

SPEECH

THE CREDIT AND MONETARY POLICY FOR THE FIRST HALF OF 1994-95*

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It gives me great pleasure to be in your midst this evening. Being an address immediately following the credit and monetary policy for the first half of 1994-95, I would like to take this opportunity to share some of my thoughts on the policy announcements made recently. Also, as this forum consists of bankers, I would like to say a few words about the ongoing structural reforms in the financial sector and some areas, which you as bankers, should focus upon.

2. Containing inflation is a key element of a strategy aimed at fostering maximum sustainable long-run growth of an economy. It must be held at a level where anticipated changes in the price level do not affect the parameters of economic and financial planning by the various economic units. The Reserve Bank, has therefore, been continuously keeping a watch on the build up of inflationary pressure, especially, in recognition of the fact that such a development could destabilise the reforms process.

3. When the new economic policy was launched in July 1991, policy measures and changes were introduced which were directed towards improving the efficiency of the entire economic system. Stabilisation measures and structural reform measures were introduced. The idea was to bring about economic stabilisation over the short run and to inject greater structural flexibility in the trade, industrial and financial sectors in order to spur economic growth over the medium term. The monetary and credit policy responded, by making the containment of inflationary pressures and supporting productive activities with adequate credit as the corner stone. In fact, the Reserve Bank came to bear more than its normal share of responsibility in mid-1991 when the balance of payments

* Address by Dr. C. Rangarajan, Governor, at the Bankers' Club, Bangalore on May 19, 1994.

situation had acquired a serious dimension. We had responded then, rather swiftly, through monetary and credit policy measures which were aimed at import compression and demand containment. Consequently, when the monetary and credit policy was formulated during the year 1992-93 and 1993-94, while keeping in mind the primacy of the objective of inflation control, several steps were taken to help revive the industrial and agricultural output. It was ensured that the genuine credit requirements of the small, medium and large industry as well as agriculture and exports were fully met. Operational flexibility was given to banks, so as to be able to support the recovery in the real sector, by relaxing norms for maximum permissible bank finance, consortium lending, etc.. Relaxation of selective credit control measures was also resorted to. The policy was to simultaneously expand the lendable resources of banks and entitlements of borrowers to borrow from banks. Significant moves were also made towards interest rate liberalisation and rationalisation. There occurred a considerable reduction in concessional slabs for lending rates and a sizeable reduction in the element of cross-subsidisation. The rates on Government securities went up and they were sold at auctions at much higher rates. Thus, since July 1991 and particularly during the year 1993-94, despite compelling needs to check monetary growth so as to contain inflationary pressures, attempts were made to ensure that the availability of credit to the productive sectors of the economy was adequate.

4. Presently the rate of inflation as measured by index of wholesale prices on a year to year basis is 11.0 per cent (as on April 30, 1994) as compared with 6.9 per cent a year ago. It had therefore become imperative to squelch the

inflationary expectation by strong anti-inflationary monetary policy and specific supply management measures. Keeping in view the overall objectives of the new economic policy and the economic reforms, the monetary policy for the first half of 1994-95 has been formulated keeping a sharper focus on the price front. In my policy circular to all the Chairmen of scheduled commercial banks, I have therefore emphasised the imperative need to contain inflationary pressures in the system.

5. In 1993-94, a sea change occurred in the factors operating behind the monetary and credit expansion. The quantum jump in foreign exchange reserves, although welcome for a variety of reasons led to a substantial expansion in primary money and monetary growth. This year there occurred a phenomenally high reserve money expansion of 25.1 per cent as against an increase of 11.3 per cent in the previous year. The increase in the net foreign exchange assets of the Reserve Bank in 1993-94 by 127 per cent was more than the total increase in reserve money. The net domestic assets (i.e. reserve money minus net foreign exchange assets), however, showed a decline during 1993-94; this is a phenomenon which has not been witnessed in the past 15 years. Unlike in the past, when the net Reserve Bank credit to the Central Government accounted for a predominant share of created money, the increase in such credit in 1993-94 was a nominal Rs.260 crore. The expansion of M₃ (broad money) during 1993-94 was 17.8 per cent as compared with an increase of 15.7 per cent in 1992-93. As the large increase in net foreign exchange assets took place mainly towards the latter part of 1993-94, the growth rate in M₃ was significantly lower than the growth rate in reserve money. The incremental money multiplier was only 2.34 as compared with the average money multiplier of 3.12.

6. With the opening up of the external sector, the transmission of impulses from the domestic to the external sector and *vice versa* is becoming powerful. Therefore, domestic monetary policy and policies relating to the external sector need

to be harmonised. Stability of the real exchange rate depends crucially on the degree of success achieved in holding down inflationary pressures. Thus, it is imperative that excessive monetary expansion should be avoided. The monetisation effect of large foreign capital inflows and the consequent inflationary impact of the monetary expansion is a major concern. If the increase in the net foreign exchange assets is large, it will be necessary to take various measures to offset their impact. In this context active open market operations by the Reserve Bank in Government securities would be an integral part of the monetary policy endeavour to sterilise the inflows.

7. The most significant change in the policy pertains to the CRR, which has been raised by 1 percentage point. This has been done keeping in view strong expansionary impact of the increase in the net foreign exchange assets in recent months which has made it necessary to expeditiously sterilise a part of the inflow. By impounding some portion of the resources a reduction in monetary expansion will occur. While formulating this measure it has been taken into account that the possible loss of income to banks as a result of the increase in CRR to 15 per cent will be modest and the banks through better funds management will be able to recoup losses on the CRR resources.

8. Meanwhile, we have continued to pursue our medium term objective of reducing the statutory liquidity ratio for the banks. With the progressive move by the government towards market-related rates, the need for high SLR has diminished. Accordingly, SLR to be maintained by scheduled commercial banks excluding RRBs has been reduced from 34.75 per cent to 33.75 per cent. The SLR on the increase in net DTL over the September 1993 position will continue to be 25 per cent. The impact of this measure will be that the amount of SLR required to be maintained by scheduled commercial banks will get reduced without affecting the government's borrowing programme.

9. In the area of export credit rupee refinance, the base for determining the rupee refinance limits has been brought forward by a year. Under the post-shipment export credit refinance facility, denominated in US Dollars, banks' access has been reduced from 90 per cent to 80 per cent of such outstanding credit. The result of these changes will be that the refinance limits of banks will get reduced. Our view is that this reduction in the refinance limits is not likely to cause any problems for the banks in view of the fact that data available to us shows that much of the refinance limits has remained underutilised during the year 1993-94.

10. As regards selective credit controls, some tightening has been undertaken by raising the minimum margin and reducing the level of credit for bank advances against pulses, oilseeds, vegetable oils and cotton and kapas. Bank advances for oilseeds and vegetable oils to certain State-level cooperative institutions have also been raised by 15 percentage points. Banks have now been asked to maintain a minimum margin of 25 percent for these categories of advances.

11. Several measures have also been taken with regard to the agriculture and priority sector. The monetary and credit policy continues to pursue its objective of providing additional stimulus to agricultural operations. Additional resources have therefore been provided to NABARD by enhancing RBI's general line of credit I and II by Rs.500 crores. Public sector banks have also been advised to prepare, by the middle of the year, specific action plans for enhancing agricultural lending. They have also been asked to ensure that they attain their special targets for lending to the agricultural sector and make concerted efforts to make up for the shortfalls wherever existing. Similarly, to promote investment in agriculture, particularly in the high-tech areas, banks have been asked to ensure that there is at least one specialised branch of a commercial in each State which adequately deals with high-tech agricultural loans.

12. To improve the flow and effectiveness of credit to the priority sector, certain definitional changes have been brought about in the priority sector, taking into account the structure of the credit institutions and the changing credit requirements. Banks have also been asked to adhere to the priority sector targets and sub-targets and initiate effective steps to correct any shortfall. In the light of the experience gained in the implementation of the service area approach and also taking into account the findings of the evaluation studies the recent credit and monetary policy has introduced special modifications to make the service area approach more purposeful.

13. We have also tried to bring about some flexibility in the banks' portfolio operations, by doing away with the sub-ceiling of 1.5 per cent applicable to the banks for acquiring shares and debentures of corporate bodies. Thus, banks can within the overall ceiling of 5 per cent have the flexibility to hold shares, including PSU equity. This should help banks to structure their portfolio in a more optimal and profitable manner and also provide some support to corporates which are coming out with new equity and debt instruments.

14. Finally, steps have been taken to activate a secondary market in government securities. The development of liquid and deep market for government securities is an essential component of our programme of financial sector reform. The Reserve Bank proposes to introduce a system of primary dealers in government securities which will help to strengthen the institutional structure of the market. These dealers will play a dual role of acting as underwriters, as well as market makers for the new issues of government securities. This will support an active market in government securities. You may recall that in the last credit policy, the Reserve Bank had announced the setting up of the Securities Trading Corporation of India which will act as a primary dealer and market maker in government securities; the STCI has been

incorporated and is expected to start operating shortly.

15. It must be clarified that while the focus has been on containing inflation through both demand and supply side measures, and in ensuring that the increase in M₃ ranges around 14-15 per cent, our projections, based on the aggregate deposit growth of scheduled commercial banks show, that credit adequacy will be maintained by the banking system for industry and agriculture.

16. Shifts in the thrust of monetary policy however, need to be supported by the financial system intermediating efficiently. Its allocative efficiency of available savings must be of a high standard. The Indian financial system has grown over the years and comprises of an impressive network of institutions, instruments and markets. The extension of banking and other financial facilities to a very large cross section of the population stands out as a significant achievement. However, despite the deepening and widening of the financial system questions have been raised about the viability and the performance of banks. Several stresses characterised by costly intermediation, low profitability and deterioration of portfolio have also become evident. The present predicament of the Indian banking system is the result of a combination of factors both internal and external and financial sector reform proposals are meant to address both these factors. These weaknesses have resulted both, from factors *external* to the system, such as government policies and the nature of financial regulations and *internal* factors, such as the structural features embedded in the banking system. The current attempt thus is to put in place durable structural changes which enhance the efficiency of resource use and help support the activities in the real sector. The major policy thrust is to improve the operational and allocative efficiency of the banking sector.

17. The financial sector reforms fall broadly into three categories - (a) removing the external constraints operating on the profitability of

banks, (b) improving the financial health of banks and introducing greater transparency in their balance-sheets, and (c) injecting a greater element of competitiveness in the system. The external constraints in the form of high levels of statutory liquidity requirements have been considerably relaxed in the recent years. The structure of administered interest rates has also been simplified.

18. In improving financial health of banks, an aggressive recapitalisation programme has been started; stringent norms relating to income recognition, provisioning for bad and doubtful debts and capital adequacy have been put in place. The introduction of prudential accounting standards has, for the first time and in close conformity with the international standards, revealed the true financial position of the banks. Banks having operations at overseas centres have to achieve eight per cent CRAR by 31st March 1995 and other Indian banks by 31st March 1996. In order to protect the viability and financial health of Indian banking system, a large capital contribution of Rs.5,700 crores was made in the Government of India budget for 1993-94 to enable nationalised banks to meet the gap created by the application of the first stage of provisioning norms. A similar contribution of Rs.5,600 crores has been made in budget for 1994-95.

19. It was thought appropriate that before induction of such large capital into nationalised banks there should be specific commitments from each bank to ensure that their future management practices resulted in a high level of portfolio quality so that problems of the past do not recur. Accordingly, the nationalised banks have executed documents containing performance obligations, on their part for the year 1993-94 with the Reserve Bank of India in December 1993. These commitments cover improvements in qualitative and quantitative aspects of their functioning. These commitments are to be continuously reviewed by the bank managements and Board of Directors. The Reserve Bank of India is also reviewing the

position at regular intervals. The first of such reviews is expected to start after the audited working results are available.

20. The Banking Companies (Acquisition & Transfer of Undertakings) Act, 1970/80 has recently been amended to enable the public to contribute to the capital of nationalised banks upto 49 per cent of the total capital. Government will, however continue, at all times, to hold 51 per cent of the equity of each of the nationalised banks. While this will enable some banks to raise capital directly from the capital market, it will also require such banks to begin to carefully monitor and manage their profitability ratios. As shareholders, the public, I am certain, will be looking forward to a healthy return on their equity holdings. SBI which has an enabling provision for partial private participation in its statute was the first public sector bank to access the capital market during the year 1992-93. The bank raised Rs.2,032 crores through equity and Rs.1,000 crores through bonds.

21. In introducing greater competition in the system, 'in principle' approvals for ten new banks in the private sector have been issued. Three of these have been given banking licences. The entry of new banks is part of the medium term strategy to restore the financial and operational health of the Indian banking system and to improve its overall viability, efficiency and productivity. Sufficient care has however been taken to see that entry of new banks takes place within a set prudential framework which includes adequate capital and proven technical and professional capacity to manage the bank safely and soundly. The new banks will have to meet the priority sector lending targets and other social obligations.

22. Legislative changes have also been made to strengthen the legal framework supporting the financial sector. To improve loan collection, Government is setting up tribunals to hasten recovery of bank overdues which bear upon the bank's financial viability. The first such tribunal has started functioning at Calcutta. A Bill

amending the Banking Regulation Act, 1949 has also been passed by the Parliament.

23. In order to strengthen the system of external audit, auditors have been given a longer tenure of four years with a view to enabling them to develop a feel of the organisation and its policies. The format of Long Form Audit Report has been revised to enable the auditors to bring to the notice of the management and the RBI the more important operational inadequacies. The mechanism for off-site surveillance is also being strengthened. A system of concurrent audit has also been introduced in such a manner that more than fifty per cent of the total business is likely to be covered by such audit.

24. The diagnostic phase is now nearly complete. The task of financial strengthening has also been undertaken, along with the short-term goal of stabilising the financial position of banks and laying a durable foundation for institutional recovery. The real challenge therefore is now before the banks, i.e. to react appropriately.

25. The public sector banks are indeed a diverse group, representing different situations and warranting different solutions. Nevertheless, for a sustainable turnaround there do exist a few pre-requisites. In any well managed bank, the net profit must be sufficient to allow for additions to reserves so that the base of owned funds keeps pace with the growth of the bank's business. Viability of operations thus, should assume an important place in a bank's priorities. Although, capital constitutes only a small part of the bank's resources, it plays the role of a 'shock absorber' since the remaining part of the bank's liability structure is inflexible. In fact, capital exists to secure depositors' interests and losses in the value of the bank's assets. Hence our emphasis on maintaining international standards of capital adequacy.

26. By 31st March 1994, all banks would have had completed full provisioning against their

non-performing assets. Therefore, the first and foremost concern of any bank should be to ensure that non-performing assets do not accumulate. The desire to improve net margins should not drive banks to take risky decisions or even, becoming prone to concentrating their loan portfolio among a few borrowers or certain specific sectors. The most recent agreement with the employees' union provides adequate scope for banks to introduce modern technology and banks must make full use of it as part of their customer oriented strategy.

27. Indeed, today, the Indian banking system is on the threshold of far reaching changes. Bank staff and employees have to acknowledge the rapidly changing environment and in order to be the legitimate and effective agents of social and economic change, they have to respond fast and efficiently. Standards of efficiency and productivity have to rise. It is now a known fact that while operating in a similar environment, the efficiency and profitability of banks differs vastly. This clearly indicates that substantial opportunities exist for several banks to improve their financial and operating positions.