The Reserve Bank of India

Volume 4
1981–1997

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EARLIER THREE VOLUMES

The Reserve Bank is one of the few central banks to document its institutional history. So far, the Reserve Bank has brought out three volumes of its history. Volume 1, covering the period from 1935 to 1951, was published in 1970. It details the initiatives taken to put in place a central bank for India and covers the formative years of the Bank, which commenced operations on April 1, 1935. It highlights the challenges faced by the Bank and the Government during World War II and the post-independence era.

Volume 2, covering the period from 1951 to 1967 was published in 1998. This period heralded an era of planned economic development in India. This volume captures the initiatives taken to strengthen, modify and develop the economic and financial structure of the country. Apart from the Bank's role as the monetary authority, it highlights the endeavour to establish an institutional infrastructure for agricultural and long-term industrial credit in India. This volume succinctly covers the external payment problems faced by the country and the rupee devaluation of 1966.

Volume 3 covering the period from 1967 to 1981 was released by the Hon'ble Prime Minister, Dr Manmohan Singh on March 18, 2006. An important event of this period was nationalisation of fourteen banks in 1969, leading to spread of banking in country's hinterland. The issues of safety and prudence in banking also gained prominence. Internationally, the abandonment of the Bretton Woods system in 1971 posed serious challenges for the developing countries including India. The volume also deals with the matters of co-ordination between the Reserve Bank and the Government.

RESERVE BANK OF INDIA HISTORY VOLUME 4 (1981–1997)

The Reserve Bank of India, established in 1935, is one of the oldest central banks in the developing world. The rationale for documenting institutional history of the Reserve Bank is to share the process of evolution of this institution as well as reflect on policies and decisions that influenced the economy and the financial sector. The history of the Reserve Bank thus in many ways is intertwined with the economic history of India.

Volume 4 of the Reserve Bank of India history, being released today by Dr Manmohan Singh, Hon'ble Prime Minister of India, is fourth in the series of the history of the Reserve Bank of India. It covers the eventful 16 years from 1981 to 1997 and is published in two parts, Part A and Part B, which ideally should be read as a continuum.

Part A focuses on the transformation of the Indian economy from a regime of restrictions to progressive liberalisation. The 1980s were characterised by an expansionary fiscal policy accompanied by automatic monetisation of budgetary deficit that strained the conduct of monetary policy. Similarly, a heavily regulated banking system impaired efficiency. The domestic macroeconomic imbalances combined with deteriorating external conditions triggered the balance of payments (BoP) crisis of 1991. Subsequent reforms ushered in far reaching changes not only in the economy but also in central banking.

Part B of the volume captures the implementation of structural and financial sector reforms: fiscal correction and phasing out of automatic monetisation; development of government securities market; and greater integration among money, securities and foreign exchange markets. It also covers the transformation in banking with liberalisation and improvement in credit delivery. At the same time the Reserve Bank had to contend with a securities scam which led to the introduction of better control systems and strengthening of the payment and settlement systems.

The period covered by Volume 4 (1981–1997) is notable for that there were six Governors at the helm. It encompasses partly the period of the governorship of Dr I.G. Patel (December 1, 1977 to September 15, 1982) to start with and ends with the governorship of Dr C. Rangarajan. It covers fully the periods of the governorship of Dr Manmohan Singh (September 16, 1982 to January 14, 1985), Shri A. Ghosh (January 15, 1985 to February 4, 1985), Shri R.N. Malhotra (February 4, 1985 to December 22, 1990), Shri S. Venkitaramanan (December 22, 1990 to December 21, 1992) and Dr C Rangarajan (December 22, 1992 to November 22, 1997).

The decade of the 1980s was largely characterised by an administered regime though several attempts were made to liberalise various segments of the economy during this period. These endeavours, however, lacked an overarching framework. Ironically, India began the decade with a severe BoP crisis and ended it with another.

The fiscal position of the central and the state governments remained difficult in the late 1980s. This combined with the critical external payments position and elevated inflationary pressures resulted in the build-up of macroeconomic imbalances. The merchandise trade deteriorated continuously against the backdrop of surge in crude oil imports, as the international oil prices escalated. Significant contraction in the level of foreign exchange reserves during the early 1980s pointed to an emerging crisis situation. India went for an IMF loan in November 1981 to manage its external payments problems. As the BoP position improved, the IMF loan was terminated in May 1984, about six months before the original schedule. The BoP, however, again came under strain, especially after 1987. An expansion in the current account deficit (CAD) against the backdrop of high government expenditure led to a gradual build-up of a crisis situation by 1989–90.

The signs of a crisis on the external account were visible in the second half of the year 1990–91. By March 1991, the official reserves slid down to a level equivalent to 1.3 months of imports, at approximately US$ 5.8 billion. The situation was aggravated as remittances of the Indian workers ceased to flow in, short-term credit dried up and NRI deposits were shored out. India, for the first time was faced with the risk of a default on its external obligations during the early 1991–92. To avoid such a scenario, the Government took recourse to pledging gold to raise resources, a step that incited criticism but was deemed necessary to garner international support. The Government also embarked on a 20-month IMF programme of stabilisation and structural adjustment from 1990–91 to 1992–93. These measures led to improvement in the external sector situation and provided an opportunity to address the reform process that went well beyond the management of the BoP crisis. Dr Manmohan Singh, as the Finance Minister, carried forward the much needed reforms in close co-ordination with the Reserve Bank.

The positive developments, post the implementation of the economic reform initiatives reflected in an increase in the reserves to US$ 9.8 billion and a recovery in economic growth to 4.0 per cent by the close of 1992–93. The export performance was robust during 1993–94 to 1995–96, with a structural shift in India's exports in favour of manufactured goods. Imports buoyed up during 1994–1996 on the back of resilience in the industrial sector. The debt-service ratio, though high, declined significantly from 30.2 per cent in 1991–92 to 23.0 per cent in 1996–97, foreign exchange reserves scaled to US$ 26.4 billion in 1996–97 and CAD to GDP ratio, which was 3.0 per cent in 1990–91, came down to 1.25 per cent in 1996–97. The high level committee on BoP chaired by Dr C. Rangarajan, drawing from the consequences of the crisis observed that the CAD should be maintained at 1.6 per cent of GDP over the medium term, which could be financed with normal capital inflows. The IMF obligations under Article VIII were accepted by India in August 1994, which marked the introduction of current account convertibility.

The preparatory steps towards implementing economic reforms entailed devaluation of the Indian rupee. Devaluation was carried out in two stages: on July 1, 1991 and after confirmation of the positive market reaction, on July 3, 1991. The two step downward adjustment in the value of the rupee worked out to

17.38 per cent in terms of pound sterling and about 18.7 per cent in US dollar terms. This was followed by liberalisation of the Indian economy and its financial sector. India's approach to reforms was guided by five principles, *i.e.*, cautious sequencing of reform measures, introduction of mutually reinforcing norms, initiating complementary reforms across sectors (monetary, fiscal, external and financial sectors), development of financial institutions, and growth and integration of financial markets.

The banking system in the early 1980s broadly tracked the government priorities and subserved national objectives. Thus the early 1980s were characterised by expansionary banking policy and promoting priority sector credit even at the cost of operational efficiency. Several actions were taken to impart flexibility to the financial system and encourage competition. The late 1980s witnessed policy emphasis on the practices of regulation and prudential supervision, with the Reserve Bank's efforts to position the financial system in alignment with international best practices. The Bank facilitated rapid deregulation of the financial sector in the mid-1980s in co-ordination with the Government to make it more efficient and competitive. NABARD was established in 1982 to exclusively focus on agriculture and rural development. The money and capital markets were activated by introducing new instruments.

The Janakiraman Committee pointed to several deficiencies in the functioning of the financial system and highlighted lack of internal control mechanisms following a securities scam in 1992. Against the backdrop of committee's suggestions, the Reserve Bank and the Government took concerted steps to restore public confidence in the country's financial system. The banking reforms encompassed, inter alia, strengthening and consolidation of banks, introducing prudential norms, specifying provisioning, introducing a system of capital to risk weighted assets ratio and establishing a strong supervisory system. Entry of new banks in the private sector, mergers and strengthening the internal control systems were also important tenets of the reforms process. The Board for Financial Supervision (BFS) set up under the aegis of the Reserve Bank in 1994 aimed at giving specialised and independent focus to supervision over banks and the financial institutions. In parallel, regulatory supervision over the NBFCs was also reinforced.

The policies towards rural credit during the 1980s were influenced by an approach aimed at targeting and prioritising equitable distribution of benefits accruing from economic growth. Despite several initiatives, the concerns remained about inadequate flow of credit to agriculture and other priority activities. At the advent of the economic reforms in 1991, the rural credit system was relatively weak, afflicted by problems of mounting overdues. Despite an impressive geographic spread of the formal channels of finance and diminishing influence of informal channels, the rural financial institutions showed several limitations. Attempts were made to ameliorate the problems related to flow of agricultural credit in pursuance of recommendations of the Narasimham Committee recommendations. In this context, a movement through the self-help groups (SHGs)—bank linkage was launched in 1992 on a pilot basis, paving the way for a new approach to financial inclusion aimed at providing doorstep finance for women and other vulnerable sections in the rural sector.

The Chakravarty Committee in 1985 suggested ways to reform the monetary system. The committee emphasised co-ordination between the Government and the Reserve Bank as fiscal dominance was the order of the day. The objectives of monetary policy of the Reserve Bank continued to be multi-dimensional during the 1990s, with as much emphasis on growth as on price stability. Further, in the eventful post-liberalisation era, monetary management was also vested with the responsibility of maintaining orderly conditions in money, credit, securities and foreign exchange markets. Initially in the reforms cycle, monetary policy operating procedures were constrained, as the IMF criteria had to be met. Once inflation was under control and external payments position improved; progressive rationalisation and deregulation of interest rate structure became integral to the process of refining the operating procedures of monetary policy.

There was a marked shift in emphasis from direct to indirect instruments of credit control. The Reserve Bank also made efforts to develop financial markets to serve as an efficient transmission mechanism of monetary policy impulses.

The historic agreement signed between the Reserve Bank and the Government in September 1994 to phase out automatic monetisation of budget deficit afforded considerable manoeuvrability to the Reserve Bank in the conduct of monetary and credit policy. The large capital inflows since 1993–94 and resultant accretion to foreign exchange reserves posed new challenges to monetary policy, since the external payments position impinged strongly on the domestic economy.

With the implementation of Narasimham Committee recommendations, interest rates on government borrowings were progressively linked to market rates. An active internal debt management policy was envisioned as a means of integrating debt management with monetary management against the backdrop of emphasis on moderation in gross fiscal deficit (GFD) during the early 1990s. In effect the government securities market had to be nurtured through a continuous dialogue with treasury managers. The ability of the Reserve Bank to put in place debt management practices consistent with the objectives of monetary policy received a stimulus with the agreement signed between the Reserve Bank and the Government for phased reduction in the issuance of ad hoc Treasury Bills and ultimate discontinuation of such bills with effect from April 1997. This led to the introduction of ways and means advances (WMA) mechanism leading to improvement in fiscal discipline while imparting greater manoeuvrability to the conduct of public debt management consistent with monetary policy objectives.

The financial sector grew rapidly over the decades of 1980s and 1990s, although until the close of the 1980s, markets were subject to a plethora of controls. Early liberalisation of the money market in the mid-1980s resulted in the introduction of new short-term instruments. The evolution of the financial markets was guided by the recommendations of the Chakravarty Committee (1985), Vaghul Committee (1987), Narasimham Committee (1991) and Sodhani Committee (1994). Several internal working groups and committees constituted for the purpose also steered the process. The implementation of reforms and supervision under the aegis of the Reserve Bank strengthened the interplay of market forces and fostered integration among various segments of the financial markets. By 1996–97, the role of financial markets had become critical in more than one way, *i.e.*, in mobilising savings, transmitting signals for policy formulation and facilitating liquidity management consistent with the overall short and medium-term policy objectives.

The organisational structure of the Reserve Bank grew in terms of size and complexity and witnessed continuous transformation during 1981–1997. The organisational edifice of the Bank was continually modified to respond to domestic necessities and contemporaneous international developments. The Bank embarked upon technological transformation, and upgraded its systems and procedures to manage its functions effectively.

The robust financial system developed over the years and strengthened during the 1990s along with prudential management of monetary, exchange rate and capital account policies helped India to manage the impact of a series of crises that plagued the emerging markets in the mid-1990s. India remained rather unaffected by such adversities. The deft handling of exchange rate management and the capital account management by the Reserve Bank, in fact, set a benchmark for the emerging market economies (EMEs) after the South-East Asian crisis struck.