

# 19

## Conclusion: First Seven Years of the 1990s

### INTRODUCTION

The Reserve Bank, one of the oldest central banks in the developing world, was formed primarily as a monetary institution in 1935. It was enjoined with the responsibility of maintaining the domestic and external value of the currency and overseeing and directing the credit system in a manner that worked to the country's advantage. The Bank was also entrusted to be the regulator, holder of foreign exchange reserves and guide of exchange rate management. Over time, its functions encompassed promotional and developmental roles in order to support economic development and the growth of the financial markets. As the economy was highly controlled until the late 1980s and the Government played a dominant role in managing the economy, the Reserve Bank as the monetary authority was supportive of government policies, while ensuring co-ordination in monetary, credit and foreign exchange policies.

The Reserve Bank grew in terms of size and complexity and witnessed continuous transformation in terms of organisational set up and management. The operations of the Bank emerged out of a diversity of roles played by it and were marked by flexibility. The organisational structure was continually modified to respond to domestic necessities and contemporaneous international developments. The Bank embarked upon technological transformation, and upgraded its systems and procedures to manage its functions effectively. The commitment of the employees in an environment of free expression and debate over emerging policy issues within the Bank, helped in arriving at solutions over the years with a good degree of success. These positive organisational features augured well for promoting productivity and improving the work ethos.

The decade of 1990s marked a new beginning in the organisational evolution of the Reserve Bank. While the Bank was not *de jure* an independent institution, the onset of wide-ranging reforms in the financial sector necessitated the Bank to gain some degree of autonomy, particularly in areas of monetary management and financial market regulation, although the process of close consultation with the Government continued. This chapter provides perspectives relating to the role played by the Reserve Bank in the post-reform period with particular focus on its functional areas, where sophistication for maintaining price and financial stability for sustainable growth was called for, as brought out in detail in chapters 11 to 18 of this volume.

### A GRADUALIST APPROACH

The Indian economy was in the midst of several uncertainties as the decade of the 1990s dawned. The fragile economic situation resulted mainly from domestic macroeconomic imbalances and unforeseen economic events world-wide, apart from the uncertain political environment. It called for strong policy actions to correct the fiscal and external positions and help improve growth on a sustained basis.

While policy actions that flow from well-crafted comprehensive economic reforms are recognised the world over as essential, in India the consensus was on having the speed of policies to be gradual, orderly and well-sequenced. The gradualist approach entailed a fair-paced process of undertaking policy actions and balancing and rebalancing levers of control to realise the expected economic outcomes within a time frame perceived as reasonable. Transparency and involvement of all stakeholders had, in the process, become integral to imparting credibility to the reform measures.

The interesting aspects of the evolution of the policy framework in respect of the financial sector reforms were: first, financial sector reforms were undertaken early in the reforms cycle; second, the process was not driven by any banking crisis, but was home-grown and coincided with the structural adjustments taken under arrangements that were backed by the International Monetary Fund (IMF) and the World Bank; third, the reforms, facilitated as they were by domestic expertise, took onboard the international experiences as well.

India's approach to reforms was guided by five principles, *i.e.*, cautious sequencing of reform measures, introduction of mutually reinforcing norms, initiating complementary reforms across sectors (monetary, fiscal,

external and financial sectors), development of financial institutions, and growth and integration of financial markets. The financial sector reforms were led by strengthening prudential and supervisory measures that were introduced early in the reforms agenda. This was followed by interest rate deregulation and a gradual lowering of statutory pre-emptions. The more complex aspects of legal and accounting measures were brought in subsequently, once the basic tenets of reforms were already in place.

The gradualist and prudential management of the external sector including the commitment to maintain orderly conditions in the foreign exchange market through 1991 to 1996 helped the country to tide over the potential contagion of the South-East Asian crisis that jolted emerging market economies (EMEs) in the mid-1997.

#### THE CRISIS BUILD-UP AND RESPONSE

The fiscal position, both of the Centre and the state governments, remained precarious in the late 1980s and posed a major challenge. The combined deficit of the central and state governments, as per cent of gross domestic product (GDP), increased substantially, from 8.8 per cent during 1984–85 to 9.4 per cent during 1990–91. In addition, the critical external payments position and elevated inflationary pressures contributed to the build-up of macroeconomic imbalances. The structural rigidities and the instability in the economic system constrained the sustainability of the growth process to a certain extent. There was consistent deterioration in merchandise trade, almost entirely attributable to a rise in petroleum, oil and lubricants (POL) imports, which registered a sizeable increase in volume as well as in value terms due to escalating international oil prices. Massive loss of foreign exchange reserves during the early 1990s considerably slowed the pace of broad money expansion. This combined with a sluggish real economy on account of transport and other infrastructure constraints led to moderation in savings and investment rates.

The reforms programme of the 1990s was preceded by some significant measures, in particular in trade, industry, taxation and exchange rate management areas. The early reform initiatives introduced since the mid-1980s had lacked an overarching framework and led to the emergence of macroeconomic distortions. A sizeable component of monetised deficit in the already large fiscal deficit resulted in rapid growth of monetary liquidity that was far out of alignment with real economic growth, thus generating severe demand pressures and accelerating the pace of inflation.

Such imbalances, in turn, were reflected in the build-up of a large and unsustainable current account deficit (CAD). The persistently high levels of fiscal deficit and CAD led to the accumulation of sizeable public debt, both domestic and external. By 1990, there was a realisation among policymakers that the widening fiscal deficit and associated money growth had high inflationary potential, besides posing risks to the balance of payments (BoP). Such concerns were communicated by the Reserve Bank to the Government from time to time.

The serious external payments crisis that struck in the 1991 was the result as much of highly expansionary fiscal policy pursued since the mid-1980s as of some serious distortions in macroeconomic policies pursued in the domestic and external sectors, combined with geopolitical developments. A confluence of economic and political factors was at play in the build-up of the external payments crisis. The turmoil in the world oil market in the aftermath of the gulf war had adverse implications for India's external balance.

By the early 1990s, concessional aid had dried up. This meant resorting to commercial borrowings as a major source of external finance, which resulted in escalation of the debt-service ratio to 35.3 per cent in 1990–91. The incipient signs of a crisis on the external account were visible in the second half of 1990–91, when the gulf war led to a sharp increase in oil prices. The official reserves, which were relatively stable between 1982 and 1989, slid to a level equivalent to 1.3 months of imports by March 1991. This, in quantity terms, was approximately US\$ 5.8 billion. The effect of the rise in oil prices was aggravated by the events that followed. Indian workers employed in Kuwait had to be airlifted back to India and their remittances ceased to flow in. Loss of confidence in the Government's ability to manage the situation exacerbated the crisis. The composition of external debt shifted from the official to commercial debt. More importantly, external debt tended to be short-term, an aspect acknowledged as a sign of external vulnerability. Short-term credit dried up, imposing a severe strain on the BoP position. In addition, the outflow from non-resident Indian (NRI) deposits was substantial, which were in effect a form of short-term debt. With effect from October 17, 1990, the Reserve Bank in consultation with the Government commenced the practice of revaluation of the gold holdings from time to time in accordance with international price movements in order to present a more realistic picture of India's foreign exchange reserves.

India, for the first time in several decades, was faced with the risk of a default on its external obligations during the early months of the fiscal 1991–92. To avoid risking a default, India sold 20 metric tonnes of government gold with a re-purchase option to the Union Bank of Switzerland (UBS) through the State Bank of India (SBI), yielding a little more than US\$ 200.0 million. Subsequently, as a part of the reserves management policy and as a means of raising resources, the Reserve Bank pledged 47 metric tonnes of gold with the Bank of England (BoE) and the Bank of Japan (BoJ) and raised a loan of US\$ 405.0 million in July 1991. Criticism about pledging the gold to recover from the crisis was countered by the argument that the action was necessary to garner international support and it also provided an opportunity to address the reforms process that, in fact, went well beyond the management of the BoP crisis.

The strain on external and internal resources, the threat to monetary stability and the resultant inflationary pressures had begun to hamper investment plans. The situation called for strong stabilisation efforts in the form of fiscal correction, monetary tightening, inflation control and strengthening the competitiveness of India's exports.

The period was characterised by considerable political uncertainty that halted the steady progress being made towards reforms since the mid-1980s. The country had three unstable governments in a span of two years prior to the point when the BoP position reached a crisis level. It was left to the Government formed under the Prime Minister, Shri Narasimha Rao to tackle the situation. Dr Manmohan Singh, as the Finance Minister, carried forward the much needed reforms in close co-ordination with the Reserve Bank, facilitated by the multilateral institutions.<sup>1</sup>

With the CAD reaching 3.0 per cent of GDP in 1990–91 and dwindling foreign exchange reserves, the Government felt it necessary to effect exchange rate adjustments, undertake fiscal reforms and counter destabilising market expectations as immediate policy responses. Devaluation of the Indian rupee, an emergency measure, was implemented in two stages: on July 1, 1991 and, after confirmation of the positive market reaction, on July 3, 1991. The two step downward adjustment in the value of the rupee worked out to 17.38 per cent in terms of the intervention currency, *i.e.*, the pound sterling and about 18.7 per cent in US dollar terms.

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1. Also refer to chapter 1: Introduction and Overview.

The Government followed up the devaluation process with wide-ranging reforms that set in motion the course of liberalisation of the Indian economy and its financial sector. The reforms process comprised, *inter alia*, abolition of licensing for all except 18 industries; removal of investment caps on large industrial houses; retention of only 6 industries in the public sector; liberalised access to foreign technology; abolition of import licensing; sharp reduction in import duties; and grant of permission to exporters to open foreign currency accounts.

Both the Government and the Reserve Bank were involved in executing measures needed to bring about these adjustments since the late 1989 and through 1990. However, it was only when the country faced the threat of a default in its external payments that it was felt necessary to shore-up international confidence by embarking on a 20-month IMF programme of stabilisation and structural adjustment from 1990–91 to 1992–93. The support of the IMF lent credibility and the arrangement set structural benchmarks to be achieved in stages by May 1993, that were widely regarded as realisable given the strong commitment of the authorities to reforms.

#### EXTERNAL SECTOR DEVELOPMENTS

The successful mobilisation of external finance and a marked improvement in the external payments situation as well as the debt indicators was experienced after the agreement with the IMF. As a result, there were positive developments in the economy, which included an increase in reserves to US\$ 9.8 billion and recovery in the economic growth to 4.0 per cent by the end of 1992–93. This provided the basis for further liberalisation of trade, tariff, export credit and foreign investment policies during the ensuing period, *i.e.*, 1992–93 to 1996–97.

During 1992–93, export performance remained subdued and the increase in import demand was moderate. The collapse of trade with the erstwhile USSR, one of India's principal markets in 1993, led to a marked shift in the destination of exports and sources of imports between general currency area (GCA) and rupee payment area. During the subsequent three years, *i.e.*, from 1993–94 to 1995–96, export performance was robust. India's exports also exhibited substantial structural changes in favour of manufactured goods. The shift in the composition of merchandise imports, however, was not as perceptible. Further, a rebound in India's imports from the contraction of 1990–91 and 1991–92 was

strong in the year 1992–93. The significant expansion in imports during 1994–95 and 1995–96 can be attributed to the marked buoyancy in the industrial sector. The trade deficit widened due to an increase in imports but growth in invisibles came to the rescue to a significant extent. At this point thus, the Indian economy was much less vulnerable than most East Asian economies. Debt service payments on past debts were high; the debt-service ratio, however, declined gradually but significantly from 30.2 per cent in 1991–92 to 23.0 per cent in 1996–97. The CAD to GDP ratio also declined to (-)1.25 per cent in 1996–97. Further, short-term debt was 7.2 per cent of total debt and foreign exchange reserves climbed to US\$ 26.4 billion in 1996–97.

Drawing lessons from the crisis of 1991, the high level committee on BoP chaired by Dr C. Rangarajan observed that the CAD should be maintained at 1.6 per cent of GDP over the medium term, which could be financed with normal capital flows. The IMF obligations under Article VIII were accepted by India and, in pursuance of this, current account convertibility was introduced in August 1994.

The capital account was dominated by foreign investment inflows, which met more than half the financing needs of the country. A welcome development was the spurt in foreign direct investment (FDI) from 1995–96. During 1997–98, inflows of FDI far exceeded that of portfolio investment. There was also a steady improvement in inflows arising from investment proposals made by NRIs. The US continued to be the largest direct investor, followed by the UK.

### EXCHANGE RATE MANAGEMENT

The dual exchange rate arrangement instituted on March 1, 1992 under the liberalised exchange rate management system (LERMS) was a successful transitional step to move in an orderly manner from a managed float regime to a market-determined system. The spread between the official and market rates moved in a narrow range, except in the month of February 1993, when speculative activity resulted in some turbulence in the inter-bank exchange market. LERMS, however, created conditions for transferring an augmented volume of foreign exchange transactions on to the market. It imparted stability, resulted in significant deceleration in the rate of inflation and a build-up in the level of foreign exchange reserves. At this point, the Reserve Bank evaluated three options for modification of the extant mechanism of LERMS. These were: (i) to maintain the status

quo; (ii) to change to an 80:20 ratio; and (iii) to have a unified exchange rate regime with a few exceptions, with no requirement for authorised dealers (ADs) to surrender any part of foreign exchange receipts to the Reserve Bank. The Bank went for the third option.

Accordingly, the unified exchange rate management system came into effect from March 1, 1993. A number of measures were put in place that enabled a smooth transition to a regime under which the external value of the rupee was determined by market forces. The unification of the dual exchange rate system into a single floating exchange rate imparted a significant degree of flexibility to the exchange rate regime in BoP adjustment. The experience with the free floating market-determined exchange rate was found to be satisfactory. Contrary to the speculation, remarkable stability was achieved in the exchange rate of the rupee. This also enabled the foreign exchange market to grow further and to mature. The Reserve Bank's interventions in such a regime were passive and occasional, motivated primarily by the need to protect export competitiveness by containing the potential appreciation of the rupee.

Following the success of the unified market determined exchange rate system introduced in 1993 and the accumulation of foreign exchange reserves to a comfortable level, the Reserve Bank further simplified the procedures and delegated greater autonomy to ADs in respect of a number of current account transactions. While the linkage between the money market and foreign exchange market was weak in the pre-LERMS period, the switch to the market-determined exchange rate and the growing importance of the forward market in the foreign exchange transactions strengthened the conduits of transmission of impulses between the short-end of the money market and the foreign exchange market. Several measures were taken by the Reserve Bank to deepen the foreign exchange market in India.

The Reserve Bank set up an expert group (Chairman: Shri O.P. Sodhani) in November 1994 to recommend measures for the growth of an active, efficient and orderly foreign exchange market and to suggest introduction of derivative products. The group made wide-ranging recommendations concerning removal of market constraints, development of derivative products and propositions for risk management, accounting and disclosure standards. It also dealt with aspects such as information systems and clearing mechanisms relating to the market. This was followed up with the Reserve Bank introducing institutional measures directed towards widening and deepening the exchange market

and providing greater functional autonomy to market participants. The efforts resulted in increasing the average monthly turnover of merchant transactions.

### MONETARY MANAGEMENT

The objectives of monetary policy of the Reserve Bank in the 1990s continued to be multi-dimensional, with as much emphasis on growth as on price stability. Towards this end, the Reserve Bank perceived that monetary growth should be consistent with the estimated output growth and a tolerable inflation rate. In pursuit of these objectives, the monetary policy had to be flexible enough to make strategic adjustments to any market disequilibria as also the surge in foreign capital inflows. Thus, in the eventful post-liberalisation phase, monetary management was also vested with the responsibility of maintaining orderly conditions in money, credit, securities and foreign exchange markets.

Monetary policy had to bear the brunt of external adjustment in the initial years of reforms when the stringent performance criteria of the IMF were to be met. Once inflation was under control and the external payments position improved, progressive rationalisation and deregulation of the interest rate structure became integral to the process of refining the operating procedures of monetary policy. Broad money ( $M_3$ ) continued to act as an intermediate target, while the level of bank reserves served as the operating target. There was nevertheless a marked shift in emphasis from direct to indirect instruments of credit control. It was expected that the flexibility provided to policy formulation would improve the functioning of the financial markets and, in the process lead to close alignment in the interest rates and greater market integration. Open market operations (OMOs) and repos were, therefore, actively deployed to influence the level of reserves with commercial banks and thereby adjust liquidity in the system. The Reserve Bank made efforts to develop the financial markets to serve as an efficient transmission mechanism of monetary policy impulses.

The historic agreement signed in September 1994 between the Reserve Bank and the Government to phase out automatic monetisation of budget deficit, afforded a good degree of manoeuvrability to the Reserve Bank in the conduct of its monetary and credit policy. The phenomenon of continuous and large inflows of foreign capital since 1993–94 and the resultant accretion to the foreign exchange reserves posed new challenges to monetary policy, since the external payments position impinged strongly on the domestic economy. The period witnessed the integration

of monetary policy with debt management policy, as also between the money, gilt-edged and foreign exchange markets.

### ACTIVE PUBLIC DEBT MANAGEMENT

The decade of the 1980s was an era of tightly regulated interest rates, including those on government securities. The government securities market during the decade was characterised by administered interest rates, high statutory liquidity ratio (SLR) requirements for banks and administrative directions to insurance and investment institutions and provident funds (PFs) that provided a captive market. As a result, a liquid and a transparent secondary market for government securities could not develop. The borrowing costs of the Government were kept artificially down by offering low coupon rates. The automatic accommodation to the Central Government by the Reserve Bank led to voluminous expansion of short-term government debt, through the mechanism of issue of *ad hoc* Treasury Bills. As a result, the debt management practised by the Bank remained passive.

With the implementation of the Narasimham Committee recommendations, the interest rates on government borrowing were progressively made market related, which were expected to help reduce SLR. Against the backdrop of the emphasis on moderation of gross fiscal deficit (GFD) in the reforms period in the early 1990s, it was envisaged that an active internal debt management policy would facilitate the integration of debt management policy with monetary policy. An Internal Debt Management Cell (IDMC) carved out of the Secretary's Department in April 1992 was converted into a full-fledged inter-disciplinary and independent department in October 1992. The move was aimed at strengthening delivery capabilities in developing both the primary and secondary segments of the government securities market.

The developments in public debt management in the initial reforms period included introduction of auction-based issuance of 91-day Treasury Bills, auctions of dated government securities, introduction of longer maturity 364-day Treasury Bills, repos in government securities by the Reserve Bank for efficient liquidity management, launch of innovative debt instruments such as zero coupon bonds, floating rate instruments, partly paid stocks and conversion of Treasury Bills into dated government securities to reduce roll-over risk of the government debt. In effect, the market had to be groomed and nurtured during this phase through continuous dialogue with the treasury managers and by organising workshops.

These efforts led to the emergence of a market based yield curve. Since the growth of the secondary market was rather slow initially, primary yields through auctions served as proxies in the attempt to evolve a yield curve. The manoeuvrability of the Reserve Bank to set in place public debt management practices consistent with monetary policy received a stimulus with the agreements signed between 1994 and 1997 for a phased reduction in issuance of *ad hoc* Treasury Bills and the ultimate discontinuation of such bills with effect from April 1997, to be replaced by a system of limited ways and means advances (WMA) from the Reserve Bank. The transition from *ad hoc* Treasury Bills to the WMA mechanism was a major milestone in fiscal, financial and monetary policy reforms. It led to substantial improvement in fiscal discipline and ensured greater flexibility to the conduct of public debt management consistent with monetary policy objectives.

The move towards the strengthening of public debt management operations by the Reserve Bank in co-ordination with the Government during 1992 to 1997 proved to be extremely beneficial in terms of the high proportion of market absorption of government securities and lower devolvement of such securities on the Reserve Bank. This facilitated competitive pricing of securities, and gradually led to the emergence of a market responsive yield curve that resulted in greater attention to treasury management and interest rate risk management by bankers and investors.

#### DEVELOPMENT OF FINANCIAL MARKETS

The Indian financial system grew rapidly over the decades of the 1980s and 1990s and comprised an impressive network of institutions. The deepening and widening of the financial system was most significant in the case of banking and term-lending institutions. But, until the close of the 1980s, markets were subject to a plethora of controls. While the equity market got a boost beginning in the 1980s, the money, debt and credit markets suffered on account of a plethora of controls. Nevertheless, the mid-1980s witnessed early liberalisation in the money market and a few new short-term instruments were introduced in the market.

Financial market evolution was guided by the recommendations made by the Chakravarty Committee (1985), Vaghul Committee (1987), Narasimham Committee (1991) and Sodhani Committee (1994). In addition, the Reserve Bank followed a consultative approach to the development of financial markets by constituting internal working groups

and committees with participation from other institutions and market players from time to time.

Financial sector reforms also included policies and measures directed towards improving the allocational and functional efficiency of the economic system. The implementation of the reforms process and supervision under the aegis of the Reserve Bank strengthened the interplay of market forces and fostered the process of integration among various segments of the financial markets. Towards this end, efforts were made to develop institutions and instruments, and put in place the operating procedures for smooth functioning of the markets. These measures resulted in relative rates of return on various instruments in different market segments moving in alignment, within a narrow range. Further, the development of a liquid and deep market for government securities infused vigour into the entire financial system and imparted flexibility to the conduct of monetary policy.

By the year 1996–97, the role of the financial markets had become critical in more than one way, *i.e.*, in mobilising and apportioning savings in the economy, transmitting signals for policy formulation and facilitating liquidity management consistent with the overall short and medium-term policy objectives. While the long-term goal of achieving integration among different segments of the financial markets was continuously kept in view, the main thrust of the Reserve Bank's policies was on eliminating the factors that constrained the free flow of resources among various market segments and facilitating opportunities for arbitrage across segments and maturities in order to achieve efficient pricing. These inter-linkages added another dimension to the conduct of monetary policy, *i.e.*, the necessity to access, on a continuous basis, the liquidity available in the system and adopt appropriate measures for minimising volatility in the financial markets.

The Reserve Bank evolved a combination of liquidity management tools, such as repo operations and management of refinance facilities, to absorb and inject liquidity at discretion and provide greater stability to the short-term money market. Attempts were made to activate Bank Rate as the benchmark rate, and a system of prime lending rate (PLR) was introduced to impart efficacy to the interest rate channel of monetary policy. This met with limited success, and Bank Rate was posited to eventually become a signalling rate. There were also, in parallel, attempts to deepen and diversify the money market by introducing new instruments in the form

of auctioning of Treasury Bills of varied maturities, commercial paper (CP) and certificates of deposit (CDs). For structural reasons, such as the high cash reserve ratio (CRR) and limits on the maturity structure of deposits, the money market continued to be dominated by the overnight call money market. The term money market was a non-starter. As a result, while a term structure of interest rates evolved with the deepening of the government securities market, attempts to develop a short-term yield curve and benchmarks along the lines of the London interbank offered rate (LIBOR) did not take off.

### BANKING AND FINANCIAL INSTITUTIONS

The early 1980s were characterised by continuation of expansionary policy towards the banking system combined with intensification of efforts to promote priority sector credit at the cost of operational efficiency. This resulted in the surfacing of several weaknesses, such as poor quality of lending and an increase in non-performing loans (NPLs), thereby necessitating a rethink on the credit delivery system. The consolidation measures were thus introduced, beginning in the mid-1980s. The policies towards regulation and prudential supervision gained momentum from the late 1980s, with the Reserve Bank gradually bringing the financial system in alignment with international best practices.

The Reserve Bank kept a constant vigil over international developments, since a wave of breakdown of the fixed exchange rate system, liberalisation and deregulation was sweeping across its Asian counterparts, especially in the financial sector. The Bank learnt from international experiences, imbibed and internalised new policies and practices that it adapted to Indian conditions, against the backdrop of constraints, such as, government ownership of major FIs and banks, directed lending practices, regulated interest rate structure, pre-emption of bank resources under the reserve requirements and exchange controls. The Reserve Bank, nevertheless, in co-ordination with the Government facilitated rapid deregulation of the sector, beginning in the mid-1980s to make the financial system more efficient and competitive.

During the period 1991–1997, as part of financial sector reforms, a significant transformation took place in the banking and financial system. The implementation of the Narasimham Committee report gave a fillip to the process. While the systemic shock due to irregularities in securities transactions in 1992 affected the financial system and the banking sector

in particular, the lessons from the episode led to far-reaching reforms in market regulation and settlement practices. This also strengthened the bias towards a gradualist approach to the reforms process and continuation of public sector dominance in the financial sector.

The banking reform measures encompassed, *inter alia*, strengthening and consolidating banks, prescribing prudential norms relating to asset classification and income recognition, provisioning for bad and doubtful assets, introducing a system of capital to risk-weighted asset ratios and establishing a strong supervisory system. The entry of new banks, including private sector banks, mergers, putting in place supervisory and surveillance mechanisms and in house strengthening of banks also formed part of the reforms package. The implementation of prudential norms and guidelines was a significant step towards the introduction of transparency in accounting practices and brought the norms in line with international best practices. A Board for Financial Supervision (BFS) was set up under the aegis of the Reserve Bank on November 16, 1994, to give a specialised and independent focus to supervision of banks and FIs.

The banking system withstood a major set-back which came in the form of the securities scam of 1992. The Janakiraman Committee was appointed to investigate the irregularities in funds management by commercial banks and FIs, especially their dealings in government securities, public sector bonds, units of the Unit Trust of India (UTI) and similar instruments. The committee report pointed to several deficiencies in the functioning of treasuries in banks and FIs, the absence of necessary internal controls, raising money without backing of genuine securities, diversion of call money funds to current accounts of chosen brokers, massive collusion between officials and the brokers involved in government securities dealings and the breakdown of necessary discipline regarding issue and recording of bankers' receipts (BRs).

The committee made a series of recommendations that included introduction of proper control systems, strengthening monitoring mechanisms and removing lacunae in the existing systems and procedures to avoid recurrence of such irregularities. The Reserve Bank and the Government, in light of these suggestions, took concerted action to restore public confidence in the country's financial system. Several follow-up measures were initiated by the Reserve Bank in close co-ordination with the Government to unearth ramifications of the scam, recover bank dues, impose penalties on the guilty and put in place preventive measures to avoid recurrence of such events.

The 1990s witnessed, in parallel, strengthening of the regulatory role of the Bank over non-banking financial companies (NBFCs) which came often into disrepute on account of cheating and fraud on trusting depositors. Prudential norms were strengthened across all categories of non-banking companies, in particular those accepting deposits from public. The Reserve Bank attempted to bring the supervisory and regulatory standards by and large in harmony with those applicable to the banking system.

### AGRICULTURE AND RURAL DEVELOPMENT

The Reserve Bank, since its inception, had a unique role statutorily carved out in the field of agriculture and rural development. It initiated the All-India Rural Credit and Investment Survey in 1951 and nurtured the rural co-operative credit institutions through a specialised Agricultural Credit Department (ACD). It also formed the Agricultural Refinance Corporation (ARC) as a development finance institution in July 1963, later known as the Agricultural Refinance and Development Corporation (ARDC). It created the institution of regional rural banks (RRBs) in the late 1970s. In 1982, spanning out of the ACD and ARDC was the apex institution for agriculture and rural development, namely, the National Bank for Agriculture and Rural Development (NABARD). In the post-nationalisation period after 1969, directions for bank lending to agriculture and rural development schemes through priority sector norms were issued, thereby significantly improving organised lending to agriculture and relieving the farm sector from the control of money lenders.

Following an expansionary phase during the 1980s, the intensity of efforts towards increasing agricultural productivity and providing rural credit in the aftermath of the external sector crisis and its resolution, however, lost much of its momentum. Thus, at the advent of the economic reforms in 1991, the rural credit delivery system was relatively weak. From the early 1990s, the rural credit system had been on the downslide, afflicted with mounting overdues that dampened the flow of funds. This trend adversely affected the economic viability of lending institutions, especially the co-operatives and RRBs. Despite the impressive geographic spread of the formal channels of finance, and the diminishing influence of informal channels, the rural financial institutions showed several weaknesses, such as low productivity, inefficiency, poor recovery culture and diminishing profitability.

In pursuance of the recommendations of the Narasimham Committee, measures were initiated to ameliorate the problems related to flow of agricultural credit, apart from strengthening commercial banks and RRBs. The thrust of the approach was to improvise credit delivery at reasonable interest rates within the extant legal and institutional constraints. First, the coverage of rural credit was expanded to include additional facilities such as storage. Second, procedural and transactional bottlenecks were removed, reducing margins, redefining overdues to coincide with crop-cycles, and announcing new debt-restructuring policies, as also one-time settlement and relief measures for farmers who owed debt to non-institutional lenders. Third, the kisan credit card (KCC) scheme was improvised and its coverage widened, while some banks also floated general credit cards (GCCs) that offered overdraft for multipurpose use, including consumption. Fourth, public and private sector banks were encouraged to enhance credit delivery while promoting disincentives for shortfall in priority sector lending. Fifth, banks were urged to price credit for farmers on the basis of actual assessment of individual risk rather than on a flat rate, depending upon the category of borrower or end-use, while ensuring that interest rates charged were justifiable. Other measures introduced included delegation of more powers to branch managers, simplification of applications, opening of more small scale industries (SSI) specialised branches, enhancement in the limit for composite loans and strengthening of the recovery mechanism.

In order to align the priority sector lending of foreign banks operating in India with that of the Indian banks, the target for priority sector lending by foreign banks was raised in October 1993 from 15.0 per cent to 32.0 per cent of their net bank credit, inclusive of two separate sub-targets of at least 10.0 per cent each in respect of advances for the SSIs and exports to be achieved by end-March 1994. Taking into account their difficulties in extending credit to the agricultural sector due to the lack of rural branch network, the composition of priority sector advances for foreign banks was enlarged to include export credit extended by them with effect from July 1, 1993. The overall target of priority sector lending in respect of foreign banks remained unchanged at 32.0 per cent of net bank credit with a sub-target of 10.0 per cent in respect of advances for SSIs. The sub-target for export credit was, however, raised from 10.0 per cent to 12.0 per cent of net bank credit for the year ending March 1997. In the event of shortfall in priority sector lending from the stipulated targets and sub-targets, the policy of requiring foreign banks to place deposits equivalent to the

shortfall with the Small Industries Development Bank of India (SIDBI) at an interest rate of 8.0 per cent per annum was maintained.

Though the need to augment the growth of agricultural and rural employment was part of the Government's policy, the fact remained that economic reforms were largely confined to industry, trade and commerce. The financial sector reforms stressed the productivity, efficiency and profitability of banking, which compelled the banking system to focus on viability-based expansion of business, while at the same time extending finance to agriculture and the rural sector at relaxed terms and conditions. In forward-looking initiatives, several subsidised employment-linked programmes, particularly those to uplift weaker sections, and the micro-credit system of extending finance were attempted on an experimental basis.

The Reserve Bank continued to play a key role in development of the agricultural and rural sector by providing refinance, and extending policy and regulatory support to NABARD and scheduled banks, which included RRBs and the co-operative sector. NABARD, established in 1982 as an apex national bank to exclusively cater to agriculture and rural development, continued to depend on the Government and the Reserve Bank for its resources and operations. Though agriculture was the backbone of the economy, it did not get the focused attention that it deserved in view of the need to ensure the viability of the banking sector combined with the necessity of providing low-cost funds to this segment.

As a result of weaknesses in credit delivery through conventional priority sector norms, a new model in the form of the micro-finance movement was ushered in following the example of the grameen bank of Bangladesh. NABARD spearheaded this movement through a self-help group (SHG)-bank linkage programme in 1992 on a pilot basis. This programme was extended countrywide subsequently. The model was further expanded with the foray of non-government organisations (NGOs) and microfinance institutions (MFIs) into the field. This paved the way for a new approach to financial inclusion that aimed at providing access to financial services at the doorstep for women and other vulnerable sections in the rural sector.

### COMMUNICATION PRACTICES

While the practices of communication evolved over time, it remained by and large one-way until the 1980s, as the policies were centralised and

mostly encompassed directions in a tightly regulated financial regime.<sup>2</sup> Communication, however, emerged as an important central banking function in the 1990s, as with the liberalisation and financial sector reforms, the Reserve Bank adopted an active communication strategy and started to influence markets through its announcements. Besides, the Bank's withdrawal from the micro-management of FIs and allowing them more operational flexibility helped to make communication a two-way process. Through the communication practices, the Bank discharged its responsibility of keeping various segments of society informed about its role in the financial system.

The Reserve Bank's communication, although broadly categorised as external and internal, can be viewed in three dimensions in terms of channels, namely, publications, speeches, and other modes. While periodic publications, *viz.*, bulletins, reports, newsletters and pamphlets provided a wealth of information on macroeconomic and policy developments within and outside the Bank, the speeches delivered by the top executives provided insights into the Reserve Bank's thinking and policy stance on various issues. There was a noticeable increase in such addresses made by the top executives since the mid-1980s. This was necessitated in order to foster financial education in the country. The Reserve Bank, in tune with the revolution in information and communication technology, operationalised its website with the URL <http://reservebank.com> on September 17, 1996. The site helped to host the publications, speeches and notifications/circulars of the Bank.

Market intelligence took centre-stage in pursuance of the recommendations of the Janakiraman Committee. Market intelligence cell (MIC) was set up in the Bank in 1992–93 to track market developments to co-ordinate with the departments within the Bank and to collect sensitive information on areas of concern to the Bank, thereby providing important market-related inputs for policy evolution. All these endeavours resulted in evolving a gradual but integrated network to connect with markets, other stakeholders and public and yielded agreeable results.

## TO CONCLUDE

The robust financial system built up over the years and further strengthened during the 1990s, combined with prudential management of monetary, exchange rate and capital account policies, helped India to

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2. Chapter 20: Communication Practices gives a more detailed account of this aspect.

overcome the potentially unfavourable impact of a series of currency, banking and capital account crises that plagued emerging markets in the mid-1990s. India came out rather unscathed from such adversities. Besides, the unique handling of exchange rate management and management of the capital account by the Reserve Bank, much against the paradigm advocated by multilateral institutions and a number of economists, served as a model for the EMEs after the South-East Asian crisis struck.