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Introduction and Overview

This fourth volume of the institutional history of the Reserve Bank of India covers 16 years from 1981–82 to 1996–97, ending shortly before the onset of the South-East Asian crisis in mid-1997. Thus, it covers the 1980s and a major part of the 1990s. It partly encompasses the period of the governorship of Dr I.G. Patel (December 1, 1977 to September 15, 1982) to start with and ends with the governorship of Dr C. Rangarajan. It covers fully the periods of the governorship of Dr Manmohan Singh (September 16, 1982 to January 14, 1985), Shri A. Ghosh (January 15, 1985 to February 4, 1985), Shri R.N. Malhotra (February 4, 1985 to December 22, 1990), Shri S. Venkitaramanan (December 22, 1990 to December 21, 1992) and Dr C Rangarajan (December 22, 1992 to November 22, 1997).

THE BROAD APPROACH

This is an institutional and official history. The description and analysis of the events, policy developments and operations have been brought out in the historical context. The narrative draws mainly from official documents, such as file notings, official letters and other communications and periodic publications of the Reserve Bank, particularly the Annual Report, Report on Trend and Progress of Banking in India and Report on Currency and Finance. It also draws from the official publications of the Government, such as the Economic Survey and the Union Budget.

In addition, the speeches of the top management of the Reserve Bank were found to be rich sources in highlighting the historical context and policy perspectives. Media reports and research reports that were interpretative are also referred to, where necessary, to give a reasonable balance of different perceptions. Besides, differences in viewpoints at times between the Government and the Reserve Bank have been brought out to emphasise the underlying spirit of co-operation and co-ordination in policies. File notings within the Reserve Bank that showed different opinions and nuanced arguments by officials, particularly on new policies and approaches, were also taken into account wherever possible and were considered useful for a better understanding of the rationale for the decisions that were finally taken.

This volume is the outcome of about three years' team effort, mostly from the present and former officials of the Reserve Bank guided by an independent advisory committee chaired by Dr Bimal Jalan, former Governor. The volume consists of two parts, *viz.*, Part A and Part B.

TWO DISTINCT PHASES

The defining event of the period under the purview of the present volume was the balance of payments (BoP) crisis of 1991 that fell almost in mid-course between 1981 and 1997. The period covered in this volume falls into two distinct phases: pre-crisis and post-crisis, or pre-reform and post-reform. The BoP crisis of 1991 and the consequent wide-ranging economic and financial sector reforms represented a definitive and a major structural break in the Indian economic system. It also signified a major shift in the underlying economic philosophy, political thinking and direction, which brought about changes in economic policies and operations. It would not, therefore, be fair to treat the history of this period as a continuum, either functionally or chronologically.

In narrating the events, the approach, as followed in earlier volumes, has been to deal with developments functionally and, within each function, to cover the events according to their significance and not necessarily in a chronological sequence. The chapter titles have been identified accordingly. Given the defining event of 1991, the focus of the chapters varies between the two phases, (*i.e.,* 1981 to 1989 and 1989 to 1997) as also the macroeconomic contexts. The phases are entitled Consolidation and Early Liberalisation: 1981 to 1989 and Crisis and Reforms: 1989 to 1997. Each phase begins with an analysis of the macroeconomic context and ends with concluding remarks to enable readers to capture the fundamental features distinguishing the two periods. The periodisation is broadly indicative and is drawn with a view to trace the turning points in public policy and macroeconomic management. However, data and the events are often referenced across the periods to present the facts in a proper perspective.

With fiscal profligacy overshadowing monetary policy during the 1980s, the Reserve Bank was concerned about the need for reducing the fiscal deficit to improve the efficacy of monetary policy. With the onset of reforms, fiscal consolidation, the activation of public debt management and freeing the Reserve Bank from automatic monetisation of budget deficits became dominant issues, along with sound exchange rate management from the early 1990s. Accordingly, a separate chapter has been devoted to the monetary-fiscal nexus in the first phase, while a chapter on public debt management has been included in the second phase. Monetary management had to deal with the new market-oriented environment by shifting the focus to indirect instruments for policy interventions. Monetary policy also gained significant autonomous status after the phased elimination of automatic monetisation of budget deficits in the latter phase. Alongside, when the external sector was opened up, controlled foreign exchange regime gave way to current account convertibility and liberalisation of the capital account. The 1990s saw significant relaxations in exchange controls and fixed exchange rate system gave way to an increasingly managed float regime of the Indian rupee. This is reflected in the differently-oriented coverage of the external sector between the two phases.

The banking and the financial sectors, devoid of market orientation until the 1980s, witnessed decontrol in several respects, leading to greater operational flexibility combined with elements of competition emerging even within the public sector, with the regulation focusing increasingly on strengthening prudential standards on par with international best practices. While the social objective of banking and the financial system in fulfilling the needs of the priority sector was retained, there was a reorientation of the priority sector in the 1990s, reducing the intensity of cross-subsidisation by freeing lending rates to a significant extent. The liberalisation of markets also meant that the Reserve Bank could devote greater attention to the development of various segments of financial markets, encompassing money, government securities and foreign exchange in terms of instruments, institutions and infrastructure. Hence, a separate chapter on financial markets has been included in the second phase.

While several major structural changes define the break in 1991, it was also thought necessary and equally important to bring out in some detail the prelude to the crisis itself, the political and economic environment leading to it along with the unprecedented, co-ordinated and integrated policy response from the Government and the Reserve Bank to resolve the crisis during the period from 1989–90 to 1992–93, amidst intense political uncertainty. While this period is not treated as a separate phase in narration, two chapters deal exclusively with the prelude to the external payments crisis, and management and resolution of the crisis.

MANAGING CHANGE: PRE-REFORM AND POST-REFORM

The most significant event during this period was the BoP crisis of 1991, providing the major context for the onset of comprehensive economic reforms in India. The two decades thus fall into two phases, namely, pre-reform and post-reform. Since this was signified by a paradigm change and a marked transformation in the underlying philosophy behind economic and financial policies at both the political and executive arms of the Government, the role of the Reserve Bank also logically moved in tandem and the Bank responded to the new challenges posed by this transformation. How the Reserve Bank successfully faced this challenge and handled related policies and operations in harmony with the Government, with occasional dissent with the Government in the larger public interest, is reflected in narration of events covered by this volume.

The Reserve Bank has undergone continuous transformation over time in response to the changing environment while formulating and implementing monetary and financial policies since its inception in 1935. The functions of the Reserve Bank have emerged out of the diverse roles entrusted to it. With the onset of economic planning and structural transformation of the Indian economy, the role of the Reserve Bank expanded manifold. Although it was founded on the pattern of European central banks, "the evolution of its functions has undergone radical transformations from traditional central banking in the formative years to that of building institutional infrastructure during the developmental phase and to ensuring financial sector soundness in the reform phase."[1]

As the central bank of an emerging independent India, the Reserve Bank had to play a proactive role in the nation-building process in filling the resource gaps of the Government in Plan financing and in creating the necessary financial infrastructure. The Reserve Bank played a crucial 'supply leading' role in the development of the financial sector, in contrast with the 'demand following' pattern of financial development observed in advanced countries. In the initial years, therefore, the emphasis was

1. Reserve Bank of India. *Report on Currency and Finance, 2004–05.*

on putting in place the institutional machinery and the base to support development planning. This got a renewed thrust with the nationalisation of 14 major commercial banks in 1969, followed by another 6 banks in 1980.

CENTRAL DIRECTION TO MARKET ORIENTATION

The central direction of the economic policies, mostly emanating from the Government, dominated the functions and operations of the Reserve Bank in the pre-reform period. In the absence of operational independence, *de jure*, the Reserve Bank worked in unison with the Government in framing rules and exercising regulation over the banking and financial institutions (FIs) as also in operating its credit and interest rate and exchange rate policy tools. Most of the decisions were announced in close consultation with the Government, even while the Bank expressed its concerns on certain matters in its periodic publications, in particular the Annual Reports.

With the policy paradigm shifting from central direction to market orientation, the imprint of the Government's dominance on the Reserve Bank functioning and policies slackened. This should be viewed as a natural concomitant of the post-reform environment. In a way, this shift meant that the Reserve Bank gained more discretion, operational flexibility and manoeuvrability in exercising powers, and the Government also increasingly recognised the need for granting a rather expanded and delegated role to the Bank. This central thread can be seen through all the chapters of this volume. To the extent that, *de jure*, the Reserve Bank is still not an autonomous institution and works in close co-ordination and harmony with the Government, this change of role could be considered as constrained discretion or independence.

One major gain of the transformed role was the freedom the Reserve Bank obtained from automatic monetisation of government deficit that had characterised the macroeconomic scene right from the mid-1950s. The Reserve Bank also constantly refined its operating procedures and instruments in the direction of developing sound financial markets and financial infrastructure. The Reserve Bank acquired technical expertise and delivery capabilities in handling public debt management and developing the government securities market. This enabled it to efficiently discharge the twin responsibilities of debt and monetary management, while meeting government borrowing requirements and market expectations. Another significant area was exchange rate management, where the Reserve Bank carved out a niche for itself.

ADAPTATION RATHER THAN ADOPTION

The Reserve Bank had, in the process, to situate itself on a new learning curve with every change that was influencing the global economy, in turn impacting the domestic economic and financial conditions. Fortunately, its culture, built over the years, kept it as a learning institution. This process was substantially strengthened in the post-reform period. The Reserve Bank chose a consultative approach in policy formulation and a number of institutional arrangements were put in place. While constantly absorbing international developments in central banking and finance, India's policies remained essentially home-grown, as the narrative of this volume indicates.

On the issue of integrating the Indian financial markets with the global financial system, India has chosen to proceed cautiously and in a gradual manner, adjusting the pace of liberalisation with the underlying macroeconomic developments, the state of readiness of the domestic financial system and the dynamics of the international financial markets. This stand was not only because of its inherent preference for gradualism but also because of its recognition of the distinctive institutional and legal features. The Reserve Bank took a number of initiatives to strengthen the supervisory and regulatory framework, while simultaneously providing sufficient flexibility to the FIs to respond to the growing competition and take advantage of the business opportunities unfolded by technological advancements. While pursuing the reforms, the Reserve Bank made conscious efforts to improve systemic efficiency by re-orienting its traditional functions including currency management and regulation of payments and settlement systems. All these initiatives facilitated strengthening of the financial sector in India, enabling it to adapt to the emerging environment and this was reinforced by a change in the perception of the world community towards India as an upcoming economic powerhouse after the reforms era beginning in the 1990s.

REFORMS IN THE 1980s

While 1991 marked the major paradigm shift, it was not a big bang approach to reforms as was the case in many countries during the post-Bretton Woods breakdown period from the late 1970s. The early seeds of liberalisation and reforms were sown during the 1980s, which helped the country to step into the post-1991 phase of relatively sharp and comprehensive reforms seamlessly. In a way, the reforms of 1991 could be viewed as the culmination of several steps taken at both the Government and the Reserve Bank level, particularly since the mid-1980s, despite the weak political environment and support. The 1980s reforms broadly covered three areas, *viz.*, industry, trade and taxation along with deft exchange rate management. It is pertinent to note that this was the time when similar policies were gaining ground across many countries following the examples of the UK and the US. However, the reforms initiated in the mid-1980s by the Prime Minister, Shri Rajiv Gandhi, were paused due to the uncertain political developments in the late 1980s.

In the year 1985–86, a wide array of industrial policy initiatives aimed at removing constraints on growth and creating a more dynamic industrial environment, which sought to accelerate growth, investment and productivity, were taken. In March 1985, the Government announced delicensing of 25 broad categories of industries. By December 1985, liberalisation was extended to 82 bulk drugs, related drug formulations and to the Monopolies and Restrictive Trade Practices Act (MRTP) and Foreign Exchange Regulation Act (FERA) companies. To those industries remaining within the ambit of licensing, the facility of broad-banding was accorded to allow for rapid changes in their product mix without fresh licensing. Apart from the general policy, a number of important measures were adopted in key sectors of industry.[2] By 1990, the number of delicensed industries rose to 31.

The investment limit below which no industrial licence would be required was raised to ₹ 50 crore in backward areas and ₹ 15 crore elsewhere, provided the investments were located in both cases at stipulated minimum distances from urban areas of specified sizes. Broad-banding, which allowed firms to switch production between production lines such as trucks and cars, was introduced in January 1986 in 28 industry groups. This provision was significantly expanded in the subsequent years and led to increased flexibility in many industries. In 1986, firms that reached 80.0 per cent capacity utilisation level in any of the five years preceding 1985 were assured authorisation to expand capacity up to 133.0 per cent of the maximum capacity utilisation reached in those years. Firms that came under the purview of the MRTP Act were subject to different rules and could not take advantage of the above liberalised policy changes. To relax the hold of the licensing and capacity constraints on these larger firms, in 1985–86, the asset limit above which firms were subject to MRTP regulations was raised from ₹ 20 crore to ₹ 100 crore. As a result, as many

2. Government of India. *Economic Survey, 1985–86.*

as 90 out of 180 large business houses registered under the MRTP Act were freed from restrictions on growth in established product lines.

A long term fiscal policy (LTFP) was announced for the first time in December 1985. Major reforms were introduced in the tax system. The multipoint excise duties were converted into a modified value-added (MODVAT) tax, which enabled manufacturers to deduct excise paid on domestically produced inputs and countervailing duties paid on imported inputs from their excise obligations on output. By 1990, MODVAT came to cover all the sub-sectors of manufacturing except the petroleum products, textiles and tobacco. This change significantly reduced the taxation of inputs and the associated distortions. In parallel, a graduated schedule of excise tax concessions for small scale industries (SSIs) was introduced, which reduced incentives for them to stay small.

Industrial reforms were combined with stock market reforms with the establishment of the Securities and Exchange Board of India (SEBI) in 1988–89 and two new mutual funds as subsidiaries of public sector commercial banks. The Unit Trust of India (UTI) floated the India growth fund during August 1988 to provide an opportunity for non-resident Indians (NRIs) and other foreign investors to participate indirectly in the Indian securities market. Another important development during 1988–89 in the field of capital markets was the establishment of a framework for launching venture capital companies and venture capital funds.[3]

On the foreign trade front, in April 1985, the export-import policy was announced for the first time for a period of three years with the objective of imparting continuity and stability to the policy regime. The open general licence (OGL) list was steadily expanded. Having disappeared earlier, this list was reintroduced in 1976 with 79 capital goods items on it. The number of capital goods items included in the OGL list expanded steadily reaching 1,007 in April 1987, 1,170 in April 1988, and 1,329 in April 1990. These changes resulted in significantly expanded scope for imports of machinery and raw materials by entrepreneurs.

Several export incentives were introduced or expanded, especially after 1985, which helped expand imports directly when imports were tied to exports and indirectly by relaxing the foreign exchange constraints. This factor became particularly important during the period from 1985 to 1990 when exports expanded rapidly. In addition to a substantial widening of

3. Government of India. *Economic Survey, 1988–89.*

the coverage of the products available to exporters against replenishment licences, several export incentives were introduced between 1985–86 and 1989–90.

Beginning in 1986–87, Indian exports grew considerably, faster than growth in world trade and comparable to other developing countries, thanks, *inter alia*, to strategic exchange rate management. Since inflation in India during this period rose faster than that of its trading partners, it was necessary to bring about adjustments in the nominal effective exchange rate (NEER), which meant a considerable change in the official policy towards exchange rate depreciation. Based on the real effective exchange rate (REER), the rupee was depreciated by about 30.0 per cent from 1985–86 to 1989–90.

These reforms contributed to a pick-up in economic growth. Growth during the 1980s was higher than in the preceding decades, with a significantly high growth rate recorded at 7.6 per cent during 1988–1991. Growth in the 1980s, however, was fragile and unsustainable, since the reforms process in the 1980s was limited in its scope and without a clear roadmap. Nevertheless, the reforms process of the 1980s must be viewed as a trendsetter. Further, the 1980s reforms proved to be more enduring and not isolated, sporadic, or subject to quick reversal as in the previous decades. These reforms crucially elevated the confidence at the official level regarding the ability of policy changes to spur growth without disruption. However, as the growth during the 1980s was also propelled by fiscal expansion, it became unsustainable and led to the crisis of 1991.

DOMESTIC POLITICAL DEVELOPMENTS

Despite early liberalisation and reforms contributing to higher growth in the late 1980s, India, particularly towards the close of the decade, was afflicted with a series of events causing political uncertainty. In January 1980, the Congress party came to power after a gap of about three years. Smt Indira Gandhi assumed charge as the Prime Minister and Shri R. Venkataraman was appointed Finance Minister. The economic environment, at this point, was not favourable. Inflation was high, running at 22.0 per cent. Foreign exchange reserves, following the second oil crisis of 1979–80, had depleted. There was an unprecedented drought in the country and additional resources were needed to fund the Sixth Five Year Plan.

The budget had no room for manoeuvre in the early 1980s and no major change in the economic paradigm was envisaged. The budget was essentially a fire-fighting one, designed to contain the budget deficit and the deficit on the external current account. The expectations that the fiscal contraction of 1980–81 could resolve the twin crisis of high inflation and a large current account deficit (CAD) were short-lived. By the time the budget for 1981 came around, it became clear that India was in the middle of a major crisis and that something more was required to be done to overcome the situation.

A loan from the International Monetary Fund (IMF) from its extended fund facility (EFF) was arranged in November 1981 and, helped by a good monsoon and prudent monetary policy, the crisis was resolved by the beginning of the next financial year. Inflation was down to high single digit, the IMF loan had given some breathing space for imports, exports were starting to pick up and oil prices had stabilised.

The three budgets from 1982 to 1984 presented by the Finance Minister, Shri Pranab Mukherjee, steadily raised Plan allocations to all ministries. On October 31, 1984, Smt Indira Gandhi was assassinated. Her place was taken by Shri Rajiv Gandhi, who had a vision to take the Indian economy forward on a higher growth path. Shri V.P. Singh took charge as Finance Minister and the budget of 1985 was marked by several liberalisation measures. He made steep reductions in taxes, liberalised imports, eased the rigours of industrial licensing and decided that, up to a point, the job of resource allocation would be entrusted to the markets. The markets went bullish and a primary issues boom started, which, with a few interruptions, continued for the rest of the decade.

The budget for 1986 carried forward the process that began in 1985 by cutting taxes further, liberalising imports, reducing tariffs, *albeit* marginally, and pumping more money into the system. Better tax compliance and stiff tax administration, it was believed, would help stabilise the fiscal position. Due to internal conflicts surfacing again within the ruling party, in January 1987, Shri Rajiv Gandhi decided to take over the finance ministry himself.

The Government seemed to assume that high fiscal deficits would be sustainable. It did not pay attention to the warnings, including those by the Reserve Bank, especially on the CAD, which was partly a spill-over of the fiscal deficit. Disillusionment with the Government had set in. Shri V.P. Singh resigned from the Government over the Bofors issue in April 1987.

In August 1988, seven opposition parties formed the National Front with Shri V.P. Singh as its convenor. There surfaced several regional and communal tensions across the country. By the end of 1988–89, political stability seemed to have returned and Shri S.B. Chavan took charge as

Finance Minister. By 1989–90, the budget deficits had widened to reach unsustainable levels. It was clear that unless the next Finance Minister, Prof Madhu Dandavate, took some dramatic decisions, a crisis loomed large.

General elections were held in November 1989, followed by the formation of a Government under Shri V.P. Singh as Prime Minister. As this was a coalition Government, there were news reports of intense lobbying for leadership and internal conflict between coalition partners continued to surface till announcement of acceptance of the Mandal Commission report in August 1990. The announcement set off a series of demonstrations and agitations that continued for several months. The fragile National Front coalition faced a nation-wide crisis in the summer of 1990. Shri Chandra Shekhar broke off from the Government and, with the support of the Congress party he took oath as Prime Minister in November 1990. In less than a year, in February 1991, the support was withdrawn and the scheduled budget could not be passed. The former Prime Minister, Shri Rajiv Gandhi, was assassinated in May 1991. General elections were held in May 1991 and Shri Narasimha Rao formed the Government, which took over in June 1991. Thus, within a span of two years, during which the country faced a stressful BoP position, there were three governments at the Centre. This was a major factor that explains some delay in the Government approaching international financial institutions for financial assistance well ahead of the onset of the BoP crisis in 1991.

When the new coalition Government assumed power after a prolonged period of political uncertainty preceding the crisis, under the leadership of the Prime Minister, Shri Narasimha Rao, it was left to the Finance Minister, Dr Manmohan Singh, and his team of bureaucrats to launch and spearhead wide-ranging economic and financial sector reforms. Even after the Janata Government took the reins of political power after 1996, the spirit of economic and financial reforms initiated in 1991 got strongly embedded in the political economy of the country.

THE ECONOMY AND THE GOVERNMENT

In the prevailing socioeconomic milieu, it was the Government that set the contours of public policy in every sphere and a policymaking body like the Reserve Bank supported such initiatives for best outcomes, although ideally the latter ought to have enjoyed operational freedom in specific domains such as monetary management and regulation of the financial system. The institutional history has to be cognisant of this fundamental and delicate relationship between the Government and the Reserve Bank.

While the macroeconomic contexts of developments are captured in the text, an attempt is made here as part of the introduction to the volume to provide a glimpse of the delicate relationship that explains the interaction between the political economy and the evolution of Reserve Bank policies.

India's development strategy and economic policy was served by centralised planning and direction to help attain rapid growth and ensure equity with distributive justice. The average growth rate during the first three decades after independence was around 3.5 per cent and there was increasing realisation among policymakers that most of the controls and regulations had not delivered in the absence of adequate incentives. Following this recognition, the 1980s were marked by efforts initiated in various directions to restore reasonable price stability through a combination of tight monetary policy, fiscal restraint and some structural reforms. These initiatives were specifically aimed at changing the extant procedures associated with inward-oriented trade and investment practices. Although these shifts were not in the form of a comprehensive package and lacked an overarching framework to ensure reversal of the protectionist bias of the trade regime and other distortions, they started yielding results nevertheless. As a result, the Indian economy moved to a higher growth trajectory during the 1980s as compared with the previous three decades. The average annual growth rate of gross domestic product (GDP) rose to 5.7 per cent during the Sixth Plan period (1980–1985) and was 5.8 per cent during the Seventh Plan period (1985–1990). The high growth performance, however, was not achieved without certain interrelated adverse consequences and macroeconomic distortions.

On the flip side, the developments, *inter alia,* included deterioration in public sector savings from the mid-1980s. Public sector savings constituted about 4.0 per cent to 5.0 per cent of GDP between the mid-1970s and early 1980s. The situation, however, reversed from 1984–85 when public sector savings decelerated from 5.1 per cent during 1982–83 to 1.8 per cent of GDP during 1990–91. These savings improved marginally thereafter to more than 2.0 per cent of GDP, except in 1993–94, and were recorded at 2.2 per cent of GDP during 1996–97. Partly reflecting this trend, the combined fiscal deficit, which was 7.5 per cent of GDP during 1980–81, escalated to 9.4 per cent during 1990–91. The bulk of this deterioration in the fiscal deficit was accounted for by the Centre's fiscal deficit, which worsened from 6.1 per cent of GDP during 1980–81 to 8.3 per cent during 1990–91. The fiscal deficit of the Central Government hereon showed improvement and was recorded at 4.7 per cent in 1996–97.

Second, the country's BoP deteriorated continuously through the 1980s, and significantly from the mid-1980s. The trade deficit remained more or less constant at around US$ 7.5 billion for the entire decade of the 1980s. However, the CAD deteriorated steadily from an average of (–)1.3 per cent of GDP during the Sixth Plan to (–)2.3 per cent during the Seventh Plan and further to (–)3.0 per cent in 1990–91. The deterioration could be attributed primarily to the rapid increase in interest payments. The bulk of the increase in interest payments emanated from a sharp rise in private capital receipts, in particular external commercial borrowings (ECBs) and deposits by NRIs, which on one hand had a higher interest liability and on the other hand, shorter maturities. As a consequence, the Government had to step up domestic borrowings and its foreign exchange reserves in order to bridge the gap. This was necessitated by the fact that the proportion of CAD financed by external assistance declined substantially from about 75.0 per cent in the early 1980s to about 22.0 per cent in 1990–91. Hereafter, the implementation of structural reforms resulted in the CAD/GDP ratio improving significantly to (–)0.4 per cent in 1993–94. The ratio stood at (–)1.2 per cent in 1996–97.

The above factors culminated in the country's external liabilities rising sharply from about US$ 23.0 billion in 1980–81 (12.0% of GDP) to US$ 82.0 billion in 1990–91 (24.0% of GDP). The debt-service ratio (debt-service payments to current account receipts) correspondingly deteriorated from 10.0 per cent in 1980–81 to 30.0 per cent in 1990–91. Several macroeconomic imbalances engulfed various segments of the economic system. The economy thus plunged into a crisis that was unprecedented in the economic history of the nation. Dr I.G. Patel in the Foundation Day lecture delivered at the Indian Institute of Management (IIM), Bangalore, on October 28, 1991 stated:

> With the new wave of ushering in the twenty-first century, we had a series of financial excesses — large increases in defence expenditures, unbridled growth of subsidies, a quantum jump in public salaries and indeed a philosophy stated in so many words that money did not matter. It was already clear by 1986 that we were in an internal debt trap which would soon engulf us in an external debt trap. Rather than take any remedial action, we went merrily along, borrowing more and more at home and on shorter and shorter terms abroad. The climate for official and concessional capital had turned irretrievably adverse for many years. But our response to that was not to strive harder for self-reliance but to

increase the amount as well as the proportion of short-term debt in our external indebtedness...We mismanaged macro-economically in the 1980s and compounded the error by liberalising imports before restoring a better fiscal and monetary balance.

FISCAL BALANCE

The decade of the 1980s was characterised by government revenue expenditure consistently exceeding revenue receipts. The fiscal deficit of the Central Government had grown to 8.3 per cent by the year 1990–91, financed by a substantial increase in domestic and external borrowings. The external debt situation experienced in 1990–91 was largely a result of this trend. Further, the interest payments on account of additional debt raised domestically by the Government shot up by about 20.0 per cent per annum during the period from 1985 to 1990. The burgeoning deficit levels rendered the stabilisation efforts rather difficult. The Government, therefore, had little option left than to rein in fiscal deficit through increasing tax revenues, reducing revenue expenditures, particularly subsidies, and reducing public investments in infrastructure by encouraging greater private sector participation. To further inculcate fiscal discipline and rein in the temptation to finance the deficit through money creation at relatively low cost, the Government entered into an agreement with the Reserve Bank in September 1994 to bring down the fiscal deficit, in a phased manner, to nil by 1997–98. This was a historic event in the economic history of the country and particularly the institutional history of the Reserve Bank.

The cornerstone of the economic reforms programme was the comprehensive reforms agenda for both direct and indirect tax systems. The tax reforms committee set up by the Government in 1991 (Chairman: Dr Raja J. Chelliah) proposed a reforms package. Important elements of this package, *inter alia*, included a reduction in the average customs duty from above 100.0 per cent in 1990–91 to about 25.0 per cent within a reasonable time frame. It was intended that any reduction in revenue inflow on this account would be made good from other sources. The multipronged strategy for direct tax reforms was based on the principle of moderate rates, a wider base and better tax administration, which yielded substantially higher collections.

In the field of indirect taxes, the committee proposed simplifying and rationalising the tax structure and continuing the move towards moderate rates. This meant avoiding high and multiple rates, narrowing the exemptions, unifying rates where required, introducing flexibility in the system, expanding the tax base and minimising litigation. After the implementation of recommendations of the tax reforms committee, tax collections, which increased at an average annual rate of 16.5 per cent per annum during 1980–81 to 1990–91, slipped drastically to only 8.2 per cent in the transition phase of 1991–1994. The collections, however, posted an uptrend from 1994–95, when there was a sharp pick-up of 19.3 per cent that was higher than the average growth of the 1980s.

The thrust on curbing government expenditure continued during the 1990s. The total expenditure of the Centre declined from 20.0 per cent of GDP on average during the 1980s to about 18.0 per cent in the post-reform period.[4] The major part of this 2.0 per cent reduction was accounted for by capital expenditure, which shrank from 6.1 per cent of GDP in 1990–91 to 4.4 per cent in 1994–95, *i.e.*, by 1.7 percentage points. As a result, the share of capital expenditure in total expenditure dropped from around 30.0 per cent to 24.0 per cent and further down to 21.0 per cent in 1996–97. Of the components of revenue expenditure, the interest payments posted an increase from 4.0 per cent of GDP in 1990–91 to 4.6 per cent in 1994–95 and to 4.7 per cent in 1996–97. The burgeoning interest payments called for careful monitoring, since these posed a real problem and were anticipated to rise further due to retirement of low-cost old debt and its replacement with high-cost fresh debt in addition to a substantial increase in net government borrowings from ₹ 10,570 crore during 1990–91 to above ₹ 25,000 crore in 1994–95 and further to ₹ 32,892 crore in 1996–97. This was against the backdrop of the Government's decision to reduce the extent of money finance (monetisation) of fiscal deficit in order to control inflationary pressures. As pointed out in the mid-term appraisal of the Eighth Five Year Plan:

> The need to contain money finance (monetisation) of the Government's fiscal deficit has been accentuated primarily by the need to contain increase in reserve money and the over-all money supply in the context of a massive increase in the liquidity in the Indian economy arising out of foreign portfolio inflows, as well as the need to prevent a nominal appreciation of the rupee in order to protect the export performance. It appears therefore

4. Government of India (1996). *Draft Mid-term Appraisal of the Eighth Five Year Plan 1992–1997*. Planning Commission. September.

> that the increase in private international liabilities has led to a corresponding increase in public domestic indebtedness, with the positive effect largely being the rapid build-up of foreign exchange reserves. The net outcome, however, is a permanent bulge in the government's interest liabilities which may have adverse repercussions on investments in future.

INDUSTRIAL DELICENSING

Industrial licensing was the backbone of the economic regime right from the mid-1950s on the grounds of safeguarding the limited quantum of foreign exchange reserves in the face of high demands for imports of both raw materials and finished goods, to drive growth and to protect domestic initiatives for industrial production. The licensing system, however, led to stifling of incentives to invest as well as to misgovernance. It was, therefore, decided to introduce industrial delicensing, which meant freedom from constraints on output, inputs, technology and location as well as free entry into delicensed category of industries. The first major initiative for delicensing was taken in 1988 when all industries, excepting 26 industries specified in the negative list, were exempted from licensing, subject to investment and location limitations. In June 1988, the Government introduced the growth centre scheme to promote industrialisation of backward areas. Further, in an attempt to transform India into a major partner and player in the global arena, the industrial licensing policy of 1991 abolished industrial licensing for most industries, barring a few that included defence and social and environment protection. Compulsory licensing was required only in respect of 18 industries and the small scale sector continued to enjoy reservation. Automatic approvals for technology upgrading, larger inflow of foreign direct investment (FDI) in high-priority industries, 100.0 per cent FDI in most of the manufacturing industries in special economic zones (SEZs) and restructuring of public sector units were some elements of the new industrial policy.

BUILD-UP TO THE CRISIS AND THE REFORMS AGENDA

By 1991, the Government was headed into an internal debt trap as its interest payments on ever-increasing borrowings ballooned. In 1992, these payments accounted for a quarter of all government revenues and the proportion was rising. Externally, the short-term creditors were losing confidence in the economy and beginning to take their money out.

Inflation was at around 15.0 per cent and there seemed no real prospect of getting it under control. The macroeconomic imbalances, partly policy-induced and partly caused by external developments, hastened the severity of the economic crisis that was already lurking around the corner.

In the early 1991, India's holdings of foreign exchange, which are also referred to as forex reserves in this volume, were just US$ 1.1 billion, enough to cover, despite widespread import restrictions, a mere five weeks of imports. It was obliged to mortgage its gold to the Bank of England (BoE) and impose further and more severe import restrictions. These actions, however, were not enough. The crisis was the result of the confluence of adverse developments in fiscal, monetary, debt and BoP areas, all of them interrelated. The decade of the 1990s marked a paradigm shift from the 1980s in terms of the package of reforms. Whereas the liberalisation measures undertaken during the 1980s lacked an overarching framework, the reforms of the 1990s were part of a well-designed and co-ordinated set of macroeconomic and structural policy measures in a systematic and integrated manner to pull the economy out of a severe economic crisis.

In 1990–91, oil prices escalated sharply as a result of the gulf war. During the year, the trade balance deteriorated sharply by US$ 2.0 billion and remittances from Indian workers in the gulf also diminished. As a result, the current account balance declined by almost US$ 3.0 billion and the foreign exchange reserves also plunged to about US$ 1.0 billion by the end of 1990–91. These adverse developments led to a crisis of confidence in the Indian economy among international lenders. By April 1991, not only was there a significant withdrawal of NRI deposits from India, but several international banks also stopped honouring Indian letters of credit (LCs) for import transactions. Serious inflationary pressures posed a threat to the stability of the system against the backdrop of scarcity of essential commodities and deterioration in fiscal discipline. By June 1991, the annual inflation rate was running at about 16.0 per cent, and the economy was on the verge of a major crisis.

In an effort to resolve the crisis, the Government initiated a series of stabilisation measures in July 1991 with the technical and moral support from the multilateral institutions. As an initial step, a substantial devaluation of the rupee was executed while retaining the controls on foreign exchange on imports imposed by the Reserve Bank. Further, the fiscal deficit of the Central Government was curtailed from 8.4 per cent in 1990–91 to 6.0 per cent in 1991–92. The Government formally approached the IMF and the

World Bank to provide BoP support by way of both financial and technical assistance, which helped ease the situation considerably. A process of structural reforms in trade and industrial policies was commenced, which aimed at correcting the macroeconomic distortions that had developed in the immediate past.

The Eighth Five Year Plan took cognisance of the setbacks suffered by the economy in 1990–91 and 1991–92 and observed:

> ...in view of the impact of structural adjustment programme, the resource crunch which the public sector is facing, and the need for correcting the fiscal imbalances, it would be prudent to plan more or less for the growth rate achieved during the decade and lay down foundations for higher growth in future.

The growth target and the macroeconomic parameters accompanying the set targets were, therefore, rather conservative compared with what they would have been, had the crisis situation not developed. The Plan envisaged a somewhat lower growth target than the Seventh Plan and placed greater reliance on domestic resources for investments. There was a clear emphasis on reversing the trend of imports growing faster than exports in order to avoid serious BoP and external debt difficulties.

While the economic benefits of reforms were widely recognised, questions were raised about the adverse impact of the reforms, namely, widening inequality among various segments of society and limited impact on poverty alleviation. The multilateral institutions, for their part, underscored the need for providing social safety nets when countries embarked on large-scale structural transformation. It was, therefore, pertinent to work out the medium term mechanisms for the implementation of reforms that would withstand the short to medium term effects on the vulnerable or weaker sections of society and on the economic and social infrastructure of the country, especially during the transition. Further, it was imperative to take steps to counter pessimism about the likely success and outcomes of the reforms in terms of output, investments, employment generation and general living standards.

SAVINGS AND INVESTMENT

The Eighth Five Year Plan visualised a significant step-up in the rate of investment in the Indian economy. As the years passed, it was realised that the expectations had not materialised. While the investment rate stood at 26.0 per cent in 1990–91, it gradually slid thereafter. The gross domestic capital formation (GDCF) was 22.1 per cent in 1991–92 and at 22.5 per cent in 1993–94. This decline caused serious concern since the process of restructuring the Indian economy, as envisaged in the reforms agenda, pivoted around the levels of investment and their efficient use. The intention was to promote the efficiency of productive enterprises and to channelise resources into sectors where the economy had a competitive edge. Sluggishness in the investment rate could thwart such efforts. The rate of capital formation in the private corporate and household sectors was particularly low, declining from 17.4 per cent in 1990–91 to 11.5 per cent in 1993–94. The investment rate, however, showed signs of revival and stood at 25.5 per cent in 1994–95 and 24.0 per cent in 1996–97.

FDI, although highly encouraging when compared with pre-reform level, also did not match the expectations. While the approvals had been on track as envisaged, the actual inflows were not impressive. The receipts ranged from as low as 17.0 per cent of the approvals in 1992 to 33.0 per cent in 1994. This trend mirrored the uncertainty about the progress of reforms resulting in less-than-expected private investments. In this context, it was noted with concern that government investment had lagged behind, and this had serious consequences for the resource availability for infrastructure development with adverse effects on private sector initiatives. The investment rate, it was emphasised at the policy level, had to be maintained in order that the growth objectives were met. A glaring aspect of public investment was in the area of agriculture where public investment had declined by about ₹ 700 crore between 1980–81 and 1992–93, with no offsetting increase in private investment. The share of agriculture in gross capital formation had, as a result, halved from 18.0 per cent in 1980–81 to only 9.0 per cent in 1992–93.

To meet such vast investment requirements in various sectors of the economy, the Eighth Plan had envisaged a substantial step-up in domestic savings. However, the gross domestic savings (GDS) rate, which was at a high of 22.9 per cent in 1990–91, showed steady deterioration and was 21.3 per cent in 1992–93. This was primarily on account of a drop in the savings rate of the household sector from 18.5 per cent in 1990–91 to 16.5 per cent in 1992–93. Corporate savings had shown a rising trend, but public sector savings hovered around 2.0 per cent of GDP during the same period. The GDS rate, however, rose to 23.6 per cent in 1994–95 and stood at 22.4 per cent in 1996–97.

THE EXTERNAL SECTOR

The country was able to tide over the BoP crisis as a result of far-reaching stabilisation efforts. The BoP situation and foreign exchange reserves position improved considerably from 1991–92 to 1993–94. The CAD, which stood at US$ 10.0 billion in 1990–91, came down drastically to less than a billion dollars in the years 1993–94 and 1994–95. As a percentage of GDP, it improved from (–)3.0 per cent in 1990–91 to about (–)1.0 per cent in 1994–95. The sharp reduction in the CAD within a short period of three years obviated the need for exceptional external financing.

The improvement in the current account balance was accompanied by a turnaround in the capital account. The measures taken not only helped arrest capital flight, which was underway after the crisis, but also led to a surge in capital inflows, especially in the form of foreign portfolio investment. Foreign investment, which stood at US$ 103.0 million during the year 1990–91, went up to US$ 4.1 billion during 1993–94, and continued to rise thereafter, touching US$ 6.1 billion during 1996–97. A major upsurge took place in portfolio investment, which escalated from a mere US$ 6.0 million during 1990–91 to US$ 3.5 billion during 1993–94 and remained flat at around US$ 3.3 billion during the year 1996–97.

The expansion in capital inflows coupled with a declining CAD resulted in a substantial build-up of foreign exchange reserves (excluding gold and special drawing rights [SDRs]), which increased from about US$ 5.8 billion at the end of 1990–91 (equivalent to about 1.3 months of imports) to over US$ 19.0 billion by the end of 1993–94 and further rose to touch a level of US$ 26.4 billion in 1996–97. The build-up in foreign exchange reserves reflected the positive response of the economy to the stabilisation and adjustment efforts. The policy actions relating to the depreciation of the rupee, easing of restrictions on the capital account, liberalising the current account and special measures to attract NRI deposits and foreign investment were notable in the 1990s. Besides, there was improved international understanding of the challenges of the economy in a constructive and helpful way, with support from the IMF and the World Bank for the policies that were formulated and implemented.

Imports declined consequent to the devaluation of the rupee. However, certain exogenous factors too affected the behaviour of imports. Imports of petroleum, oil and lubricants (POL) in dollar terms declined in the post-reform period, despite the fact that domestic output of petroleum was also falling. The decline occurred primarily in the wake of the fall in international prices of crude oil in 1991 as a result of the general recovery of world oil output after the dislocation caused by the gulf war. Non-POL non-food imports, however, did not witness much increase on account of recessionary conditions in the real economy. The industrial revival in 1994–95, however, led to a reversal of this trend. Reduction in trade barriers gave a fillip to imports; caution was exercised during the import liberalisation process in order to avoid excessive high growth of imports during the transition phase.

The ratio of exports to GDP showed a gradual but a consistent improvement from 5.8 per cent in 1990–91 to 8.2 per cent in 1993–94 and further to 8.8 per cent in 1996–97. It was considered important to sustain export growth in this scenario so that the external debt burden did not exceed manageable levels. This prompted policymakers to analyse and assess export performance, focusing on the areas of strength, *i.e.*, the traditional items such as textiles and garments, handicrafts and gems and jewellery, and export of machinery and engineering goods. Sluggishness set in thereafter and exports growth was recorded at a low of 5.3 per cent in 1996–97. By 1993–94, the economy had pulled out of recession and the depreciation of the REER of the rupee between 1989 and 1993 also started to reverse. It was envisaged that the increased 'pull' of the domestic market in this scenario and the reduced profitability of exports would lead to a slowdown in export growth unless the investment pattern was re-oriented towards the exports sector.

Further, it was envisioned at this point that India's export growth in the long run would have to be based on achieving competitive advantage through improved productivity and quality, and by focusing on product and market diversification. It was analysed by the policymakers that it was essential to adopt an active exchange rate policy, as it was the only direct instrument available for dynamic export promotion in the short run. Towards this end, the exim policy (1992–1997) stipulated steps for sustained export growth, which, *inter alia,* included enlarging the export promotion capital goods (EPCG) scheme; expanding and liberalising the advance licence scheme; rationalising schemes for export-oriented units (EOUs), export processing zones (EPZs) and electronic hardware and software technology parks; abolishing the advance customs clearance permit; freeing the imports of components and consumer durables; expanding the list of freely importable goods (OGL); and enabling single-window clearance for applications to set up joint ventures (JVs) or wholly-owned subsidiaries abroad. One specific and critical problem area identified was constraints in exports infrastructure.

TRENDS IN INFLATION

The inflation rate, which was at a high of over 16.0 per cent in the beginning of the 1990s steadily declined to 7.0 per cent at the end of 1992–93. However, during the period from 1991 to 1995, the average inflation rate (measured by the wholesale price index [WPI]) stood at 10.7 per cent, which was substantially higher than the 7.8 per cent on average posted in the pre-reform period of 1985 to 1991. This was in contrast to the objectives of the stabilisation programme, which meant to achieve a rather stable price scenario. A critical element of inflation was that food inflation increased substantially in 1990–91 on the back of significant upward revision in the administered prices of food grains effected by the Government during the period from 1990–91 to 1993–94. The rise in the central issue price of rice and wheat was 25.0 per cent and 22.0 per cent, respectively in 1993–94, which was much higher than the corresponding increases during the preceding three years. The increase was necessitated by a sharp increase in the minimum support prices (MSPs) of agricultural commodities on one hand and the need to reduce subsidies in an attempt to rein in the fiscal deficit, on the other. The escalation in the MSPs was the fallout of the reduction in subsidies on all fertilisers in August 1991, which accounted for a substantial component in the cost of cultivation. The upward revision in procurement prices of food grains during the period 1990–91 to 1993–94 exerted upward pressure on the average inflation rate. In tandem with the food grain price escalation, the prices of commodities under the administered control of the Government, such as sugar, *khandsari* & *gur* and cotton textiles, also posted substantial increases from 1990–91 to 1993–94 compared with the pre-reform era.

An upsurge in inflation during the year 1994–95 was, however, experienced in the case of commodities, which showed greater sensitivity to aggregate demand and supply factors. This, therefore, was a matter of grave concern and caused sharp increases in the prices of non-food grain food articles such as fruit, milk, eggs, meat and fish. The overall price behaviour, examined against the backdrop of the macroeconomic environment, showed that in the case of tradeable goods, increased demand was reflected more in increased imports or a decrease in exports, thereby worsening the balance of trade, rather than in price increases. The non-tradeable sectors, however, tended to show high price responses. The average rate of inflation, which was 8.6 per cent during the Eighth Plan, came under control and was reported at 4.5 per cent during the Ninth Plan.[5]

With the setting in of the reforms process and the liberalisation of imports from 1990–91, the build-up of excess capacities on account of recessionary conditions in the real economy was expected to increase the supply responsiveness of the Indian economy in 1994–95. This, in conjunction with a stable nominal exchange rate and lowering of indirect tax rates, was expected to mitigate the build-up of inflationary impulses in the Indian economy. A rapid rise in imports and high industrial production during 1994–95 seemed to suggest that such a process was under way, although it was not found sufficient to stem inflationary impulses from developing in supply-constrained segments of the system. This indicated a need to address supply constraints in the economy as a long-term resolution. Further, the experience of the mid-1990s confirmed that inflationary pressures also emanated from sharp increases in monetary aggregates on the back of foreign portfolio inflows and the inability of the Indian economic system to utilise them productively.

THE MEN AT THE HELM

During the period 1981–1997, the Reserve Bank had six Governors. Dr I.G. Patel's tenure as Governor began on December 1, 1977 and ended on September 15, 1982. Dr Manmohan Singh took the reins on September 16, 1982 and held office till January 14, 1985. Subsequently, after a period of less than a month's interim governorship of Shri A. Ghosh, Shri R.N. Malhotra took over on February 4, 1985 and remained Governor until December 22, 1990.

A major re-organisation of departments was undertaken by Dr I.G. Patel in the Bank along with the introduction of combined seniority of officers in most departments. It was during his tenure that the Deputy Governor, Shri M. Ramakrishnayya, played an active role in the establishment of National Bank for Agriculture and Rural Development (NABARD) and in improving and strengthening the rural credit infrastructure. During Dr Manmohan Singh's tenure, rural development got a further fillip and, most importantly, the foundations for modern day monetary policymaking that would be consistent with high growth

5. Government of India, Planning Commission, *Mid-term Appraisal of the Ninth Five Year Plan (1997–2002).*

and the expansion of financial markets were laid. The setting-up of the Chakravarty Committee (1985) to reform the monetary and financial system was a reflection of this idea. The period, when Shri Malhotra was the Governor, set the stage for reforms in the money and credit markets and the consolidation and diversification of banking and non-banking business. He persistently pursued the issue of fiscal consolidation with the Government. It is relevant to mention that during this period, the Deputy Governor, Dr C. Rangarajan in the area of monetary and credit policy and research and Shri A. Ghosh in the area of banking regulation and supervision, played a crucial role in carrying forward the early reforms.

Along with the onset of reforms in 1991, the Governor, Shri S. Venkitaramanan, had to fire-fight the external sector crisis, besides the irregularities in the securities markets that broke out in April 1992. After his two-year tenure in the Government as a Member of the Planning Commission, Dr C. Rangarajan assumed charge as the Governor on December 22, 1992 and continued until November 22, 1997. He pushed forward monetary and financial sector reforms and ended the four-decade practice of automatic monetisation of the fiscal deficit through active co-ordination with the Government. Dr Bimal Jalan took the reins thereafter and teamed up with the Finance Minister, Shri P. Chidambaram, to carry forward the successful implementation of several far-reaching reforms within the Reserve Bank and in the financial system.

REFLECTIONS ON RESERVE BANK POLICIES AND OPERATIONS

After the Bretton Woods system was abandoned in 1971, the Reserve Bank kept a vigil on the radical changes taking place around the world in terms of economic reforms and paradigm shifts in several countries, in particular the Latin American and East Asian countries. The banking, external and financial sector policies during the early 1980s in general followed the legacy of the late 1970s. A plethora of controls and directions regarding financial sector management was the order of the day. Rates of interest were administered, both on the lending and the borrowing sides, and they ran into long lists that rendered the structure too difficult to fathom. Coupon rates on government securities were fixed, remained low and were unrelated to market rates. From the mid-1980s, the Reserve Bank embarked upon liberalisation of the money and credit markets and rationalisation of interest rates.

While India did not embark on any extensive reforms after the oil crisis of 1979, the Government and the Reserve Bank were generally eclectic in their approach and undertook reforms selectively. They preferred to introduce incremental changes, mostly within the existing legislative and institutional framework and remained cautious in their stance.

Two major developments marked the beginning of the Reserve Bank freeing itself from the adverse consequence of the overwhelming fiscal dominance since the mid-1980s. The first was the constitution of the committee to review the working of the monetary system (Chairman: Prof Sukhamoy Chakravarty, 1985), which examined the monetary system in all its dimensions and paved the way for strengthening the monetary policy framework. One of the major recommendations of the committee was to look at the budget deficit from the angle of monetisation of the same by the Reserve Bank. The framework of the structure of interest rates proposed by the committee led to introducing a series of measures in changing interest rates, rationalising and reducing the number of administered interest rates, making government securities interest rates inflation-hedged and helping to retrieve the banking system from the gap created by the depreciation of the government securities portfolio. With effect from May 1, 1989, the Indian Banks' Association (IBA) withdrew the ceiling on the call money rate of 10.0 per cent per annum fixed in April 1980. Although the freeing of the call money rate initially resulted in extreme volatility in the interest rates in the call money market, it marked an early step towards interest rate liberalisation. Selective credit controls were gradually dismantled. Interest rates in the money market, in particular the overnight market, were freed. All these reforms augured well when a large-scale overhaul of the financial system was initiated after the Report of the Committee on the Financial System (Chairman: M. Narasimham) came up for implementation in 1991.

The second major development was reforming the money and credit markets. A series of market-based instruments, such as 182-day Treasury Bills, certificates of deposit (CDs) and commercial paper (CP) were introduced, based on the report of the working group on money market (Chairman: Shri N. Vaghul, 1987), along with the setting-up of a discount house to create a market for such bills and instruments. In another development, the direct involvement of the Reserve Bank on credit dispensation for large and medium-sized loans was withdrawn in the late 1980s. In furtherance of the objective of institutional development, on January 1, 1982, Exim Bank was set up to provide a comprehensive package of financial and allied services to exporters/importers. NABARD was formed to strengthen the structure of and supervision over rural credit systems, and it started operations in July 1982. On July 9, 1988, the National Housing Bank (NHB) was set up under the NHB Act, 1987. The Discount and Finance House of India Ltd (DFHI) also came up during 1988 to improve the efficiency of the money market.

In June 1987, some banks were allowed to engage in the business of mutual funds. These included Canara Bank, the State Bank of India (SBI) and Bank of Baroda (BoB). The Reserve Bank also allowed banks to diversify into activities such as leasing, housing subsidiaries, venture capital and merchant banking. Besides providing operational flexibility, this paved the way for the penetration of universal banking practices into the Indian banking scene.

At the time of the crisis in 1991, inflation was at high levels mainly due to the expansionary fiscal policy. The adverse consequences of inflation were sought to be mitigated by hiking interest rates and restricting credit flow to the commercial sector in various ways. The excess money supply was absorbed by raising cash reserve ratio (CRR) and accommodating government funding through increasing statutory liquidity ratio (SLR). These ratios reached their statutory limits, practically making the monetary policy ineffective. Thus, perhaps the most important and challenging development for macroeconomic policy and management that directly affected the Reserve Bank's role was fiscal prudence giving way to unbridled fiscal expansion. The fiscal deficit widened substantially and automatically and was heavily monetised by the Reserve Bank through the mechanism of *ad hoc* Treasury Bills and direct participation in primary issues of government loans. The seriousness of this issue was known to the Reserve Bank and appropriately voiced in its Annual Reports. The initial steps taken during that period were fixing the limits on *ad hoc* Treasury Bills beginning in 1994–95 and ultimately eliminating these bills in April 1997.

MONETARY MANAGEMENT

The Chakravarty Committee report was at the core of the transformation of monetary management practices and a revamp in the existing framework. This led to far-reaching reforms as discussed earlier in this chapter. Further, the task of estimating credit requirements was entrusted to the major commercial banks at their credit budget discussions. The estimates arrived at by the banks were tallied with the Reserve Bank projections to ensure credibility. After this exercise, a view was taken on whether the increase in money supply or bank credit assessed was desirable from the viewpoint of maintaining price stability and any other designated objective. Against this backdrop, the Reserve Bank took decisions to regulate credit growth. The quantitative targets set for credit deployment were thus flexible, rather than unalterable.

The Reserve Bank through its credit policy measures attempted to moderate the growth of liquidity to the desired levels in order to restrain inflationary pressures without disrupting the flow of credit to vital sectors of the economy. The Bank also had to provide funds for the budgetary operations of the Central Government and for its market borrowing programmes. Thus, monetary policy had to contend with the unenviable task of neutralising the inflationary impact of the growing deficit in the Government's budgetary operations.

The seasonality in the announcement of the monetary policy reflected the agricultural bias and the general pattern of the credit cycle in the economy. In order to make a realistic assessment of the acceptable or desirable increases in bank credit as also its allocation among various sectors, besides the limit up to which the Reserve Bank could support the borrowing programme of the Government, the Reserve Bank prepared monetary and credit budgets at the beginning of each financial year. These proposals were normally reflected in the Union Budget. Also, the estimation of monsoon prospects and their impact on the real sector of the economy were considered, and the forecast was made using rainfall data from previous years. In this context, connect between growth in bank deposits and the currency component was derived once the deposit growth had been estimated. While the Reserve Bank's views on the market borrowing programme were an input into budgetary policymaking, the fiscal policy had other objectives besides non-inflationary financing. The Reserve Bank was aware of this situation and considered the final budget figures, even if they deviated from its own proposals, as decisive ones for the smooth conduct of the borrowing programme after the budget was announced.

In this context, the Reserve Bank maintained close and continuous dialogue with the Ministry of Finance. The Bank's ability to carry out monetary policy depended to a considerable degree on the extent of consensus with the Government to meet the latter's financing requirements in a non-inflationary manner. The appropriate public debt management policies and agreements for financial accommodation were indeed integral and crucial factors for the efficacy of monetary policy.

In tune with the monetary policy objectives of the 1980s, the policy stance during the eventful period beginning in 1992, with the advent of economic reforms, remained multi-dimensional, with equal emphasis on growth, and price and financial stability. Towards this end, the perception within the Reserve Bank was that monetary growth had to be consistent with the expected growth in output and a tolerable rate of inflation. In pursuance of the dual objective, monetary policy had to be flexible enough to make strategic adjustments to the market disequilibria and the surge in capital inflows.

From 1991–92, the Reserve Bank and the finance ministry worked in unison and this resulted in monetary policy formulation that was in sync with the economic and fiscal policies. The co-ordination strengthened over the years and was formalised with the signing of a historic agreement in September 1994 to phase out automatic monetisation of the budget deficit in three years, which provided the Reserve Bank with a relatively higher degree of manoeuvrability in monetary management as well as in public debt management.

In the liberalised regime, monetary management was vested with the additional responsibility of maintaining orderly conditions in the money, credit, securities and foreign exchange markets. More importantly, the progressive rationalisation and deregulation of the interest rate structure, which was recognised as an integral part of financial liberalisation, was expected to improve the functioning of the financial markets. The process would facilitate close alignment in the interest rates and progressive integration of the financial markets. As a corollary, it required a marked shift in emphasis from direct to indirect instruments of credit control. Open market operations (OMOs) and its derivative, the repos, were actively utilised from 1993–94 to influence the level of reserves with commercial banks and, thereby, the liquidity in the economy. The mechanism facilitated discreet changes in the volume of primary liquidity in the system and served to communicate to the market participants the perceptions of the monetary authority about the conditions in the money and financial markets in a subtle manner.

EXCHANGE RATE MANAGEMENT

After the collapse of the Bretton Woods system of fixed rates of exchange, major currencies floated relatively freely in the world currency markets. The developing countries, including India, pegged their currencies to either one of the major currencies or to a select basket of currencies. A free operation of the exchange markets was considered difficult, and the exchange markets in these economies provided support to trade rather than opportunities for pure exchange trading. Many developing countries could not afford a free float for their currencies, since they did not have the institutional arrangements for establishing the requisite linkages with the international markets and the position of their BoP did not offer such a possibility. Further, the policy with respect to the exchange rate had to be in consonance with the macroeconomic policy objectives.

The typical role performed by central banks in the 1980s included framing the exchange rate regime and supervising the operations of foreign exchange markets on a continuous basis. The Reserve Bank too was in the same mould. Further, Reserve Bank regulations on forward market operations were comprehensive, facilitating need-based market service and discouraging speculation. The Reserve Bank strived to develop an active exchange market with wide participation and facilitate customers to get fine quotes for the traded currencies. Thus, the exchange market in India during the 1980s remained well-regulated, with restrictions on external transactions, barriers to entry, low liquidity and high transaction costs.

The exchange rate in the early 1990s became central to the management of the external sector and played a role beyond issues relating to international trade. The Government was committed to eliminating various trade interventions. The introduction of current account convertibility, on one hand supported market-oriented reforms and, on the other, imparted a degree of discipline to India's exchange rate policy.

The committee on balance of payments (Chairman: Dr C. Rangarajan, 1991) recommended the introduction of a liberalised exchange rate management system (LERMS). It was introduced in 1992 after extensive discussions between the Government and the Reserve Bank. LERMS was a transitional system with dual rates. It subsumed the declared objective of moving towards full convertibility of the current account transactions, keeping in view the macroeconomic developments in the economy and the world trading environment. The system was part of the liberalisation measures and, apart from providing a boost to exports, aimed at enhancing efficiency. Under LERMS, the proportion of official allocation of foreign exchange for the purposes of public good could be steadily reduced, thereby enhancing the proportion of foreign exchange that importers could buy from the market. On March 1, 1993, a unified exchange rate was introduced, wherein the exchange rate was determined by demand and supply in the Indian foreign exchange market. The Bank, along with the Government, worked internally to prepare the economy for full relaxation of controls on transactions under the current account. Eventually, India was accorded Article VIII status of the IMF in August 1994. In parallel, the Reserve Bank also reduced capital account controls to a considerable extent.

BANKING SCENARIO

In 1980–81, banking was beset with a host of difficulties, the most prominent of which were low banking penetration and poor credit facilities. The Government re-oriented the banking policy, transforming the banking system to assume increasing social obligations. In this sense, banking became a social institution and in the process lost its commercial edge. The major flaws of the system at the beginning of the 1980s were that it was overextended, undermanned and undercapitalised. The agenda for the system during the 1980s was to consolidate and usher in commercialisation, and the key elements of the strategy for the sector included, *inter alia*, a slowdown in branch expansion, while covering spatial gaps in rural areas, devising action plans for banks covering various aspects of organisation, housekeeping, training, customer service, credit management, recovery aspects, technology adoption, human resource efficiency, productivity and operational efficiency. Consolidation, therefore, was the key for commercial banking survival and rejuvenation. This also included streamlining the payment and settlement systems and updating the necessary legal framework.

In the agenda for the structural reforms of the 1990s, the financial sector reforms were embarked upon upfront. This was against the backdrop of an external payments crisis rather than any banking crisis. The restructuring elements of the financial system were, however, home-grown, but taking cognisance of international experiences as well. The reforms were carefully sequenced with respect to the instruments and objectives, resulting in the introduction of supervisory and prudential norms early in the cycle. This was followed by interest rate deregulation and a gradual lowering of statutory pre-emptions pursued as a part of banking reforms. Thereafter, the more complex aspects of legal measures and accounting practices were addressed, with the basic tenets of reforms already in place. The Report on Trend and Progress of Banking in India[6] noted:

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6. Reserve Bank of India, 1990–91.

> ...the changing environment of competition amongst different segments of the financial system would call for a different work and management ethos, much more professionally oriented and goal and performance determined.

The roadmap for these reforms was drawn from the Narasimham Committee recommendations. This also led to the issuing of guidelines in respect of income recognition, asset classification, provisioning by the Reserve Bank and, finally, adoption of the Basel Accord of capital adequacy standards. Other major contributions of the package were the institution of the Board for Financial Supervision (BFS), the induction of more capital in public sector banks (PSBs) for better financial strength with provision for accessing the capital market and permitting the entry of private sector banks into the system, because they were more technologically advanced. The systemic shock of the 1992 securities scam had adverse implications for the financial system and the banking system in particular. The lessons learnt in its aftermath led to far-reaching modifications in market regulation and settlement practices. This provided the requisite justification for the gradualist approach adopted by India to the reforms procedures in the financial sector.

FINANCIAL MARKETS

During the 1980s, most of the financial markets in India were characterised by controls, over pricing of financial assets, restrictions on the flow of transactions, barriers to entry, low liquidity and high transaction costs. Monetary policy was also not attuned to the use of market-based indirect instruments. These characteristics severely inhibited the growth of the financial markets and reduced the allocative efficiency of the resources channelled through them.

In the early 1990s, as part of financial sector reforms, the Reserve Bank embarked upon development of the financial markets, *i.e.*, money market, government securities market and foreign exchange markets. The initiative was aimed at fostering smooth and integrated functioning of these markets. Repo (repurchase agreement) was introduced as an operating instrument for liquidity management and put into operation as a money market instrument during the 1990s.

The development of the money market and strengthening of the government securities market were at the core of the Chakravarty Committee recommendations. Thereafter, the Vaghul Committee report provided a detailed procedural roadmap in the context of strengthening the institutional structure, instruments and operating procedures to widen and deepen the money market while emphasising that transparency of rules was more important than discretion. The major thrust of the recommendations of the Narasimham Committee was on the working of the commercial banking sector and development financial institutions. The committee observed that efforts had been made to broaden money market activities and to create a secondary market, and indicated that induction of more participants and enlarging the variety of instruments would facilitate the development of a well-functioning and sufficiently deep secondary market.

Apart from implementing the recommendations of the three committees, the Reserve Bank put in place a consultative approach to the development of financial markets by setting-up internal working groups and committees with participation from a range of institutions and market players.

PUBLIC DEBT MANAGEMENT

The Reserve Bank is enjoined by a statute under section 21 of the Reserve Bank of India (RBI) Act, 1934, with the function of managing the public debt of the Central Government, and by agreement with respective states under section 21A, the Bank assumed a similar function with respect to the states. Under section 17(11) of the RBI Act, the Bank is empowered to act as an agent of the central and the state governments in managing their public debt.

The debt management function was performed rather passively during the period of tightly-regulated interest rates during the 1980s as the demand for government debt came from captive investors and the Reserve Bank participated to absorb the debt not subscribed by others. Also, there was a practice of unlimited and automatic monetisation of Central Government deficit through *ad hoc* Treasury Bills that had been in vogue since the mid-1950s. As a result, there was practically no secondary market in government securities. The Chakravarty Committee had envisaged that to reduce the extent of debt monetisation, the Government's borrowing requirements should be financed from the open market. The DFHI was set up in 1988 as a money market institution in furtherance of the initiatives taken.

The Narasimham Committee envisaged that an active internal debt management policy would enable the integration of the debt management policy with monetary policy. Thus, the activation of public debt management gained prominence only in the wake of fiscal consolidation undertaken as part of the structural reforms initiated in the early 1990s. The Reserve Bank initiated several reforms in quick succession during 1992–1997, paving the way for full-fledged development of a government securities market that enabled the Bank to actively move away from direct instruments, such as directed credit, the CRR and refinancing, to indirect market-based instruments, such as OMOs and other liquidity management operations such as repos. The manoeuvrability thus provided to the Reserve Bank in managing public debt consistent with the monetary policy stance was enhanced by the agreements signed between 1994 and 1997 for phased reduction in the issuance of *ad hoc* Treasury Bills and their ultimate discontinuation in April 1997. They were replaced with limited ways and means advances (WMA) from the Reserve Bank.

ORGANISATIONAL STRUCTURE

The Reserve Bank evolved its organisational structure and capacity building, responding to domestic economic needs and taking cognisance of international practices. The progression of the organisation enlarged the structure of the Bank not only in terms of size but also the functional transformation necessitated by evolving economic and financial conditions. The creation of new departments, the computerisation of various departments, initiatives in mechanisation and improving industrial relations were some of the aspects that engaged the attention of the management through the years. The operations of the Bank emerged out of the diversity of roles entrusted to it. They were also marked by flexibility in operations and practices, which typically characterised the transformation of the Reserve Bank over the decades.

During the period of the 1980s and 1990s, the organisational structure had to be aligned with the spirit of the regime of economic liberalisation and well-modulated regulation of markets and institutions in the financial sector. Thus, the Bank established new departments, such as the Department of Information Technology (DIT) and Internal Debt Management Cell (IDMC, later converted into an independent inter-disciplinary department) during the 1990s and changed the nomenclature of the Credit Planning Cell (CPC) to the Monetary Policy Department (MPD). The creation of the office of an Ombudsman in the mid-1990s was a case of providing a platform to cater to the needs of bank customers.

Communication practices in the Reserve Bank, in line with international practices, were strengthened through the years. Though the role played by communication was well recognised, only practices of communication were in place. Such practices were aimed at providing information on monetary policy and the role being played by the Reserve Bank in the economic system, besides disseminating data for public use. Internally, there were attempts at improving inter-department communication and communication from the management to staff. The aim was to strengthen the work ethos and improve productivity. Various establishments of the Reserve Bank, such as the training colleges, performed an important role in bridging skill gaps in various cadres in the commercial banks as also the Reserve Bank staff.

The period of 16 years covered in this volume was very eventful for the Reserve Bank, as it was both an observer and a contributor to policies in transforming an inward-looking economy into a vibrant and forward-looking one. The political and socioeconomic conditions underwent dramatic changes, making the Reserve Bank play a pivotal role in bringing about reforms in the entire financial system in tune with the aspirations of the Government and as per the rapid changes taking place all over the world. The events of the 1980s and 1990s and the proactive and timely responses by the Reserve Bank to fulfil its obligations and responsibilities took the institutional integrity and reputation of the Bank to further heights in the domestic as also in the international sphere.