri***

214 Tradable Water Rights and Pareto Optimal Water Allocation in Agriculture: Results from a Field Experiment in Bhavani Basin, Tamil Nadu
by ***L. Venkatachalam***

213 Economics of Adaptation to Climate Change: Learning from Impact and Vulnerability Literature
by ***Chandra Sekhar Bahinipati***

212 Spot and Futures Markets of Agricultural Commodities in India: Analysis of Price Integration and Volatility
by ***B.S. Sumalatha***

211 Employment and Maternity Protection: Understanding Poor Coverage of Beneficial Legislation through Content Analysis of Some Judgments
by ***Padmini Swaminathan***