SPEECH

BANKING AND FINANCE : MONETARY AND FISCAL POLICIES*

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It is a great pleasure for me to inaugurate the FICCI conference on "Banking and Finance : Monetary and Fiscal Policies" in the series of seminars on the successful implementation of Industrial Policy Reforms.

The years 1991 to 1993 are watershed years in India's economic history, in terms of our undertaking new policy initiatives to achieve macroeconomic stabilisation coupled with structural reforms. The macroeconomic imbalances of the past and the persistence of structural rigidities in the industrial and financial sectors are being sought to be corrected as part of the reform process. I do hope that seminars such as this will help to make the reforms process credible.

I will attempt this morning to cover two issues. One relates to the inter-relationship between fiscal policy and monetary policy and its significance as an element in the process of economic stabilisation and second, certain aspects of structural reforms in the financial sector.

Broadly speaking, the three major objectives of economic policy in India have been growth, social justice implying a more equitable distribution of income and price stability. Monetary policy is an arm of economic policy and in that sense the objectives of monetary policy are no different from the overall objectives of economic policy. As an instrument of economic policy, monetary policy has certain advantages. For instance, the lag between the time when action is needed and when action is actually taken is shorter in the case of monetary policy than in fiscal policy. Similarly, monetary policy changes, unlike in the case of fiscal plicy, can be made at any time during a year. However, the lag between the change in the variables immediately under the control, and the impact on real variables such as output and employment, is much longer in the case of monetary policy, since it does not directly influence the income and expenditure flows. Monetary policy acts through influencing the cost and availability of credit and money and its effectiveness in the first place depends on the institutional framework that is available for transmitting the impulses released by the central bank.

In the early years of planning, deficit financing which in the Indian context meant Reserve Bank credit to Government was assigned a place in the financing of the Plans though its quantum was to be limited to the extent it was non-inflationary. As each successive Plan came under a resource crunch, there was an increasing dependence on market borrowing and deficit financing which became pronounced in the Seventies and thereafter. In fact, the single most important factor influencing the conduct of monetary policy since 1970 has been the phenomenal increase in the reserve money contributed primarily by the Reserve Bank credit to Government. Over the years, the practice grew under which the entire budget deficit of the Central Government was taken by the Reserve Bank of India, leading to an automatic monetisation of the deficit.

Government's borrowing programme was maintained at relatively high levels and budgetary deficit represented by the increase in the volume of treasury bills outstanding, went up sharply. Government finances came under increasing pressure with surpluses on revenue account giving way to deficits. Interest payments as a proportion of tax receipts showed a sharp rise.

* Inaugural Address by Dr. C. Rangarajan, Governor at the Conference on the titled subject organised by FICCI at Bombay on May 21, 1993.

The market borrowing of the Government has generally been at lower than market rates. Banks and other institutions have been required to invest a prescribed proportion of the funds mobilised by them in Government securities. Even the growing captive market for Government securities represented by the fast growing commercial banks could not absorb fully the Government securities which were floated. As the earnings from holding these securities were not attractive and the banks had other alternative avenues for utilising their funds more profitably, they held Government securities only to the extent they were required to hold them under statutory obligations. In these circumstances, the Reserve Bank of India, which managed the public debt, became the residual subscriber to Government securities and treasury bills. As Government incurred deficits every year, the question of retirement of treasury bills did not arise.

The monetary policy therefore had to address itself to the difficult task of neutralising to the extent possible, the expansionary impact of deficits after taking into account the short-term movements in its holdings of net foreign exchange assets. The increasing liquidity of the banking sector resulting from rising levels of reserve money had to be continually mopped up. Given the interest rate structure, the task of absorbing excess liquidity in the system had to be undertaken mainly by increasing the cash reserve ratio. With the borrowing requirements of the Government remaining at high level, the statutory liquidity ratio had also to be progressively increased to meet these requirements.

Crucial to the process of restoration of macro economic stabilisation and consolidation therefore are firm measures required to bring the budgetary deficit under control. Government's commitment in the last few years to control the deficit and bring about greater fiscal discipline provides the basis for greater manoeuvrability in monetary policy.

As part of the financial sector reforms, a start has been made to reduce reserve requirements. The Central Government reduced the fiscal deficit from 8 per cent of GDP in 1990-1991 to 6.5 per cent in 1991-92. While the Central Government had planned to reduce the fiscal deficit to 5 per cent of GDP in 1992-93, due to several factors, such as revenue shortfall caused by unexpected circumstances, the overall fiscal deficit of the Central Government would exceed the original target of 5 per cent. The Central Government, however, expects to reduce the fiscal deficit to 4.7 per cent of GDP in 1993-94. As fiscal and budget deficits come down, it will be possible to reduce the reserve requirements, thus enabling banks to provide larger amount of credit at their discretion. This has already happened. Because of the changes made in these ratios, the preemption of incremental deposits which stood at 63.5 per cent in 1991-92 came down to 45 per cent in the first half of 1992-93.

An objective of credit policy during 1993-94 is to enlarge the availability of credit to commercial sector. Thus the total incremental reserve requirement in the first half of 1993-94 will be 23 per cent as against a little less than 45 per cent in the first half of 1992-93. The one per cent point reduction in SLR and CRR requirements, would thus augment bank's total lendable resources. In fact, the effective *incremental* Cash Reserve Ratio in the first half of 1993-94 would be a nominal 0.5 per cent while the effective incremental SLR would be 22.5 per cent. The total resources available for extending non-food credit after the release of resources during the first half of 1993-94 would be of the order of Rs. 11,850 crore which will imply an incremental net non-food credit/deposit ratio of around 70 per cent. Thus, the resources available for the first half of 1993-94 will be far higher than what was made available in the first half of 1992-93.

While we are committed to a reduction in the levels of preemptions in the form of CRR and SLR, these would depend on the fiscal stance. While reduction in CRR would depend upon reduction in monetised deficit, reduction in SLR would depend on the extent of reduction in fiscal deficit and the extent to which government borrows at market-related rates of interest. In effect, as budget and fiscal deficits come down and as we move away from automatic

monetisation of deficits, monetary policy will come into its own. The regulation of money and credit will be determined by the overall perception of the central monetary authority on what the appropriate level of expansion of money and credit should be depending on how the real factors in the economy are evolving.

A central feature of the Indian monetary and credit system is that interest rates are administered. In the case of commercial banks, both deposit rates and lending rates are regulated. The rate of interest on government securities could be maintained at lower levels because commercial banks and certain other institutions were required to invest a substantial proportion of their liabilities in government securities. The purpose behind an administered structure of interest rate is to enable certain preferred or priority sectors to obtain funds at concessional rates of interest. An element of cross-subsidisation gets automatically built into the system if the concessional rates provided to some sectors are to be compensated by higher rates charged on other non-concessional borrowers. Regulation of lending rates leads to the regulation of the deposit rates. If the average lending rate is to be maintained at a certain level, the deposit rates has to be accordingly adjusted. Over the years, the system of administered interest rate structure became complex as the number of sectors and segments to which concessional credit was provided proliferated.

While administered structure of interest rates continues to be a central feature of the Indian monetary and credit system, it has witnessed some significant reforms in recent years. The number of concessional slabs has been reduced, bringing down the element of cross-subsidisation. In this context one has to appreciate the recent thrust towards developing the Government securities market with the development of new instruments, viz., 364 Days and 91 Days Treasury Bills, introduction of treasury bills auctions, repos auctions, auctions of dated securities, and more importantly, appropriate interest rate adjustments. Artificially low interest rates on Government securities have become a thing of the past. Interest rates on Government securities are now close to the realm of substitutability: the maximum rate on securities is 13.5 per cet, while the weighted average lending rate on advances is around 15 per cent. Given the risk perception, by the end of the decade, it is quite conceivable that the banks' choice of asset holdings will be determined not by statutory prescription but by the risk reward perception on securities and bank lending. Strengthening the efforts aimed at placing the Government's financing needs at market-related rates and development of a secondary market for Government securities remain an integral part of the financial sector reform agenda.

Coming to the general question of interest rate, the freeing of interest rate structure has to be done in phases. Interest rate is a variable, which is significantly influenced by central bank actions. This is so world over. While in the industrially advanced countries the interest rate is influenced by indirect instruments of control, we have operated with administered structure of interest rates. While ultimately the objective is to try to influence general level of interest leaving the structure to be determined by the financial system itself, we need to proceed in steps. A control over limited number of interest rates may still be the appropriate intermediate step along the lines indicated by the Chakravarty Report. The Committee had suggested the prescription of a maximum deposit rate, a minimum lending rate and one rate below it while leaving the rest to be decided by the banks themselves. So long as certain rates of interest are determined we need to ensure that these rates are close to market perceptions. In this context, I must refer to an argument made some times that the bank deposit rates can be lowered because there is no evidence to suggest that aggregate savings out of a given level of income are interest sensitive. While relatively low interest rates may have generated savings a decade or two ago, savers are becoming increasingly discriminatory and do respond to changes in interest rates. Bank depositors shift their deposits from one maturity to another maturity in response to changes in interest rates. If there has to be a larger proportion of savings in the form of financial assets, there is need to offer depositors a positive real rate of interest. Financial assets constitute one important conduit

to transfer resources from one sector to another. In determining the lending rates, it is necessary to ensure that the spread available to banks between cost of funds and return on funds is adequate to provide for the cost of mobilising deposits and servicing the deployment of assets. While there is a link between lending rate and deposit rate, it is necessary at the same time to ensure that administrative and other costs are kept to the minimum so that the spread is not widened.

Financial Sector Reforms

Efficient financial intermediation is an important factor contributing both to stabilisation and economic development. The ongoing reforms are designed to make the financial sector more viable, more efficient and more responsive. The major policy thrust is to improve the operational and allocative efficiency of the financial system as a whole by correcting many of the exogenous and structural factors affecting the performance of financial institutions.

Despite the overall progress made by the financial system, there has been a growing concern about the operational efficiency of the system. Low profitability, high and growing non-performing assets and relatively low capital base continue to cause anxiety. The rate of growth of earnings has been slower than the rate of growth of business and working funds. Profitability of banks has fluctuated rather than show any consistent trend. With the decline in the quality of loan assets the need for provisioning has become more urgent. The capital base — the ratio of paid-up capital and reserves to deposits of Indian banks — is very much lower by international standards and in fact, has gone down over time. The attitude thus far that with government ownership there is little to worry about the ratio, has resulted in a situation where the capital-deposit ratio has been falling. Lack of proper disclosure norms has led many banks to keep the problems under cover.

In order to ensure that the market for banking and financial services operates on sound and competitive basis, the agenda of the structural reforms in the financial sector focuses broadly on (a) the strengthening of prudential regulations, including issues such as provisioning against loan losses, capital adequacy and reform in the accounting and reporting procedures; (b) improving the access of banks to the capital market; and (c) increasing the competitive element of the market through entry of private participants.

As a capital adequacy measure, a capital risk-weighted asset ratio system has been introduced for banks in India conforming to international standards. Indian banks which have branches abroad will have to achieve the norm of 8 per cent as early as possible and in any case by March 31, 1994. Foreign banks operating in India will have to achieve this norm by March 31, 1993. Other banks will have to achieve a capital adequacy norm of 4 per cent by March 31, 1993 and the 8 per cent norm by March 31, 1996. Banks have been advised to review the existing level of capital funds vis-a-vis the prescribed level and plan to increase funds in a phased manner to achieve the prescribed ratio by the end of the period stipulated.

In relation to income recognition, banks have been given a clear definition of what constitutes a 'non-performing' asset. Instructions have also been given that no interest should be charged and taken to income account on any non-performing asset. Banks are required to classify their advances into four broad groups: (i) standard assets, (ii) sub-standard assets, (iii) doubtful assets, and (iv) loss assets, by compressing the existing eight 'health codes.' Provisions have to be made on advances depending on the classification of assets ranging from 10 per cent to 100 per cent. This has been allowed in a phased manner spread over two years.

In this regard the link between capital adequacy and provisioning has to be understood well. The criterion of capital adequacy will have to be met after ensuring that adequate provisions have been made. Thus, the task before the commercial banks in reaching capital adequacy is onerous. While the Government will have to come in, in a strong way to provide adequate capital, some of the stronger banks may be in a position to go to the capital market to raise funds on the strength of their balance sheets. Going to the capital market will

require certain legislative changes which are being worked out.

In fact, in recognition of the need to recapitalise banks, the Government has made a provision in the 1993-94 Budget for contributing Rs. 5700 crores towards the capital of public sector banks. Banks, in turn will have to give specific commitments, so as to ensure that the strengthening of banks is carried out on a durable basis. The Government is soon going to set up a Tribunal to hasten recovery of debts due to banks and financial institutions. The bill for setting up the Tribunal has already been introduced in the Parliament. This will help to improve loan collection and consequently bear upon the banks financial viability.

As regards fostering a healthy and competitive financial system, guidelines have already been issued for the entry of new privately owned domestic banks. A large number of requests have come in which are being actively processed. For well over two decades, after the nationalisation of 14 larger banks in 1969, no banks have been allowed to be set up in the private sector. While recognising the importance and the role of public sector banks, it is also being recognised that there is an urgent need to introduce greater competition which can lead to higher productivity and efficiency of the financial system. Our system thus, will now have room for both public and private sector banks, subserving the underlying goals of the financial sector reform.

Financial sector reforms should help banks and financial institutions to act as autonomous business units, fully responsible for their performance. They will have to become efficiency conscious, focussing on balancing profitability with liquidity and servicing the necessary socio-economic objectives of our development efforts. Successful identification and exploitation of the emerging opportunities will help their recovery and performance. As Peter Drucker recently said — "whoever exploits structural trends is almost certain to succeed." Banks and financial institutions thus should reexamine their business strategies and reposition themselves to successfully adjust to the new environment. Technological innovations, modern management methods, improved processing of operations etc. should be thought out in order to improve efficiency and productivity. Choices need to be made to either build on the existing lines of business or to diversify and pursue niche strategies.

Banks and term lending institutions are legitimate instruments of social and economic change. However, their ability to respond to certain socio-economic concerns will depend on their overall performance. The productive sectors need for their successful functioning an efficiently operating financial system which, while transferring funds from the surplus units to deficit units will do so at minimal operating costs. If banks and financial institutions become high cost units, they have an impact on the rest of the system. Hence the compulsion to cut costs, improve productivity and show better profitability -- and this will have to become the mission of the financial system in the coming years.