Glimpses of Indian Economy and its Financial Sector*

Chairman Sergey M. Ignatiev and distinguished central bankers of the Bank of Russia,

I am grateful to Chairman Ignatiev for inviting me to visit your bank and interact with you for mutual benefit.

I have the pleasure of meeting my friend Chairman Ignatiev, almost once a month, in meetings of BIS or G20 or IMF or other international seminars. His address in Buenos Aires in early June on the current state of Russian economy was highly appreciated because he gave a glimpse of not only the achievements of Russian economy in recent years but also a hint of admirable future for the Russian economy.

We, in India, always had a very special bond with Russia, in technology, trade, culture and diplomacy. These are being further strengthened in recent years in terms of cooperation both bilaterally and multi-laterally.

At my persistent request, Chairman Ignatiev came to India in January and he delivered an address in the Reserve Bank of India. We had a scintillating discussion session where Chairman Ignatiev gave a frank and a highly professional response to the searching questions. We hope to get permission of Chairman to publish the script of the speech in English in India.

In my address today, I intend giving brief introduction to Reserve Bank of India, followed by glimpses of the Indian economy. I will give a more detailed account of reforms in India's financial sector, in particular, the banking sector, and financial markets.

Introduction to the RBI

The RBI was established under the Reserve Bank of India Act, 1934 on April 1, 1935 as a private shareholders' bank but since its nationalisation in 1949, is fully owned by the Government of India. The Preamble of the Reserve Bank describes the basic functions as '*to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally, to operate the currency and credit system of the country to its advantage*'. Thus, unlike the current trend in many

* Speech delivered by Dr. Y.V. Reddy, Governor, Reserve Bank of India at the Central Bank of the Russian Federation on July 2, 2007.

countries, there is no explicit mandate for price-stability or formal inflation targeting, but the mandate appears to be similar to that of the Federal Reserve of the USA. The twin objectives of monetary policy in India have evolved over the years as those of maintaining price stability and ensuring adequate flow of credit to facilitate the growth process. The relative emphasis between the twin objectives is modulated as per the prevailing circumstances and is articulated in the policy statements by the Reserve Bank from time to time. Consideration of macro-economic and financial stability is also subsumed in the mandate. The Reserve Bank is also entrusted with the management of foreign exchange reserves (which include gold holding also), which are reflected in its balance sheet.

While the Reserve Bank is essentially a monetary authority, its founding statute mandates it to be the manager of market borrowing of the Government of India and banker to the Government.

The function of regulating and supervising of banks has been assigned to the Reserve Bank by a separate legislation enacted in 1949, while the regulation of Non-Banking Finance Companies (NBFCs) has been entrusted to it through an amendment to the RBI Act recently. The powers for regulation of money markets, government securities market, forex market and gold are derived from the RBI Act and the regulation explicitly entrusted through government notifications under the Securities Contracts (Regulation) Act.

The regulation of current and capital account transactions of the external sector was assigned to the Reserve Bank under another statute in 1999, replacing an earlier one in 1973.

In addition to the issuance of currency, the Reserve Bank is also entrusted with the responsibilities relating to distribution of coins.

The Reserve Bank has been assigned some responsibilities in several statutory bodies such as public sector banks, development finance institutions governing Agriculture, Housing and Deposit Insurance, *etc*.

The Reserve Bank's affairs are governed by a Central Board of Directors, consisting of fourteen non-executive, independent directors nominated by the Government, in addition to the Governor and up to four Deputy Governors. Besides, one Government

official is also nominated on the Board who participates in the Board meetings but cannot vote.

The Reserve Bank has 19 regional offices and 4 sub-offices, mostly in state capitals. The Reserve Bank is the debt-manager and banker to State governments (*i.e.*, the provinces constituting the Indian federation).

The Reserve Bank renders advice to the Central and the State Governments, particularly in regard to financial sector reforms.

In brief, the Reserve Bank has been assigned several functions, in addition to monetary management. In performing each of the functions, the statute as well as the functional content, requires that the Reserve Bank exercise varying degrees of autonomy and coordination *vis-à-vis* the government. The three over-arching features governing the relations with the Government are autonomy in operations; harmony in policies; and coordination in structural transformations.

Performance of Indian Economy: Self accelerating growth with stability

Sometimes India is described as a re-emerging economy. Since in the 18th century, this geographical area had accounted for about a quarter of world output – but that is part of history. The annual growth rate of GDP in the geographical area of India in the first half of 20th century is estimated to be around an average of 0.9 per cent per annum and per capita income at an average rate of 0.1 per cent per annum. The economy of independent India which is of contemporary interest had to be built upon the overhang issues of second World War, the trauma of partition, the integration of princely states numbering over 500 and a low level of GDP. From an annual average growth rate of 3.5 per cent during 1950 to 1980, the growth rate of the Indian economy accelerated to around 6.0 per cent in the 1980s and 1990s. In the last four years (2003-04 to 2006-07), the Indian economy grew by 8.6 per cent. In 2005-06 and 2006-07, it had grown at a higher rate of 9.0 and 9.4 per cent, respectively. There is, thus, tangible evidence of self-accelerating growth.

An important characteristic of the high growth phase of over a quarter of century is resilience to shocks and considerable amount of stability. We have witnessed one serious balance of payments crisis triggered largely by the Gulf war in the early 1990s. Credible macroeconomic structural and stabilization programme was undertaken in

the wake of the crisis. The Indian economy in later years, could successfully avoid any adverse contagion impact of shocks from the East Asian crisis, sanction like situation in post-Pokhran scenario, and border conflict during May-June 1999. Seen in this context, this robust macroeconomic performance, in the face of recent oil as well as food shocks, demonstrates the vibrance and resilience of the Indian economy.

The average saving rate in India was 10 per cent in the 1950s, which rose to 17.5 per cent in the 1970s and further to 23.4 per cent in the 1990s. The saving rate was 32.4 per cent in 2005-06. The strengthening of economic activity in the recent years has been supported by persistent increase in gross domestic investment rates from 22.9 per cent of GDP in 2001-02 to 33.8 per cent in 2005-06. It may also be noted that over 95 per cent of investment in the country during this period was financed by the domestic savings.

On the price stability front, India's performance has been fairly good. Since independence, the inflation rate, in terms of the wholesale price index (WPI), on an average basis, was above 15 per cent in only five out of fifty years. In thirty-six out of fifty years, inflation was in single digit and on most occasions high inflation was due to shocks – food or oil. The tolerance level to inflation has been low, relative to many developing countries, especially on account of the democratic pressures in the country.

The inflation rate accelerated steadily from an annual average of 1.7 per cent during the 1950s to 6.4 percent during the 1960s and further to 9.0 per cent in the 1970s before easing marginally to 8.0 per cent in the 1980s. However, the inflation rate declined from an average of 11.0 per cent during 1990-95 to 5.3 per cent during the second half of the 1990s (1995-2000) and further to 4.9 per cent during 2003-07.

More recently during 2006-07, WPI based inflation rate increased from 4.1 per cent at the end of March 2006 to an intra-year peak of 6.7 per cent at end-January 2007 and remained firm in the range of 6.1-6.6 per cent in the succeeding weeks before moderating to 5.9 per cent by the end of the financial year (*i.e.*, as on March 31, 2007). Since then, the inflation has further moderated and as on June 16, 2007, the WPI inflation rate was 4.0 per cent.

In recent period, there has been considerable improvement in the fiscal position. The average gross fiscal deficit of the central government as per cent to GDP during the

decade of 1980s was 6.8 per cent as against 3.8 per cent in the 1970s. The Government of India is pursuing the path of rule-based fiscal consolidation from the year 2004-05 under the Fiscal Responsibility and Budget Management Act, 2003 whereunder time-specific targets have been mandated. The underlying purpose of the targets is to reduce the ratio of gross fiscal deficit (GFD) to gross domestic product (GDP) to three per cent by 2008-09. Furthermore, the revenue deficit (RD) to GDP ratio has been targeted to touch 0.0 per cent by 2008-09 so that borrowed resources can be used to meet only capital expenditures. The progress of targeted fiscal consolidation has been satisfactory so far and GFD/GDP and RD/GDP ratios are budgeted to reduce to 3.3 per cent and 1.5 per cent, respectively, in 2007-08. The objective is to meet the targets under the Fiscal Responsibility Act by 2008-09.

The average current account deficit since 1950-51 has been around one per cent of the GDP. During this period, except for 11 years when there was marginal surplus in the current account, we had modest deficit during the rest of the years. In the aftermath of the balance of payment crisis in the early 1990s, several stabilisation and structural reform measures were undertaken.

External sector indicators show considerable level of sustainability attained in the last decade. Sustained growth in export of services and remittances has continued to provide buoyancy to the surplus in the invisible account, which has enabled financing a large part of trade deficit. The capital flows have been buoyant leading to sustained rise in foreign exchange reserves. The merchandise trade deficit is currently close to 7.0 per cent of GDP; however, the current account deficit is under 1.5 per cent of GDP, mainly due to receipts from services and the steady support from remittances from Indians working abroad

Prospects of Indian Economy

In terms of immediate prospects, overall, we expect the real GDP growth in 2007-08 to be around 8.5 per cent, assuming no further escalation in international crude prices and barring domestic or external shocks. For the year 2007-08, the Reserve Bank's policy endeavour would be to contain inflation close to 5.0 per cent. In the medium term, in recognition of India’s evolving integration with the global economy and societal preferences, the resolve, going forward, is to condition policy and expectations for inflation in the range of 4.0–4.5 per cent.

The acceleration of growth in the real sector has been reflected in the upward shift in the growth trajectory of credit extended by commercial banks, which in the past three years has been unprecedented in the history of the Indian economy. There has been some sign of deceleration in the recent period.

In consonance with the rising capital flows, the reserve money growth has been higher in the recent period averaging 17.8 per cent during 2003-07. The rate of growth of reserve money was 23.0 per cent as on June 22, 2007 on year on year basis (18.2 per cent a year ago).

Similarly, the high credit growth in the recent period has led the money supply growth to remain high averaging 16.8 per cent during 2003-07. During 2006-07, the money supply grew by 21.3 per cent. As on June 8, 2007, the growth in money supply on year on year basis was 21.0 per cent (18.5 per cent a year ago).

Taking into account the high expansion of money supply worldwide, and given the monetary overhang of 2005-07, it is important to contain monetary expansion in 2007-08 at around 17.0-17.5 per cent, in consonance with the outlook on growth and inflation. The Annual Policy Statement for the year 2007-08 also placed aggregate deposits growth in 2007-08 at around Rs.4,900 billion and a graduated deceleration of non-food credit to 24.0-25.0 per cent in 2007-08.

For the medium term, the Approach Paper for the Eleventh Five Year Plan (2007-08 to 2011-12) targets an average annual growth of 9 per cent relative to 8 per cent targeted by the Tenth Plan (2002-03 to 2006-07). This aspiration for growth would require significant acceleration in investment from 27.8 per cent in the Tenth Five Year Plan to 35.1 per cent in the Eleventh Five Year Plan.
Realising that the growth benefits need to trickle down further, the Eleventh Five-Year Plan is likely to provide an opportunity to restructure policies to achieve a new vision based on faster, more broad-based and inclusive growth. Doubling of agricultural GDP growth to around 4 per cent is particularly important in this context. The Approach Paper suggests that this must be combined with policies to promote rapid growth in non-agricultural employment so as to create 70 million job opportunities in the 11th Plan.

Very recently on May 29, 2007, our Honourable Prime Minister announced a major scheme to double the growth rate of agriculture to 4.0 per cent over the 11th Plan period. The Government would provide rupees 250 billion for new farm initiatives launched by States. A time-bound Food Security Mission was also announced to counter rising prices of food products and to ensure visible changes in their availability over three years.

If these objectives are achieved, the percentage of people in poverty could be reduced by 10 percentage points by the end of the Plan period. The policy reforms and monitorable targets as indicated in the Approach Paper, particularly on education, health, women and children, infrastructure, when attained, are expected to benefit a larger chunk of population immensely. This will help in making the Indian growth process more inclusive and durable.

Financial Sector

The Indian financial system of the pre-reform period, before 1991, essentially catered to the needs of planned development in a mixed-economy framework, where the Government sector had a predominant role in economic activity. Interest rates on Government securities were artificially pegged at low levels, which were unrelated to the market conditions. The system of administered interest rates was characterised by detailed prescriptions on the lending and the deposit side, leading to multiplicity and complexity of interest rates. As would be expected, the environment in the financial sector in those years was characterised by segmented and underdeveloped financial markets coupled with paucity of financial instruments. Consequently, by the end of the eighties, directed and concessional availability of bank credit to certain sectors adversely affected the viability and profitability of banks. Thus, the transactions between the *de facto* joint balance sheet of the Government, the Reserve Bank and the commercial banks were governed by fiscal priorities rather than sound principles of financial management and commercial viability. It was then recognised that this approach, which, conceptually, sought to enhance efficiency through a co-ordinated approach, actually led to loss of transparency, accountability and incentive to seek efficiency.

Banking

The banking system in India has undergone significant changes during last 16 years. There have been new banks, new instruments, new windows, new opportunities and, along with all this, new challenges. While deregulation has opened up new vistas for banks to augment incomes, it has also entailed greater competition and consequently greater risks. India adopted prudential measures aimed at imparting strength to the banking system and ensuring its safety and soundness, through greater transparency, accountability and public credibility. The capital adequacy ratio has increased to 12.4 per cent for scheduled commercial banks as at end March 2006, which is much above the international norm. Commercial banks' net profits remained at 0.9 per cent of total assets during 2004-05 and 2005-06, up from 0.16 per cent in 1995-96. The ratio of NPLs to total loans of scheduled commercial banks, which was as high as 15.7 per cent at end-March 1997, declined steadily to 3.3 per cent by end-March 2006. The net non-performing assets declined to 1.2 per cent of net advances during 2005-06 from 2.0 per cent in 2004-05. According to the preliminary financial results available for most of the banks for the year 2006-07, the financial soundness has improved further.

Our banking sector reform has been unique in the world in that it combines a comprehensive reorientation of competition, regulation and ownership in a non-disruptive and cost-effective manner. Indeed our banking reform is a good illustration of the dynamism of the public sector in managing the overhang problems and the pragmatism of public policy in enabling the domestic and foreign private sectors to compete and expand. There has been no banking crisis in India.

The Government took steps to reduce its ownership in nationalised banks and inducted private ownership but without altering their public sector character. The underlying rationale of this approach is to assure that the salutary features of public sector banking were not lost in the transformation process. On account of healthy market value of the banks' shares, the capital infusion into the banks by the Government has turned out to be profitable for the Government.

An independent Banking Codes and Standards Board of India was set up on the model of the UK in order to ensure that comprehensive code of conduct for fair treatment of customers is evolved and adhered to. With a view to achieving greater financial inclusion, since November 2005, all banks need to make available a basic banking 'no frills' account either with 'nil' or very low minimum balances as well as

charges that would make such accounts accessible to vast sections of population. Banks were urged to review their existing practices to align them with the objective of ‘financial inclusion’.

There is a scheme of Ombudsman, located in fifteen cities to provide redressal to grievances of the bank customers. Customer-service is accorded high priority in the supervisory evaluation and according regulatory comfort to the Reserve Bank.

With a view to strengthening the supervisory framework within the Reserve Bank, a Board for Financial Supervision (BFS) was constituted in 1994, comprising select members of the Reserve Bank’s Central Board with a variety of professional expertise to exercise 'undivided attention to supervision' and ensure an integrated approach to supervision of commercial banks and financial institutions. The Reserve Bank has also instituted Off-site Monitoring and Surveillance System (OSMOS) for banks in 1995, which provides for Early Warning System as also a trigger for on-site inspections of vulnerable institutions.

Capital Adequacy: Three-track approach

In India, we have 84 commercial banks, which account for about 81 per cent (total assets) of the financial sector at end-March 2006; over 3000 cooperative banks, which account for 11 per cent; and 133 Regional Rural Banks, which account for 3 per cent. Taking into account the size, complexity of operations, relevance to the financial sector, need to ensure greater financial inclusion and the need for having an efficient delivery mechanism, the capital adequacy norms applicable to these entities have been maintained at varying levels of stringency. One might say that we are adopting a three-track approach with regard to capital adequacy rules. Given the differential risk appetite across banks and their business philosophies, it is likely that banks would ‘self select’ their own approach, which in turn, is likely to engender a stabilising influence on the system as a whole.

On the first track, the commercial banks are required to maintain capital for both credit and market risks as per Basel I framework; the cooperative banks, on the second track, are required to maintain capital for credit risk as per Basel I framework and through surrogates for market risk; the Regional Rural Banks, on the third track, have a minimum capital requirement which is, however, not on par with the Basel I framework. Consequently, we have a major segment of systemic importance on a full

Basel I framework, a portion of the minor segment partly on Basel I framework, and a smaller segment on a non-Basel framework.

The guidelines for Basel II implementation have been issued. According to the schedule, foreign banks operating in India and Indian banks having presence outside India are to migrate to the standardised approach for credit risk and the basic indicator approach for operational risk under Basel II with effect from March 31, 2008. All other scheduled commercial banks are encouraged to migrate to these approaches under Basel II in alignment with them but in any case not later than March 31, 2009.

Development of Financial Markets

Financial markets in India in the period before the early 1990s as I mentioned earlier were marked by administered interest rates, quantitative ceilings, statutory pre-emptions, captive market for government securities, excessive reliance on central bank financing, pegged exchange rate, and current and capital account restrictions. As a result of various reforms, the financial markets have now transited to a regime characterised by market-determined interest and exchange rates, price-based instruments of monetary policy, current account convertibility, phased capital account liberalisation and auction-based system in the government securities market. A noteworthy feature is that the government securities and corporate debt markets are essentially domestically driven since Foreign Institutional Investor and non-resident participation in these markets are limited and subjected to prudential ceilings.

The Reserve Bank has taken a proactive role in the development of financial markets. Development of these markets has been done in a calibrated, sequenced and careful manner such that these developments are in step with those in other markets in the real sector. The sequencing has also been informed by the need to develop market infrastructure, technology and capabilities of market participants and financial institutions in a consistent manner.

The Reserve Bank has accorded priority to the development of the money market as it is the key link in the transmission mechanism of monetary policy to financial markets and finally, to the real economy. The Reserve Bank has special interest in the development of government securities market as it also plays a key role in the effective transmission of monetary policy impulses in a deregulated environment.

A qualitative change was brought about in the legal framework by the enactment of the Foreign Exchange Management Act (FEMA) in June 2000 by which the objectives of regulation have been redefined as facilitating trade and payments as well as orderly development and functioning of foreign exchange market in India. The legal framework envisages both the developmental dimension and orderliness or stability. The legislation provides power to the government to re-impose controls if public interest warrants it. The Reserve Bank has undertaken various measures towards development of spot as well as forward segments of foreign exchange market. Market participants have also been provided with greater flexibility to undertake foreign exchange operations and manage their risks.

Linkage between the money, government securities and forex markets has been established and is growing. The price discovery in the primary market is more credible than before and secondary markets have acquired greater depth and liquidity. The number of instruments and participants has increased in all the markets, the most impressive being the government securities market. The institutional and technological infrastructure has been created by the Reserve Bank to enable transparency in operations and to provide secured payment and settlement systems.

Current challenges

In assessing short-term prospects, say for 2007-08, it is essential to recognise that the impressive growth in GDP at 9.4 per cent during the preceding year, reflects the contribution of both – the structural and the cyclical factors though their relative contribution is somewhat non-quantifiable. The critical task before the public policy, in general, and Reserve Bank of India, in particular, is to strengthen the structural factors in the economy but determinedly moderate the cyclical and excessively volatile elements of the economy.

There are reasonable grounds for optimism in regard to the prospects for Indian economy, and this has been globally recognised. However, it is necessary to remain guarded in matters relating to economic growth and stability of an emerging market economy in the current global environment of high output-growth, notable inflation pressures, persisting global imbalances, incipient signs of re-pricing of risks, and perceived volatility of capital flows.

We do recognise that relative to most large emerging market economies, we have several significant economic strengths but we also have twin deficits – current and fiscal; have a higher component of more volatile portfolio flows on capital account, and severe policy challenges in managing capital flows.

In view of the proven success of our overall approach to reform over the last fifteen years, there is considerable merit in pursuing the gradualist, participative and harmonious approach towards further reforms in financial and external sectors. Since it is generally accepted that financial and external sectors in India are reasonably strong and resilient, high priority is being accorded for further reforms in fiscal sector, agriculture, physical infrastructure, especially in power and urban areas, and delivery of public services such as water, health and education. Progress in these sectors will help, over the medium term, enhance competitiveness and accelerated reforms in financial and external sectors, in a harmonious and non-disruptive manner, thus, reinforcing self -accelerating growth with assured stability.

Let me conclude by thanking Chairman Ignatiev of Bank of Russia for his kind invitation and warm hospitality. We hope to further strengthen our bilateral co-operation in matters relating to central banking, since we realise that we have much more in common than we were aware of.