*Financial Sector Policies for Growth and Employment**

Y.V. Reddy

I am thankful to Governor Burhanuddin Abdullah for inviting me to participate in the Annual International Seminar 2007. We deeply appreciate the excellent arrangements, warmth and hospitality of Bank Indonesia. In particular, special thanks are due to Deputy Governor, Ms. Miranda Goeltom. I also sincerely appreciate the thoughtful selection of the topics for discussion during this Seminar, which are of significant contemporary relevance to all of us.

The role of financial sector policies in growth and employment would naturally have significant relationship with the institutional arrangements for overall public policy of the country concerned. The framework and conduct of policy would also be specific to the country or society concerned and would vary, over time, in response to changing economic developments, in general, and financial sector developments, in particular. My comments today would, therefore, be confined to the Indian experience and capture the changing role of financial sector policies of Reserve Bank of India (RBI) in the context of ongoing economic reforms.

Monetary Policy

In India, the objectives of monetary policy have been clearly enunciated as price stability along with provision of adequate credit for productive purposes. Thus, growth as one of the two objectives is part of our mandate, but the relative emphasis in policy operations would depend upon the circumstances and is articulated from time to time. It is often said that the best anti poverty programme in India is maintenance

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of price stability since a large part of the work force is in the unorganised sector, with little or no hedge against inflation. In recent years, the strong growth environment coupled with increases in prices of oil and food items have required added emphasis on price stability, especially inflation expectations.

As articulated in the recent monetary policy statements of the RBI, the poor tend to reap the benefits of high growth with a time lag while rises in prices affect them instantly. In the short term, the impacts of high growth and price rises are asymmetrical between the non-poor and the poor, warranting a greater emphasis on price stability at this juncture of high growth for maintaining social accord as well as securing popular mandate for the reform process itself. In his welcome address, Governor Abdullah mentioned about the issue of inequalities in the context of globalisation and importance of central banks' commitment to stability and conducive environment for business.

Similarly, in regard to financial stability also, we note that most of the active participants in financial markets are non-poor. To the extent there are externalities in terms of financial sector - both positive and, on occasions, negative - the weight for stability in our policies has been higher in view of limited capacity of the poor to bear risks that may occur in the real sector by virtue of developments in the financial sector. The lack of social security mechanisms and public safety nets in India are also relevant. The design and pace of liberalisation of financial sector in India thus takes into account the due weight for stability.

Regulation and Development of Financial Markets, Institutions, Technology, *etc.*

To enhance efficiency and stability of the financial system and thus contribute to growth and employment, several steps have been undertaken for widening, deepening and integrating financial markets although it is 'work in progress'. Simultaneously, new processes and institutional arrangements have been put in place in regard to the banking sector, deposit-taking non-banking financial companies and systemically important non-deposit-taking non-banking financial companies. By and large, these initiatives, in particular supervisory systems, are in alignment with the global best practices, but there are dynamic trade offs between public ownership of financial institutions, regulation, financial innovation, *etc.* Similarly, several steps have been taken to enhance use of technology and market micro-structures in the financial sector. The financial sector policies are continuously evolving, essentially in a proactive manner. Medium term frameworks or vision documents have been formulated in each of these areas since 2004 and are being implemented through a continuous process of consultations with market participants and industry associations (some of which were established with encouragement from RBI). The thinking as well as the progress in actions in this regard are articulated through RBI's Annual Policies and Mid Term Reviews.

Cost of Credit

In the past, as part of the pervasive regime of administered interest rates, banking and financial institutions were providing loans on concessional terms to certain sectors and also certain categories of borrowers, leading to significant cross-subsidisation. The credit allocation by banks was also directed to many such sectors/ borrowers through various prescriptions. The RBI had also been contributing regularly to Long-Term Operations (LTO) Funds to refinance industrial or agricultural development, generally on concessional terms. Combined with automatic monetisation of budget deficits of the Central Government, such contributions also caused significant increases in primary or reserve money. This practice has been gradually phased-out in the recent years as part of economic reform, on the ground that, in a liberalised environment, refinance institutions should expand the avenues of raising resources from the market. However, if any of their activities result in cross-subsidisation, we believe that the Government of India should rightfully bear the primary responsibility of providing the support. Hence, RBI support, if any, for such worthy causes should be through the Government of India by way of transfer of profits. Thus, while discontinuing contributions to the LTO Funds, net transfer of profits of the RBI as dividend has increased from about Rs.200 crore (Rs.2 billion) in 1992 to Rs.11,400 crore (Rs.114 billion) in 2007.

Financial sector reform has several dimensions and of particular relevance to the issue of output and employment is the cost of credit and its availability. Interest rates have been deregulated to a significant degree not only to aid movement of monetary policy to the use of more effective indirect instruments, but also because administered interest rate regime proved to be inefficient and costly, without necessarily ensuring flow of credit to the needy. The RBI's recommended approach, however, does not preclude subsidisation by the Government but, it disfavours excessive use of banking system to cross subsidise, especially if it were to favour non-poor. RBI favours a financial system that provides incentives to encourage flow of credit at justifiable terms and conditions and for purposes that ensure servicing of interest and principal, *i.e.*, bankability of schemes.

There has been broad agreement between the Government and the RBI on the above approach, and accordingly, subsidies on interest rates through the banking system to small farmers and small exporters are currently provided for a limited period. There are several Government-sponsored programmes intended for the vulnerable sections and these are small-sized loans for which Government provides subsidy, particularly for employment generation. Thus, the financial sector, in particular the banking system, is utilised as a conduit by the Government's fiscal policy, to subsidise select activities or vulnerable sections, and RBI plays a supporting role in enabling such measures while emphasising the longer term goals of a conducive credit culture. The overall objective remains growth with stability, but with elements of selective fiscal support for ensuring inclusive and equitable growth. Currently, the aggregate annual fiscal burden of subsidisation on account of the above measures, through the financial sector, is estimated to be about a quarter per cent of GDP.

Availability and Allocation of Credit

The pre-reform period was characterised by high pre-emptions, aggregating to well over fifty per cent of bank deposits, through the prescription of cash reserve ratios and statutory liquidity ratios for banks. As part of the reform process, these rates have been progressively brought down and are currently close to thirty per cent – partly reflecting the current policy of liquidity management. Accordingly, the proportion of resources available for credit to non-governmental purposes from the banking system have thus increased substantially since the commencement of the reform process. Further, with planned improvement in revenue accounts of Centre and States and more normal liquidity conditions in money markets, there should be significant further enhancement in the proportion of bank funds that are made available for financing growth and employment in private sector.

Selective credit controls, as a means of encouraging or discouraging credit flow to select sectors, was pervasive during the pre-reform period. These have since been dismantled. However, recently, it became necessary to enhance the risk weights and provisioning requirements for bank's exposure to capital market, real estate, housing and consumer loans in order to enhance the sensitivity of banks to the potential risks arising out of rapidly escalating asset prices. The measures, which are temporary, appear to be having desirable impact on credit allocation to these sensitive sectors.

The most important instrument for influencing allocation of credit in the banking system, keeping in view the compulsion of growth and employment, has been the stipulation regarding bank's lending to priority sector. The stipulation is that forty per cent of advances in the case of domestic banks (and thirty two per cent, inclusive of export advances, in the case of foreign banks) be lent to specified priority sectors such as agriculture, small industries *etc*. As a result of financial sector reforms, there has been expansion in lendable resources. However, during the reform process, the list of eligible sectors for treatment as 'priority sector' was expanded to include investments in specified bonds and also activities such as venture capital. Several dilutions and distortions in computation of the stipulation occurred in the process. As a result, there had been a growing perception of inadequate flow of credit to the traditionally preferred sub-sectors of priority sector, namely agriculture and small industries. In order to address these concerns, a consultative and comprehensive exercise of review was undertaken and new guidelines on priority sector were issued in April 2007. Consequently, priority sector is now restricted to advances to highly employment intensive sectors such as agriculture, small industry, educational loans for students and low cost housing. The shortfalls in lending to the priority sectors will have to be, as in the past, deposited with refinance institutions dealing with agriculture and small industries. Thus, sectoral focus in credit flow, with emphasis on employment, is ensured through stipulations relating to priority sector without necessarily undermining commercial considerations in banking activities.

Sub-targets under priority sector, along with other guidelines including those relating to Government sponsored programmes, are used to encourage flow of credit to the identified vulnerable sections of population such as scheduled castes, religious minorities and scheduled tribes.

The accelerated growth in the Indian economy has benefited several States, but there are few States where credit deposit ratios of the banking system are observed to be low. It has become necessary to identify unique problems for each State for expanding banking facilities to such lagging States and formulate area specific action plans for accelerated financial deepening. These plans are drawn up with full participation of State Governments, banks and other local developmental agencies. Such plans have already been drawn up for Uttaranchal, North Eastern States, Himachal, Jharkhand, Andaman & Nicobar and Bihar. There is enthusiasm among banks in view of expanding business opportunities and significant support from State Governments which see a synergy. RBI plays a catalyst, as well as a coordinating role, in these initiatives of growing co-operation between the States and the banking system. In fact, the RBI has played active role in States' debt management, treasury management, management of Consolidated Sinking Fund, transparency in budget, computerisation of Government accounts and enactment of legislation on fiscal responsibility. The relationship between the RBI and the States is based on mutual trust and is in recognition of the credibility of the RBI.

An important component of these state-specific action plans, in some cases, have been the scope for expanded role of non-governmental organisations and other microfinance agencies. Banks, under the overall guidance of NABARD, play an active role in promoting micro-finance, especially in view of the recently approved innovative approaches, such as business correspondence models.

An area of concern has been the concentration of bank branches in metropolitan areas to the detriment of semi urban and rural areas. To mitigate this problem, since 2006, opening of new branches for any bank is approved by RBI only on condition that at least half of such new branches are opened in under-banked areas as notified by RBI. Many banks now find that the branches in semi-urban and rural areas are also commercially viable.

It is useful to note that the policy preferences of RBI in the banking sector, which are aimed to address issues of targeted allocation of credit and penetration of banking services have not adversely affected the improvements in accounting practices, reduction in non-performing assets and improvements in profitability as well as capital adequacy. It is useful to note that the valuation of bank stocks, of both public and private sector, are improving while foreign banks gather a fast increasing proportion of their global profits from Indian operations.

Beyond Credit : Financial Inclusion

In the reform process that commenced in 1992, the reform of financial sector was early in the cycle. The first stage of the process concentrated on elimination of financial repression which was followed by greater marketisation of financial sector and changes in regulatory regime, consistent with global standards. The process strengthened financial sector, improved efficiency, imparted stability and facilitated impressive growth, withstanding several global and domestic shocks. The next phase clearly was to ensure what may be termed as democratisation of financial sector. The process which was commenced two years ago aimed at ensuring hundred per cent financial inclusion. The process of financial inclusion consists of seeking each household and offering their inclusion in the banking system. The main features of the approach involve 'connecting' people with the banking system and not just credit dispensation; and using multiple channels such as civil service organisations, NGOs, post offices, farmers' clubs, panchayats, MFIs (other than NBFCs), *etc.* as Business Facilitators / Correspondents to expand the outreach of banks. Further, a decentralised approach is adopted which is state / region specific, and has close involvement and cooperation between the respective State Governments and banks.

Information technology is critical to minimising transaction costs. The Government's on-going massive programme of rural employment and pension payments *etc.* can be implemented with minimal transaction costs by recourse to financial inclusion through Information Technology Several districts have already been covered under total financial inclusion and a process of evaluation and feedback is underway. RBI is encouraging and aiding the process.

The importance of financial inclusion for Emerging Market Economies (EMEs) was expressed eloquently by Governor Tito Mboweni in the 13th C.D. Deshmukh Memorial Lecture on 2nd November 2007 in the following words :

"Then, there is the added concern that the unequal distribution of wealth brings with it a tension between the haves and the have-nots. Under these circumstances, the broadening of access to financial services becomes an important policy objective. It is well recognised that the financial inclusion of the lower echelons of society into the financial sector is a powerful contributory factor to poverty alleviation through, for example, the provision of microfinance. As the demand for consumer finance increased, a greater range of financial instruments are needed and the financial sector will need to adapt."

A beginning has been made to enhance financial literacy and impart financial education to enable vast numbers of new entrants into employment and higher incomes to better manage their finances in a rapidly marketising fincancial sector. Informed choices are preferred in the interests of the individual customers as also the financial system as a whole. In view of the surge in retail loans, especially consumer durables, and attendant debt-servicing problems for many, a beginning has been made in the establishment of credit counselling centres as a non-profit activity, by some banks.

Institutional Reforms

There was no banking crisis or currency crisis since reforms commenced in 1992.

However, it was observed that some scheduled commercial banks had inadequate capital; several urban cooperative banks were bankrupted and rural cooperative credit system deteriorated significantly. Corrective steps have been taken in recent years. The institutional reform of scheduled commercial banks reinforced governance standards and witnessed the disappearance of all who could not meet the capital adequacy standards. But, the credit needs of vast section of population, especially of unorganised sector, traders, rural areas are best met by revival, restructuring and revamping of what may be termed as community based banks. Rural areas, particularly in backward regions, are sought to be better served by restructuring an institutional mechanism, namely Regional Rural Banks (RRBs). A special programme for the revival of rural cooperatives has been launched with close involvement of RBI, National Bank for Agriculture and Rural Development (NABARD), Government of India and State Governments with a possible fiscal support to the tune of about 0.50 per cent of GDP. These reforms are considered essential to cater to the gaps in services by scheduled commercial banks, not only in banking but in other related services including forex for current account, insurance products, *etc*.

Innovative mechanisms through Memorandum of Understanding between the RBI and the State Governments to overcome issues of dual control and ensure better co-ordination, which were found to be successful when adopted for re-vamping the urban co-operative banks, have also been adopted in the ongoing programme of revival of the rural cooperative system.

Beyond Deregulation and Competition

As the reform progressed, it was assumed that deregulation and competition would enhance efficiency and ensure better than before quality of service at reasonable but competitive cost to the customers. However, while many improvements have taken place, entirely as expected, several adverse features in regard to retail customers were noticed particularly in respect of a few banks. Apart from issues of appropriate pricing, instances of unequal contracts, unfair trade practices, non-transparent fees, intrusion into privacy, excessive penalties, delays in cheque-clearing, arbitrary revision of interest rates or equated monthly instalments, usurious interest charges in some cases and excesses by loan recovery agents have been noticed warranting several institutional, policy and procedural interventions by RBI. A delicate balance between competing considerations is needed but to the extent banks have special privileges, the regulator who has granted such privileges has a responsibility to ensure financial deepening and widening in an efficient, fair and equitable manner. RBI considers delicate balances of these considerations to be critical for both growth of financial sector and a meaningful contribution of financial sector to growth and employment.

Latest Initiatives

The RBI's Mid-Term Review of Annual Policy Statement, October 30, 2007, refers to some new initiatives that are worth noting. First, an internal working group has been constituted to consider recommendations made by a Committee on

Agricultural Indebtedness (Chairman : Dr. R. Radhakrishna). Second, recommendations of a Technical Group (Chairman : S.C. Gupta) on improving the legal and enforcement framework relating to money lenders was forwarded to State Governments for appropriate consideration. Third, the National Commission for Enterprises in the unorganised sector (Chairman : Dr. Arjun K. Sengupta) submitted a comprehensive report to the Central Government. A working group is being constituted to study those recommendations which relate to the Indian financial system. Fourth, it is proposed to review the working of lead bank scheme and related arrangements of coordination between RBI, banks, NABARD, State Government at the state and district levels. The review of these institutional arrangements for development oriented banking would help design a new framework reflecting not only the new orientation such as financial inclusion, financial literacy and credit counselling, but also increasing demands of rapidly growing economy led by domestic investment, domestic consumption and export demand.

Concluding Remarks

To conclude, our experience shows that financial sector policies and instruments need to be constantly rebalanced to respond not only to financial markets, prices and overall stability considerations but also to developments in real sector, in particular trends in growth across sectors, regions and sections of population. Such a comprehensive but dynamic approach to development of the financial sector enhances contribution of financial policies to growth and employment while maintaining stability.