THE HINDU BusinessLine

How India banked on reforms

C RANGARAJAN

The monetary and banking sectors have benefited, with policy changes playing a crucial role

Reforms were a response to the acute economic crisis that India faced in 1991. There is a common thread running through the various measures introduced since July 1991 and that is to improve the productivity and efficiency of the system by injecting a greater element of competition. There has thus been a paradigm shift in India's approach to economic policy.

Even as reforms were introduced in the real sector, it became obvious that without corresponding reforms in the financial sector, the expected results would not be achieved. It may be worthwhile to recall the key changes in the monetary and banking sectors that were brought about in the first few years after the reforms. The difficulties faced were no less challenging than what they were in the real sector.

Monetary sector reforms

The institutional framework within which monetary policy operated underwent far-reaching change. The most important change was the phasing out of the system of the issue of ad hoc treasury bills by the Government to the Reserve Bank of India. Under that system, whenever the cash balances of the Government fell below a particular level, it could issue these ad hoc treasury bills and replenish its cash balances. This innocuous arrangement had the effect of automatically monetising the fiscal deficit of the Centre.

Under such an arrangement, the RBI virtually lost control over regulating money supply. The fiscal dominance was complete. I had argued even prior to 1991 for doing away with this system. As governor, I pressed with the finance minister to make this change and he readily agreed. This may indeed be considered as the first step towards giving autonomy to the RBI in relation to the conduct of monetary policy. This was followed up later when the Fiscal Responsibility and Budget Management Act put an end to the RBI entering the primary market in government securities. These are essential reforms to enable the RBI to regulate liquidity in the system according to its judgment.

Coupled with the decision to phase out the system of ad hoc treasury bills was the decision to compel the Government to go to the market and raise funds at market-determined rates. The statutory liquidity ratio, which is the proportion of deposits to be kept by banks in the form of government securities, was also brought down steadily from 38.5 per cent in 1991 to 25 per cent by 1996. As a consequence, an elaborate system for auctioning of government bonds of various maturities had to be put in place. The system of primary dealers in government securities was also introduced.

The most important consequence of this move for monetary policy was that open market operations emerged for the first time as an instrument of monetary control. So long as rates of interest on government bonds were artificially fixed, there was no scope for open market operations to be used as an instrument of credit control. Under those circumstances, Cash Reserve Ratio became the primary instrument of credit control.

Yet another change was the dismantling of administered structure of interest rates. With the freeing of the interest rate structure, the bank rate also became a potential instrument of credit control. If today we are able to talk in terms of the repo rate which is only a cousin of bank rate as a signal rate, the foundation for that was laid in the early years of the reform period. There is a continuing debate on what the objectives of monetary policy should be.

However, the instrumental freedom necessary for the conduct of monetary policy was achieved in the early years of reform process.

Banking sector reforms

The Indian banking system as it was in 1990 was dominated by two features. First, the public sector accounted for the bulk of banking assets. Second, it operated under a heavily controlled regime. It had evolved in an environment of administered interest rates and stipulations on asset allocation.

The growth of the banking system during the first two decades after nationalisation of banks in 1969 was marked by a spectacular spread of banking with an increase in the number of branches from 8,187 in 1969 to 59,752 by the end of March 1990. The growth of rural branches was even faster increasing from 1,443 in 1969 to 34,791 as at the end of March 1990. While the banking sector widened its reach, its own health had got impaired. Low operational efficiency contributed to low profitability and consequently to erosion of its capital base. There was, therefore, an urgent need to address the issue and the move towards reforms was a natural corollary.

A committee was set up under the chairmanship of M Narasimham which had recommended the steps to be taken to revitalise the banking system. A set of prudential norms relating to income recognition, asset classification, provisioning and capital adequacy were introduced. Prudential and capital adequacy norms were prescribed to ensure the safety and soundness of the system. In line with international standards, public sector banks (PSBs) were required to progressively achieve a capital to risk assets ratio of 8 per cent. A frequently asked question at that time was since these banks were owned by government, was there a need to prescribe norms such as capital adequacy ratio. Prudential norms are required to make the system stand on its own strength. The imposition of the capital adequacy norms required the government which owned the PSBs to contribute to capital in order to reach the prescribed ratio. This was indeed a difficult task at a time when the government as part of its fiscal policy reforms was trying to contain fiscal deficit. But the government did not flinch and for over several years it continued to contribute to the capital of PSBs. The term, 'non-performing assets', was unknown in India till 1991. The RBI progressively tightened the definition for what constitutes a non-performing asset.

Major changes

Three other important changes in relation to the banking system must also be noted. First, the Nationalisation Act was amended to enable the government to reduce its share of holding in PSBs to 51 per cent. This was indeed a difficult legislation.

The members of the Congress Party had a sentimental attachment to the nationalisation of banks. However, the public character of the institutions was maintained as the majority was still in the hands of government. But the induction of private sector into the ownership structure had its own effect in terms of performance.

Second, reforms in the banking sector would not be of any avail unless the administered structure of interest rates was dismantled. With interest rates stipulated by the RBI, there was hardly any competition. But the dismantling had to be done in a measured way so that banks could get adjusted to the new regime. It took about two-three years before we could move to a system in which banks had the freedom to determine deposits rates and lending rates.

Third, in order to create a more competitive environment in the banking system, after several decades, licences were granted to the private sector to open new banks with new norms set for the opening of banks. Initially, long-term lending institutions that were already in existence were given licences to open banks.

The introduction of prudential norms did create an uncomfortable situation for banks. Several PSBs had to show losses. This was a traumatic experience. As the reforms were introduced, profitability and efficiency increased and the non-performing asset ratio progressively came down. Care was taken to ensure that the social content of lending was not reduced.

The Indian banking system has emerged considerably stronger because of the changes introduced. Prudential norms have been tightened and altered in the context of changing circumstances. The problem of NPAs has once again reared its head. The prudential norms only make transparent the health of the banks.

External sector reforms

The external sector went through a complete regime change. This is to be expected since the crisis itself was triggered by an acute balance of payments problem. The reform of the external sector comprised two elements. The first related to changes in the trade sector. Quantitative controls over imports were being removed step by step. The tariff rates were also brought down steadily from the high levels at which they stood at the time. The changes in the trade sector signalled a movement away from an inward looking approach to the adoption of an open policy of integrating with the rest of the world.

The second element in external sector reforms related to changes in the exchange rate management. The steep devaluation effected in early July 1991 was followed by the introduction of the Exim scrip scheme which enabled exporters to import a certain percentage of their export earnings without restrictions. This effectively meant a selective devaluation. In 1991, the government appointed a high level committee on balance of payments (BoP) under my chairmanship to look at the capital account of India's BoP. Apart from recommendations relating to the management of capital account, the committee also made key recommendations with respect to exchange rate. Based on the recommendations of the interim report of this committee and other inputs, the government and RBI moved to a dual exchange rate system in March 1992. Until that time, the exchange value of the rupee was determined by the RBI every day.

Under the new system, 40 per cent of the current receipts were required to be surrendered to the RBI at an official exchange rate, while the rest was allowed to be sold at the market-determined exchange rate. The committee in its final report recommended the adoption of a unified market-determined exchange rate system. In fact, the experience with the dual exchange rate system provided courage to move to a full-fledged market-determined exchange rate system.

Under the dual exchange rate system, while the official rate continued to be □25.80 a dollar, the market rate ranged between □30 and □31.50 a dollar. In March 1993, we moved to a unified market-determined exchange rate system. The transition was smoother than expected. Though the rupee weakened a bit immediately after the Budget, it subsequently strengthened and a remarkable stability was seen in the behaviour of the exchange rate which remained steady at a level of □31.37 against the dollar for a long period.

This new system did not preclude intervention by the RBI. In the context of the reasonably good capital flows, the value of the rupee remained stable because of the intervention of the RBI in the market which resulted in the accumulation of foreign exchange reserves. There was a compelling necessity at that time to raise the level of reserves. The RBI from time to time has clarified its position regarding the policy of intervention. After 1992-93, it must be said that the BoP position of India has remained strong, unlike what it used to be prior to 1991. Though the system that was adopted is called 'managed float', it nevertheless remains mostly determined by the demand and supply of foreign exchange. The rupee became convertible on current account in 1994.

Changes in the institutional infrastructure relating to monetary policy, banking and exchange rate regime were an integral part of the reforms. Subsequent changes were in consonance with the original intentions. Institutional reforms are, however, the first step. They have to be supplemented by appropriate policies to achieve results.

The writer was a governor of the RBI

(This article was published on August 16, 2016)