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Introduction

Managing Liberalisation

This volume of the history of the Reserve Bank of India (RBI) covers events during the eleven financial years from 1997–98 to 2007–08 (the 'reference period'). Over this period, the Reserve Bank faced several major external shocks and had to function in a rapidly changing economic environment within India. While the economic liberalisation process had begun in the early 1990s, key institutional and financial market reforms occurred, and integration of the Indian economy with the world economy accelerated, during the reference period.

The Bank shaped the transition, and adapted to it, by adjusting its approach to containing inflation and maintaining financial stability, focusing on financial market institutions and infrastructure, taking legal and other steps to achieve operational autonomy, making improvements in organisational capability and communication practices. It also worked not only to improve customer service in banks and the rural credit system but also to enhance financial inclusion. In all these efforts, the Bank relied on its own expertise as well as that available outside the organisation.

This is an institutional history. It thus records developments in policies and operations of the Bank in its functional areas and documents the evolution of the organisation itself. While the details of policies, operations and organisational changes appear in subsequent chapters, this introductory chapter presents a compact account of these developments during the reference period. The chapter begins with a brief review of the macroeconomic trends and political situation, followed by a review of the major areas of activity of the Bank during the reference period, and a brief chapter outline.

Backdrop

The beginning of the reference period witnessed several stressful events. The Asian currency and financial crisis (1997) posed major challenges for the policy environment in India. In the aftermath of the nuclear tests in Pokhran in May 1998, several Western nations imposed sanctions on India, leading to the partial suspension of multilateral lending, downgrading by international rating agencies and reduction in investment by foreign institutional investors.

Despite these shocks, the reference period saw robust growth of the Indian economy. Continuing from previous years, the corporate sector responded to increasing openness and global competition by improving productivity. All relevant financial parameters relating to solvency, liquidity and profitability improved. The services sector propelled overall economic growth, supported by booming software exports and advances in information technology related services. Inflation was relatively moderate, even though towards the end of the reference period, an increase in oil and food prices exerted pressure on the price level. The fiscal situation of both the central and the state governments improved after 2003, which narrowed the public sector saving–investment gap and released resources for the private sector.

Increasing openness was a defining feature of the process of change during these years. India's external sector expanded thanks to progressive liberalisation of current and capital account transactions. Growth in the invisibles, including remittances, and unprecedented capital inflows sustained the overall balance of payments position. The progressive opening of the foreign exchange market necessitated changes in the legal framework, especially the introduction of the Foreign Exchange Management Act, 1999, to replace the highly restrictive Foreign Exchange Regulation Act, 1973.

Despite several changes in government, dominated by coalitions and regional parties, the political stance was generally in favour of continuing with economic and financial sector reforms initiated in the early 1990s. Between April 1997 and March 2008, the Finance Ministry was headed mainly by three ministers, P. Chidambaram, Yashwant Sinha and Jaswant Singh. Except for the first eight months when C. Rangarajan was the Governor, during the remaining part of the reference period, two Governors, Bimal Jalan and Y. V. Reddy, were at the helm of the Reserve Bank. This situation made for a stable relationship between the Bank and the government (see Box 1.1). Some differences nevertheless surfaced in the latter half of the period in such policy areas as monetary management, exchange rate, and reserve management and the quality of capital flows.

It is well known that the government enjoys overriding statutory powers over the Bank. It is perhaps not so well known that the Reserve Bank of India

Box 1.1 Reflections on Managing Liberalisation

… when one looks at this whole period 1997 to 2008, although it covers the tenures of two governors … I see it as having been quite remarkably continuous in the sense that policies and operational matters whose direction was decided in Jalan's tenure continued in the same direction in Reddy's tenure also.

Indira Rajaraman, economist

Chidambaram, Yashwant Sinha and Jaswant Singh … we had an excellent relationship with all of them and were always in close consultation with them.

Bimal Jalan, former Governor, RBI

Between 1991 and … [the] late 1990s … our macroeconomic management benefited a great deal from having more or less the same cast of characters. People like Dr. Rangarajan, Mr. Ahluwalia, Dr. Reddy and to some extent myself … we had been in the policy game since the 1980s; so we had internalized a lot of learning and we worked well together.

Shankar Acharya, economist

Act, 1934, is the only statute among the regulatory legislations in India which requires the government to consult the Reserve Bank Governor before issuing any direction to the Bank in public interest. De facto, the Bank gained more independence from the 1990s in operating monetary policy, and in choosing the tools for doing so. There were three ways in which the Bank gained more operational autonomy in the conduct of monetary policy. First, in the early 1990s, following efforts by Governor C. Rangarajan, an agreement was signed (1994–95) that set limits on the net issue of ad hoc treasury bills, and, by 1997, ended automatic monetisation of deficits. Second, the Bank's sustained dialogue with the government led to the passage of the Fiscal Responsibility and Budget Management Act, 2003, which, among other things, prohibited the Bank from purchasing government securities in primary issues. Third, amendments to the RBI Act, 1934, and the Banking Regulation Act, 1949, led, in 2006–07, to more flexibility in the use of conventional tools of monetary policy such as cash reserve ratio and statutory liquidity ratio. In the sphere of regulation and supervision of the financial system, and in exchange rate management, the Bank and the government needed to calibrate their stances and coordinate policies often (for reflections on the autonomy of the Bank in these years, see Box 1.2).

Box 1.2 Reflections on the Autonomy of the Reserve Bank

... independence of our Central Bank is highly contextual.... [D]uring the period we were there, independence was very much in the news, but we were aware ... that we don't have absolute independence. But we had to negotiate because we wanted to move to market economy. It should be more independent than it was before but not *independent*.

Y.V. Reddy, former Governor, RBI

… in the Government, the importance of honouring the autonomy of Central Bank is not appreciated well enough.… Many people, including Finance Secretaries, some Finance Ministers … look upon the Reserve Bank of India as just another public sector institution.

D. Subbarao, former Finance Secretary and former Governor, RBI

The reference period ends just before the global financial crisis (2007–08) began in the wake of the collapse of the Lehman Brothers in the United States of America (USA). The crisis did not have serious consequences for India, as the reforms undertaken in earlier years in the areas of the exchange rate and reserve management, financial regulation and supervision, and payment and settlement systems stood India in good stead in managing the crisis.

The Reserve Bank's Activities during the Period

A short account of the Bank's activities during the period needs to distinguish eight main functional areas: monetary management; external sector policies; financial market policies; regulation and supervision; public debt management; currency management; financial inclusion, rural credit and customer service; and organisational reform. Subsequent chapters divide these eight larger themes into fourteen more specific topics.

Monetary Management

Monetary policy in India was conventionally guided by two objectives – keeping inflation under control and ensuring adequate flow of credit to the economy. Until 1997, regulation of bank credit via direct and indirect means was the most important instrument to achieve this. During the reference period, there was a shift away from administered rates towards market-driven interest rates, deregulation of credit supply, and a shift towards market-based auctions for government borrowing programmes. The Bank also intervened in the foreign exchange market and conducted both overt and covert operations through public sector banks to stabilise the market at minimum cost.

The decisive change that made the deregulation possible took place in the sphere of liquidity management, in the shape of the liquidity adjustment facility (LAF). The LAF carrying a repurchase agreement clause (repo) allows the sale and purchase operations in government securities. It operates through daily repo and reverse repo auctions, which set a 'corridor' for the short-term interest rate. It allows the central bank to modulate short-term liquidity daily and enables it to de-emphasise the targeting of bank reserves, make interest rates free of administrative control, and focus on stabilising interest rates instead.

The LAF was introduced in 2000. The reference period saw it being established, reviewed and fine-tuned. Open market operations and daily repo operations emerged as the principal instruments of liquidity management. In place of the Bank Rate, the repo rate evolved gradually into a signalling rate reflecting conditions of the money market. Many sector-specific systems of liquidity injection were abolished. There were, however, a few exceptions such as the export refinance facility, and collateralised support extended to the primary dealers (PDs) in the securities market.

While monetary policy had operated reasonably well on the domestic front, a new challenge emerged in the form of having to deal with capital flows. This was complicated by the rapid escalation in asset prices, particularly equity and real estate, driven by capital flows. These pools of capital, which were private, often opaque, highly leveraged and largely unregulated, posed threats to overall financial stability. The Market Stabilisation Scheme (MSS) was an innovation introduced in 2004 to sterilise the liquidity impact of a surge in foreign exchange inflows during the latter part of the reference period. As part of the MSS, Government of India treasury bills and/or dated securities were issued to absorb excess liquidity. The unique feature of the MSS was that the proceeds from those issues were immobilised by holding them in a separate identifiable cash account maintained and operated by the Bank.

As the financial system became more complex, the mode of monitoring economic activity and assessing the need for intervention changed. Traditionally, the Bank used M3 (broad money) as the intermediate target. After 1997, with the movement towards market operations and away from direct regulation, policy statements started to focus on movements in the financial market rates and liquidity conditions. In this way, the framework of 'monetary targeting' gave way to a 'multiple indicators approach' to managing liquidity. In the new regime, a range of monetary and financial market indicators such as credit, interest rates, exchange rates and prices began being monitored.

On the pricing of bank credit, the Bank introduced in 1994 the requirement for banks to fix and announce their own prime lending rates (PLRs), the minimum rate that would be charged for prime or best borrowers. While the system of PLR was aimed at enhancing transparency in lending rates, in practice, the system became increasingly non-transparent. The Bank introduced modifications in and flexibility on PLR, and to impart more clarity to the process, in November 2003, handed over the responsibility to issue guidelines on the benchmark prime lending rate (BPLR) to the Indian Banks Association, the reason being that such decentralisation was more consistent with the reform process and international practice. The move brought BPLR under a self-regulatory mechanism. The Bank's intent throughout was achieving transparency in the process of setting benchmark rates rather than being prescriptive.

External Sector Policies

India in the early 1990s had a closely regulated external sector. India made its current account fully convertible in 1994 and in 1997 planned to open its capital account. A committee appointed to consider this reform suggested a phased movement to capital account convertibility subject to fulfillment of certain preconditions. The Asian crisis underlined the dangers of free capital movement and required India's reform measures to be implemented with prudence. However, the drive to further liberalise was strong in the early 2000s. To rationalise many sector-specific rules and put in place risk mitigating tools, the Bank formed several committees, internal working groups and task forces. These included the Committee on Procedures and Performance Audit on Public Services (CPPAPS, 2004), Internal Technical Group on Forex Markets (June 2005), Fuller Capital Account Convertibility or Tarapore II (2006), Working Group on Rationalising Remittances (2006), Task Force on Rationalising and Simplifications of Forex Regulations (2007) and Internal Working Group on Currency Futures (2007).[1] In all cases, there was close collaboration among the regulator, market experts, settlement agencies and other stakeholders. The overall outcome was that the anomalies in the regulatory framework were reduced, and the hedging of foreign exchange exposures, rupee–foreign currency swaps, currency futures and derivative products were made easier.

The sharp rise in capital inflows into the economy, however, created four types of challenges. First, India had to confront the 'impossible trinity' (the idea that free capital movement, independent monetary policy and fixed exchange rate cannot be pursued together). The Bank sought to address the situation using unconventional macro-prudential policies. Second, the Bank continually expressed concern that the foreign institutional investors' investment in the stock market through participatory notes without disclosure of their ownership should not be permitted. Third, the Bank restrained government proposals to use foreign exchange reserves for domestic investment on legal and economic grounds. Fourth, the Bank brought more clarity into the relative responsibilities of the government and the Bank in the management of the exchange rate. Despite initiating these changes, the Bank was criticised in several quarters that its policies were too conservative. However, 'gradualism' stood India in good stead when the global financial crisis of 2008 broke out.

Financial Market Developments

There are three market segments under the purview of the Reserve Bank: the money market, government securities market and the foreign exchange market. Within the money market, the call money market occupies a strategic position by serving as the equilibrating mechanism between day-to-day surpluses and deficits in the financial markets, and by transmitting the monetary policy impulses to the financial system quickly. Since the economic liberalisation began, the three markets had become progressively integrated. A series of institutional and technological changes took the process further forward during the reference period.

The Bank actively promoted the development of the government securities market in the early 1990s to ensure smooth government borrowings to finance the deficit, facilitate the emergence of a risk-free yield curve to serve as a benchmark for the pricing of other debt instruments, and improve the effectiveness of transmission of monetary policy impulses in a deregulated environment. The reforms in the government securities market were ultimately expected to further these objectives. In this market, therefore, major reforms were undertaken, and these were supported through the LAF combined with liquidity support to PDs. The foreign exchange market grew in importance with a large inflow of foreign funds and the liberalisation of the foreign exchange regime. The market operates in close affinity with the call money market because of the day-to-day liquidity management operations of the Bank.

The money market was made purely an interbank market supplemented by a parallel process of market development. A significant initiative was the development of the repo market outside the official window for providing a stable collateralised alternative, particularly to banks and non-banks. This had the effect of money market activities migrating from the uncollateralised call market segment to the collateralised market segments of repo and collateralised borrowing and lending obligation (CBLO). The growth of repo (outside the LAF) and CBLO attracted a wide spectrum of investors such as banks, PDs, non-banks and mutual funds. Foreign institutional investors could participate in the government securities market.

The links between the domestic money and foreign exchange markets and overseas markets were facilitated by allowing banks and authorised dealers to borrow and invest funds abroad and to lend in foreign currency to companies in India. Repo turned out to be the most useful and flexible tool of short-term liquidity adjustment. The new auction-based instruments introduced were: treasury bills of different maturities, zero-coupon bonds and floating rate bonds. An inflation-indexed bond was issued. The Bank also planned to issue new instruments to the extent feasible in the form of separate trading of registered interest and principal of securities, or STRIPS. Derivative products such as forward rate agreements and interest rate swaps were introduced in July 1999 to enable banks and other institutions to hedge interest rate risks.

Institutional development facilitated market integration. The Clearing Corporation of India Ltd. was set up in 2001 to act as a central counterparty to all trades involving foreign exchange, government securities and other debt instruments routed through it and to guarantee their settlement. The Discount and Finance House of India, the Securities Trading Corporation of India and PDs could participate in more than one market, again facilitating market integration.

At the same time, significant changes were made in the payments and settlement infrastructure. At the beginning of the reference period, the payment system in India was mostly paper based. During the reference period, major advances were made in the areas of electronic funds transfer system and electronic clearing services. In 1996, the Bank set up an information technology institute dedicated to the application of technology to financial systems (Institute for Development and Research in Banking Technology, Hyderabad). A separate department, the Department of Payment and Settlement Systems, and a Board for Regulation and Supervision of Payment and Settlement Systems were in place from early 2005 to bring in a sharper focus on payment and settlement systems. The delivery-versus-payment system, the negotiated dealing system and its variants, and the real-time gross settlement system improved efficiency of the settlement process.

Regulation and Supervision

While regulation provides the policy framework to ensure solvency and liquidity of financial institutions, supervision refers to the instruments used to ensure compliance with this framework. The Bank's regulatory jurisdiction extends to commercial banks, including urban cooperative banks, non-banking financial companies (NBFCs) and all-India financial institutions. Whether the two functions can be performed by the same institution is a debated issue. Although the Bank handles both the functions, at the board level, a separate entity for financial supervision was created to avoid conflict of interest.

Consistent with the financial sector reforms, the Bank shifted towards managing competition, new entry and corporate governance. There had been a gradual move away from an administered or fixed interest rate regime to a system of flexible interest rates. Banks were given the freedom to fix their own PLRs as early as 1994. While the Bank's expectation was that the PLR would serve the objective of transmission of policy signals through changes in repo rate, the experience was not that satisfactory. As discussed earlier, by the end of the reference period, the Bank left the decision on PLR to the banks themselves.

During the reference period, a series of steps were taken to provide more operational flexibility to banks and their boards. At the same time, an emphasis was laid on corporate governance, compliance with prudential norms, provisions for market risks, classification and valuation procedures for investments, and asset classification and provisioning norms. The Bank's approach to banks' exposure to the capital market and real estate, however, remained cautious. Steps were taken to ensure that consumers could choose from a broader range of products, and the system gained efficiency from complex and new business processes, and a reformed organisational structure. These changes blurred the difference between banking and non-banking businesses to some extent.

In practice, regulatory reform involved negotiations with the government, which owned by far the largest segment of the banking system. The reforms undertaken during the reference period did produce significantly positive results. One indication of this was the limited impact that the 2007–08 subprime crisis had on India. More substantially, by all performance indicators, commercial banks improved their performance during the period.

The Bank issued detailed guidelines on ownership and governance of private sector banks. The broad principles were to ensure that ownership and control remained well diversified and that the large shareholders, directors and executives commanded trust. During the reference period, several small and under-capitalised banks were merged with other entities. The availability of sovereign guarantee gave the government-owned banks a competitive advantage. Despite a skewed playing field, private sector banks raised their share of deposits, thanks to the accent on technological change, customer service, innovative products, a younger staff and less bureaucratic decision-making.

The regulatory framework applicable to the all-India financial institutions underwent fundamental changes. The Bank played a pivotal role in effecting improvements in governance and transparency in NBFCs and urban cooperative banks. Despite occasional frictions and differences, the government shared that broad aim.

In exercising supervision, the Bank adapted global best practices to the Indian context. During the reference period, off-site surveillance of banks was broadened and made more focused. The system handled and analysed more information than before. These actions contributed to some extent to the limited impact the global financial crisis had on Indian banks. The period, however, witnessed the failure of one private sector commercial bank and a major urban cooperative bank due to fraud.

Public Debt Management

Two far-reaching changes took place in the framework of coordination between the Reserve Bank and the Government of India in the management of public debt. First, as mentioned earlier, the issuance of ad hoc treasury bills and automatic monetisation of the fiscal deficit came to an end on

1 April 1997. Second, with the enactment of the Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act), the Bank was prohibited from subscribing to the primary issues of government securities, and the government could not borrow from the Bank except by way of advances to meet temporary excess of cash disbursements over cash receipts.

The Bank also played a significant role in strengthening public debt management of the states, by, inter alia, streamlining the floatation of state government securities, administering the ways and means advances and overdraft arrangements of the states, and assisting and guiding in enacting model fiscal responsibility legislation at the state level.

Currency Management

The share of currency in broad money had fallen from 40 per cent at the end of March 1971 to 16 per cent at the end of March 2001 and fell further to 14 per cent at the end of March 2009. The long-term trend was a result of financial deepening, increased use of credit and debit cards, and more liquid financial markets. Consistent with this trend, the thrust of currency management by the Bank underwent a shift from managing volumes to improving the quality of notes in circulation, tackling counterfeit notes and making note exchange easier. The mechanisation of note processing and destruction of non-issuable currency notes became one of the major thrust areas. The last six years of the reference period saw continuous improvement in the technology of production and distribution.

Customer Service, Rural Credit and Financial Inclusion

Banking reforms and the entry of new players did not serve customer interest significantly better than before. In rural areas, often only one bank served many people, and hence the benefits of competition remained limited. Further, the legal processes for establishing customer rights and entitlements were unaffordable in time and money. To refocus attention on the consumer, the Customer Service Department came into being in 2006. The Banking Codes and Standards Board of India was set up in collaboration with banks. The aims of the Board were to prepare and publish voluntary codes and standards for banks for providing fair treatment to customers, function as an independent watchdog to ensure that the codes were followed, undertake research of codes and standards, and enter into covenants with banks on the observance of codes and train their employees. These measures succeeded in making bank managements take the customer more seriously than before. The Bank started publishing bank-wise complaints received by the Banking Ombudsman, which put pressure on banks to strengthen their own internal grievance redressal machinery so as to avoid complaints getting escalated. Financial inclusion measures saw millions of new accounts being opened. By comparison, the initiatives on financial education and credit counselling, though timely, were less effective.

The Bank is required to 'study various aspects of rural credit and development' as it may consider necessary to do so for promoting integrated rural development (Section 54 of the RBI Act). This aim was achieved by means of directed credit, mainly in the shape of 'priority sector lending'. During the reference period, the Bank pursued its goal of transforming the banking system into a strong market player while securing the interests of the priority sector. This was a tightrope walk.

Organisation

The Reserve Bank became a leaner, more dynamic and a more outward-looking organisation during the reference period, capable of handling a more diverse and challenging range of tasks with a smaller workforce. One of the ways this was achieved was by incentivising training and professionalism, restructuring the workforce, and making strategic changes in placement and recruitment policy. The Bank also began recruiting specialised staff on a contract basis, to meet the needs for new types of service. A particular problem of withdrawal of updating of pension by the Bank at the instance of the government, however, remained unresolved until the end of the reference period.

Several old departments were either wound up or merged with other departments as their functions became redundant. The Bank also divested its ownership in subsidiaries and, at the same time, new departments were set up as the need arose. The Bank management, being conscious of the crucial role of communication in the conduct of its monetary, regulatory and supervisory initiatives, focused on enhancing the coverage, quality and format of information dissemination. Both internal and external communication of the Bank received impetus during this period. Internal communication processes facilitated two-way communication and, during the period of reference, were made more transparent. The Bank officials were encouraged to engage more closely with market participants with an emphasis on providing prompt response to the media and the public.

Chapter Outline

The rest of the book narrates these changes with more details than it has been possible to discuss here. The next chapter presents a longer overview of the macroeconomic conditions that form the background to the Reserve Bank's operations during this period. The remaining chapters follow the eight large themes as set out in the previous section. Chapter 3 deals with monetary management. Chapters 4 and 5 discuss the external sector policies in two stages, which are (*a*) foreign exchange market and management of the capital account and (*b*) foreign exchange reserves management. Chapter 6 covers the financial market policies. Chapter 7 discusses public debt management. The payment and settlement systems is taken up in Chapter 8. Chapter 9 discusses currency management. Chapters 10 and 11 deal with the regulation and supervision of the financial system. Rural credit and financial inclusion are discussed in Chapters 12 and 13. The final two chapters of the book deal with, respectively, communication (Chapter 14) and organisational change (Chapter 15).

Note

1. The CPPAPS was a major initiative towards customer protection and service and covered foreign exchange transactions, government transactions, banking operations relating to deposit accounts and other facilities, and currency management.