Presentation by Dr. Y.V. Reddy, Deputy Governor, RBI at J.L. Kellogg Graduate School of Management Department of Accounting & Information System Northwestern University, Illinois on May 12, 1997

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Financial Sector Reforms in India - Recent Trends

Professor Bala and friends,

1. It was with great pleasure that I accepted the invitation of Professor Bala to visit Kellogg School. I could not come last month for an international seminar but Prof. Bala took a promise that I shall do so at the earliest; and here I am. I consider this both as a privilege and as an opportunity : a privilege to be in this prestigious school, and an opportunity to present recent trends in financial sector reforms in India.
2. I shall begin with a brief but factual account of the perform ance of Indian economy in the last three years to illustrate the positive impact of economic reforms in general; and the reforms in the financial sector in particular. This would be followed up with a review of the financial sector reforms in terms of objectives, ownership and control, competition, regulation and policy environment. There would then be a detailed update of reforms attempted this year (1997-98) through the budget as well as the monetary and credit policy announcements. In particular, I would focus on elements of continuity, contextual response and change in the monetary and credit policy.

Indian Economy : Recent Trends

3. The growth in real Gross Domestic Product (GDP) in the last three years ranged from 6.8 to 7.2 per cent and current year (1997-98) should be no exception. While growth in industry averaged 10.4 per cent in the last three years, that of agriculture was 2.5 per cent inspite of a negative growth in 1995-96. Gross Domestic Savings as a percentage of GDP continued to rise from 24.9 per cent in 1994-95 to 25.6 per cent by 1995-96.
4. Gross Fiscal Deficit of Government of India as a percentage of GDP has come down from 6.1 per cent to 5 per cent in the last three years and is estimated to go down further to 4.5 per cent this year. The internal debt of the government as a percentage of GDP is also down correspondingly. The rate of inflation as measured by Wholesale Price Index went down from 10.4 per cent in 1994-95 to 5.0 per cent in 1995-96 but has jumped again to 7.3 per cent in 1996-97. In the current year, we expect that it will be down to around 6.0 per cent. Consistent with this, broad money growth is targeted to grow only by 15 to 15.5 per cent this year. Growth in non-food credit, however, was sluggish at 10.1 per cent in 1996-97 but we expect it to move towards a figure of over twenty per cent, closer to the very high actuals in 1994-95 and 1995-96.
5. Growth of exports and imports in SDR terms averaged 13.3 per cent and 17.5 per cent respectively in the last three years, but the performance last year was below average at 9.6 and 10.7 per cent. In the external sector, Current Account Deficit as a percent of GDP

has averaged at a little over one per cent. The exchange rate has been under pressure on occasions but overall while nominal exchange rate vis-`-vis US dollars exhibited a steadily depreciating trend, the real effective exchange rate has been appreciating during the last three years.

Financial Sector Reforms : A Review

Objectives

6. The major objectives of the financial sector reforms, as elaborated by Dr. Rangarajan, Governor, RBI fall under the three broad categories viz.
   i. measures aimed at removing the external constraints bearing on the profitability of banks,
   ii. measures aimed at improving the financial health of banks by introducing appropriate prudential norms and
   iii. measures aimed at institutional strengthening including improving the competitiveness of the financial system.

However, for convenience these measures can be related to issues of ownership, competition, regulation and policy stance.

Reforms in Ownership and Control

7. The thrust of reforms in this area relates to privatization and restructuring. Public sector banks have been permitted diversified ownership by law subject to 51 per cent holding of Govern ment/RBI/SBI. IFCI and IRBI were converted into public limited companies. The Industrial Development Bank of India Act, 1964 was amended to allow IDBI to raise capital up to 49 per cent of its paid up capital from the public. Legal amendments have been made to induct private participation in the Board of Directors. As a part of restructuring efforts, weak public sector banks were recapitalised through budgetary support.

Reforms to Increase Competition

8. New private sector banks have been established and Local Area Banks have been licensed to instill a greater element of competition in the financial system. There is a more liberal policy of permitting branches of foreign banks. In the area of interest rate, the administered structures were dismantled, both on the deposit and lending side. The lending rates were rationalized to two categories and on the deposit side, the Reserve Bank of India (RBI) prescribes only one rate in the 30 days to one year category and that too in the form of 'not exceeding 9.0 percent'. Further, credit norms have been liberalized and banks now have more freedom to open new branches/upgrade existing extension counters.

Reforms in Regulation

9. Prudential norms have been introduced based on objective criteria for income recognition, asset classification and provisioning. The Basle Committee framework for capital adequacy has been adopted. A Board for Financial Supervision has been set up for exercising integrated supervision both, on-site and off-site over banks, financial institutions and finance companies. Besides, several steps have been taken to improve the audit system in general. Non-banking financial companies have been brought under more effective supervision of RBI.

Reforms in Policy Environment

10. The Indian banking system operated on a high level of reserve requirements for a long time. Progressive reduction has brought down the Statutory Liquidity Ratio from 37.5 per cent to 25 per cent on an incremental basis and the Cash Reserve Ratio, including incremental CRR from 25.0 per cent and 10.0 per cent. As I mentioned earlier, there is near full deregulation of both deposit and advances interest rates. The financial sector is now operating in a more open and more market oriented environment. Government debt is now mostly at market rates. Foreign exchange rate is also market-determined.

Financial Sector Reforms : An Update (1997-98)

11. The budget of 1997-98 and the monetary policy for the first half of 1997-98 are considered landmarks in the process of economic reform in India. In the budget of 1997-98, there are some elements of great relevance to the financial sector, while the monetary policy announcement that followed has been described as a `big bang' in financial sector reform.

Budget
Ways and Means Advances

12. A historic reform related to the financial sector was the abolition of the system of ad hoc Treasury Bills and the introduction of the system of the Ways and Means Advances. The ad hoc Treasury Bills emerged as a mode of financing the Government's deficit in the mid-1950s. The ad hoc Treasury Bills, which were meant to be temporary, gained a permanent as well as cumulative character. It became an attractive source of financing Government expenditure, especially since it was available at an interest rate pegged at 4.6 per cent per annum since 1974.

    Under the new system of Ways and Means Advances (WMA), financial limits have been fixed to accommodate the temporary mismatches in Government receipts and payments. Interest rates on the WMA would be at market related rates. The process of elimination of ad hoc Treasury Bills was in three stages. In the first stage between 1994-95 and 1996-97, limits were set for the yearly increases in ad hoc Treasury Bills. In the second stage, i.e., for two years beginning April 1997-98, overdraft would be permit ted beyond ten consecutive days, but at a cost. In the final phase, i.e. after the transition of two years, no overdraft will be permitted beyond ten consecutive days. The new system gives more autonomy to the central bank to conduct its monetary policy.

Other Measures

13. Many other measures having significant implications on the financial sector were announced. The Budget commenced the phasing out of interest tax. It removed the Tax deduction at source on Government Securities, which had hitherto distorted pricing in the secondary markets. The Government announced the launching of Capital Indexed Bonds. A committee has been set up to draw the road map for capital account convertibility. It also acknowledged that in India's progress towards a more open economy, the regulations governing foreign exchange transactions need to be modernised. In view of this, the budget proposed to replace the exist ing Foreign Exchange Regulation Act 1973 with a Foreign Exchange Management Act.

Monetary and Credit Policy : Issues

14. In the backdrop of the performance during 1996-97, four major issues had to be addressed by the monetary policy for 1997-98.

    First, what should be the order of increase in broad money growth? Should M3 be targeted at all ?

    Secondly, what should be the approach towards large capital inflows in case it occurs ? If nominal exchange rate is allowed to appreciate, what would be the impact on exports ? On the other hand, if an interventionist policy is pursued, the resultant expansion of money supply would need to be sterilized. But, there are limits to sterilization; both in terms of costs and availability of securities.

    Thirdly, the prevailing level of interest rates did not reflect the stance of monetary policy. The sizeable reduction in the cash reserve ratio did not impart reduction in lending rates. Under the circumstances, what measures could be taken to bring interest rates down ?

    Fourthly, on the issue of credit dispensation and credit flows, what could be done to correct the sluggish growth in non-food credit by banks. Can credit flow enhancement be a target at all ?

    Monetary and Credit Policy For 1997-98

15. There are elements of continuity, contextual response and more important, significant changes in the recent half yearly monetary and credit policy.

Continuity

a. As Governor of the RBI, Dr. Rangarajan stated, the basic objectives of monetary and credit policy continue to be the same. The stance of this policy also continues to be maintaining reasonable price stability and ensuring availability of adequate bank credit to support growth of output in the real sector.
b. Often we used to mention in the policy statement the important measures that are kept unchanged. This time we did not: But there are many features including CRR and SLR on domestic liabilities which remain unchanged. The general thrust of financial sector reforms continues and will continue over the period through series of measures that will be announced from time to time. This is the normal practice.
c. The process of reduction in sector specific refinance has been carried further. Over the past few years, we have been gradually moving away from refinance to banks against export credit, investment in Government Securities, etc.
d. The increase in the proportion of loan system signifies conti nuity. Until recently, banks were extending working capital finance to corporates through a system of cash credits. There has been a gradual shift from the cash credit system of financing to the loan system.
e. The general approach continues to be gradual. We have always recognized the need for a cautious step-by-step approach rather than a rapid deregulation.

Contextual Response

a. The rate of inflation at 7.3 per cent during 1996-97 was a matter of concern. The current policy tries to respond by revising the target for growth of M3 downward. As against the target of 15.5 - 16.0 per cent for 1996-97, the actual performance was 15.6 per cent. The target for 1997-98 was scaled down to 15.0 - 15.5 per cent.
b. To the extent, the slow growth of non-food credit - or credit choke - is related to capital markets, advances against shares have permitted. Banks have been allowed to extend

loans to corporates against shares held by them to enable such corporates to meet the promoters' contribution to the equity of new companies in anticipation of raising resources. Changes in the credit delivery system were effected to give banks more autonomy and operational flexibility.

c. In the area of lending rates, measures were taken on a number of fronts, especially through rationalization and signaling, to reinforce the downward movement that has already taken place in the short end of the market.
d. The possibility of continued capital inflows was recognized and as stated in the policy, would be a factor in regulating money supply.
e. The policy continues to be exporter-friendly. The policy rewards exporters who bring back their proceeds quickly. Interest rates for usance bills up to 90 days have been prescribed at `not exceeding 13 per cent. Previously it was fixed at 13 per cent. Exporters can now extend trade related advances out of EEFC accounts up to $ 3 million per account without prior approval of the RBI.

Change

a. The policy seeks greater market orientation in the financial sector by empowering banks with greater operational flexibility. RBI has moved out of microregulation. Now banks are given total freedom on consortium arrangements and methodology of assessing working capital requirements. No doubt, prudential guidelines will continue to be prescribed by the RBI. These measures signify changes in the relationship between the RBI and banks.
b. Borrowers have also been empowered to reinforce marketisation. These measures have changed the relationship between the banker and the borrower. Borrowers can choose to go through a single bank or multiple banks or take the syndication route. Access to commercial paper is freer now.
c. Macromanagement by the Reserve Bank has been emphasized. The bank rate will emerge as a signal of the stance of monetary policy and determine the rate at which funds will be available to the system from the RBI. Interest rates on domestic term deposits (maturity of 30 days and up to 1 year) and NRE deposits, RBI refinance rates and the rates at which RBI provides liquidity support to Primary Dealers have all now been linked to the bank rate.
d. Integration of money market, Government Securities market and forex markets has commenced. Measures towards this end include exemption of CRR/SLR on inter-bank liabilities, permission to Authorised Dealers (ADs) to borrow from and lend in overseas market, permission to ADs to book forward cover on the basis of past performance, permission to undertake rupee/forex currency swaps, allowing repos in all Government Dated Securities, reverse repos for all SGL account holders, reducing the minimum period of Commercial Paper (CP), etc.

   The integration of the domestic and foreign exchange market could lead to increased volatility in the domestic market as the impact of exogenous factors could be transmitted to the domestic market. However, the proposals for deepening and widening the forex market such as allowing forward cover based on business projections, development of rupee-forex swap markets have strengthened the market participants with additional instruments to hedge risks and reduce volatility.

e. Extensive consultations with market participants were held both formally and informally before finalising the policy. Further, as a signal on ongoing consultations, a Committee for Money Markets has been constituted, similar to the Technical Advisory Committees on Forex and Government Securities Markets. Significantly, it signals a difference in relationship between the Reserve Bank and market participants at the informal level.

Big Bang :

In conclusion, it would be useful to explore why the recent policy is described as a `big bang'. After all, as in the case of any Monetary Policy, there has been a combination of Continuity, Contextual response and Change. But, there are some significant features which have led observers to describe them as institutional and structural reforms and these relate to changes in relationships. First, the policy changes the relationship between RBI and banks from micro regulation to macromanagement. Second, it changes 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 changes the relationship between different market participants. Finally, the relationship between the RBI and market participants is changed by expanding and reinforcing the consultative process.

Through the various reform measures so far, we have laid down the foundation for a more efficient financial system. Need for further changes is recognized and for example, a Committee on Capital Account Convertibility has been appointed. The cumulative experience provides us with the necessary confidence to grapple with the future challenges and our success so far makes us go ahead with a sense of optimism.