

## **Monetary and Financial Sector Reforms in India: A Practitioner's Perspective**

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The objectives of this paper are to review the monetary and financial sector reforms in India, identify the emerging issues and explore the prospects for further reform. The first part is devoted to a brief background on the need for reforms taken up in 1991-92. The second part is devoted to the institutional aspects of the reform. Issues relating to ownership, competition and regulation in the financial sector as a whole, but primarily in the banking sector are analysed. The third part relating to policy framework focuses on monetary policy and credit delivery. The fiscal policy insofar as it impacts on the financial sector is also analysed. The fourth part focuses on managing process of reform in its various dimensions and perspective is that of the Reserve Bank of India (RBI). The concluding part identifies the critical elements that would possibly determine the progress of reform.

### **Need for Reforms**

The Indian financial system of the pre-reform period essentially catered to the needs of planned development in a mixed-economy framework where the Government sector had a predominant role in economic activity. As part of planned development, the macroeconomic policy in India moved from fiscal neutrality to fiscal activism (Reddy 2000). Such activism meant large developmental expenditures, much of it to finance long-gestation projects requiring long-term finance. The sovereign was also expected to raise funds at fine rates, and understandably at below the market rates for private sector. In order to facilitate the large borrowing requirements of the Government, interest rates on government securities were artificially pegged at low levels, which were unrelated to market conditions. The government securities market, as a result, lost its depth as the concessional rates of interest and maturity period of securities essentially reflected the needs of the issuer (Government) rather than the perception of the market. The provision of fiscal accommodation through *ad hoc* treasury bills (issued on tap at 4.6 per cent) led to high levels of monetisation of fiscal deficit during the major part of the eighties. In order to check the monetary effects of such large-scale monetisation, the cash reserve ratio (CRR) was increased frequently to control liquidity.

The environment in the financial sector in these years was thus characterised by segmented and underdeveloped financial markets coupled with paucity of instruments. The existence of a complex structure of interest rates arising from economic and social concerns of providing concessional credit to certain sectors resulted in "cross subsidisation" which implied that higher rates were charged from non-concessional borrowers. The regulation of lending rates, led to regulation of deposit rates to keep cost of funds to banks at reasonable levels, so that the spread between cost of funds and return on funds is maintained. The system of administered interest rates was characterised by detailed prescription on the lending and the deposit side leading to multiplicity and complexity of interest rates.

By the end of the eighties, the financial system was considerably stretched. The directed and concessional availability of bank credit with respect to certain sectors resulted not only in distorting the interest rate mechanism, but also adversely affected the viability and profitability

of banks. The lack of recognition of the importance of transparency, accountability and prudential norms in the operations of the banking system led also to a rising burden of non-performing assets.

In sum, there was a *de facto* joint family balance sheet of Government, the Reserve Bank and commercial banks, with transactions between the three segments being governed by plan priorities rather than sound principles of financing inter-institutional transactions (Reddy, November 2000). There was a widespread feeling that this joint family approach, which sought to enhance efficiency through co-ordinated approach, actually led to loss of transparency, of accountability and of incentive to measure or seek efficiency.

The policies pursued did have many benefits, although the issue of the higher costs incurred to realise the laudable objectives remains. Thus, the post-nationalisation phase witnessed significant branch expansion to mobilise savings and there was a visible increase in the flow of bank credit to important sectors like agriculture, small-scale industries, and exports. However, these achievements have to be viewed against the macroeconomic imbalances as well as gross inefficiencies at the micro level in the financial sector compounded by non-transparent accounting of intra-public sector financial transactions.

## **Institutional Aspects of Reforms**

### *Institutions*

At present, the institutional structure of the financial system is characterised by (a) banks, either owned by the Government, the Reserve Bank or private sector (domestic or foreign) and regulated by the Reserve Bank; (b) development financial institutions and refinancing institutions, set up either by a separate statute or under Companies Act, either owned by Government, the Reserve Bank, private or other development financial institutions and regulated by the Reserve Bank and (c) non-bank financial companies (NBFCs), owned privately and regulated by the Reserve Bank.

Since the onset of reforms, there has been a change in the ownership pattern of banks. The legislative framework governing public sector banks (PSBs) was amended in 1994 to enable them to raise capital funds from the market by way of public issue of shares. Many public sector banks have accessed the markets since then to meet the increasing capital requirements, and until 2001-02, Government made capital injections out of the Budget to public sector banks, totalling about 2 per cent of GDP. The Government has initiated legislative process to reduce the minimum Government ownership in nationalised banks from 51 to 33 per cent, without altering their public sector character. The underlying rationale of the proposal appears to be that the salutary features of public sector banking is not lost in the transformation process.

Reforms have altered the organisational forms, ownership pattern and domain of operations of financial institutions (FIs) on both the asset and liability fronts. Drying up of low cost funds has led to an intensification of the competition for resources for both banks and FIs. At the same time, with banks entering the domain of term lending and FIs making a foray into disbursing short-term loans, the competition for supply of funds has also increased. Besides, FIs have also

entered into various fee-based services like stock-broking, merchant banking, advisory services and the like. Currently, while Industrial Credit and Investment Corporation of India Ltd. (ICICI) is in the process of finalising its merger with ICICI Bank, Industrial Development Bank of India (IDBI) is also expected to be corporatised soon.<sup>1</sup> At present, the Reserve Bank holds shares in a number of institutions. The further reform agenda is to divest the Reserve Bank of all its ownership functions.

In the light of legal amendments in 1997, the regulatory focus of the NBFCs was redefined, both in terms of thrust as well as the focus. While NBFCs accepting public deposits have been subject to the entire gamut of regulations, those not accepting public deposits have been sought to be regulated in a limited manner. In order to consolidate the law relating to the NBFCs, regulation is being framed to cover detailed norms with regard to entry point and the regulatory and supervisory issues.

### *Competition*

Steps have also been initiated to infuse competition into the financial system. The Reserve Bank issued guidelines in 1993 in respect of establishment of new banks in the private sector. Likewise, foreign banks have been given more liberal entry. Recently, the norms for entry of new private banks were rationalised. Two new private sector banks have been given 'in-principle' approval under these revised guidelines. The Union Budget 2002-03 has also provided a fillip to the foreign banking segment, permitted these banks, depending on their size, strategies and objectives, to choose to operate either as branches of their overseas parent, or, corporatise as domestic companies. This is expected to impart greater flexibility in their operations and provide them with a level-playing field *vis-à-vis* their domestic counterparts.

As a group, however, the performance of PSBs in terms of profitability, spreads, non-performing assets and standard assets position seems to have been lower than that of the new private sector and foreign banks. There have been significant divergences in performance among the public sector banks -some have performed on par with private and foreign banks, whereas the performance of others has been relatively unsatisfactory. Hence, although PSBs have been subject to Government intervention, these do not appear to provide a complete explanation of bank performance. Bank specific factors such as rapid expansion, higher operating costs and differential industry focus seem to have been important considerations as well. Public sector banks operating in the same environment with the same constraints have shown varied performance; ultimately this reflects the performance of management.

### *Regulation and Supervision*

A second major element of financial sector reforms in India has been a set of prudential measures aimed at imparting strength to the banking system as well as ensuring safety and soundness through greater transparency, accountability and public credibility.

Capital adequacy norms for banks are in line with the Basel Committee standards and from the end of March 2000, the prescribed ratio has been raised to 9 per cent.<sup>2</sup> While the objective has been to meet the international standards, in certain cases, fine-tuning has occurred keeping in

view the unique country-specific circumstances. For instance, risk weights have been prescribed for investment in Central Government securities on considerations of interest rate risk. Also, while there is a degree of gradualism, there is an intensification beyond the 'best practices' in several instances in recent period, an example being exposure norms stipulated for the banking sector in respect of investment in equity. Investments are valued and classified into appropriate categories, as per international best practices. To take into account the vagaries of interest rate risks, a prescription for meeting a targeted Investment Fluctuation Reserve out of the realised profits from sale of investments within a stipulated time frame has also been prescribed recently. The supervisory strategy of the Board for Financial Supervision (BFS) constituted as part of reform consists of a four-pronged approach, including restructuring system of inspection, setting up of off-site surveillance, enhancing the role of external auditors, and strengthening corporate governance, internal controls and audit procedures. The BFS, in effect, integrates within the Reserve Bank the supervision of banks, NBFCs and financial institutions.

Prudential regulations have had a significant impact on the banking system in terms of ensuring system stability even in the face of both external and internal uncertainties, almost throughout during the second half of the nineties. As at end-March 2001, 95 out of 100 scheduled commercial banks had capital adequacy ratio of 9 per cent or more. There was a distinct improvement in the profitability of public sector banks measured in terms of operating profits as well as in terms of net profits to total assets. Reflecting the efficiency of the intermediation process, there has been a decline in the spread between the borrowing and lending rates as reflected by the decline in the ratio of net interest income to total assets. The most significant improvement has been in terms of reduction in NPAs.

## **Policy Environment**

### *Changing Monetary Policy Framework*

Since the onset of the reforms process, monetary management in terms of framework and instruments has undergone significant changes, reflecting broadly the transition of the economy from a regulated to liberalised and deregulated regime.<sup>3</sup> While the twin objectives of monetary policy of maintaining price stability and ensuring availability of adequate credit to productive sectors of the economy to support growth have remained unchanged; the relative emphasis on either of these objectives has varied over the year depending on the circumstances. Reflecting the development of financial markets and the opening up of the economy, the use of broad money as an intermediate target has been de-emphasised, but the growth in broad money (M<sub>3</sub>) continues to be used as an important indicator of monetary policy. The composition of reserve money has also changed with net foreign exchange assets currently accounting for nearly one-half. A multiple indicator approach was adopted in 1998-99, wherein interest rates or rates of return in different markets (money, capital and government securities markets) along with such data as on currency, credit extended by banks and financial institutions, fiscal position, trade, capital flows, inflation rate, exchange rate, refinancing and transactions in foreign exchange available on high frequency basis were juxtaposed with output data for drawing policy perspectives. Such a shift was gradual and a logical outcome of measures taken over the reform period since early nineties.

The thrust of monetary policy in recent years has been to develop an array of instruments to

transmit liquidity and interest rate signals in the short-term in a more flexible and bi-directional manner. A Liquidity

Adjustment Facility (LAF) has been introduced since June 2000 to precisely modulate short-term liquidity and signal short-term interest rates. The LAF, in essence, operates through repo and reverse repo auctions thereby setting a corridor for the short-term interest rate consistent with policy objectives. There is now greater reliance on indirect instruments of monetary policy. The Reserve Bank is able to modulate the large market borrowing programme by combining strategic debt management with active open market operations. Bank Rate has emerged as a reasonable signal rate while the LAF rate has emerged as both a tool for liquidity management and signaling of interest rates in the overnight market. The Reserve Bank has also been able to use open market operations effectively to manage the impact of capital flows in view of the stock of marketable government securities at its disposal and development of financial markets brought about as part of reform.

The responsibility of the Reserve Bank in undertaking reform in the financial markets has been driven mainly by the need to improve the effectiveness of the transmission channel of monetary policy. The developments of financial markets have therefore, encompassed regulatory and legal changes, building up of institutional infrastructure, constant fine-tuning in market microstructure and massive upgradation of technological infrastructure.

Since the onset of reforms, a major focus of architectural policy efforts has been on the principal components of the organised financial market spectrum: the money market, which is central to monetary policy, the credit market, which is essential for flow of resources to the productive sectors of the economy, the capital market, or the market for long-term capital funds, the government securities market which is significant from the point of view of developing a risk-free credible yield curve and the foreign exchange market, which is integral to external sector management. Along with the steps taken to improve the functioning of these markets, there has been a concomitant strengthening of the regulatory framework.

The medium-term objective at present is to make the call and term money market purely inter-bank market for banks, while non-bank participants, who are not subject to reserve requirements, can have free access to other money market instruments and operate through repos in a variety of instruments. The Clearing Corporation of India Ltd. is expected to facilitate the development of a repo market in a risk free environment for settlement. A phased programme for moving out of the call money market has already been announced and the final phase-out will coincide with the implementation of the Real Time Gross Settlement (RTGS) system. Further reform is being contemplated in terms of reduction of CRR to the statutory minimum of 3 per cent, removal of established lines of refinance, limits on call money lending and borrowing by banks and PDs and a move over to a full-fledged LAF.

With the switchover to borrowings by Government at market related interest rates through auction system in 1992, and more recently, abolition of system of automatic monetisation, it was possible to progress towards greater market orientation in government securities. Further reforms in the government securities market have resulted in the rationalisation of T-Bills market, increase in instruments and participants, elongated the maturity profile, created greater

fungibility in the secondary market, instituted a system of delivery *versus* payment, strengthened the institutional framework through Primary Dealers and more recently Clearing Corporation, and enhanced the transparency in market operations. Clarity in the regulatory framework has also been established with the amendment to the Securities Contracts Regulation Act. A Negotiated Dealing System for trading in government securities is in operation. Further developments in the government securities market hinges on legislative changes consistent with modern technology and market practices; introduction of a RTGS system, integrating the payments and settlement systems for government securities and standardisation of practices with regard to manner of quotes, conclusion of deals and code of best practices for repo transactions.

The movement to a market-based exchange rate regime took place in 1993. Reforms in the foreign exchange market have focused on market development with prudential safeguards without destabilising the market. Thus, authorised dealers have been given the freedom to initiate trading position in the overseas markets; borrow or invest funds in the overseas markets (up to 15 per cent of tier I capital, unless otherwise approved); determine the interest rates (subject to a ceiling) and maturity period of Foreign Currency Non-Resident (FCNR) deposits (not exceeding three years); and use derivative products for asset-liability management. These activities are subject to net overnight position limit and gap limits, to be fixed by them. Other measures such as permitting forward cover for some participants, and the development of the rupee-forex swap markets also have provided additional instruments to hedge risks and help reduce exchange rate volatility. Alongside the introduction of new instruments (cross-currency options, interest rates and currency swaps, caps/collars and forward rate agreements), efforts were made to develop the forward market and ensure orderly conditions. Foreign institutional investors were allowed entry into forward markets and exporters have been permitted to retain a progressively increasing proportion of their earnings in foreign currency accounts. The Reserve Bank conducts purchase and sale operations in the forex market to even out excess volatility.

In respect of the financial markets, 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 in the markets has increased in all markets, the most impressive being the government securities market. The institutional and technological infrastructures that have been created by the Reserve Bank to enable transparency in operations and secured settlement systems. The presence of foreign institutional investors has strengthened the integration between the domestic and international capital markets.

### *Credit Delivery*

The reforms have accorded greater flexibility to banks to determine both the volume and terms of lending. The Reserve Bank has moved away from microregulation of credit to macro management. External constraints to the banking system in terms of the statutory preemptions have been lowered. All this has meant greater lendable resources at the disposal of banks. The movement towards competitive and deregulated interest rate regime on the lending side has been completed with linking of all lending rates to PLR of the concerned bank and the PLR itself has been transformed into a benchmark rate.

As a result of reforms, borrowers are able to get credit at lower interest rates. The lending rate between 1991-92 and 2001-02 has declined from about 19.0 per cent to current levels of 10.5-11.0 per cent. The actual lending rates for top rated borrowers could even be lower since banks are permitted to lend at below Prime Lending Rate (PLR). Further, since banks invest in Commercial Paper (CP), which is more directly related to money market rates, many top rated borrowers are able to tap bank funds at rates below the prime lending rates. These developments have been possible to banks because the overall flexibility now available in the interest rate structure has enabled them to reduce their deposit rates and still improve their spreads.

In terms of priority sector credit also, the element of subsidisation has been removed although some sort of directed lending to Agriculture, Small Scale Industry (SSI) and export sector have been retained. The definition of priority sector has been gradually increased to help banks make loans on commercially viable terms. However, the actual experience has been that the credit pick up is not up to the mark and has been generally less than projected by the Reserve Bank in its monetary policies, in a number of years. Also, while in general the rates of interest have come down, they are available more to highly rated borrowers than to the small and medium enterprises. There is considerable concern about the inadequate flow of resources to rural areas, and in particular agriculture, while interest rates have not been reduced to the extent they were, for the corporate sector.

#### *Fiscal Policy and Financial Sector*

There are several channels that link the fiscal and financial sectors and in the Indian context four of them appear significant. These relate to (a) governments' borrowing programme; (b) guarantees extended by governments; (c) mechanisms such as 'direct debits'; and (d) governments' investments in financial sector.

The market borrowing programme of the Central Government continued to be relatively large, both in gross and net terms. Since a large part of the borrowing programme has to be completed in the first half of the fiscal year, in view of seasonality for demand for credit on private account, the monthly average borrowing by centre is around three quarters of a per cent of GDP in recent years. Further, there has been an upward revision in the borrowing programme of Central Government during the course of every year, usually, around three quarters of a per cent of GDP. It has been possible for the Reserve Bank as debt manager to complete the borrowing programme while pursuing its interest rate objectives without jeopardising external balance, by recourse to several initiatives in terms of institution, instruments, incentives and tactics. At the same time, it has been able for the Reserve Bank to reduce statutory preemptions in regard to banks to the prescribed minimum of 25 per cent of their net liabilities. The banking system, in which PSBs account for about three quarters of activity, holds majority of the outstanding stock of government securities, and currently their holdings in excess of statutory prescriptions are far in excess of the annual borrowing programme of the Central and State Governments. In any case, a large part of outstanding government securities are held by Government owned financial institutions, especially in banking and insurance sectors. The Reserve Bank has so far been able to successfully reconcile the interests of Government as its debt manager and of banks as regulator and supervisor. In this regard, recognising the importance of containing interest rate risks and widening the participant profile, the Reserve Bank has prescribed an Investment

Fluctuation Reserve for banks and is pursuing retailing of government securities. While technological, institutional and procedural bottlenecks for retailing are being overcome by the Reserve Bank, some of the constraints such as tax treatment and relatively high administered interest rates do persist.

The conduct of borrowing programme of State Governments is, however, posing several problems. While the market borrowing programme of states in aggregate is well below a quarter of centre's market borrowings, in a liberalised environment, banks cannot be compelled to subscribe to the programme. It was necessary to provide investors a premium for states' paper over the centre's paper of a comparable maturity. Of late, the premium is widening and differing as between states, while in the case of some states, there have been some difficulties in ensuring subscriptions. In recent years, the increases in states' borrowing programme over the budgeted amounts have been large with the attendant problems of garnering subscriptions. It has, however, been possible for the Reserve Bank to conduct the programme without serious disruption in the markets, since some states have also begun to take initiatives to improve their fiscal profile and discharge their liabilities, especially to banks, in a timely fashion. It is necessary to recognise that size of government borrowings is only one element in public debt management, since there are other liabilities also, especially ballooning of pension liabilities.

In this regard, extra budgetary transactions are also emerging, which impinge on the balance sheets of banks and other financial institutions which take an exposure on them. For example, "oil bonds" to settle Government's dues to public sector oil companies and "power bonds" to settle dues from State Electricity Boards to national level power utilities fall in this category. Banks exposure to food credit, which is in the nature of funding of buffer stock operations is also relatively large at over 2.0 per cent of GDP. The Reserve Bank had been advocating that a law be passed imposing a ceiling on government borrowings as enabled by the Constitution, but more recently, a Bill is under contemplation for fiscal responsibility at the centre and several states.

Financial intermediaries, especially banks, take exposures with a great degree of comfort when there is a sovereign guarantee. Such guarantees are often formally extended and notified as such to the legislative bodies and financial markets. The Reserve Bank has encouraged governments to pass a legislation prescribing a ceiling on such guarantees and also charge a fee without exception to ensure credibility to guarantees and comfort to subscribers. Several State Governments have passed such legislations, though some are less stringent than others. In view of the magnitudes of such guarantees by many States, banks have been advised to exercise due diligence in subscribing to them. Apart from explicit guarantees, recourse is occasionally made by Governments to letters of comfort which have a similar effect, and the Reserve Bank has been dissuading such relatively non-transparent practices.

There are, in addition, what may be termed as "implicit-guarantees" which have maximum linkage between fiscal and financial sectors. A predominant point of financial intermediation through banks, mutual funds, and insurance, in spite of significant reform is undertaken by publicly owned or Government backed financial institutions. Hence, public tend to repose confidence with a corresponding implicit direct obligation on the part of government to protect the interests of depositors or investors. Such a reasonable expectation is not only justified on the considerations of reputational risk and the concept of "holding out" or backing, but also by the



obligations discharged in the past by the Government of India, in several cases; some of them at the instance of regulator concerned.

In some cases, banks and financial institutions seek and obtain instructions for direct debit of dues to them from government accounts to ensure the timely recovery of dues to them and thus bring about comfort through credit enhancement. Since large scale recourse to such mechanisms, especially when State Governments are under fiscal strain has the potential of eroding both the integrity of budget process and the *de facto* comfort to financial intermediaries, the Reserve Bank has been vigorously advocating avoidance of recourse to such direct debit mechanisms.

The Governments have, in its asset portfolio, equity holding and some debts of financial intermediaries that they own, and financial returns on these do impact the fiscal situation. More important, whenever pockets of vulnerability arise in financial sector, the headroom available in the fiscal situation to provide succour to financial entities needs to be assessed. Fortunately, on present reckoning, the magnitudes of the few pockets of vulnerability appear to be manageable without undue fiscal strain.

In assessing fiscal financial linkage, the scope for money financing of budgets *vis-à-vis* bond financing also needs to be considered. Since there are elements of open capital account, the maneuverability for the Reserve Bank in the short-term to monetize government's deficit is severely circumscribed by the direction and magnitudes of such flows. Keeping these considerations in view, the Reserve Bank and Government have agreed upon freedom to the Reserve Bank to determine the extent of monetization of government budget consistent with macroeconomic stability.

## **Managing the Process of Reform**

### *Financial Sector Reform and Changes in Law*

Any reform has both public and private dimensions, and ideally all participants should recognize the emerging new realities, assess costs and benefits and make attempts to cope. Reform outcomes should thus, be related not only to public action but also several other factors. In public action itself, there can be legal, policy and procedural aspects including subordinate legislations and institutional changes. There are possibilities of significant policy and procedural changes within a given legal framework and these need to be explored since changes in law are often difficult to get through in any democratic process.

The Reserve Bank has been articulating the need for appropriate changes in Law, assisting the Government in the process and has also been bringing about changes in the financial sector without necessarily waiting for changes in law. Thus, several legislative measures affecting ownership of banks, IDBI, debt recovery, regulation of non banking financial companies, foreign exchange transactions and money market have been completed. Those on the anvil include measures relating to fiscal and budget management, public debt, deposit insurance, securitisation and foreclosure, and prevention of money laundering. The agenda for further legal reform, as identified by several Advisory Groups relate to the Reserve Bank, Banking Regulations, Companies, Chartered Accountant, Income-tax, Bankruptcy, Negotiable Instruments, Contracts,

Unit Trust of India, etc.

The legislative process is complex in a democratic set up and it will be inadvisable to rush into legislation through a “big bang” approach. Furthermore, many elements of economic reform and underlying legislative framework need to be harmonised. At the same time, it may not be necessary to wait for legislative framework to change to bring about some of the reforms or initiate processes to demonstrate usefulness of reform-orientation. In fact, there are several examples of managing reform within constraints of law which need to be recalled. For example, there are some enabling but not mandated provisions which may or may not be used. Thus, the Reserve Bank had shed its direct developmental role in the sense of money financing, by ceasing to operate on relevant provision and by and large, confining money creation for Government of India only. Supplemental agreement to terminate automatic monetisation (WMA) of government’s deficit has been used, by way of a signed agreement between the Reserve Bank and Government of India, though a legislative compulsion is still under consideration as part of Fiscal Responsibility and Management Bill.

In several cases, contracts with stipulated conditions have been framed in the absence of specific law governing such transactions. Examples relate to regulation of Clearing Houses; operating current payment systems and functioning of electronic trading even before instructions under I.T. Act came into force. Similarly, it has been possible to invoke prudential regulations over the Reserve Bank regulated financial institutions to effectuate best practices in financial markets, though the legal compulsion as a regulation on all market participants may not be possible; the example of successes achieved are dematerialisation of Commercial Paper and Dematerialisation of Debt instruments, brought about in the requirements on Banks and financial institutions. There could also be use of incentives to conform though legal or formal regulation may be difficult. Examples relate to valuation and accounting norms being performed by a self regulatory organisation and adopted by banks and proposals relating to information sharing with Credit Information Bureau pending legislative initiatives. A deliberate decision may be taken not to use regulatory powers, thus enabling development of markets. For example, current account convertibility in external sector was implemented even before a new law was introduced by recourse to large scale relaxations. Similarly, Credit Guarantee was virtually given up though a new law is yet to be enacted giving up the credit-guarantee function of Deposit Insurance Guarantee Corporation. In all these cases, however, a positive approach to law to enable reform was possible because of clarity about what was to be done and finding of legal ways of doing even if it were second best.

### *Managing Uncertainties During Reform*

Reforms in the financial sector had to be implemented keeping in view not only the desirable directions and appropriate measures carefully sequenced, but also the emerging uncertainties, both in domestic and global arena. By all accounts, India has managed the uncertainties reasonably well. Recognising that such uncertainties have a tendency to impact the exchange rate, it is instructive to briefly review the processes of management and draw some tentative lessons. The Gulf crisis, which triggered the reform process was managed without any rescheduling of any contractual obligation, but with a recourse to stabilisation measures and initiation of structural reforms. The current account convertibility in 1994 led to liberalisation of

gold imports and large capital inflows upto 1996. In 1997, the timely efforts to depreciate the currency warded off a possible crisis due to persistence of a relatively over valued rupee in the forex markets. This also enabled the implementation of a package of monetary and other prompt actions in resisting contagion effects of Asian crisis in late 1997 and early 1998. The imposition of sanctions by U.S. government and others consequent upon nuclear tests required replacement of normal debt flows with a type of extra ordinary financing.

There was also an occasion, as in May-August 2000 where inexplicable changes in expectations put pressure on the currency warranting yet another package to counter the market sentiment. In contrast the events of September 11, 2001 needed measures to reassure the markets with timely liquidity and stability in monetary measures. The reasonable success in managing these uncertainties while adding to forex reserves with marginal addition to total external debt but maintaining both reasonable overall macro-economic stability and pace of reform in financial sector has some tentative lessons to offer.

First, stable and appropriate policies governing overall management of the external sector are important. As part of the reform process, a policy framework was developed to gradually liberalise the external sector, move towards total convertibility on current account, encourage non debt credit inflows while containing all external debt especially short term debt in capital account and make the exchange rate largely market determined. The policy reform in the external sector, accompanied by other changes was guided by the Report of High Level Committee on Balance of Payments, April 1993 (Chairman : Dr.C.Rangarajan).

Second, the impression that a closed economy is less vulnerable to crisis is not borne out by facts. India was a closed economy on the eve of the Gulf Crisis but the impact was severe. Though it is now a relatively more open economy, it could without serious disruptions withstand several uncertainties. Third, as evident from experience, if the fundamentals are weak, the economy is more vulnerable in the face of uncertainties.

Fourth, in all instances of serious uncertainties, the existence and manifestation of harmonious relations between the Government and the central bank become critical and appropriate coordination is extremely useful. Fifth, while it is difficult to anticipate or assess the uncertainties, there may be advantages in taking the risk of early action than late action. Sixth, while in a rapidly changing world of uncertainties, commitment to ideology can prove to be a drag on policy, especially in emerging countries, which are attempting structural transformation, it has been demonstrated by events the world over as well as by the Indian experience, that when the going is good, Government is perceived to be a problem but when the going gets tough, effective public policy may be the only solution. As such, the state has a pivotal role in stabilising the economy when there is a spell of stormy weather.

Seventh, there may be need for several short-term actions to meet challenges but this should not distort the medium term vision to proceed with economic reform to improve standards of living. In other words, it is necessary for the policy makers to be conscious and more importantly, essential for the policy maker to convince market participants that some measures to meet the crisis are short term, while some others may get embedded into the public policy in the medium-term. Related to this approach and to reinforce this, there is advantage in designing measures that

are easily reversible, preferably with an explicit indication that the measures are reversible even as they are being announced, though a specific time frame may not be prescribed

Eighth, as regards the techniques and instruments of managing uncertainties, they have to evolve keeping in view the reform process itself, especially developments in financial markets, monetary policy, the nature, composition and evolution of market participants and above all public opinion.

Ninth, it is necessary to have an appropriate mix of surprise elements and anticipated elements in policy actions for meeting any uncertainties. As an example, when the markets are in need of comfort or assurances, when the convergence in the objectives of policy makers and the markets are matched, and such convergence is observable in regard to instruments, there is merit in taking the market into confidence and proceeding accordingly. Where there is a perception that the market expectations and their possible actions in the direction are not considered to be desirable by the policy makers, it is always advantageous to bring an element of surprise preferably with firmness and credibility so that all possible anticipatory actions as well as resistance are avoided. There may be occasions when the wavelengths of markets or segments thereof and policy maker differ significantly and in such circumstances, the conduct of policy would presumably be more complex and difficult.

Finally, the issue of transparency is extremely important. There are many occasions where transparency is desirable but there are also occasions where instant transparency is not entirely essential and could even be counter-productive. An acceptable approach seem to be one that practices transparency as a rule but the timing of transparency could vary depending on the circumstances.

### *RBI and Government*

During the early 1960s, Governor Iengar identified four areas of potential conflict between the Bank and the Central Government. These were interest rate policy, deficit financing, cooperative credit policies and management of sub-standard banks. It may be of interest to note that these four areas are still some of Reserve Bank's concerns.

During the post-reform period, the relationship between the central bank and the Government took a new turn through a welcome development in the supplemental agreement between the Government and the Reserve Bank in September 1994 on the abolition of the *ad hoc* treasury bills to be made effective from April 1997. The measure eliminated the automatic monetisation of Government deficits and resulted in considerable moderation of the monetised deficit in the latter half of the Nineties.

At the same time, with gradual opening up of the economy and development of domestic financial markets, the operational framework of the Reserve Bank also changed considerably with clearer articulation of policy goals and more and more public dissemination of vast amount of data relating to its operations.

In fact, during the recent period, the Reserve Bank enjoys considerable instrument independence

for attaining monetary policy objectives. Significant achievements in financial reforms including strengthening of the banking supervision capabilities of the Reserve Bank have enhanced its credibility and instrument independence. It has been pointed out by some experts that the Reserve Bank, though not formally independent, has enjoyed a high degree of operational autonomy during the post-reform period.

In terms of redefining the functions of the Reserve Bank, enabling a movement towards meaningful autonomy, Governor Jalan's statement on Monetary and Credit Policy on April 19, 2001 is a landmark event. First, it was decided to divest the Reserve Bank of all the ownership functions in commercial banking, development finance and securities trading entities. Secondly, a beginning was made in recommending divestiture of the Reserve Bank's supervisory functions in regard to cooperative banks, which would presumably be extended to non-banking financial companies and later to all commercial banks. Thirdly, the Reserve Bank signalled initiation of steps for separation of Government debt management function from monetary policy. These measures would enable the Reserve Bank to primarily focus on its role as monetary authority and enhance the possibility of a move towards greater autonomy.

The emerging issues relating to autonomy of the Reserve Bank can be addressed at different levels. First, at the level of legislative framework, several suggestions have been made to ensure appropriate autonomy and many of them are under consideration. In particular, proposed Fiscal Responsibility and Budget Management Bill and other amendments to Reserve Bank of India Act would cover significant ground. Several other suggestions relating to legal framework, as recommended by the Advisory Groups are yet to be taken up.

Second, at the policy level, there are three important constraints on the operational autonomy even within the existing legal framework. One, the continued fiscal dominance, including large temporary mismatches between receipts and expenditures of Government warranting large involuntary financing of credit needs of Government by the Reserve Bank. Two, the predominance of publicly owned financial intermediaries and non-financial public enterprises, which has created a blurring of the demarcation between funding of and by Government *vis-à-vis* public sector as a whole. Three, the relatively underdeveloped state of financial markets partly due to legal and institutional constraints, which blunts the effectiveness of instruments of monetary policy. These issues need to be resolved to enhance genuine autonomy.

Third, at the operational and procedural level, there is a problem of "old habits die hard". In a deregulated environment, there is considerable scope to reduce micro-management issues in the relations between the Government and the Reserve Bank. At the level of degree of transparency, there is a temptation to continue, what has been termed as the "joint-family approach"; which ignores basic tenets of accounting principles in regard to transactions between the Reserve Bank and Government.

### **Some Critical Elements for Progress in Reform**

In spite of difficulties in prioritising the elements relevant for reform, an attempt is made to mention some elements which present themselves as critical in the light of experience gained so far. First, as elaborated in Governor Jalan's recent statements on Monetary and Credit Policy,

several legislative measures are needed to enable further progress. These relate in particular, to ownership, regulatory focus, development of financial markets, and bankruptcy procedures.

Some of the serious shortcomings in the anticipated benefits of reform such as in credit delivery do need changes in legal and incentive systems. In particular, there is need to focus on reduction of transaction costs in economic activity, and enhancing economic incentives. Severe penalties in law, including criminal proceedings, may not be substitutes for increasing enforceability (*i.e.*, probability of being caught, prosecuted, and punished adequately and in a timely fashion). In regard to institutions, there is need to clearly differentiate functions of owner, regulator, financial intermediary and market participant, to replace the joint-family approach that is a legacy of the pre-reform framework.

Second, fiscal empowerment appears to be essential for obvious reasons. While the existing level of fiscal deficit may be manageable, the headroom available for meeting unforeseen circumstances appears rather limited. The problem is somewhat acute in regard to finances of states, which have serious structural problems and their resolution is possible only through accelerated fiscal support from Central Government consistent with the fiscal soundness of Central Government. Some of the legal reforms may also be necessary for this purpose and the link for further progress in the financial sector is obvious. In particular, the nature of fiscal dominance does constrain the effectiveness of monetary policy to meet unforeseen contingencies as well as maintain price stability and contain inflationary expectations.

Third, the reforms in the real sector are needed to bring about structural changes in the economy. The liberalization of financial sector and of external sector can provide impetus for further growth and in turn help more rapid progress only when accompanied by reforms in the real sector, particularly in domestic trade.

Fourth, there are what may be termed as 'overhang' problems in the financial sector, such as non-performing assets of banks and financial institutions. There are similar overhang problems in other areas as well, and it is necessary to make a distinction between what may be termed as flow issues and overhang issues. There is merit in insulating the overhang problem from flow issues and demonstrably solve the flow problem upfront. For example, in regard to food stocks there is addition to buffer stocks virtually on a continuous basis and a policy needs to be evolved to tackle this flow. Any attempt to sort out the overhang accumulated excess stocks on an *ad hoc* basis would obviously have limited success. Any solution to the overhang problem of large magnitude is bound to be operational over the medium-term and may involve admission of the magnitude of possible losses to be incurred. Yet another example relates to the power sector, where addition to capacities to generate without ensuring cost recovery adds to the problem of accumulated losses. *Prima facie*, the major areas with considerable overhang problems apart from the financial sector are public enterprises, pension and provident fund liabilities and the cooperative sector. The criticality of the issue is in terms of their cumulative impact on financial sector as a whole.

Fifth, it will be useful to distinguish between what a financial sector can contribute and what fiscal action can contribute to matters relating to poverty alleviation. In the interest of efficiency and stability of financial sector, intermediation may have to be progressively multi institutional

rather than wholly bank-centred. Social obligations may have to be distributed equitably among banks and other intermediaries but that would be difficult to achieve in the context of emerging capital markets and relatively open economy. In such a situation, banks which are special and backbone of payment systems, may face problems if they are subject to disproportionate burdens. Hence, mechanisms have to be found to reconcile these dilemmas.

Furthermore, monetary policy is increasingly focused on efficient discharge of its objective including price stability, and this no doubt would help poverty alleviation, *albeit* indirectly, while the more direct attack on poverty alleviation would rightfully be the preserve of fiscal policy. Monetary and financial sector policies in India should perhaps be focusing increasingly on what Dreze and Sen call “growth mediated security” while “support-led security”, mainly consisting of direct anti-poverty interventions are addressed mainly by fiscal and other governmental activities.

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**1 The Reserve Bank has enunciated that in processing specific proposals for the movement towards universal banking from concerned institutions, the overwhelming consideration would be to meet the strategic objectives of the concerned financial institution for meeting the varied needs of different categories of customers, while at the same time, ensuring healthy competition in the financial system through transparent and equitable regulatory framework applicable to all participants in the banking business. In such a situation, particular attention would be paid to the primary need to ensure safety of public deposits, especially of small depositors, and to promote the continued stability of the financial system as a whole, and of the banking system, in particular.**

**2 As at end-March 2001, as many as 95 out of the 100 scheduled commercial banks (except Regional Rural Banks) had CRAR of 9 per cent and above. The corresponding figures for 1995-96 were 54 out of a total of 92 banks.**

**3 The evolution of monetary policy during the nineties has been detailed in Reddy (May 2001).**