COMPETITION POLICY IN A GLOBAL ECONOMY*

I am thankful to Dr. Tarun Das and Dr. Rakesh Mohan for giving me this opportunity to be here today.

The relationship between competition, regulation and ownership has undergone dramatic changes in the recent past. The competitive conditions in the financial sector, especially in the banking industry, have also changed globally.

In our country, we have been trying to catch up with global trends since economic reform. Financial sector reform, which is part of broader economic reform, has altered the atmosphere in which the participants operate. Greater competition is possible now than before.

However, the competitive strength of our financial sector has assumed added significance in the current context of our goal of capital account convertibility. In fact, to this end, a committee has been recently set up by the Reserve Bank of India.

Debate

Competition, ownership and regulation are admittedly interrelated. But, in respect of financial sector, regulation assumes a special role. There are some differences of opinion on the desirable extent of State's intrusion into financial markets, but I will not go into it.

I will only speak on India's experience in tackling this inter-relationship while moving from non-competition policy to a policy of enabling competition.

Non Competition Policy Until 1991

Until 1991, financial intermediation was virtually the monopoly of the public sector. Major banks, Development Financial Institutions and Insurance Companies were all fully Government owned.

For over two decades after nationalisation of major banks in 1969, no banks were being allowed to be set up in the private sector. Public sector banks had by 1990, over ninety per cent of the total bank branches and handled over 86 per cent of the total banking business in the country. Intermediation by the public sector was biased in favour of meeting the financial requirements of the Government. With large pre-emptions, directed credit and administered interest rates, it was difficult to induce competition among these participants.

In the external sector also, the bulk of aid was channelled through Government. Over 90 per cent of external commercial borrowings were contracted by public enterprises. Private external borrowings were minimal. NRI deposits were mobilised for balance of payments support by giving exchange guarantees. Thus, external sector policies did not exactly enhance scope for competition.

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* Address by Dr. Y.V. Reddy, Deputy Governor, RBI at a Seminar sponsored by Confederation of Indian Industry, National Council of Applied Economic Research, GF-IBA (UK), CIS (Canada) and World Bank-EDI (USA) at New Delhi on March 17, 1997.

Enabling Competition

We entered the nineties with large internal and external financial imbalances which were exacerbated by the Gulf crisis of August 1990. As a response, we took up a reform programme encompassing areas of trade policy, fiscal containment, industrial delicensing, exchange rate policy, financial sector, and to some extent public enterprises. Naturally, the Reserve Bank of India had to take initiatives for reforms in the financial sector.

Dr. Rangarajan, the architect of our reforms, specially in the financial sector, has clearly laid down the objectives and approaches, viz., to impart efficiency to our financial system and reach global standards.

How did the Reserve Bank of India enable competition in the financial sector ?

Well, by acting on all fronts, i.e., policy environment, ownership and regulation.

From a policy point of view, the measures related to reduction in statutory pre-emptions like reserve ratios and deregulating interest rates so that banks have more freedom to compete in the markets. We have realised the medium-term targets of reduction in the Statutory Liquidity Ratio to 25 per cent and the Cash Reserve Ratio to 10 per cent; and deregulated all interest rates barring a few.

External sector liberalisation gave more freedom to private corporates, especially larger corporates, and thus banks and development financial institutions had to compete for their business. We have capital account convertibility for many transactions – especially non-residents. Road-map for further liberalisation and inducing international competition will be available in two to three months.

In the area of ownership, legislative changes have been made to permit diversified ownership in public sector banks, though they continue to be under special statutes and not under the Companies Act. Now, public sector banks can expand their equity provided the percentage of shareholding by Government does not fall below 51 per cent. A number of banks have already raised funds from the capital markets. Of course, disinvestments of Government shareholding is still not permissible. Similar changes have been made in development financial institutions, where some of them have been converted into companies under the Companies Act and some disinvestments is possible. The Government has injected adequate capital to many public sector banks. The World Bank’s financial sector loan has been of special significance in this process.

The Reserve Bank of India has taken many initiatives in the area of regulation and supervision.

First, the entry conditions have been relaxed. We now have larger number of branches of foreign banks than ever before. In fact we have been permitting entry of more foreign banks than we have to under our current obligations to WTO. Also, we have licensed new private sector banks and some of them have already become household names.

Second, in terms of operations, many constraints on credit delivery systems and procedures have been removed.

Third, capital adequacy guidelines and prudential norms, in line with international standards, have been prescribed though we are yet to reach strict global specifications.

Fourth, we have established an independent Board for Financial Supervision to ensure compliance.

Current Status

The Reserve Bank of India has also been responding to the emerging needs of enabling competition. For example, when we found that foreign banks and private sector banks are concentrating on corporate clients in metropolitan areas, we introduced licencing of Local Area Banks to induce competition in rural areas. Three banks have already been permitted.

Let me also give examples of ensuring competition with a level playing field. We have extended regulatory and supervisory framework to development financial institutions. Legislative changes have just been made to strengthen RBI's role in non-banking financial companies, some of which were adopting unfair practices.

There is one issue that needs our attention, viz., the continuing dominant strength of the public sector. The managements of public sector are feeling the pressures of competition. Many of them have commenced restructuring. However, public sector banks are still constrained by operational inflexibility and lack of autonomy in critical areas. These banks are not permitted to close non-viable branches in rural and semi-urban areas. They cannot have their own promotion and recruitment policies. They are subjected to rules and regulations equally applicable to all banks, irrespective of their size, strengths and weaknesses.

Although the Reserve Bank of India has created the environment for enabling competition, the objective conditions are such that public sector banks as a whole are not subjected to intense pressures of competition. No doubt, private sector banks are too few. More important, the Government has also to create appropriate environment for enabling the public sector banks to respond to the pressure of competition.

As a result, instead of competing effectively, private sector banks and foreign banks have become price takers. Let me illustrate. The range of Prime Lending Rates of public sector banks is 14.5-15.5 per cent, while private sector banks have a higher range of 15.0-17.5 per cent and foreign banks even higher at 17.0-18.5 per cent. Again, let us look at the spreads, as announced by them. Most public sector banks have a ceiling on spreads at 4.5 percentage points above the PLR, while private sector and foreign banks have typically ceilings of 5.0 and 6.25 percentages points over PLR, respectively. This means that the highest interest rate charged by public sector banks is 20.0 per cent, while private sector and foreign banks charge up to 22.5 per cent and 24.75 per cent, respectively.

Let us look at their profits. The foreign banks as a group account for less than 10.0 per cent of total business of scheduled commercial banks in terms of deposits but have about 20.0 per cent share of profits. The picture is similar in case of private sector banks. There are explanations including quality of service. But the real issue is the market structure.

Tasks Ahead

To enable improved competition within the banking sector, the Reserve Bank of India has removed legal and regulatory hurdles. The Reserve Bank has created enabling policies, regulatory and supervisory environment but cannot by itself ensure effective competition. The RBI has been active in charting medium-term actions. It has been proceeding according to a design, taking into account the emerging developments. Progress has been more than satisfactory. We have been responding to the developments in the financial sector as a whole – not merely in the banking sector. I have already touched upon various fronts in which we have to move forward to meet global standards.

The next bold step for us is capital account convertibility. The three important pre-conditions relate to fiscal policy, the level of reserves and well functioning financial markets. The nature of competition in financial markets, particularly in banking sector, is critical to ensuring efficiency. Effective competition and not merely enabling environment is the key.