RECENT MONETARY POLICY MEASURES AND THE BALANCE OF PAYMENTS*

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It gives me great pleasure to be in your midst this afternoon and to formally release the Credit Card of Bank of Maharashtra. I understand this Credit Card is to be linked with the India Card of Bank of India, which is already well established in the market. I take the occasion to congratulate both the Chairman of Bank of Maharashtra and the Chairman of Bank of India on this joint effort.

The use of Credit Cards has become a way of life in the industrially advanced countries. The use of currency and coin is restricted to the minimum. Almost all purchase transactions are effected through the use of Credit Cards. While there is a view that the extensive use of Credit Cards and other credit facilities have led to an era of consumerism and excessive consumption expenditure in these countries, there is no doubt that Credit Cards are a convenient tool to make purchases. Customers in India are also becoming more and more demanding, as they should and I am glad banks like Bank of Maharashtra are responding to this.

The Reserve Bank of India has been very much in the news these days and I thought I would take this opportunity to say a few words on the recent policy measures of RBI.

Balance of Payments

An aspect of the Indian economy which has been a source of major concern in the most recent period relates to the balance of payments situation. The formulation of all economic policies has been dominated by this concern. The Seventh Plan period saw a widening of India's current account deficit. The ratio of current account deficit to GDP averaged 2.2 per cent during the period 1985-90, far above the figure of 1.6 per cent projected for this period in the Seventh Plan Document. In absolute terms, the current account deficit averaged Rs.7,771 crore (US $ 5.5 billion) as against that of Rs.2,277 crore (US $ 2.3 billion) during the Sixth Plan period. For 1989-90, current account deficit is estimated at US $ 6.245 billion. The already difficult balance of payments situation was exacerbated in 1990-91 by a sharp rise of oil prices and by other effects of the Gulf war. During 1990-91, imports of POL products rose by US $ 2.2 billion. The volume growth of exports which averaged around 10 per cent per annum during 1986-87 to 1989-90 also came down substantially. While the current account deficit in 1991-92 may go down in absolute terms to the levels reached in 1989-90 or 1988-89, the additional problem that has arisen is on how to finance this order of deficit.

During the Sixth Plan period, nearly 50 per cent of the financing needs was met by external assistance, 28 per cent by way of IMF credits, 14 per cent by way of non-resident deposits and 8 per cent through other capital. During the Seventh Plan period, external assistance, commercial borrowings and non-resident deposits contributed more or less equally to the financing pattern, the proportions being 29 per cent, 24 per cent and 23 per cent, respectively, and the reserves were drawn down to the extent of 15 per cent. With current account deficits persisting year after year, the external debt liabilities began to rise.

During 1990-91, the level of foreign currency assets declined from US $ 3.4 billion in March 1990 to US $ 2.2 billion by the end of March 1991 despite the drawal of US $ 1.8 billion from the IMF. In the current financial year, there has been a further decline and the foreign currency assets stood at US $ 1.2 billion at the end of April 1991. While the level of reserves is low, any further loss in the reserves has been stemmed and they remain at that level at the end of May. A

* Text of the speech delivered by C. Rangarajan, Deputy Governor, on the occasion of the launching of the Bank of Maharashtra's 'Indiacard' at Bombay on June 7, 1991.

combination of political and economic circumstances has tended to dry up some of the sources of financing,more particularly commercial borrowings,both short-term and long-term. Thus, in the area of balance of payments, we need to address the problem at two levels: First, during the course of the next few years, the current account deficit must be brought down to levels which can be sustained by normal capital flows. For this purpose structural reforms wherever necessary must be put in place. Second, in the immediate period, given the commitment to scrupulously honour all our external financial obligations, a substantial compression in imports has become unavoidable.

Stance of Monetary Policy

The monetary policy for the current year has thus to be framed not only against the background of the recent trends in money supply, prices and output but also against the background of a difficult balance of payments situation. Though there was some moderation in money supply in 1990-91, it was essentially a consequence of the substantial draw-down of the foreign exchange reserves during the year. There was, however, a sharp increase in prices, part of which was accounted for by the increase in oil prices. It would be incorrect to relate the increase in prices in any particular year only to the change in money supply in that year. Because of the various lags that operate in the system, these are relationships that hold good only over a period of time. With the national income expected to increase around 4 per cent in 1991-92,consistent with the need to moderate price increase the stance of monetary policy would in any case have been one of restraint. The difficult balance of payments situation has made it even more compelling.

It may be useful to recall the measures that have been taken. The credit policy for the first half of the year announced on April 12, 1991 raised the rate of interest on bank deposits of maturity of three years and above by one percentage point to a historically high level of 12 per cent. Simultaneously, the minimum lending rate for large borrowers was also raised by one percentage point to 17 per cent. The incremental non-food credit-deposit ratio excluding exports was fixed at 45 per cent. Subsequently, an incremental cash reserve ratio of 10 per cent was imposed in addition to the average ratio of 15 per cent. A limit was also set on the amount of drawing that large borrowers can make during the first half of the year. Along with these measures, certain other steps directly aimed at import containment and accelerated export realisation were also taken. Cash margins were prescribed with respect to the imports of certain categories. These margins now range between 50 and 200 per cent. However, imports related to exports have been given a concessional treatment and there is an exemption from cash margins in general against such imports. The cost of import finance has been increased with the imposition of a 25 per cent interest rate surcharge while the rate of interest of post-shipment export credit beyond 90 days was also increased sharply to accelerate export realisation.

While one looks at the totality of these measures, it can be seen that these measures fall broadly into two categories. One set of measures is direcly aimed at import containment. At a time when the balance of payments situation is difficult the need for such measures is perhaps widely recognised. While imports required for exports have been given a special treatment, these measures quite clearly are intended to discourage imports in general. Such measures as imposition of cash margins and higher interest rate are seen as non-discriminatory ways of containing imports.

The second set of measures stemming from a restrictive monetary policy has also been prompted by the need to contain the current account deficit in the balance of payments. Perhaps, sometimes the need for such a policy is not fully understood. In macro-economic terms the current account deficit which implies an excess of import of goods and services over exports of goods and services means that a country is spending more than it is producing. Therefore, for a given level of income unless expenditures are brought down or, to use the jargon, unless the absorption is reduced, it is not possible to bring down the balance of payments deficit. Reducing the absorption essentially means reducing the overall monetary demand in the system. The reduction in the overall demand does not, however, immediately translate it into an improvement in the balance of payments situation. It has to work through several links in the system and would depend upon such parameters as marginal propensity to import out of income. To some extent measures aimed at restraining the aggregate expenditure may also affect production. While efforts should be made to minimise such adverse effects, the over all compulsion to contain expenditures cannot be avoided until the balance of payments moves to a more comfortable level. Needless to add that in any scheme of macro-economic stabilisation a major factor will be the containment of the fiscal deficit. A regime of tight money and credit should also result in greater efficiency in the use of resources.

Even while imposing tight monetary controls, care has been taken to see that the export efforts are not adversely affected. It is for this reason that in the case of imposition of cash margins, imports meant for exports have generally been excluded from the restriction. Even with respect to overall credit measures, an exception has been provided in the case of exports. The restriction on the incremental non-food credit-deposit ratio is now to be calculated after excluding export credit. As regards the restriction on the drawals of credit up to September 1991 by borrowers with limits of Rs. 1 crore and above, export credit is exempted from the purview of this measure. It may be noted that in 1979-80 when a tight money policy was imposed, large borrowers were allowed to draw only up to 80 per cent of the peak level credit drawn by them during the previous two years. In the current policy, we have allowed units to draw up to 100 per cent of the peak level reached in the previous three years.

Money Market

A freely operating money market is a sensitive barometer of current conditions in the financial markets and ideally this market should provide for market clearing of short-term surpluses and deficits. During the past four years, there have been a number of significant developments in the Indian money market. Until 1987, the money market had a paucity of instruments and both interest rates and participants were tightly regulated and, as a result, the market was virtually moribund. After the series of reforms introduced in recent years there has been a significant activation of the money market. A number of new instruments have been introduced, the interest rates have been totally freed, participation has been made broad-based and a secondary market developed with the setting up of the Discount and Finance House of India. Freeing one segment of the financial market while other segments remain tightly controlled does create an element of distortion in that the entire burden of equilibrating the system falls on the segment which is deregulated. It is in this context that I would now like to address certain issues regarding the development of the money market.

It is sometimes argued that the deregulation of the money market has had an adverse impact on banks which are borrowers as their cost of funds has increased. In my view this is erroneous. Even when money market rates were subject to ceilings, the actual rates escalated during periods of tight money and various devices were used to breach the ceilings. As such, it is simplistic to argue that interest rates in the money market under a deregulated regime are higher than under a regulated regime.

Another issue which needs to be addressed is the question of chronic borrowers and chronic lenders. This is a structural imperfection and such chronic one-way positions of participants in the money market, both by borrowers and lenders, points to less than optimal fund management. A bank just cannot plead that it has a large and structural dependence on the money market and that measures should be taken to ensure that funds are provided to it at low rates of interest. The discipline of a deregulated money market is that a bank with a structural dependence on the money market is forced to undertake a correction of its imbalance. As such, a deregulated money market ensures prudent fund management by banks.

Another issue which needs to be addressed is the role of Reserve Bank refinance vis-a-vis the movements in money market interest rates. While the Reserve Bank can certainly cool down a tight money market by stepping up its refinance either directly or through the DFHI, it needs to be appreciated that Reserve Bank refinance is also a tool of monetary policy and it is necessary to ensure that such refinance is not so excessive as to militate against the basic tenets of the monetary policy. In the recent period, the Reserve Bank provided discretionary refinance to the tune of Rs.5,000 crore in early April 1991 and the DFHI's average call rate during the fortnight ended April 5, 1991 was around 16 per cent as compared with 40 per cent in the comparable period of the previous year. However, it would not be prudent to maintain discretionary refinance at that level for long periods as it would go against other objectives of monetary policy.

In the last month and a half, there has been an escalation of call money rates to very high levels and the average for the fortnight ended May 17, 1991 was as high as 43 per cent as against 23 per cent for the comparable fortnight in the previous year. Such high call rates are clearly not viable from the view point of borrowers and as such their demand for funds has come down. There are clear signals of call money rates scaling down. For the fortnight ended June 1, 1991 the average rate was 21 per cent as against 22 per cent in the corresponding period of the previous year. In fact such high call rates do distort the pattern of investment in favour of short-term lending rather than for more productive purposes. If reasonable rates are to prevail, banks have to see that they do not over-extend themselves in terms of provision of credit in the hope that the call market would meet the gap.

In recent years, there has been a substantial growth and diversification in the Indian financial system. The financial market, from the short end to the long, is developing into a continuum. The capital market has shown remarkable growth and buoyancy in the recent past, which reflects the growth and profitability of the corporate sector and the increasing institutionalisation of the market. A process of liberalisation has been initiated in the banking industry to impart greater flexibility to its operations. There has been a relaxation of interest rate regulations, an easing of operational constraints in the credit delivery system and an introduction of new money market instruments. The emphasis of future reform will need to be on capital adequacy, reducing risk concentration, greater disclosure and overall improvement in accounting practices. The banking system is subject to a number of constraints both on the liability side and on the asset side. With a rapid growth of non-bank financial intermediaries the question of establishing level playing fields will become increasingly relevant.