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South Asia

Financial sector reforms in India, 1991-1994

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96/5

Research School of Pacific and Asian Studies ANU

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abstract

In 1991, the Indian government initiated a comprehensive market-oriented reform program. At the core of the program was a phased deregulation of the financial sector. The purpose of the paper is to analyse the process of financial liberalisation and the regulation of the financial sector in India for the period 1991 to 1995. The paper undertakes an examination of the changes in major sectors (banks and development finance institutions) and markets (money, government securities and stocks). It also discusses two specific issues in the reform process: the regulatory regime pertaining to banks and development finance institutions; and the link between the financial liberalisation process and the general macroeconomic environment within which it occurs.

abbreviations

BFS	Board for Financial Supervision
BSE	Bombay Stock Exchange
CRR	cash reserve requirement
DFI	development finance institution
DICGC	Deposit Insurance and Credit Guarantee Corporation
EPW	Economic and Political Weekly
FCNR	foreign currency non-resident
FII	foreign institutional investor
GDR	global depository receipt
ICICI	Industrial Credit and Investment Corporation of India
IDBI	Industrial Development Bank of India
IFCI	Industrial Finance Corporation of India
IRBI	Industrial Reconstruction Bank of India
NABARD	National Bank for Agriculture and Rural Development
NRI	non-resident Indian
NSE	National Stock Exchange
OFI	other financial institutions
OTCEI	over the counter exchange of India
RBI	Reserve Bank of India
REER	real effective exchange rate
SBI	State Bank of India
SEBI	Securities and Exchange Bank of India
SFI	state financial institution
SIDBI	Small Industries Development Bank of India
SLR	statutory liquidity ratio

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Financial sector reforms in India, 1991–1994

In 1991, the Indian government initiated a comprehensive market-oriented reform program. At the core of the program was a phased deregulation of the financial sector along with reforms of trade and industrial policies. Important elements of the financial liberalisation program were a lifting of several interest rate ceilings in both credit and bond markets, an easing of requirements that had made it mandatory for banks to hold a part of their portfolio in non-interest bearing reserves and low-yielding government securities, a partial dismantling of barriers to entry into the banking sector and greater freedom to banks to close unviable branches in rural and semi-urban areas. Along with the liberalisation measures was a move to introduce a regulatory mechanism that could ensure the safety and solvency of the financial sector in the deregulated environment.

The purpose of the paper is to analyse the process of financial liberalisation and the regulation of the financial sector in India during the period 1991/92 to 1994/95.[1] The paper undertakes an examination of the changes in major sectors (banks and development finance institutions) and key financial markets (stock, money and government securities).[2] It also analyses two specific issues in the reform process: first, the regulatory regime pertaining to banks and development finance institutions; and second, the link between the financial liberalisation process and the general macroeconomic environment within which it occurs.

The paper is structured as follows. In the next section, we discuss the motivation for the financial sector reforms. We then provide an overview of the financial intermediation process in India for the period 1971/72 to 1992/93 using data drawn from the flow of funds statements published by the Reserve Bank of India (RBI) with a view to identifying salient features of the financial intermediation process in India during the pre-reform period and the years immediately following the reforms. In this section, we analyse the effect of the reforms on the two major sets of financial intermediaries in India—commercial banks and other financial institutions. We also trace the evolution of financial markets during the reforms. In the third section, we describe the macroeconomic environment in which the reforms took place and the effects, if any, that financial deregulation might have had on macroeconomic stability. Finally, we provide an overall assessment of the financial liberalisation process.

Repression and reform in the Indian financial sector, 1969–95

Background to the reforms

Prior to 1969, the Indian banking sector operated in a more or less deregulated environment with all commercial banks (except the State Bank of India, SBI) being privately owned. The State Bank of India (and its associate banks), which was earlier named the Imperial Bank, came under RBI supervision in 1946. 'Social control' of the banking sector effectively began in July 1969 when 14 of the largest Indian scheduled-commercial banks were nationalised. The nationalisation of these 14 banks—when combined with the SBI and its associate banks—meant that 22 of the largest banks, accounting for 86 per cent of the deposits, had become public sector banks (Krishnaswamy et al. 1987). Six more banks were nationalised in April 1980, bringing the share of public sector banks' deposits to 92 per cent. The ostensible objective of the nationalisation was the need for the Government of India to 'control the heights of the economy and to meet progressively...the needs of development of the economy in conformity with national policy and objectives'.[3] With resource mobilisation being a key objective of the Indian planning process, the newly nationalised banks were 'asked' to mobilise deposits on a massive scale by setting up branches in rural and semi-urban areas. At the same time, with the adoption of the Fourth Five Year Plan in 1969, a strategy for agrarian development which put great emphasis on technological modernisation was initiated (Chakravarty 1987). One important element in the above strategy was the provision of adequate credit to the agricultural sector. Furthermore, there was renewed emphasis on poverty alleviation and employment generation in the planning process during this period. This led to intense pressure on the public sector banks by the government to lend to the priority sectors (covering agriculture and allied activities, small-scale industry, retail trade, transport operators, professionals and craftsmen). By March 1979, the 'priority sector lending requirements' (as they came to be known) stipulated that 33 per cent of each bank's total credit should be advanced to the priority sector, with not less than 16 per cent going to agriculture. This was later raised to 40 per cent (where it has stayed ever since), with a further stipulation that one-half of advances to the agricultural sector consist of loans to small and marginal farmers. During this period the banking sector was protected from competition due to significant barriers to entry for both foreign and private domestic banks.

The other financial institutions have had a longer history of public ownership with existing insurance companies being nationalised in 1956 to form the Life Insurance Corporation of India. Financial institutions such as the Unit Trust of India, a publicly owned mutual fund, and the Industrial Development Bank of India (IDBI) were set up by the RBI in collaboration with other financial institutions with specific objectives in mind—the former to promote the stock market (since the goal of the UTI was to invest savings mobilised from households in corporate stocks and bonds) and the latter to provide direct and indirect long-term finance to firms in the industrial sector. (The IDBI was taken over by the government in 1975 and converted into a separate organisation.) Term loans to the industrial sector were also provided by the Industrial Finance Corporation of India (IFCI) and the Industrial Credit and Investment Corporation of India (ICICI).

It should be noted that the policies of financial repression began in the Indian context with the bank nationalisation episode of 1969. However, while the need for social control of the banking sector provided the initial rationale for the policies of financial repression, the subsequent intensification of these policies over the 1970s and 1980s was in great part due to the government's increasing need to use the banking sector for financing its deficits. The fiscal deficit to GDP ratio increased steadily during this period from 3.6 per cent in 1971/72 to 1975/76 to 8.3 per cent in 1986/87 to 1990/91. The way that the government used the banking sector as a captive source of funds was by means of the statutory liquidity ratio. The statutory liquidity ratio is the proportion of net demand and time deposits that banks have to maintain in India in cash, gold and approved government and semi-government securities. Originally the statutory liquidity ratio requirement was intended as an instrument of monetary policy to prevent banks from offsetting the effects of changes in reserve requirements by liquidating their holdings of government securities. However, over the years, the statutory liquidity ratio 'has provided an expanding captive market for government securities and hence served as a means of allocating a larger share of banks' resources to government' (Chakravarty Committee 1985: 254). The statutory liquidity ratio also performed another important role: that of allocating cheap funds to development finance institutions, whose bonds were a part of approved securities. The statutory liquidity ratio requirement was 28 per cent in 1970/71 and had increased to 38.5 per cent in 1989/90.

To partially neutralise the effects of the increase in the monetary base brought about by deficit financing, there was a steady increase in the cash reserve ratio from 7 per cent in 1973/74 to 15 per cent in 1989/90. This meant a larger proportion of bank funds were locked into non-interest bearing bank reserves. At the same time, to keep the cost of borrowing low for itself, the government systematically suppressed government securities markets (and money) markets during this period. As a result, open market operations, which were an important instrument of monetary policy in the pre-repression period, lost their effectiveness as policy tools.

The effects of financial repression policies had an observable negative effect on the financial sector:

- markets were heavily segmented and the underdeveloped nature of secondary markets inhibited competitive pricing of assets (Rangarajan 1994)
- the presence of non-price allocation mechanisms led to an inefficient use of credit
- the several restrictions on banks' uses of funds and the imposition of branch licensing requirements had a significant negative impact on bank profitability
- the restrictions on bank entry and the dominance of public sector banks greatly inhibited competition and efficiency in the banking sector.

The strategy of financial sector reform

The impetus to reforms in the financial sector came with the submission of three influential reports—the Chakravarty Committee in 1985, the Vaghul Committee in 1987 and the Narasimham Committee in 1991. The first committee suggested ways of activating the treasury bills market so that open market operations could gradually become the dominant instrument of monetary policy. The second committee recommended a phased decontrol and development of money markets and the gradual integration of these markets with other key short-term markets such as the treasury bills market. The recommendations of the Narasimham committee provided the blueprint of the reforms that followed in the post-1991 period, especially with regard to banks and other financial institutions.

Since the mid-eighties, the Reserve Bank has implemented in a phased manner several of the key recommendations of the Chakravarty and Vaghul committees. In the government securities market, a scheme for 182 days treasury bills was introduced in November 1986, initially on a monthly auction basis and without any rediscounting facilities with the RBI. The RBI also took several steps to develop the money markets. In April 1988, it instituted the Discount and Finance House of India, to provide liquidity to the money markets. In May 1989, as a further step towards the liberalisation of the money markets, the ceiling on the call money rate was withdrawn. In 1988/89, the RBI also introduced Commercial Paper and Certificates of Deposit as new short-term instruments in the Indian financial market. Consequently, by the late 1980s, there was significant deregulation and development of the short-term segment of the financial markets in India, but there was little progress in the deregulation of credit and capital markets.

More radical reforms had to wait till the adoption of the structural adjustment cum stabilisation program in mid-1991. With the the reform package, two important pre-conditions for financial sector reform were fulfilled. First, with a sharp reduction in the central government's fiscal deficit in the first year of the reforms, there was less need to use the banking sector as a captive source of funds. Second, the implementation of far-reaching reforms in trade and industrial policies meant that the allocation of resources was increasingly market-driven. This implied that for the reforms in the real sector to succeed, trade and industrial policy reforms had to be supported by reforms in the financial sector so that scarce investible funds could go to the most productive uses.

Structure and evolution of the Indian financial sector

There are two major sets of financial institutions in the Indian economy—commercial banks and other financial institutions. Other financial institutions in turn can be classified into three groups

- all India development banks (or development finance institutions)
- state financial institutions
- investment institutions, comprising insurance companies and mutual funds (the most important being the Unit Trust of India).

The development finance institutions specialise in the provision of long-term finance to the agricultural and industrial sectors. The most important of the development finance institutions are the Industrial Development Bank of India, the Industrial Credit and Investment Corporation of India, the Industrial Finance Corporation of India, and the Industrial Reconstruction Bank of India, which primarily provide long-term finance to the industrial sector. Along with the above are two other development finance institutions—the Small Industries Development Bank of India and the National Bank for Agriculture and Rural Development (NABARD), which specialise in catering to the needs of the small-scale and agricultural sectors respectively

Almost all the major institutions in the above three categories are government owned (except the ICICI). All these institutions provide assistance to firms either by providing loans or subscribing to shares and debentures issued by them. They also underwrite new issues and provide guarantees for term loans and deferred payments to enable firms to tap other sources of credit.

To examine the relative importance of commercial banks and other financial institutions in the intermediation of funds, we present the distribution of assets across major financial intermediaries at four different points of time (Table 2). The pre-

Table 1 **Selected macroeconomic indicators, 1981/82–1994/95**

Year	*1981/82–85/86*	*1986/87–90/91*	*1991/92*	*1992/93*	*1993/94*	*1994/95*
Output						
Growth rates of						
GDP	5.0	6.3	1.1	4.0	4.9	
GDP, agriculture	2.7	4.6	-2.5	5.0	3.3	
GDP, manufacturing	8.1	7.2	-3.2	2.0	4.7	
GDP, finance[a]	6.1	7.6	12.7	2.8	9.5	
Prices						
Inflation	6.8	7.8	13.7	10.1	8.4	
Real effective exchange rate (% change)[b]	-1.2	-5.1	-15.1	2.7	7.6	
Monetary variables						
M3/GDP	42.1	49.1	51.1	52.2	55.1	
Growth rates of						
M3	16.4	17.6	18.5	16.4	18.2	
Monetary base	14.4	18.4	13.4	11.5	24.9	
Net RBI claims on government	19.1	18.0	5.8	4.7	0.9	
Foreign currency assets	2.4	19.7	136.0	20.2	127.1	
Real bank credit	10.4	50.6	-5.1	10.0	-0.2	
Output						
Growth rates of						
GDP	5.0	6.3	0.8	5.1	5.0	6.3
GDP, agriculture	2.7	4.6	-2.6	6.6	3.4	5.1
GDP, manufacturing	8.1	7.2	-3.7	4.1	4.3	9.0
GDP, finance[a]	6.1	7.6	10.5	3.0	8.5	4.3
Prices						
Inflation	6.8	7.8	13.7	10.1	8.4	10.4
Savings and investment						
As percentage of GDP						
Domestic savings	19.1	21.4	22.8	21.8	21.4	24.4
Real investment	22.6	24.0	20.4	21.8	20.2	N/A
Monetary variables						
Growth rates of						
M3	16.4	17.6	18.5	16.4	18.2	19.7
Monetary base	14.4	18.4	13.4	11.5	24.9	22.4
Net RBI claims on government.	19.1	18.0	5.8	4.7	0.9	2.2
Foreign currency assets	2.4	19.7	136.0	20.2	127.1	45.3
Real bank credit	10.4	50.6	-5.1	10.0	-0.2	11.4

Table 1 Selected macroeconomic indicators, 1981/82–1993/94 (continued)

Year	*1981/82–85/86*	*1986/87–90/91*	*1991/92*	*1992/93*	*1993/94*	*1994/95*
Fiscal policy						
As percentage of GDP						
Fiscal deficit	-6.8	-8.4	-5.9	-5.7	-7.5	-6.5
Primary deficit	-4.3	-4.6	-1.6	-1.3	-2.9	-1.8
Seigniorage	1.8	2.2	1.9	1.2	n.a.	n.a.
External debt						
Debt/GNP	16.9[c]	24.1	34.0	37.5	37.3	n.a.
Debt service/exports	17.7[c]	29.9	30.6	29.4	28.4	n.a.
Short term/total debt	7.8[c]	10.4	8.4	7.0	4.0	n.a.

[a] Finance and Real Estate.

[b] Combined Public Sector Deficit (includes public sector enterprises).

[c] Averages for years 1982/83–1985/86.

Sources: Economic Survey, Ministry of Finance, various issues; Reserve Bank of India, *Report on Currency and Finance*, Bombay, various issues; World Bank, *World Debt Tables*, Washington, DC, various issues; Easterly, W. *et al.*, 1994. *Public Sector Deficits and Macroeconomic Performance*, Oxford University Press, New York; and Buiter, W. and Patel, U., 1993. *Indian public finances in the 1990s: challenges and prospects*, Economic Growth Center, Yale University, Princeton.

Table 2 **Distribution of assets, banking and financial institutions** (per cent)

Assets (as at end-March)	*1971*	*1981*	*1991*	*1993*
Banking	66.0	84.0	74.4	73.1
of which				
RBI	21.0	24.4	25.8	26.8
Commercial banks	26.4	42.9	46.5	44.3
Financial institutions	34.0	16.0	25.6	26.9
of which				
Term-lending	n.a.	5.9	10.9	11.0
Indusrial Development Bank of India	n.a.	3.0	4.7	4.6
Industrial Credit and Investment Corporation of India	n.a.	0.7	1.5	1.8
Industrial Finance Corporation of India	n.a.	0.6	1.2	1.4
Industrial Reconstruction Bank of India	n.a.	0.1	0.2	0.2
State financial institutions	n.a.	1.7	2.1	1.9
Investment institutions	n.a.	8.0	12.2	13.6
Insurance	n.a.	7.7	7.4	8.5
UTI	n.a.	0.5	4.8	6.2
Other institutions	n.a.	0.2	0.4	0.4

Sources: Chakravarty Committee, 1985. *Report of the Committee to Review the Working of the Money Market*, Reserve Bank of India, Bombay; and Reserve Bank of India, 1993/94. *Report on Trend and Progress in Banking*, Bombay.

reform period, 1971–91, can be divided into two distinct sub-periods. The first sub-period, 1971–81, was the period of growth for commercial banks whose share in total assets of financial intermediaries increased sharply from 26 per cent in 1971 to 43 per cent in 1981. The second sub-period, 1981 to 1991, is the period of growth for financial institutions whose share in total assets increased from 16 per cent in 1981 to 26 per cent in 1991. The most noticeable growth was that of the term-lending institutions, whose share in total assets increased from 6 per cent in 1981 to 11 per cent in 1991. Interestingly this trend has continued in the post-reform period, with the share of commercial banks in total assets falling by two percentage points from 1991 to 1993, while the share of financial institutions increased by 1.3 percentage points over the same period.

An overview of the financial intermediation process

An analysis of the economy-wide flow of funds over the period 1971/72 to 1992/93 indicates that the two surplus sectors (net lenders) have been the household and the rest of the world sectors, while the two deficit sectors (net borrowers) have been the government and the private corporate sectors (Table 3) (data on flow of funds after 1992/93 are not available). The surpluses of the household and rest of the world sectors have increased steadily over time as have the deficits of the government and private corporate sectors. There has been some indication of a change in this trend since 1991/92, with the government sector reducing its dependence on external funds.

Among the three non-financial sectors, the government has been the largest borrower, as indicated by its share in total sources of funds (Table 4). Again, there is an indication of a reversal of this trend since the 1991 reforms. Not surprisingly, government securities have been the second most important financial instrument in total sources (after loans and advances), though the importance of corporate securities has been steadily increasing. The role of trade credit in mobilising funds has decreased steadily over the years. While the household sector has been the largest lender of funds, its share in total uses of funds has shown a surprising downturn in the first two

Table 3 **Financial surplus or deficit by sector as percentage of GDP**

Surplus (+)/Deficit (-) as per cent of GDP	*1971/72 –75/76*	*1976/77 –80/81*	*1981/82 –85/86*	*1986/87 –90/91*	*1991/92*	*1992/93*
Private corporate business	-0.9	-1.4	-2.4	-2.2	-2.7	-5.3
Government	-4.0	-5.8	-8.5	-9.9	-8.3	-6.5
Household	4.3	6.1	6.9	8.0	9.2	-7.8
Rest of the world	0.2	0.6	1.5	2.6	0.4	1.9

Source: Reserve Bank India, 'Flow of funds accounts', *Reserve Bank of India Bulletins*, Bombay, various issues.

years of the 1990s (Table 5). While currency and deposits are the most preferred financial asset for non-financial sector investment, the share of corporate and other financial institutions' securities in total uses of funds have been increasing steadily over the years.

Table 4 **Non-financial sectors' sources of external funds** (per cent)

Sectors/instruments	*1971/72 – 75/76*	*1976/77 – 80/81*	*1981/82 – 85/86*	*1986/87 – 90/91*	*1991/92*	*1992/93*
Distribution of funds by sector raising funds						
Private corporate business	17.5	16.1	21.1	17.8	31.7	37.0
Government	64.7	65.5	63.6	67.2	59.8	49.2
Household	17.8	18.4	15.3	15.0	8.5	13.7
Distribution of funds by source						
Currency and deposits	1.3	4.4	5.9	10.7	9.1	8.2
Government securities	31.1	24.6	23.4	25.7	16.6	14.4
Corporate securities	1.3	2.3	4.3	4.9	8.8	11.6
OFI securities	0.0	0.0	0.0	0.0	0.0	0.0
Loans and advances	41.3	40.6	37.4	35.7	37.8	46.8
Trade debit or credit	10.1	6.1	4.5	1.2	-0.7	-0.7
Other liabilities	14.8	22.1	24.5	21.8	28.3	19.7

Source: Reserve Bank of India,.'Flow of funds accounts', *Reserve Bank of India Bulletins*, Bombay, various issues.

Table 5 **Non-financial sectors' uses of funds** (per cent)

Sectors/ Instruments – 75/76	*1971/72 – 80/81*	*1976/77 – 85/86*	*1981/82 – 90/91*	*1986/87*	*1991/92*	*1992/93*
Distribution of funds by sector investing funds						
Private corporate business	5.1	5.2	7.6	7.0	17.0	9.6
Government	18.1	15.4	12.9	13.8	10.0	16.5
Household	26.8	79.5	79.5	79.1	73.0	73.9
Distribution of funds by uses						
Currency and deposits	49.2	26.4	42.7	45.0	45.8	40.0
Government securities	-1.2	-0.1	0.4	0.3	0.5	0.6
Corporate securities	0.3	1.4	3.5	1.7	3\4.3	5.9
OFI securities	0.6	0.6	1.9	3.7	11.9	7.6
Loans and advances	14.6	25.5	26.9	7.7	11.4	15.1
Trade debit or credit	6.3	6.3	6.8	3.0	-1.1	0.3
Other assets	30.1	39.9	17.8	38.6	27.3	30.5

Source: Reserve Bank of India,.'Flow of funds accounts', *Reserve Bank of India Bulletins*, Bombay, various issues.

Table 6 **Financing of large non-financial enterprises in the private sector**[a]

Year	*1986/87*	*1987/88*	*1989/90*	*1990/91*	*1991/92*	*1992/93*
Number of firms	621	621	645	648	650	650
Internal sources/retentions	38.8	40.6	33.2	39.2	29.9	26.3
External sources	61.2	59.4	66.8	60.8	70.1	73.7
Shares	3.3	7.3	7.3	10.4	7.8	22.9
Capital receipts	0.3	0.4	0.2	0.2	0.2	0.1
Borrowings from banks	11.0	4.7	8.8	8.0	9.0	10.8
Borrowings from financial institutions	9.4	9.4	8.4	12.9	14.6	15.4
Borrowings from government and semi-government bodies	0.5	0.7	1.2	1.3	1.5	1.0
Borrowings from others	19.3	16.6	20.9	7.8	15.7	9.5
Trade and other current liabilities	17.4	20.2	19.9	18.9	21.3	14.0
Misc. non-current liabilities	•	•	•	•	•	•
Total	46 170	47 411	115 600	131 590	191 390	218 460

[a] All figures in the table are percentages except the total which is in Rs million.
Source: Reserve Bank of India, *Reserve Bank of India Bulletins*, Bombay, various issues.

Turning to the private non-financial sector to undertake a more detailed analysis of changes in corporate financing brought about by financial sector reform, we use a data set compiled by the Reserve Bank of India which refers to a sample private corporate firms with a paid up capital of over 10 million rupees. The data set covers the period 1986/87 to 1992/93 (Table 6). The size of this sample increases marginally over the period, and the firms in the sample account for well over 40 per cent of all non-financial firms in the private corporate sector in terms of paid up capital.

The following important observations emerge.

- Internal sources have not been the dominant source of finance over the period. In fact, generally speaking, the importance of this source has been decreasing and the decrease has been rather dramatic after 1990/91, the year in which financial sector reforms were initiated.
- Borrowings from banks, which are predominantly in the nature of short-term credit, have generally accounted for 8 to 11 per cent of the total, except for the year 1987/88. After 1990/91, this share has marginally risen.
- Borrowings from financial institutions (both Indian and foreign) are generally in the nature of term loans. Their share has been rising and stood at 15.4 per cent in 1992/93.
- The share of borrowings from others (which include inter-corporate loans and deposits from the public) has varied a great deal over the years, ranging between 8 and 20 per cent.

- Trade credit and other current liabilities have always been an important source of finance.
- The importance of shares as a source of finance has increased over the years with a dramatic rise from 8 per cent in 1991/92 to 23 per cent in 1992/93.

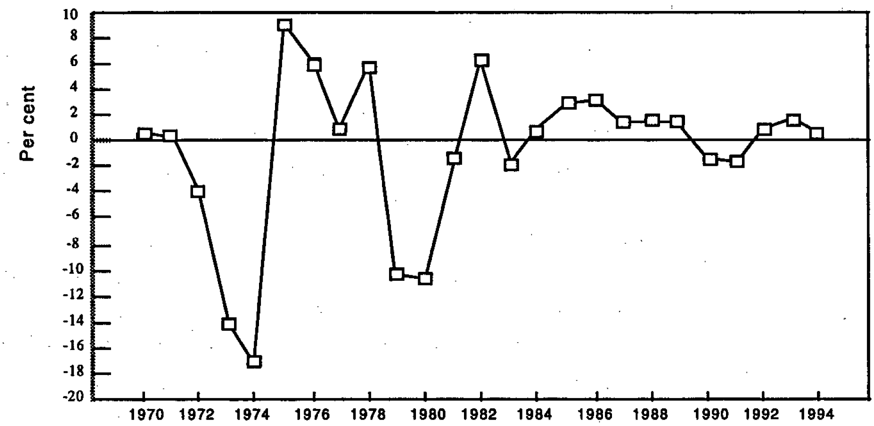
The most striking feature has been the dramatic rise in funds channelled through the stock market. Between 1991/92 and 1992/93 there has been a shift from internal sources, borrowings from others and trade and other current liabilities in favour of shares. This has been possible because of the presence of fairly well developed stock markets and measures taken to reform rules and procedures governing the stock markets and especially the primary markets. While the government and the household sector have been the largest borrowers and lenders in the real sector for the period from 1971/72 to 1991/92, there are indications that the relative importance of these two sectors may be declining in the sources and uses of funds with the onset of the reforms. We now turn to an examination of the state and level of development of the two groups of financial institutions—commercial banks and other financial institutions—at the beginning of the reform process and the implications of the reforms for the evolution of these two groups in the future.

Commercial banks

Since 1969, there has been significant growth in the commercial banking system both in geographical coverage and the amount of resources mobilised. All indicators of commercial bank progress show a distinct improvement in the period from 1969 to 1993, but perhaps the most revealing indicator is the increase in deposits as a percentage of national income from 15 per cent in 1969 to 45 per cent in 1993. Arguably, this has been the key factor behind India's impressive performance in the mobilisation of domestic savings. India's savings rate is one of the highest among countries at a similar stage of economic development (Joshi and Little 1994). There are two reasons behind the high levels of deposits mobilised by the banking sector. First, the geographical coverage of banks increased phenomenally, with a more than seven-fold increase in the number of bank branches. Most of the new branches have been set up in rural areas. This has led to a sharp decline in the population per bank branch from 65,000 in 1969 to 14,000 in 1993. As a result, the rural population has increased its' share in total deposits from 7 per cent in 1973 to 15 per cent in 1993.

A second factor behind the impressive performance in deposit mobilisation has been the positive real rate of return that was available on bank term deposits (barring the years of oil price shocks of 1973/74 and 1979/80 and the high inflation period from 1989/90 to 1991/92, see Figure 1). Mckinnon (1973) has argued that a deposit rate which is positive in real terms is an essential prerequisite for financial deepening. In the Indian context, there are few available studies that have investigated the relationship between the bank deposit rate and financial deepening, but recent study

Figure 1 **Commercial bank real deposit rate**[a,b]



[a] Interest rate on one year term deposits minus the inflation rate.

[b] Data refers to financial year.

Source: Reserve Bank of India, *Report on Currency and Finance*, Bombay, various issues.

with Indian data using a modern time-series perspective to examine the relationship finds a unequivocal positive relationship between the real deposit rate and financial saving (Athukorala 1995).

A rationale behind the current reforms in the financial sector was the fact that two decades of social control of banks had led to a 'decline in the productivity and efficiency and erosion of the profitability of the banking sector' (Narasimham Committee 1991:iii). The erosion of bank profitability has emanated both from factors operating on the side of income and on the side of expenditure of the banking industry. On the income side, banks have not been able to realise their potential income due to various restrictions on the use of funds. The most important of these have been the directed investment and credit programs. Directed credit programs have required lending to designated 'priority sectors' in the economy. At lower than rates of return available on alternative deployment of funds.

Since 1991, however, there has been a scaling down of the directed investment programs, particularly with regard to the statutory liquidity ratio. There has been a gradual reduction in the statutory liquidity ratio since the onset of the reforms, the statutory liquidity ratio standing at 31.5 per cent in October 1994, a level that was last observed in 1972. There has been less progress in reducing the cash reserve ratio mainly due to an unstable macroeconomic environment.

An important change in the branch licensing policy since 1991 has been the freedom given to banks to convert non-viable rural branches to satellite offices on certain conditions. Banks are allowed to close down loss-making branches in urban/metro centres and rural centres only if these centres are being served by two other commercial banks (except specialised banks for the rural sector called regional rural banks). Other changes in the policy include the freedom given to banks to open specialised branches per centre (in the categories of industrial finance, non-resident accounts and treasury management) without the prior approval of the Reserve Bank of India. These changes imply that while banks have been given considerable freedom in rationalising the structure of their branches, the broad thrust of the pre-reform licensing policy in ensuring that the rural population have access to banking facilities has been maintained. Following the Narasimham Committee's recommendations, the Reserve Bank of India announced in 1992/93 guidelines for the entry of new private sector banks. These guidelines attempted to ensure that new entrants were professionally managed, financially viable and would bring about technological upgradating of the banking sector.

Significant reforms in thebanking sector have also occurred with respect to regulations on the pricing of credit. There has been a gradual rationalisation of bank lending rates from six different rates prior to 1991, to four in 1991, and finally to three in 1993 (Table 7). In October 1994, the minimum lending rate on bank advances over 0.2 million rupees was discontinued and banks were allowed total freedom to set their own lending rates.[4] The tendency in the credit market has been for commercial banks to use the advance rate of the State Bank of India (the dominant public sector bank in India) as the prime lending rate. Except for the oil price shocks, the real lending rate has remained positive at around 8 to 10 per cent (Figure 2). Both the extremely high level of the real interest rate and the spread between the lending and deposit rate can be seen as an outcome of the distortion in bank use of funds, with a significant proportion of the latter 'locked' into low return priority sector loans and government securities (and non-interest bearing reserves). In the Indian context, it is difficult to argue that the high real interest rate on loans to private corporate firms may have led to a more productive use of investible funds. Since bank loans are mostly for working capital purposes, a more plausible argument would be that the high interest costs faced by private firms may have been passed on to customers via higher product prices (Taylor 1983, van Wijnbergen 1983, and Sen and Vaidya 1995).

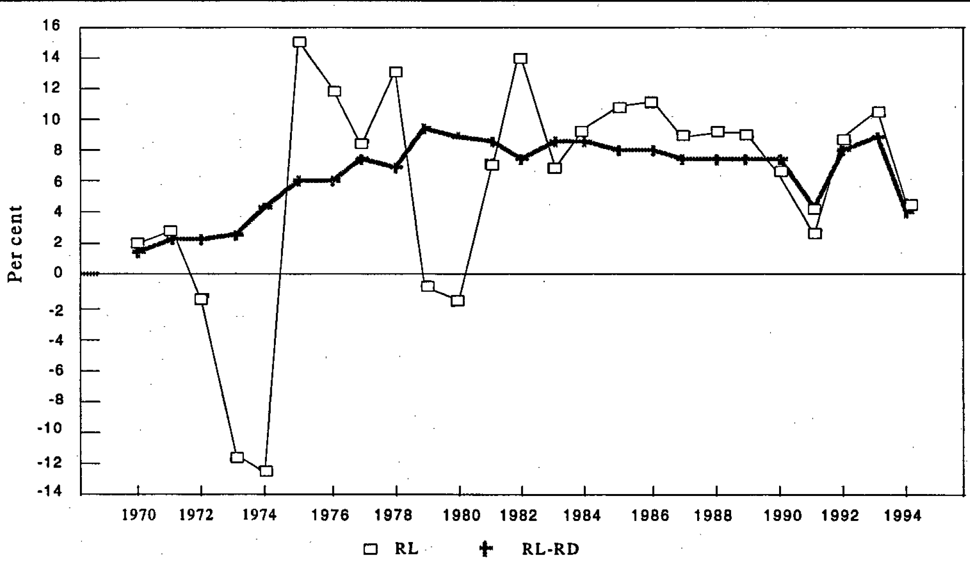
So far the reforms in the financial sector have not encompassed a reduction of the priority sector lending requirements.[5] In part this is due to the possible repercussions of such a move, particularly among the well organised and politically influential large and medium farmers. In part it could also due to an awareness among policymakers of the need to put an effective system in place for the financing of agriculture (and small scale industry) *before* priority lending requirements are reduced.

Table 7 **Structure of bank lending rates**

Category of account	*October 1991*	*April 1992*	*April 1993*	*September 1993*	*October 1994*
Up to and inclusive of Rs 7,500	11.5	11.5	n.a.	n.a.	n.a.
	n.a.	n.a.	12.0	12.0	12.0
Over Rs 7,500 andup to Rs 15,000	13.0	n.a.	n.a.	n.a.	n.a.
	n.a.	13.5	n.a.	n.a.	n.a.
Over Rs 15,000 and up to Rs 25,000	13.5	n.a.	n.a.	n.a.	n.a.
	n.a.	n.a.	n.a.	n.a.	n.a.
Over Rs 25,000 and up to Rs 50,000	15.5	n.a.	n.a.	n.a.	n.a.
	n.a.	16.5	16.5	15.0	13.5
Over Rs 50,000 and up to Rs 0.2 million	16.5	n.a.	n.a.	n.a.	n.a.
	n.a.	n.a.	n.a.	n.a.	n.a.
Over Rs 0.2 million (minimum rate)	20.0	19.0	17/0	15.0	Free
	n.a.	n.a.	n.a.	n.a.	n.a.

Source: Reserve Bank of India, *Report on Trend and Progress in Banking*, Bombay, various issues.

Figure 2 **Commercial bank real lending rate[a] (RL) and spread between lending and deposit rates (RL-RD)[b]**



[a] SBI advance rate.

[b] Data refers to financial year.

Source: Reserve Bank of India, *Report on Currency and Finance*, Bombay, various issues.

As has been argued in Sen and Vaidya (1997), given that agriculture is particularly prone to market failures due to problems of asymmetric information and contract enforcement, there is little reason to expect that banks will voluntarily lend to agriculturists once lending requirements are withdrawn.

Regulation of commercial banks. In a deregulated environment prudential regulation of banks is obviously of added importance. Deposit insurance has historically been an important aspect of bank regulation in most countries. Deposit insurance in India is provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC) which also provides guarantee cover to eligible financial institutions for their priority sector advances to small borrowers and small-scale industries. The DICGC was established in 1961 and is a wholly owned subsidiary of the Reserve Bank of India, its paid-up capital of 150 million rupees being entirely contributed by the central bank.

All commercial banks are registered as insured banks, affording an uniform protection to depositors. Every depositor of an insured bank which goes into liquidation is entitled to receive from the DICGC, through the liquidator, repayment of his or her deposits in all the branches of the bank held by him or her in the same capacity and right, up to a maximum amount prescribed from time to time (Reserve Bank of India 1983:154). In May 1993, the limit of insurance cover was increased from 50,000 to 100,000 rupees per depositor per bank. In July 1993 the insurance premium was increased from 4 paise to 5 paise per 100 rupees per annum (from 0.04 to 0.05 per cent per annum). With the growth in the banking system in the 1970s and 1980s, there has been a large increase in the number of fully protected bank accounts. In 1993 there were 360 million insured accounts, comprising 99 per cent of total bank accounts.

In the post-reform period the supervision system relating to banks has also been altered with the establishment of the Board for Financial Supervision in November 1994 by the RBI. The Board has been authorised to exercise the powers of supervision and inspection in relation to banks and non-banking financial institutions, including the term lending institutions. Another important aspect of regulation in the post-liberalisation period has been stricter application of accountancy norms especially in terms of definition of non-performing assets and provisioning norms.[6] Moreover all banks are required to meet the Bank of International Settlements capital adequacy norm of 8 per cent by March 1996. As at the end of March 1995, out of the 27 public sector banks, 13 had attained a minimum capital to risk weighted asset ratio of 8 per cent, eleven had reached 4 per cent and the remaining three were at less than 4 per cent. The move to minimum capital adequacy ratios has been greatly facilitated by the infusion of fresh capital in several public sector banks by the government in its 1993/94 and 1994/95 budgets. Sums of 57,000 million and 56,000 million rupees respectively were kept aside in the 1993/94 and 1994/95 budgets to recapitalise public sector banks.

Other financial institutions

The all-India development banks have at all times contributed over 60 per cent of financial assistance to the industrial sector (Table 8). Another important feature is that the Unit Trust of India has grown in importance over the years and the importance of the state level institutions has been on the decline.

We now turn to an analysis of the working of three of the important all-India financial institutions, the Industrial Development Bank of India, Industrial Credit and Investment Corporation of India and Small Industries Development Bank of India. Financial liberalisation has brought about two important changes in these institutions, namely, interest rate deregulation and the contraction of subsidised and captive sources of funds.

Up to 1990/91, the government fixed the interest rates at which IDBI (and other all-India development banks) lent, either directly for project loans to firms or as refinance to other financial institutions. The basic lending rate for direct loans was fixed at 14 per cent. This rate had remained constant over a long period. Term loans were rationed among various firms/sectors depending on the priorities set out by the government and the inherent soundness of the projects. The all-India financial institutions lent funds on a consortium basis till 1991/92 when they moved to a system of syndicated loans.

Table 8 **Details of financial assistance provided by institutions to the industrial sector**[a]

Institution	*1980/81*	*1985/86*	*1989/90*	*1990/91*	*1991/92*	*1992/93*	*1993/94*	*1994/95*
IDBI	47.3	42.8	28.1	28.2	29.6	28.4	28.8	30.5
IFCI	6.8	8.2	11.2	12.7	9.9	8.1	8.1	8.5
ICICI	11.5	9.8	13.5	15.9	14.4	15.6	16.5	20.5
SIDBI	n.a.	n.a.	8.9	8.8	7.2	6.1	6.7	7.4
IRBI	1.1	1.4	1.4	1.2	.	.	.	.
Sub-total[b]	66.7	62.2	65.3	68.1	62.2	60.5	63.8	71.2
UTI	3.2	10.7	10.7	12.4	17.9	20.1	22.2	13.5
Insurance	6.8	7.5	6.2	4.6	7.8	6.5	4.0	4.5
SFIs	23.3	19.6	17.2	14.2	13.7	10.8	8.5	8.8
Total	16 039	49 337	100 339	123 691	162 293	213 049	265 993	335 603

[a] All the figures in the above are in percentages except the figures in the last row which are in Rs million.

[b] The sum of the shares of all India development banks does not add up to the sub-total because a few small development banks have not been included.

Source: Reserve Bank of India, *Report on Currency and Finance*, Bombay, various issues.

As a part of the liberalisation program, in August 1990 the IDBI and other Development Banks (except SIDBI) introduced a two tier interest rate structure. The first tier referred to the initial two years of the loan period or the implementation period (whichever is shorter) of the project over which the interest rate was retained at 14 per cent. The second tier referred to the remaining period of the loan over which the interest rate was raised to 15 per cent. In August 1991 the government permitted all term lending institutions to charge interest rates in accordance with the perceived risks inherent in the projects subject to a minimum lending rate of 15 per cent. This was an extremely significant policy initiative which basically freed the interest rate on term loans. During 1991/92 the interest rates charged by the IDBI ranged between 18 per cent and 20 per cent—the freeing of interest rates was followed by a significant rise. During 1992/93 the IDBI reduced interest rates charged on term loans and the interest charged ranged between 17 per cent to 19 per cent. The year 1993/94 saw a further decline in the interest rate, ranging between 14.5 and 17.5 per cent. In 1994/95 the interest charged ranged between 14.5 and 18.5 per cent.

In the process of financial liberalisation, the rates of interest the SIDBI could charge to its direct borrowers has changed substantially but the interest rates charged are lower than those charged by the IDBI and the ICICI. In 1990/91 the SIDBI rates ranged between 6.5 and 11.5 per cent, but rose the between 7 and 15.5 per cent in 1991/92. This was a sharp increase but was not comparable to the increased rates of the IDBI and ICICI. During 1992/93 and 1993/94 the SIDBI interest rates charged ranged between 8.5 to 17 per cent, and during 1994/95 between 9 and 14.5 per cent. The generally large range of the interest rates charged are due to the presence of a large number of financing schemes introduced by the SIDBI, each of which carries a different extent of interest rate subsidy. The SIDBI has been lending to the small-scale sector at rates of interest much below the market rates. This is a conscious policy decision of the government aimed at reducing the adverse impact that an extraordinarily sharp rise in interest rates would have on the small-scale sector.

Another significant change since 1990/91 has been the reduced dependence of the IDBI and the ICICI on the government and the Reserve Bank for funds. Moreover with the reduction in the statutory liquidity ratio for banks an important captive source of funds for the IDBI, ICICI, IFCI, SIDBI, and state financial institutions has contracted. The bonds, shares and debentures issued by all the above mentioned organisations are eligible to be counted under the statutory liquidity ratio. This basically implies that subsidised and captive sources of funds have been reduced and the IDBI and ICICI have had to depend more on the market to raise resources. Nevertheless the statutory liquidity ratio requirements remain an extremely important source of funds. It should be noted that in recent years the element of subsidy on this source of funds has been almost negligible, as all the instruments held as a part of the statutory liquidity ratio carry a rate of interest which is close to the market rate. The

SIDBI nevertheless continued to receive substantial subsidised funds both from the government and Reserve Bank. As regards lending operations, since 1990 the indirect loans made by both the IDBI and SIDBI have dramatically declined. Also, as in the case of banks, these institutions were also required to meet the Bank of International Settlements norms for capital adequacy by March 1996—a requirement already achieved by the IDBI and ICICI.

Regulation of development finance institutions. In the process of financial liberalisation, the environment facing the development banks has been substantially transformed. Regulations, in such an environment, are needed to keep watch on the asset quality of these institutions. Before the financial and real sector liberalisation measures were introduced, the grant of an industrial license to a firm, was followed, almost automatically, by the sanction of assistance by the development banks. Prior to the liberalisation measures these institutions followed rather liberal lending norms (to firms possessing a license), particularly the high leverage (debt equity ratios of 2:1 were the norm) allowed and preferred (because of the fiscal system favoured debt over equity) led to weak financial structures of firms and made them susceptible to sickness when faced with increased market uncertainties. For example, in September 1992, sick units in the private sector had outstanding bad and doubtful debts of 125,860 million rupees—indicating that the quality of the portfolios of the development banks prior to the reforms, left a lot to be desired. Over the past few years the two largest development banks, the IDBI and ICICI, have to some extent been successful in improving the quality of their portfolios according to the reported classification of assets. With licensing requirements being dramatically reduced, those development banks with better capabilities to undertake techno-economic evaluation of projects should, over the years, improve their asset quality.

As the apex bank, the IDBI is the coordinating agency of the operations of all the development banks which had been operating as a consortium. There were regular meetings of the institutional heads and moreover, almost all the development banks had representation on each other's boards of directors which helped in coordinating the consortium agreements. With the areas of activities being neatly divided between banks, development banks and state level institutions, the borrowers have had little choice in selecting the institution to approach for loans. Though consortium lending had advantages (for example firms did not have to approach several institutions for funds), the greatest drawback was that if a particular loan application was rejected the borrower had no other option. For firms, this created serious barriers to entry. Moreover, this kind of coordinated lending did not pressure each institution to independently scrutinise each project carefully.

Before the financial sector reforms were initiated, the consortium financing agreements included assistance to projects costing above 100 million rupees. Leasing finance, equipment finance and bills discounting, however, were outside the consortium financing agreements. In 1990/91, the financial institutions were allowed to sanction assistance to projects costing 200 million rupees or less without reference to the inter-institutional fora. By 1991/92, the formalised system of consortium financing had given way to an informal system of loan syndication There, nevertheless, still exists some co-ordination between the various institutions and they do not compete in the true sense of the term. Another impediment to promoting competition between institutions hitherto protected is that some institutions, such as the SIDBI, continue to receive subsidised credit from either the Reserve Bank or the central government. For the subsidies to be passed on the targeted sector, a clear restriction of areas of activities is inevitable. Though at a conceptual level increased competition between development finance institutions could lead to some improvement in the allocation of resources, the existing institutional structure precludes such a possibility.

Evolution of financial markets

The stock market. India has had fairly well developed stock markets (compared to other developing countries) and their role in the overall financial system has dramatically increased since the 1980s. In 1993, India ranked 22nd in the world in terms of market capitalisation, 24th in terms of value traded and 2nd in terms of listed domestic securities. Currently there are 22 stock exchanges of which 20 are associated with particular cities. The largest stock exchange in the country is the Bombay Stock Exchange which accounts for more than 80 per cent of transactions. Recently two new exchanges were set up, namely, the Over the Counter Exchange of India which was established in August 1989 and became operational on 29 September 1992 and the National Stock Exchange of India which was set up in November 1992 and started operations on 30 June 1994.

Market capitalisation in the Bombay Stock Exchange at the end of March 1995 was 4,688,370 million rupees compared to 102,190 million rupees in December 1984. Market capitalisation as a ratio of GDP rose from 4.7 per cent in March 1983 to 51.4 per cent in March 1995. Market capitalisation as a ratio of GDP for all the stock exchanges put together rose from 7 per cent in March 1983 to 68.8 per cent in March 1994. This, by any standards, is a phenomenal increase.

In September 1992, the government allowed unrestricted entry in terms of volumes of investments in both primary and secondary markets to reputable foreign institutional investors such as pension funds, mutual funds, investment trusts and asset management companies. Foreign institutional investors were required to obtain an initial registration with the Securities and Exchange Board of India before making investments. They faced no lock-in period as regards disinvestment, no limit on total investment and a concessional tax rate of 10 per cent on long-term (more than one year) investment and 30 per cent on short-terms capital gains.[7] As of October 1994 there were 234 foreign institutional investors registered with Securities and Exchange Board of India and as of end-September 1994 their cumulative net investments in both primary and secondary markets were estimated to be 83.9 billion rupees or US$2,676.1 million of which US$1,665 million was invested in 1993/94 alone.

An important feature of the pattern of stock holding in India is that a large proportion of shares are owned by government-owned financial institutions. The 30 firms whose shares form the basis of the Bombay stock exchange sensitive index have a government-owned institutional share holding which ranges between 13 per cent to over 50 per cent. The government is thus capable of indirectly influencing the market and has done so on some occasions when the market has shown signs of a major downswing by asking the financial institutions to prop up the market by increasing their buying activity.

The financial liberalisation process has brought about fundamental changes in the operations of the stock markets in the case of both the new issues market and the secondary market. The most important among these measures has been the establishment of the Securities and Exchange Board of India in 1992 (which now works as the apex regulatory authority) and the freeing of the pricing of new issues in 1992 which hitherto had been under strict government control. These measures explain the large increase in shares as a source of funds for the private corporate sector.

Money and government securities markets. Since 1991 with the initiation of the stabilisation cum structural adjustment program, there has been an acceleration in the pace of change in the Indian money markets. This was a consequence of the Reserve Bank's move towards the greater use of indirect tools for monetary policy with the money market 'increasingly becoming the fulcrum for central bank intervention in the economy' (*EPW Money Market Review*, October 15, 1994:2711). Also, with the gradual phasing out of automatic monetisation of the budget deficit, monetary policy has become less subservient to fiscal policy and begun to take on an independent shape of its own.

In the treasury bill market, there was a phasing out of the 182 day treasury bill in 16 April 1992 with the introduction of the 364 day treasury bill on an auction basis on 28 April 1992. In January 1993, the government also introduced a scheme of auctions for 91 day treasury bills. There has been significant growth in the primary market for treasury bills, with the total amount outstanding of auction-based 91 day treasury bills increasing from 2,500 million rupees in January 1993 to 34,500 million rupees in mid-August 1994. The total amount outstanding of 364 days treasury bills increased from 6,660 million rupees in April 1992 to 71,600 million rupees in mid-August 1994. An important reason for the growth in the primary market for treasury bills has been the use of open market operations by the Reserve Bank to absorb a part of the excess liquidity in the banking system caused by the surge in foreign capital inflows. However, as with other segments of the money markets, secondary activity in treasury bills has not yet shown signs of picking up, with the Discount and Finance House of India annual turnover in the latter actually declining in the period 1990/91-94/95.

Financial liberalisation and the macroeconomic environment

In the summer of 1991, India was in the middle of a severe balance of payments crisis, with foreign exchange reserves covering less than two weeks of imports. The immediate cause of the crisis was the increase in world oil prices and the drop in remittances of migrant workers in the Gulf following the annexation of Kuwait in September 1990. The foreign exchange crisis was exacerbated by the drying-up of commercial loans and the outflow of foreign currency non-resident term deposits, as there was an expectation of default on the part of the Indian government on its external commitments (foreign currency non-resident deposits fell from US$1,536 million dollars in 1990/91 to US$290 million dollars in 1991/92). However, the roots of the crisis were more long term in nature and lay in the increasing deficits at all levels of government and in particular, in the central government's own deficit. The fiscal deficit to GDP ratio increased steadily over the 1980s reaching a peak of 8.3 per cent in 1990/91. The fiscal imbalance spilled over to the external sector with the current account deficit to GDP ratio standing at 3.2 per cent in 1990/91. Also, with fiscal deficits being increasingly monetised, the inflation rate increased fairly steadily in this period to about a high of 14 per cent in 1991/92. At the same time, the 1980s was a period of strong growth for the Indian economy with real GDP growth rates averaging over 5 per cent. This was mostly the result of a high rate of growth of manufacturing output (Table 1). (For details of the macroeconomic crisis and its aftermath, see Agrawal et al., 1995.)

The new government that came to power in 1991 undertook a comprehensive stabilisation program in that year. This involved a drastic cut in the fiscal deficit, a devaluation of about 18 per cent in nominal terms and constraints on monetary growth. The measures seem to have had an almost immediate impact, with the inflation rate falling to around 10 per cent by the next fiscal year. Foreign exchange reserves increased from a low of US$5,479 million in 1990/91 to US$9,220 million in 1991/92. The easing of restrictions on foreign portfolio investment produced a large inflow in 1993/94, leading to a further build-up of reserves to US$19,254 million in that year. As expected, the austerity measures led to a slowdown in the growth rate of real output in the initial year of the stabilisation program. By 1992/93, the GDP growth rate was

Table 9 **Foreign investment inflows, 1991/92-94/95** (US$ millions)

Type of investment	*1991/92*	*1992/93*	*1993/94*	*1994/95*
Direct investment	150	341	620	1 314
Portfolio investment	8	92	3 490	3 581
of which				
Global depository receipts	-	86	1 460	1 839
Foreign institutional investors	-	1	1 665	1 503
Non-resident Indians	8	5	15	n.a.
Offshore funds and others	-	-	350	239
Total	158	433	4 110	4 895

Source: Reserve Bank of India, *Report on Currency and Finance*, Bombay, 1994/95.

showing signs of recovery, in most part due to strong growth in agricultural output. The growth in output was maintained in 1993/94 and 1994/95, with the manufacturing sector stepping up its rate of growth.

However, there were indications of a return to macroeconomic instability by the end of the fiscal year 1993. This was evident in a resurgence in the inflation rate which had once again moved into double digits by mid-1994. The return in macroeconomic instability may be attributed to a surge in private capital inflow following the easing of restrictions in 1991/92.

The initial surge in private capital inflow came in the form of portfolio investment which increased from US$92 million in 1992/93 to US$3,490 million in 1993/94, comprising 85 per cent of total foreign investment inflow in that year (Table 9). Most of the increase in portfolio investment in 1993/94 came from an increase in foreign borrowing by domestic firms (in the form of global depository receipts) and foreign institutional investment in the Indian stock market. However, in 1994/95, the share of portfolio investment in total foreign investment inflows decreased to 73 per cent as there was an increase in foreign direct investment from US$620 million in 1993/94 to US$1,314 million in 1994/95. The surge in private capital inflow in 1993/94 led to a sharp increase in India's total capital inflows from US$2,966 dollars (1.7 per cent of GDP) in 1992/93 to US$8,992 million (3.5 per cent of GDP) in 1993/94. Foreign investment which comprised 20 per cent of total capital inflows in 1992/93 increased its share to 46 per cent in 1993/94.

The increase in total capital inflow in 1993/94 did not lead to any significant widening of the current account deficit in that year, which in fact improved from -1.8 per cent of GDP in 1992/93 to -0.1 per cent of GDP in 1993/94 (Table 10). Instead, there was a sharp increase in official reserves which after faling by US$560 million (0.1

Table 10 **India's balance of payments, 1990/91–94/95**

	1990/91	*1991/92*	*1992/93*	*1993/94*	*1994/95*
Balance on current acccount					
US$ million	-9 680	-1 178	-3 526	-315	-2 315
As percentage of GDP	-3.2	-0.4	-1.8	-0.1	-0.8
Balance on capital account					
US$ million	7 188	3 968	2 966	8 992	8 218
As percentage of GDP	2.4	1.6	1.7	3.5	2.7
Overall balance					
US$ million	-2 492	2 790	-560	8 677	5 903
As percentage of GDP	-0.8	1.2	0.1	3.4	1.9

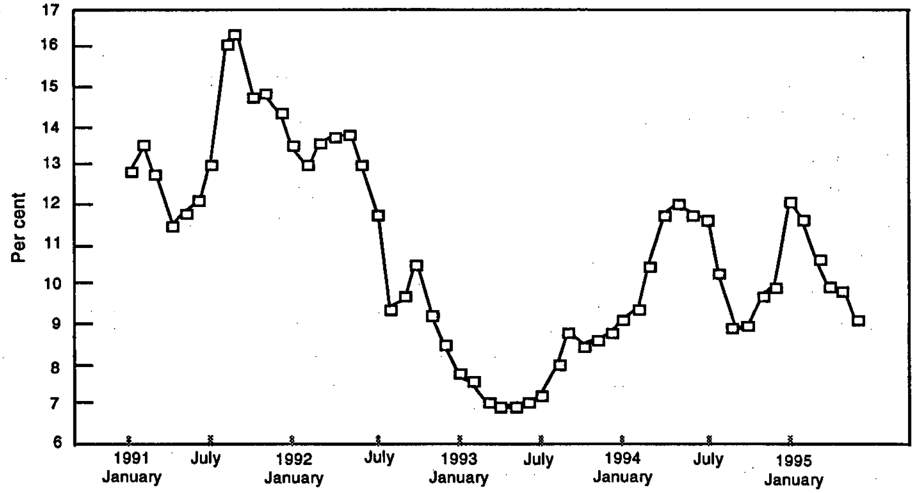
Source: Reserve Bank of India, *Report on Currency and Finance*, Bombay, 1994/95.

per cent of GDP) in 1992/93 rose by US$8,677 million (3.4 per cent of GDP) in 1993/94. This indicated that the capital inflow was met with a rather heavy degree of foreign exchange intervention by Reserve Bank as it attempted to limit the effect of the capital inflows on the exchange rate.

To sterilise the impact of the foreign capital inflow, the Reserve Bank undertook large-scale open market operations during this period which were equivalent to a 2.8 per cent increase in the cash reserve ratio. Also, after initially reducing the cash reserve ratio from 15 per cent to 14 per cent in April–May 1993, the Reserve Bank raised it again in three phases from 14 per cent to 15 per cent in June–August 1994. While these steps may have mitigated the increase in money stock, clearly the thinness of the treasury bill market and the already high level of the cash reserve ratio acted as a constraint to any further sterilisation of the capital inflow. Therefore, a large proportion of Reserve Bank intervention in the foreign exchange market during this period was in the form of purchases of foreign currency for domestic currency. Consequently, the growth rate of net foreign assets went up from 17.7 per cent in 1992/93 to 110.9 per cent in 1993/4. This led to a sharp increase in reserve money and M1 during this period.

The sharp increase in domestic liquidity in the latter half of the fiscal year 1993 had an immediate and perceptible effect on the domestic price level. The inflation rate had shown a steady decline since September 1991. However, this was reversed in mid-1993 as the rate of inflation climbed back to double digits by mid-1994 (Figure 3). Since then, the rate of inflation has shown no discernible trend, hovering in the range of 8 to 12 per cent. The high inflation rate in 1993/94 and 1994/95 was the major factor behind the sustained real appreciation of the rupee in this period, with the Reserve Bank maintaining a more or less stable nominal exchange rate during this period (Figure 4).

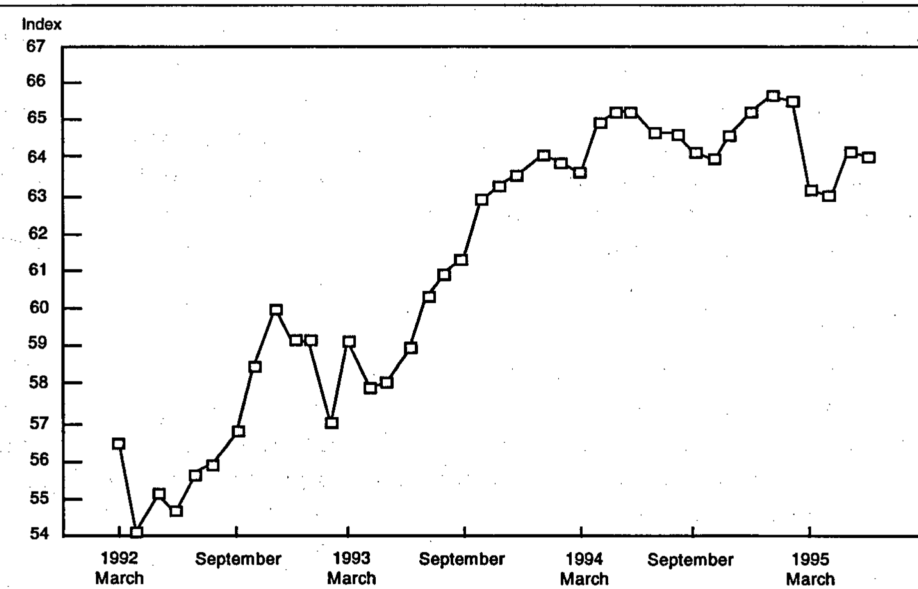
Figure 3 **Inflation rate, January 1991 to June 1995**



[a] Point to point.

Source: Reserve Bank of India, *Reserve Bank of India Bulletins*, Bombay, various issues.

Figure 4 **Real effective exchange rate—trade-weighted (REER), March 1992 to June 1995**



Source: Reserve Bank of India, *Reserve Bank of India Bulletins*, Bombay, various issues.

In 1994/95, with private capital inflows continuing unabated, there were indications of a lesser degree of intervention by the Reserve Bank in the foreign exchange market. Now, part of the capital inflow was met by a higher current account deficit, as aggregate investment increased from 21.6 per cent of GDP in 1993/94 to 25.3 per cent of GDP in 1994/95, leading to an increase in the investment–savings gap to 0.7 per cent between 1993/94 and 1994/95. Reflecting the lower amount of Reserve Bank intervention in the foreign exchange market, the growth rate of net foreign assets declined to 44.3 per cent in 1994/95.

An assessment of financial sector reforms in India

It is now over four years since the initiation of financial sector reforms in India. Though not enough time has elapsed to arrive at any firm conclusions about its success or failure, clear patterns are emerging which indicate the possible course and likely implications of the reform process. It should be remembered that the reforms were undertaken at a time when the economy was in the midst of a severe macroeconomic crisis. That the reforms have not led to serious disruptions in economic activity can be attributed both to the initial conditions and the gradualist approach followed.

Important among the initial conditions was the presence of a diversified financial sector with institutions that had a long history in the intermediation of funds. Three sets of institutions requiring special mention (in contrast to other liberalising economies) were the commercial banks, which had already contributed significantly to the financial deepening in the economy, the development finance institutions, which over a period of time had built strong links with the corporate sector, and the stock market which, though underdeveloped in many respects, had a fairly important position in the mobilisation of funds. Another favourable initial condition was that the reform process in the real sector had already begun well before the financial sector reforms. As a consequence, the market mechanism already had a significant role to play in the allocation of resources across various industries.

The gradualist approach followed involved the cushioning of certain sectors from the possible adverse consequences of deregulation. This is particularly evident in the case of commercial banks, where mandatory lending requirements were kept intact to ensure that the flow of credit to the agricultural sector and to small-scale industries was not disrupted. Also, while the reform process has led to a decline in subsidised and captive sources of credit for development finance institutions in general, institutions specialising in the provision of long term loans to the small-scale sector (such as the SIDBI) continued to have access to them. Moreover, interest rates on both short-term and long-term credit have been deregulated in a phased manner.

The deregulation of financial markets has followed a sequence with short-term markets, such as the money and treasury bills markets, being deregulated first. This was followed by the deregulation of credit markets (both short term and long term), the stock market (especially the primary issues market) and the market for dated securities. The timing of deregulation of interest rates on long-term loans (which led to an immediate and significant rise in the interest rate) and the primary issue markets (which led to a substantial decrease in the cost of raising funds because of free pricing of new issues) enabled the corporate sector to shift from the relatively more costly source to the cheaper source within a year. Though the investment climate was uncertain for about a year after the deregulation of interest rates, within about two years the lost tempo was revived with the primary issues market playing a far larger role than ever before. An important characteristic of the way Indian firms (and firms in other developing countries) finance their operations is the importance of external sources of funds. This dependence on external sources has increased after the onset of reforms.

Perhaps the most complex issue in the process of financial liberalisation is the sequencing of steps in the various markets and sectors. The experiences of other countries have shown that the appropriate ordering of the steps involved has often been the key determinant of the success of the reforms. Two aspects of the sequencing issue are of particular relevance for India. These are

- the sequencing of microeconomic and macroeconomic reforms
- the sequencing of real and financial sector reforms.

With regard to the first, it can be argued that the ordering of steps left a lot to be desired. In particular, the liberalisation of controls on foreign portfolio investment without having adequately developed the treasury bills market led to problems of macroeconomic management two years into the reforms. Here, given that 'the need of the hour' in the wake of the 1991 crisis was macroeconomic stability, a more cautious opening up of the Indian capital market to foreign portfolio investment along with a greater use of quantitative controls on the inflow of short-term capital was called for.[8] As Devlin et al. have argued, 'the more pressing the need for management, and the more underdeveloped fiscal and monetary policy is, the more likely it is that the use of direct regulations on certain types of capital flow will be warranted, even if temporarily' (1994: 41). Therefore, while regulation of capital inflows can have possible microeconomic costs, it could be argued that in the Indian context, the costs would perhaps have been offset by the benefits obtained from macroeconomic stability.

With regard to the pace of financial sector reforms in the future, two important constraints are likely to arise from the real sector. First, though a lot has been done with regard to reduction of legal barriers to entry, no real attempt has been made to streamline the operations of bankruptcy laws and exit procedures (see Sen and Vaidya

1997 for a more detailed discussion of these issues). Second, privatisation of public sector enterprises (including those in the financial sector), which is an important component of any comprehensive reform package, is not seen as a policy option in the near future (Vaidya 1994). It can be argued that for financial sector reforms to deliver the desired efficiency gains, reforms in the real sector, especially those relating to the exit and bankruptcy procedures, are vital.

Notes

1. Henceforth, we will use the following notation in the paper: 1991/92 for the Indian fiscal year, April 1st 1991 to March 31st 1992, and 1991 for the calendar year.
2. Our analysis is based on material drawn from the *Reports on Currency and Finance*, the main publication of the Indian central bank. We are constrained to limit our coverage of the Indian financial sector reforms till mid-1995 as the most recent Report available (the 1994/95 issue) does not go beyond mid-1995 for most financial and monetary data.
3. Preamble to the 'Banking Companies (Acquisition and Transfer of Undertakings) Act', August 1969.
4. However, lending rates on two slabs—advances under 25,000 rupees and between 25,000 rupees and 0.2 million rupees—continued to be administered.
5. Since October 1993, however, banks have been permitted some flexibility in their priority sector advances; small-scale industry being redefined to include units with investment in plant and machinery of up to 6 million rupees (previously it was 3.5 million rupees).
6. Minimum amount of funds that a bank has to set aside in the case of a bank loan that is non-performing.
7. There was, however, a ceiling of 24 per cent of issued share capital on the total holdings of total foreign institutional investor investment and a ceiling of 5 per cent on a single foreign institutional investor investment in any one company.
8. The Latin American experience with foreign portfolio investment in the 1990s is particularly revealing. Chile employed a wide range of quantitative controls on short-term capital inflow and was able to manage capital flows fairly effectively till late 1995. Mexico, on the other hand, suffered a run on its international reserves in early 1995 in part due to a more 'laissez-faire' attitude to short-term capital inflows (on this, see Devlin et al. 1994).

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