Indian Economy: Review, Prospects and Select Issues*

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I am honoured by the kind invitation of Governor Corbo to visit the esteemed Central Bank of Chile. We, in the Reserve Bank of India, deeply appreciate the gesture. Governor Corbo is respected for his lucid expositions on complex issues in various international fora. While his analysis of monetary policy challenges in Chile is a matter of interest to the central bankers, his understanding of global developments, especially of Emerging Market Economies is also appreciated. The performance of the Chilean economy over the last 15 years has attracted international interest and is often considered to be an interesting model of structural reforms, liberalisation and stabilisation. The Chilean experience with management of capital inflows and temporary recourse to unique Chilean type of tax on cross border capital flow is often discussed in both academic and policy circles.

The visit of Governor Corbo to India in January 2004 was the first by a Governor from Latin America to visit the Reserve Bank of India in the recent years. The scholarly speech that he delivered on the recent developments and prospects of the Chilean Economy was very well received in the Reserve Bank.

Today, in my presentation, there would be a brief review of the Indian economy, followed by assessment of short term and medium term prospects. I will conclude by addressing select issues in the conduct of policy in the areas of money and finance in India, as they are likely to be of interest to the audience here.

I. A Brief Review of the Indian Economy

India's Constitution adopted in 1950 had established parliamentary form of

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democracy and India has been a republic with universal adult suffrage, which has contributed to significant stability of political system. It is now a federation with 28 States and 7 Union territories. While the largest State (Uttar Pradesh) has a population of 166 million the smallest State (Sikkim) has a population of only 0.54 million. There is significant diversity in religious faiths with different States having majority of population belonging to different faiths such as Hindu, Islamic, Christian and Buddhist faiths. India is a host to the largest number of practicing Zoroastrians (of ancient Persia) in the world. There are 22 languages recognised by the Constitution of India as major languages spoken by a large section of society. While the boundaries of the States are based, by and large, on language, they have also been redrawn in the past to accommodate local aspirations. This is unique for any federation and reflects a subsisting spirit of accommodation. Furthermore, the local self-governments, right up to the village level, are mandated by the Constitution.

Growth

Sometimes India is described as a re-emerging economy since the 18th century, this 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.

Stability

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 only one serious balance of payments crisis triggered largely by the Gulf war in the early 1990s. Credible macroeconomic structural and stabilisation 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, the Russian crisis during 1997-98, 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 vibrancy and resilience of the Indian economy.

Saving and Investment

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 23.41 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 during this period was financed by the domestic savings.

Inflation

Since independence, the inflation rate, in terms of the wholesale price index (WPI), on 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 per cent 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 5.7 per cent by the end of the financial year (as on March 31, 2007). As on May 19, 2007, the WPI inflation rate was 5.1 per cent.

Fiscal Performance

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 Reserve Bank had to facilitate the financing of budgetary imbalances from the banking system as also through monetary accommodation. As interest rates were administered and not market determined, the interest rates on public debt were kept artificially low. By the early 1990s, as the budgetary imbalances became unsustainable, percolating into the overall macroeconomic imbalance and financial repression ensued, the Government had to initiate a programme of stabilisation and structural reforms, *inter alia*, to bring down the budgetary imbalances.

A major landmark in the interface of the Reserve Bank with fiscal developments was the Supplemental Agreement between the Reserve Bank and the Government to terminate the process of automatic monetisation through phasing out of *ad hoc* Treasury Bills and introduction of a system of Ways and Means (WMA) advances from April 1997. However, the Reserve Bank continued to participate in the primary market by privately placing/devolving the issues of government securities on its own account in the market. Subsequently, however, under the provisions of the Fiscal Responsibility and Budget Management (FRBM) Act, 2003, the Reserve Bank no longer participates in the primary market auctions of the government securities since April 2006.

The Government of India is pursuing the path of rule-based fiscal consolidation from the year 2004-05 under the FRBM Act, 2003 and FRBM Rules, 2004. The underlying purpose of the targets set under this legislative mandate has been 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 zero 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 FRBM targets by 2008-09 and remain at those levels in 2009-10.

External Sector

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.

After the Independence in 1947, higher imports and capital outflows, led by partition, resulted in significant deficit in the balance of payments necessitating running down of the accumulated sterling balances. However, the signs of strain in the balance of payments were clearly visible from the Second Five Year Plan (1956-61) onwards. Though the devaluation of 1966 brought to the fore the problems associated with the overvalued exchange rate, it did not bring immediate desired improvement in the balance of payments position. The remittances from Indians working abroad became a new source of meeting the growing financing needs in the 1970s. However, the second oil price shock during 1979-80 proved to be the precursor of another phase of strain on India's balance of payments.

In the aftermath of the balance of payment crisis in the early 1990s, several stabilisation and structural reform measures were undertaken. The hallmark of the reform process has been a gradual, cautious approach that incorporated a careful sequencing and phasing across different sectors of the economy. Recognising the macroeconomic implications of volatility associated with capital flows, India has adopted a policy of managing the capital account with a preference for non-debt flows. Consistent with the principle of hierarchy of capital flows, India has been making efforts towards encouraging more inflows through FDI and enhancing the quality of portfolio flows by strict adherence to 'Know Your Investor' principle. Going forward, the pace of further liberalisation will critically depend on the reforms in real and fiscal sectors as also global developments.

In the recent period, India's external sector has become resilient with the current account deficit being maintained at modest levels after a few years of marginal surplus during 2001-02 to 2003-04. 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 per cent of GDP; however, the current account deficit is under 1.5 per cent of GDP, mainly due to the knowledge and competitive advantage we have in services and the steady support from remittances from Indians working abroad.

Financial Sector

The experience during the initial period after Independence shows that institution building and development of the financial system was propelled by the needs of the country's central planning. It was considered necessary to ensure that sectoral needs of credit to agriculture and industry were met in accordance with the Plan priorities. The Reserve Bank was vested with the major responsibility of developing the institutional infrastructure in the financial system. With a view to expand the outreach, the 14 largest commercial banks were nationalised in July 1969 as a major step to ensure adequate credit flow into genuine productive areas in conformity with Plan priorities. Again in 1980, six more private sector banks were nationalised, thus further extending the domain of public control over the banking system.

Since the beginning of the reform period in 1991, the approach towards the financial sector in India has been to move away from financial repression and consistently upgrade the system by adopting the international best practices through a consultative process. Financial sector reforms were carried out in two phases. The first phase of reforms was aimed at creating market-oriented financial institutions operating in an environment of operational flexibility and functional autonomy. The focus of the second phase of financial sector reforms has been on strengthening of the financial system consistent with the movement towards global integration of financial services.

Major policy measures during the reform of the banking sector include phased reductions in statutory pre-emption like cash reserve and statutory liquidity requirements and deregulation of interest rates on deposits and lending, except for a select segment. The diversification of ownership of banking institutions is yet another feature which has enabled private shareholding in the public sector banks, through listing on the stock exchanges, arising from dilution of the Government ownership. On account of healthy market value of the banks' shares, the capital infusion into the banks by the Government has turned out very profitable for the Government. Foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to the prescribed guidelines. There have been new banks, new instruments, new windows, new opportunities and, along with all this, new challenges. Banks have been provided significant freedom in their resource allocation through working of the market mechanism. The Reserve Bank has endeavoured to establish an enabling regulatory framework with prompt and effective supervision, and development of legal, technological and institutional infrastructure.

The co-existence of the public sector, private sector and the foreign banks has generated competition in the banking sector leading to a significant improvement in efficiency and customer service. The share of private and foreign banks in total assets increased to 27.6 per cent at end-March 2006 from 24.7 per cent at end-March 2005 and less than 10.0 per cent at the inception of reforms.

Currently, all scheduled commercial banks are compliant with the minimum

capital adequacy ratio (CRAR) of 9 per cent. The overall CRAR for all scheduled commercial banks stood at 12.4 per cent at end-March 2006. The overhang of gross non-performing assets of scheduled commercial banks has declined from 8.80 per cent of advances in 2002-03 to 3.30 per cent in 2005-06. Operating expenses as a ratio of total assets of Indian scheduled commercial banks has declined from 2.24 per cent in 2002-03 to 2.11 per cent in 2005-06.

As development of the financial markets is an ongoing process, initiatives to further deepen and widen the various segments of the financial markets would have to be continuously pursued. Since the overall objective of maintaining price stability in the context of economic growth and financial stability will remain, the effort will be to harmonise the deregulation and liberalisation of financial markets with the domestic developments in real as well as fiscal sectors and global developments in international financial architecture.

II. Prospects

Short-Term Prospects

The distinguishing feature of India's macroeconomic performance in 2006-07 has been the strong acceleration of growth. Industry and services, comprising over 80 per cent of the economy, registered double-digit growth. While there seems to be evidence of structural changes taking place in the economy, there are indications that the upsurge of demand pressures in 2006-07 may contain a cyclical component. As regards structural changes, first, the recent growth momentum is driven by a step-up in the investment rate, which, in turn, is supported by a sizeable increase in the rate of gross domestic saving. This noteworthy improvement is attributable mainly to a distinct increase in corporate saving and turnaround in public sector dis-saving from 2003-04 onwards, while household saving continues to remain the mainstay of gross domestic saving. Second, India's linkages with the global economy are getting stronger, underpinned by the growing openness of the economy. Third, there is evidence of improvements in total factor productivity and the efficiency of capital use.

There are cyclical factors also underlying the recent growth experience. First, robust global GDP growth, which exhibited four years of strong expansion, has been supportive of high growth in India. Second, the persistent high growth in bank credit and money supply, the pick-up in non-oil import growth and the widening of the trade deficit in recent years together indicate upside pressures on aggregate demand. Third, cyclical forces are also evident in the steady increase in prices of manufactures, resurgence of pricing power among corporates, indications of wage pressures in some sectors, strained capacity utilisation and elevated asset prices.

It is important to assess India's recent macroeconomic performance against the evolving configuration of risks, which are likely to shape the outlook. First, the buoyant growth in industry and services has been somewhat marred by the setback to agriculture which has suffered substantial deceleration and volatility. It is now widely recognised that the performance of agriculture is critical not only for output and

employment but also, particularly for price stability. While over 60 per cent of the workforce is dependent on agriculture, the sector accounts for barely 20 per cent of the GDP.

Second, alongside shortfalls in agricultural performance, large gaps have emerged in the physical infrastructure. Rapid growth in demand for infrastructure with a less than proportionate supply response in the prevailing investment climate has resulted in stretching of the capacity utilisation in electricity generation, roads, ports and major airports.

Third, domestic developments in 2006-07 in terms of firming up of inflation through the year, led mainly by rising prices of primary articles, has been a matter of concern.

Monetary and financial conditions are reflecting these demand-supply gaps as well as the onset of a durable pick-up in aggregate spending. The acceleration of growth in the real sector has been reflected in the upward shift in the growth trajectory of non-food credit extended by commercial banks. The expansion in non-food credit at 29.8 per cent in the period 2003-04 to 2006-07 is unprecedented in the history of the Indian economy. There has been some sign of deceleration in the recent period as growth in year on year non-food credit was 27.2 per cent as on May 11, 2007 as compared with 32.3 per cent during the same period last year.

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 23.3 per cent as on May 18, 2007 on year on year basis (20 per cent a year ago).

Similarly, the high credit growth in the recent period has led the money supply growth to remain high averaging 16.7 per cent during 2003-07. During 2006-07, the money supply grew by 20.7 per cent. As on May 11, 2007, the growth in money supply on year on year basis was 20.2 per cent (18.2 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.

Monetary policy in India has to also contend with the burden of challenges emanating from other sources. First, it is recognised that monetary policy has to contend with the high level of public debt and fiscal deficit. While the recent improvements in the fiscal position of States and significant consolidation in the finances of the Centre have to some extent alleviated the situation, the fiscal position may need further strengthening as we proceed with further liberalisation of financial sector and capital account. Second, in the recent period, the enduring strength of foreign exchange inflows has complicated the conduct of monetary policy, as such inflows can potentially reduce the efficacy of monetary

policy tightening by expanding liquidity. Third, in India, levels of livelihood of large sections of the population are inadequate to withstand sharp financial fluctuations, which impact real activity. Accordingly, monetary policy has to also bear the burden of protecting these segments of the economy from volatility in financial markets often related to sudden shifts in capital flows. Fourth, a situation in which aggregate supply is less than elastic domestically imposes an additional burden on monetary policy. While open trade has expanded the supply potential of several economies, it does not seem to have had any significant short-term salutary effect on some supply elasticities.

The operation of monetary policy in India is also constrained by some uncertainties in transmission of policy signals to the economy. First, despite the progressive deregulation since the early 1990s, some categories of interest rates continue to be administered, thereby muting the impact of monetary policy on the structure of interest rates. Second, external sector management is complicated by the incentives for some elements of capital flows provided by public policy setting. Thus, the magnitudes and direction of capital flows to select sectors in the domestic economy are beset with uncertainties in regard to the global and domestic environment not necessarily related to economic fundamentals or the monetary policy setting. Third, the operation of monetary policy has to be oriented around the predominantly public sector ownership of the banking system which plays a critical role not only in the transmission of monetary policy signals but also in other public policy considerations.

Overall, the Reserve Bank projects 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.

Medium-Term Prospects

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. While half of the increase in investment is expected to come from private investment in farms, small and medium enterprises and in the corporate sector, the rest is estimated to emanate from public investment with a focus on the infrastructure sector. The higher level of investment is proposed to be financed by some combination of increased domestic savings and increased foreign savings. A significant portion of the required increase in domestic savings is expected to come from an improvement in government savings. Household savings and private corporate savings can also play a major role in this regard.

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 Rs. 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.

The Approach Paper to the 11th Five year Plan suggests that growth target for industrial sector and manufacturing sector could be placed at 10 per cent and 12 per cent, respectively during the Plan period. This is based on the assumption that India has also the potential of emerging as a favoured manufacturing destination of the world especially in respect of certain manufacturing activities, characterised by entrepreneurial dynamism and cost competitiveness.

The services sector in the country has benefited from the availability of vast skilled labour and is expected to continue to lead the economy, drawing from its linkage with the well performing industrial sector and expanding international trade. The Approach Paper puts special focus on services sector so that its potential to create employment and growth is fully realised.

There is commitment on the part of the Government to pursue the process of fiscal correction and consolidation. The task ahead for the Central Government is to achieve the FRBM targets, especially the elimination of revenue deficit by 2008-09. Favorable factors towards this end are buoyancy in tax-GDP ratio and turnaround in public sector dis-saving from 2003-04 onwards.

To reap the rewards of demographic dividend, public policy has a critical role to play towards creating a quality social infrastructure in terms of education and health and also generate employment which can help the easy and productive absorption of the prospective ''youth bulge''.

The Approach Paper emphasises further financial innovation, particularly the insurance and pension sectors, which are considered to be good sources for meeting the long-term-financing requirement of the infrastructure sector. The policy approach being followed is likely to ensure greater outreach of banking business, and also, in the present scenario of high growth, enable the banks to usefully lend to the disadvantaged sections and successfully pierce the informal credit segment.

II. Select Issues in the Conduct of Policy

Multiple Objectives

The preamble to the Reserve Bank of India Act, 1934 sets out the Bank's objectives as "to regulate the issue of Bank notes and the 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". Although there is no explicit mandate for price stability, as is the current trend in many countries, the objectives of monetary policy in India have evolved as those of maintaining price stability and ensuring adequate flow of credit to the productive sectors of the economy. In essence, monetary policy aims to maintain a judicious balance between price stability and economic growth. The relative emphasis between price stability and economic growth is governed by the prevailing circumstances at a particular time and is spelt out from time to time in the policy announcements of the Reserve Bank. Financial stability, subsumed in monetary stability, has gained in importance since the second half of the 1990s.

The Reserve Bank discharges the functions of debt manager and banker to the government of India and the State governments. Regulation and supervision of banks and non-banking financial companies are also assigned to Reserve Bank. In addition to management of current and capital account transactions of external sector, development and regulation of the money, government securities and forex markets are also the functions of the Reserve Bank. Payment systems also fall within the purview of the Reserve Bank.

Measurement and Targeting of Inflation

An appropriate inflation indicator should reflect price changes of the constituent items accurately and provide some understanding of the headline inflation. The consumer price index (CPI) is generally favoured as an indicator of inflation for monetary policy. Given the widely differing consumption baskets as between the rich and the poor, between the rural and the urban areas and even across regions in India, a single CPI index could be less representative. Hence, a measure of producer prices to which the wholesale price index (WPI) is akin, is currently treated as more representative and familiar across the country. However, the growing importance of services in the consumption basket makes the WPI less representative. There are occasions when divergence between WPI and CPI is larger than usual. In view of these considerations, we do monitor and disseminate all the CPI indicators, while using this as relevant information for policy formulation. In parallel, we are doing technical work on computing a Harmonised Consumer Price Index, and we are in consultation with the government in this regard.

It is increasingly recognised that monetary policy should be associated with managing inflation expectations also. The guiding criterion for inclusion of a variable in the inflation indicators panel would be the information content on future inflation. We are now actively working on collecting information relating to real- sector indicators of future inflation, such as variability of output around trend/potential, capacity utilisation, inventory, corporate performance,

industrial/investment expectations and other indicators of aggregate demand.

In India, we have not favoured the adoption of an explicit inflation-targeting framework for several reasons. First, the monetary policy in India has the twin objectives of growth and price stability but the relative emphasis between the two keeps varying depending upon the circumstances. Second, we have had a record of moderate inflation, with double digit inflation being the exception, and largely, socially unacceptable. Third, the adoption of inflation targeting requires the existence of an efficient monetary transmission mechanism through the operation of efficient financial markets and absence of interest rate distortions. In India, although the money market, government debt and forex markets have indeed developed in recent years, they still have some way to go, whereas the corporate debt market is yet to develop. Though interest rate deregulation has largely been accomplished, some administered interest rates still persist. Fourth, in an economy as large as that of India, with numerous regional differences, and continued existence of market imperfections in factor and product markets across regions, the choice of a universally acceptable measure of inflation is also difficult. Fifth, inflationary pressures often emanate from significant supply shocks related to the effect of the monsoon on agriculture in addition to oil prices.

We do not have the concept of core inflation but for purposes of analysis as well as articulation, we identify the impact of fuel- and food-price shocks. These two items are often subject to shock – both external and domestic. The two items also have a large weight in the basket, especially of consumption. It is also difficult, *ex ante*, to differentiate between the shock and the permanent components.

We, in the Reserve Bank, since three years, have nevertheless articulated, with significant impact, tolerance limit of inflation at around 5 per cent. That has since been embedded in inflation expectations as noticed in severe adverse reactions when WPI exceeded 5 per cent. In the Reserve Bank's Annual Policy of 2007-08, we indicated a self-imposed informal inflation mandate over the medium term to be in the range of 4.0 to 4.5 per cent. The goal is to anchor inflation expectation in India so as to align them with the global levels, as soon as possible for ensuring smooth economic integration with the global economy.

Use of Prudential Measures

Financial stability has emerged as one of the key considerations in the conduct of monetary policy. The Reserve Bank has adopted a two-track approach in the pursuit of financial stability. First, by ensuring monetary stability through lowering of inflation, it has lowered inflationary expectations, thereby fostering financial stability. Second, the Reserve Bank has applied a multi-pronged strategy, to promote stability of financial institutions, financial markets and the financial infrastructure. The stable economic regime, combined with the macro financial oversight of the financial system, has imparted confidence to market players to conduct their business in an orderly manner.

In India, rising economic activity has propelled non-food credit growth above

30 per cent since 2004-05. Substantially high credit growth has been observed in sectors such as real estate and consumer credit leading to sharp escalation in asset prices and strains on credit quality. The policy response has been in terms of prescribing higher provisioning and assigning higher risk weights to sectors where the price rise has been exorbitant, as a supplement to monetary policy measures.

There is a growing support for the more contemporary, pragmatic view advocating the use of prudential regulation as a policy response, to dampen excessive credit growth in pursuit of financial stability.

Single vs. Multiple Regulators

In India, as in the case of many other countries, there are several agencies entrusted with the task of regulation and supervision of different institutions and market participants in the financial sector. The Reserve Bank regulates and supervises the major part of the financial system through its various departments under the provisions of the Banking Regulation Act, 1949 and the Reserve Bank of India Act, 1934. Its supervisory domain covers Commercial Banks, Non-Banking Financial Companies (NBFCs), Urban Cooperative Banks (UCBs) and some of the All-India Financial Institutions (AIFIs). Some of these AIFIs, in turn, regulate and/or supervise other institutions in the financial sector. Thus, the Regional Rural Banks (RRBs) and Central and State Cooperative Banks are supervised by the Reserve Bank of India through National Bank for Agriculture and Rural Development (NABARD); State Financial Corporations (SFCs) through the Industrial Development Bank of India (IDBI) (since transferred to SIDBI) and the Housing Finance Companies through National Housing Bank (NHB).

Since 1992, the Securities and Exchange Board of India (SEBI) regulates the capital markets and supervises several institutions such as the Stock Exchanges, Mutual Funds, Asset Management Companies, securities dealers and brokers, Merchant Bankers and Credit Rating Agencies. The SEBI regulates venture capital funds also. The entities in the insurance sector are regulated by the Insurance Regulatory and Development Authority (IRDA) since 1999. Banks are permitted to be involved in insurance activity through joint ventures, equity participation and agency-type arrangements. An apex regulatory body for pension funds, *i.e.*, the interim Pension Fund Regulatory and Development Authority (PFRDA) has been set up in 2004. The Ministry of Corporate Affairs (MCA) regulates the deposit taking activities of non-banking non-financial companies and also some of the activities of the NBFCs.

There are several mechanisms in India by which coordination amongst the regulators in the financial system is ensured. First, there is exchange of information amongst the regulators on a routine basis and on occasions through special request. Secondly, there is a High Level Co-ordination Committee on Financial and Capital Markets presided over by the Governor, Reserve Bank with which the Finance Secretary; Chairman, SEBI; Chairman, IRDA and more recently, Chairman, PFRDA are associated as members. The High Level Committee has constituted a Standing Working Group to enable coordination amongst the Ministry of

Finance, Reserve Bank and SEBI at the operating level and to assist the Committee in its deliberations. Finally, while nominees of Ministry of Finance and Ministry of Corporate Affairs are on the Board of SEBI along with a Deputy Governor of the Reserve Bank, the Finance Secretary is a member (without the voting rights) of the Board of Directors of the Reserve Bank.

Banking Sector Reforms through Rebalancing

There are some unique aspects of banking sector reform in India. There has been no banking crisis in the Indian economy. The reform process can best be described as gradual rebalancing of the banking sector to enhance efficiency and stability. The overhang problems were managed internally without recourse to Asset Reconstruction Company (ARC). Some of the salient aspects of the banking sector reforms in India are briefly enumerated here.

First, the reform measures were initiated and sequenced to create an enabling environment for banks to overcome the external constraints – which related to administered interest rate regime, high levels of pre-emption through reserve requirements, and credit allocation to certain sectors. The interest rates in the banking system have been largely deregulated except for a few categories, *viz.,* savings deposit accounts, non-resident Indian (NRI) deposits, small loans up to Rs. 200 thousand and export credit. However, the administered interest rates prevail in small savings schemes of the Government. The statutory reserve requirements have also been progressively reduced while the norms for priority sector lending have been rationalised.

Second, as against the overwhelming dominance of the Public Sector Banks in the banking system in the pre-reform period, the share of the public sector banks in the aggregate assets of the banking sector has declined from 90 per cent in 1991 to around 75 per cent in 2000, while the share of wholly Government-owned public sector banks declined sharply from about 90 per cent to less than 10 per cent of aggregate assets of all scheduled commercial banks during this period. Diversification of ownership has led to greater market accountability and improved efficiency.

Third, with a view to enhance efficiency and productivity in the banking sector through competition, the private sector and the foreign-banks were allowed more liberal entry. Since 1993, twelve new private sector banks have been set up. As a major step towards enhancing competition in the banking sector, foreign direct investment in the private sector banks is now allowed up to 74 per cent, subject to conformity with the guidelines issued from time to time.

Fourth, consolidation in the banking sector has been another feature of the reform process, which also encompassed the Development Financial Institutions (DFIs), which have been providers of long-term finance. The Reserve Bank enabled the reverse-merger of a large DFI with its commercial-banking subsidiary, which was a major initiative towards universal banking. Subsequently, another large term-lending institution has been converted into a bank. The mergers between non-banking financial

companies and banks as also between private sector banks are now permitted, subject to the Reserve Bank guidelines. The underlying principles for consolidation would also apply, as appropriate, to the public sector banks, subject to the provisions of the relevant legislation.

Fifth, impressive institutional and legal reforms have been undertaken in relation to the banking sector. In 1994, a Board for Financial Supervision (BFS) was constituted comprising select members of the Reserve Bank Board with a variety of professional expertise to exercise 'undivided attention to supervision'. The BFS ensures an integrated approach to supervision of commercial banks, development finance institutions, non-banking finance companies, urban cooperatives banks and primary dealers. It provides direction on a continuing basis on regulatory policies including governance issues and supervisory practices.

A Board for Regulation and Supervision of Payment and Settlement Systems (BPSS) has also been recently constituted to prescribe policies relating to the regulation and supervision of all types of payment and settlement systems, set standards for existing and future systems, authorise the payment and settlement systems and determine criteria for membership to these systems.

The Credit Information Companies (Regulation) Act, 2005 and the Government Securities Act, 2004 have been enacted. Certain amendments are also being considered by the Parliament to enhance Reserve Bank's regulatory and supervisory powers.

Sixth, a number of measures for enhancing transparency in the banking sector, through disclosures standards, have been instituted. Illustratively, all cases of penalty imposed by the Reserve Bank on the banks as also directions issued on specific matters, including those arising out of inspection, are placed in the public domain.

Seventh, in the regulatory framework and supervisory practices, which have almost converged with the best international practices, two points are noteworthy. First, the minimum capital to risk assets ratio (CRAR) has been kept at nine per cent, *i.e.*, one percentage point above the international norm; and second, the banks are required to maintain a separate Investment Fluctuation Reserve (IFR) out of profits, towards interest rate risk. The IFR has helped in cushioning the valuation losses required to be booked by the banks in a rising interest rate environment.

As regards the implementation of Basel II framework for capital adequacy, a differentiated approach has been adopted in respect of commercial, cooperative and Regional Rural Banks (RRBs) – keeping in view the significant divergence in their size, operational complexity, their criticality for the financial sector and the need to achieve greater financial inclusion. Thus, the capital adequacy norms applicable to these entities have been maintained at varying levels of stringency and one might say that we are adopting a three-track approach with regard to capital adequacy rules. On the first track, the commercial banks are required to maintain capital for both credit and market risks as per the Basel I framework; on the second track, co-operative banks are required to maintain capital for credit risk

as per the Basel I framework and surrogates for market risk; on the third track, the RRBs have a minimum capital requirement, which is, however, not on par with the Basel I framework.

As regards the timeframe for implementation of Basel II framework, the foreign banks operating in India and the Indian banks with foreign branches are required to adopt the Standardised Approach for credit risk and the Basic Indicator Approach for the operational risk, with effect from March 31, 2008. All other commercial banks are required to adopt these approaches not later than March 31, 2009.

Eighth, the regulatory framework in India is increasingly focusing on ensuring good governance through 'fit and proper' owners, directors and senior managers of the banks. Transfer of shareholding of 5 per cent and above requires acknowledgement from the Reserve Bank and such significant shareholders are put through a `fit and proper' test. Banks are required to screen the nominated and elected directors through a nomination committee to satisfy `fit and proper' criteria. The directors are also required to sign a covenant indicating their roles and responsibilities. The Reserve Bank has issued detailed guidelines on ownership and governance in private sector banks emphasising diversified ownership. The listed banks are also required to comply with governance principles laid down by the SEBI – the securities-markets regulator.

Concluding Remarks

The developments in the Indian economy are attracting global attention for several reasons, such as size of the economy, recent acceleration in growth, maintenance of stability, impressive productivity increases, demographic dividend, *etc.* The contours of public policy have been predominantly domestically designed to suit the country context while harmonising with the global best practices. There are, no doubt, many challenges, specially those relating to poverty, literacy and health care, which demand high priority. We are trying to address these issues in a democratic set up through a participative process. We are appreciative of the global understanding and support for our endeavour. In this light, I wish to express my appreciation to the Governor Corbo for having invited me to brief you on our journey towards inclusive growth. I am also thankful for the excellent arrangements made and the courtesies extended to me by the Central Bank of Chile.