"Indian Banking Second Phase of Reforms Agenda and Issues" Valedictory Address by Dr. Y.V.Reddy Deputy Governor Reserve Bank of India at 20th Bank Economists' Conference at The President Hotel, Mumbai on October 8, 1997

I am thankful to the organisers and in particular, Chairman, Shri M.G. Bhide for whom I have high regard, for inviting me to deliver the valedictory address at the 20th Bank Economists' Conference.

I have had the benefit of going through the scholarly but pragmatic papers as also the reports of rapporteurs covering the deliberations. I find them highly stimulating. A number of issues of critical importance have been flagged by the participants. I will recall the major areas covered in the Conference to identify the agenda and issues for the second phase of reforms. Before doing so, let us assess when the second phase begins. I would also like to take this opportunity to illustrate our own efforts in the RBI at evolving the reform process through interactive sessions, by substituting credit planning with resource management discussions. As a central banker, I cannot but say a few words on the issues in monetary policy during the second phase of reforms.

Second Phase: 1997 -

I agree with a statement made in this Conference that reforms are a continuous process, though it is possible to identify distinct phases in the reform process. It is clearly recognised that the first phase of financial sector reforms commenced in 1991-92. As Governor Dr. Rangarajan has explained, the first phase has yielded impressive achievements. In fact, the success of this phase of reforms has given us great confidence to enter into the second phase. It is reasonable to establish the monetary and credit policy announcement of April 1997, described by some as a `big bang', as the commencement of the second phase.

First, this policy changed the relationship between the RBI and banks from microregulation to macromanagement.

Second, it changed the relationship between banks and borrowers by giving greater choice to borrowers among banks and among the modes of financing their requirements.

Third, to the extent the process of integration has started, it changed the relationship between different market participants.

Finally, the relationship between the RBI and market participants changed through the expansion and reinforcement of the consultative processes.

These measures should be seen in conjunction with certain budgetary measures specially relevant for the financial sector, as announced by Finance Minister, and the establishment of a Committee on Capital Account Convertibility by the RBI. By the beginning of the next century, we should have successfully achieved progress in the second phase so that subsequent reforms will be in conjunction with the financial sector developments in the rest of the world.

Credit Planning to Resource Management

In 1997-98, we have replaced credit planning discussions between the RBI and select commercial banks with resource management. In credit planning exercises, the emphasis was on allocation of resources to various sectors and areas, virtually at administered interest rates, consistent with the Plan objectives. In the resource management exercises, it is different. First, we exchange views on the asset-liability management as a whole and not merely quantitative deposit and credit aspects. Secondly, we seek qualitative assessment of the banks in terms of their own risk perceptions and internal control systems. Thirdly, we obtain the banks' views on their goals, strategies and likely scenarios of magnitudes and composition of assets/liabilities. Fourthly, together we agree not only on performance indicators but also critical parameters where significant deviations are monitored closely. Fifthly, we assure ourselves that flow of credit to priority sector is achieved. Sixthly, we take the opportunity to obtain feedback so that we in the RBI could fine tune our policies and procedures. Finally, the exercise provides an opportunity to share perceptions on state of the economy. In fact, the exercise helps us to refine our macro projections on the basis of micro-details presented by banks. As you all know, we invite public sector, private sector and foreign banks for these exercises. This interactive process, I believe, will be an important element of the second phase of reform.

Monetary Policy and Second Phase of Reform

As the second phase of the financial sector reforms unfolds, the financial sector would grow not only in size but also in complexity. While the basic objectives of monetary policy would remain unchanged, the conduct of monetary policy would have to undergo major operational changes. The strategy of monetary policy would be contingent upon the emerging financial environment. It is safe to assume that during the second phase, the evolution of the financial system is likely to be dominated by closer integration of financial markets, greater degree of financial autonomy to banks and financial institutions, and growing interface across the national borders. These changes would bring about structural shifts in the transmission mechanism of monetary policy.

The broad objectives of monetary policy in India will continue to be to (a) maintain a reasonable degree of price stability and (b) ensure adequate expansion in credit to assist growth. The relative emphasis as between the two objectives depends upon the conditions prevailing in the year in question. Price stability as an objective is viewed not just as an end in itself but as a means to promote sustainable, and more important, equitable growth. We have been targeting broad money expansion as an intermediate target to achieve the ultimate objectives. The concept of monetary targeting that we have been using is, however, a flexible one which takes into account the various feedbacks. Monetary aggregates as intermediate targets I believe, will continue to be appropriate in our context.

However, we cannot confine our attention to just one aggregate. A range of aggregates including aggregate credit are continuously monitored. In the literature, the alternative to monetary targeting is the interest rate. This is more appropriate when the various segments of financial markets are closely integrated, with interest rates in the different markets influencing one another. Thus, interest rate should gain greater importance in the second phase than in the first phase. The monetary authority will watch the behaviour of interest rates in various markets and be willing to intervene and smoothen the volatility. This is not necessarily inconsistent with an overall monetary target.

The RBI has also taken some significant steps to bring about a greater degree of flexibility in the operations of monetary policy such as the new system of Ways and Means Advances to the Union Government. The RBI, however, will continue to hold Government paper, though at its own discretion. While the direct support to Government Budget will over time be limited, there are aspects of fiscal policy which will continue to have a bearing on the conduct of monetary policy. For example, a high level of fiscal deficit can come in the way of effective use of open market operations as an instrument of monetary control; hence, there will be a continued need for monetary policy to take into account the stance of fiscal policy.

With the progressive opening of the economy, monetary policy is being increasingly coordinated with policies relating to the external sector, in particular, the exchange rate policy. To the extent the capital inflows add to net foreign exchange assets of the RBI, it will have a monetary impact. On the other hand, if capital inflows are not taken into reserves, it may result in an appreciation of the domestic currency. Here is a policy dilemma faced by many countries including India, which have received substantial capital inflows.

Overall, monetary policy would have to address itself towards maintaining a stable financial environment in relation to prices, interest rates and exchange rates and for absorbing systemic upheavals.

The financial structure can have an important bearing on transmission of monetary policy. Some of the aspects that have an impact on the transmission are the nature of balance sheets of entities, viz., banks, financial institutions, households, firms etc., the extent of interest rate deregulation, the substitution between foreign currency and local currency denominations in the composition of loans and deposits, the access to finance from outside the banking system, the extent of this intermediation and the depth and liquidity of secondary markets for debt and equity. In this regard, there are some characteristics of the Indian financial structure which need to be reckoned. A substantial part of financial intermediation is still occurring in the informal sector. Non- banking financial companies have been only recently brought under the regulatory framework. Banking sector is still dominated by public sector banks which have significant quantum of nonperforming assets. Debt markets have just begun to develop. Insurance sector is government-owned and a large part of long-term savings, especially contractual savings in household sector are pre-empted by public sector. Significant progress has been made to reform, liberalise and modernise the structure, but some of the rigidities persist. But, we do realise that market integration is essential to reduce transaction costs and to help improve the transmission mechanism of policy. If this integration is not rendered possible, monetary policy will have to continue to depend heavily on direct control (such as reserve requirements) for policy effectiveness.

Agenda and Issues

The Governor, Dr. C. Rangarajan, in his inaugural address to this Conference had identified the new challenges and opportunities that may dominate the future course of banking development in India. These include greater specialisation by banks in different niches of the market, greater reliance on non-fund business and greater overlap in product coverage between commercial banks and non-bank financial intermediaries. To cope with the challenges, the Governor had also outlined the imperatives for banks to operate in a competitive environment. This address provides a framework within which a detailed agenda can be elaborated.

I see from the deliberations and reports of the rapporteurs that a number of related aspects have been covered such as the need for legal changes, changes in regulatory framework of the RBI, importance of autonomy mainly for public sector banks, need for technology upgradation, efficient control systems and to some extent, the role of trade unions. These are pretty exhaustive, but it is possible to slightly expand the relevant aspects and present them in the form of an agenda, flagging some specific issues. I trust that this would be an acceptable framework for concluding the valedictory address.

Legal Issues

The Narasimham Committee Report devoted an entire chapter to legal issues. In the RBI, we had an internal Committee in 1992 to suggest legal changes. Consequently, impressive legislative changes have been made. Some others relating to foreign exchange and sick industries are at advanced stages of process.

Many of the issues raised in the Conference relating to duality of control by the RBI and Ministry, divestiture of ownership, `companisation' of banks now under different special statutes, enabling mergers, development of financial markets by abolition of stamp duty or enabling forward trading, redefining public servant to make a distinction between a government servant and bank manager - all these and many more need legislative action. Perhaps, a comprehensive exercise on legislative changes needed to put our financial sector on par with global standards is essential, though such changes would need to capture transitional provisions as well as our unique requirements.

Real Economy

As some of the papers warned, financial sector cannot carry the burden of changing the whole economy. As the latest Annual Report of the RBI points out, adequate infrastructure, sustained growth in agriculture and indeed quality of fiscal adjustment are critical to overall growth. Financial sector reform cannot afford to race very much ahead of real sector reform. The issue is - how do we locate benchmarks to ensure that financial sector and real sector are in tandem?

Regulatory Issues

The Conference has raised a number of regulatory issues such as - excessive micromanagement, plethora of guidelines on priority sector, levels of CRR and related interest rates, offsite inspections and changes in supervisory attitudes. Nobody can contest many of these on first principles. In fact, as already mentioned, we in the RBI, are moving away from micromanagement.

There are, however, some larger issues that need to addressed. Most important is the balance between internal controls and self-regulation, and externally imposed controls and supervision. It is necessary to detail, as appropriate in the Indian context, the process of strengthening internal controls while relaxing external impositions. Ideally, this should be through a consultative process between the regulator and the regulated.

Volatility

A paper has rightly pointed out the issue of volatility during reform. Monetary and fiscal policies can impart some stability, and strong fundamentals are, no doubt critical. But, we have to recognise `contagion' effects and other externally induced volatility as we globalise. What are the ways in which banks get equipped to face the possible volatility?

Information Dissemination

Market participants desire timely and reliable information, as it enhances efficiency and provides resilience to face shocks. We in the RBI, have expanded the Weekly Statistical Supplement to the RBI Bulletin to include most of the relevant information. We are up-to-date on the Monthly Bulletin and other publications. We are accessible on internet. India is one of the first countries to contribute to SDDS - an international data dissemination system sponsored by the IMF.

State Bank of India has recently brought out a `citizens' charter, which is commendable.

However, to further the cause of reform, information needs, sources, targets etc. need to be detailed, agreed and acted upon. Information needs of the regulator, regulated, analysts and the customers should perhaps be identified and met on a continuing basis and to the extent possible on a real time basis.

Payments and Settlement System

It is widely recognised that a primary reason for special status of banks relates to the payments system. We should ask ourselves the question - how far are we from global standards in this area? The viability of further reforms to impart efficiency, in my view, is critically dependent on improvements in this area.

Technology, Human Resources Development, and Industrial Relations

Issues relating to technology, HRD and IR and are closely related and most of them internal to the organisations concerned. However, the importance of wide-area network and coordinated training programmes should be recognised. Recently, we have started a series of interactive training programmes with commercial banks to develop reporting systems and balance of payments data - based on the Paniyadri Committee Report. There is need to identify many more such areas warranting close coordination between the RBI and banks, and between banks themselves.

Conclusion

Honestly, I have listed only a few items of agenda. This is illutrative and not exhaustive.

I would like to conclude by thanking the organisers for giving me this wonderful opportunity to read al th papers and reports - by insisting that I deliver this valedictory address.

Thank you.