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Financial Sector Reforms in India

by

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Abstract

The performance of the Indian economy in the last decade has been remarkable. This can be partly attributed to the multi-sector structural reforms, undertaken simultaneously in 1991, aimed at enhancing productivity, efficiency and international competitiveness of the economy. The reforms in the financial sector have been most effective. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially the money and government securities market. In addition, fiscal correction was undertaken and reforms in the banking and external sector were also initiated. The reforms have been undertaken gradually with mutual consent and wider debate amongst the participants and in a sequential pattern that is reinforcing to the overall economy. The financial markets have developed and are more integrated after the reforms, and regulatory and supervisory institutions have been set-up. The reforms, though slow paced initially but well synchronized, have begun to yield results. The economy has recorded consistently high growth rates, avoided any adverse impact from the South East Asian crisis, built substantial foreign exchange reserves, pre-paid some of its external debt and restructured its domestic debt.

Keywords: India, financial sector, reform, economic growth
JEL Codes: G15, G28, O40, O53

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The performance of the Indian economy in the last decade has been remarkably strong. One of the reasons for the robust performance of the economy could be the ongoing financial sector reform, which began in 1991.

In 1991, structural reforms were undertaken in many sectors simultaneously with an aim to enhance productivity, efficiency and international competitiveness of the economy, but the most effective of the reforms have been those in the financial sector. The main thrust of the financial sector reforms has been the creation of efficient and stable financial institutions and development of the markets, especially money and government securities. Before 1991, a large component of domestic government debt, incurred at low rates of interest and statutorily prescribed for subscription by state-owned banks and financial institutions, led to a repressed financial system. The fiscal dominance of monetary policy left little flexibility with the Reserve Bank of India (RBI) to pursue a monetary policy that could foster financial markets, price stability and economic growth. Although fiscal deficits and debt continue to be high, the stoppage of automatic monetization and resort to market determined interest rates through auctions on government borrowing have helped in the development and integration of the financial markets.

The objective of this paper is to document that the multi-sector reforms undertaken in India, though slow paced initially but well synchronized, have begun to yield results. The economy has recorded consistently high growth rates, avoided any adverse impact from the South East Asian Crises, built substantial foreign exchange reserves, pre-paid some of its external debt and restructured its domestic debt. This paper is mainly focused on financial sector reforms and is organized in four sections. In Section-I, the overall importance of the financial sector is briefly discussed. Section – II deals with the financial sector reforms initiated in 1991 accompanied by those in banking and the external sector as well as in the fiscal policy. The positive impact of the reform measures and the resilience of the economy are discussed in Section-III. The conclusions that emerge and some proposed measures for the reforms to continue are discussed in Section-IV.

SECTION – I: ROLE OF FINANCIAL DEVELOPMENT

There are different views about the role of financial development in economic growth. McKinnon (1973) and Shaw (1973) draw attention to financial markets and their role in economic growth, while Robinson (1952) argues that finance follows enterprise. In recent times, Rajan and Zingales (1998), based on a large sample of countries, find that financial development facilitates economic growth. Levine (2004) concludes that the preponderance of evidence suggests a positive role for financial intermediaries and markets in economic growth.

In any economy, the financial system plays a major role in transferring financial resources from net savers to net investors. Levine (2004) summarizes the major functions that the financial system performs – *(i)* mobilizes and pools savings, *(ii)* facilitates the exchange of goods and services, *(iii)* facilitates the trading, diversification and management of risk, *(iv)* monitors investment and exerts corporate governance, and *(v)* provides information about investment and allocates capital. Thus, the financial sector intermediates essentially through four transformation mechanisms – *(a)* liability-asset transformation, *(b)* size-transformation, *(c)* maturity transformation, and *(d)* risk transformation. A well functioning financial sector efficiently delivers allocation of resources across the economy.

There has been a considerable widening and deepening of the Indian financial system, especially in the past decade. The Indian financial system comprises an impressive network of banks, development finance institutions (DFIs) and non-banking financial companies (NBFCs). The banking system in India mainly consists of commercial banks (CBs) – public (27), Regional Rural banks (198), private (30), and foreign (36) – with 66,514 branches (rural branches – 32,645) and 9,000 ATMs, and co-operative banks (CPBs) - rural (113,267 branches) and urban (2,104). DFIs comprise diverse entities like term-lending institutions, investment institutions and specialized institutions. Of these, nine DFIs, which perform the role of development banks and refinance institutions, fall within the supervisory and regulatory domain of the RBI. NBFCs encompass an extremely heterogeneous group of intermediaries in terms of

size, nature of incorporation and function of intermediation. NBFCs that are partially or wholly regulated/supervised by the RBI include equipment leasing, hire-purchase finance, investment and chit fund companies, and primary dealers in government securities (a total of 13,849, of which 710 accept public deposits). CBs are the most important segment of the financial system, with financial assets in 2003 accounting for 56.6 per cent of GDP followed by DFIs (23.0 per cent), rural CPBs (6.7 per cent), urban CPBs (2.1 per cent) and NBFCs (1.7 per cent). Accordingly, the discussion in this paper would mainly focus on the reforms for the CBs.

SECTION –II: GENESIS AND FINANCIAL SECTOR REFORMS SINCE 1991

The initial symptoms of economic difficulties, especially in the fiscal and external sectors, were apparent from the beginning of the 1980s – administered interest rates, underdeveloped debt and financial markets, the persistently rising fiscal deficit of the government, an overvalued exchange rate, high tariffs, and a restrictive industrial policy. India could be characterized as a financially repressed closed economy with the policy emphasis on import substitution. The banks and financial institutions were state-owned and mainly expected to provide financial resources to the government, public sector enterprises and a few industrial houses. In 1991, the immediate cause of financial difficulties was the Gulf-war, which precipitated the balance of payments problem.[1]The slowdown in world trade due to recession in the industrial world, disintegration of Eastern Europe, and tight liquidity in global markets aggravated the difficult situation.

The persistently rising fiscal deficit led to increasing monetization and accelerating inflationary pressures. The disproportionate reliance on customs duty which raised more than forty per cent of the Central Government's net tax revenue, while protecting industry, had implications for efficiency, technological up-grading and export competitiveness. The fiscal imbalances spilled into the external sector and led to consistently large and unsustainable current accounts deficits - 3.1 per cent of GDP

[1] The main reasons being the high price of oil, cessation of exports to Iraq, and stoppage of inflow of remittances from Kuwait.

in 1990-91.[2] To address these issues, import restrictions introduced in October 1990 adversely affected productive activity, especially industry while inflation began to accelerate (Table - 1). The current account continued to be under stress and the critical situation assumed the role of a crisis when foreign currency assets declined to only two weeks of imports in June 1991. India had to pledge gold reserves as collateral with the Bank of England to raise foreign exchange reserves and avoid a default while a loan from the IMF followed later.

TABLE – 1: SELECT ECONOMIC INDICATORS – 1971 to 2004

(per cent)

Year	Gross Fiscal Deficit	Monetized Deficit	Current Account Deficit	NNP at Factor cost	Per Capita NNP	WPI-All Commod--ies	Services	Industry	Agriculture
	As % of GDP			*Average Annual Growth Rates in per cent*					
1	2	3	4	5	6	7	8	9	10
1971-81	***---***	***1.3***	***0.1***	***3.1***	***0.8***	***10.3***	***4.2***	***4.4***	***1.8***
1981-82	6.3	2.4	1.7	5.8	3.8	9.3	5.4	8.8	5.3
1982-83	5.9	1.3	1.7	2.3	0.0	4.9	4.8	7.3	-0.7
1983-84	7.3	1.8	1.5	7.6	5.4	7.5	5.5	8.8	9.6
1984-85	9.0	3.1	1.2	4.0	1.7	6.5	6.0	6.4	1.5
1985-86	8.0	1.6	2.1	4.3	2.1	4.4	7.7	4.6	0.7
1986-87	9.9	2.4	1.9	3.9	1.8	5.8	6.8	8.1	-0.6
1987-88	9.2	1.8	1.8	3.4	1.2	8.1	6.4	6.9	-1.3
1988-89	8.5	1.6	2.7	10.6	8.3	7.5	7.2	9.8	15.5
1989-90	8.9	2.9	2.3	6.8	4.6	7.5	8.6	11.2	1.5
1990-91	9.4	2.7	3.1	5.4	3.3	10.3	6.1	6.8	4.1
1981-91	***8.2***	***2.2***	***2.0***	***5.4***	***3.2***	***7.2***	***6.4***	***7.9***	***3.5***
1991-92	**7.0**	**0.8**	**0.3**	**0.5**	**-1.5**	**13.7**	**4.5**	**-1.2**	**-1.5**
Memo									
1992-04	***8.3***	***0.0***	***0.7***	***6.1***	***4.1***	***6.4***	***7.6***	***6.4***	***3.2***

-- - Not Available. CG – Central Government. NNP - Net National Product. WPI – Wholesale Price Index.

Sources: (a) Economic Survey, Government of India.

(b) National Account Statistics, Central Statistical Organization, Government of India.

The Governments' response to the short-lived crisis was the simultaneous implementation of measures to stabilize the economy and to introduce structural reforms. To successfully carry forward the benefits of stabilization measures, long-term issues of structural rigidities had to be addressed – removal of the myriad controls and regulations, introduction of efficient technology and encouragement of private enterprise.

[2] Financial year refers to the period April 1 to March 31.

The empirical literature indicates various reasons for a financial crisis in a liberalizing economy. Kaminsky and Reinhart (1996) conclude, based on the experiences of numerous industrial and developing countries, that banking crises precede balance-of-payments crises and that the banking crises were preceded by financial liberalization. In addition, it has been argued that credit-expansion and risk-taking by banks in a deregulated environment, in context of financial liberalization are the main reasons for banking crises (Chang and Velasco, 1998; Demirguc and Detragiache, 1997; Furman and Stiglitz, 1998; Frankel and Rose, 1996; and Sachs, Tornell and Velasco, 1996). Barro (2001) documents the association of currency and banking crises with lower economic growth and investment while Corsetti, Pesenti and Roubini (1998a and 1998b) isolate current account balances, financial liberalization, banking problems and capital flows as the major factors in Asian financial crises of 1997. In the process of financial liberalization, Rodrik (1998) and Aghion, Bacchetta and Banerjee (2003) observe that capital account convertibility can be an important destabilizing factor in some economies attempting liberalization.

Reforms, therefore, had to be cautiously undertaken and sequenced carefully, if India had to avoid another crisis. In view of the complexity of the economic situation, the simultaneous reforms then undertaken were comprehensive – fiscal, banking, external and financial sector. Major financial sector reforms could only be initiated if the other sectors that impacted it were also reformed. The general approach to financial sector reforms was – *(a)* Cautious and proper sequencing of measures, providing adequate opportunity for discussion, consultations and implementation, *(b)* Nurturing confidence in the system by introducing mutually reinforcing measures, *(c)* Development of financial infrastructure - supervisory, audit standards, technological, legal framework, and *(d)* Development and integration of money, government securities and foreign exchange markets.

II.I. FISCAL MEASURES

The origin of the difficult economic situation in 1991 was closely linked to the imbalances in the fiscal sector with the emergence of deficits on the revenue account

from 1982-83, the consequent rise in market borrowings, and the lack of an adequate absorptive capacity for government bonds in the market. Earlier, the difficult fiscal situation had been camouflaged by the conventional deficit measure, but the situation became apparent in the late eighties with the introduction of the transparent measures of deficit used internationally – fiscal, primary and monetized.[3]

The fiscal and revenue deficit continued to be high and growth in expenditure was exceeding that of revenue in the eighties (Table - 2). In the reforms undertaken since 1991, though growth in expenditure (mainly investment) has been curtailed, revenue receipts have been adversely affected, due to which the fiscal and revenue deficits continue to be high. Empirically, this type of adjustment is considered neither effective nor credible (Alesina and Perotti, 1996; and McDermott and Wescott, 1996). The rise in non-developmental expenditure is mainly due to interest payments and defense. Interest payments increased from 2.4 per cent of GDP in 1980-81 to 7.0 per cent in 2003-04 while the primary deficit declined from 5.4 per cent to 2.9 per cent over the period. Defense expenditure increased from 2.5 per cent of GDP in 1980-81 to 3.4 per cent by 1987-88 but since then has been declining - at present to the range of 2.2-2.3 per cent. The tax to GDP ratio, compared to other countries, is low at 14.5 to 17.1 per cent while the ratio of non-tax revenue to GDP continues to be still lower at 4.0 per cent. The main reasons for low tax-GDP ratio are – non-taxation of agricultural sector[4]; inadequate taxation of the fast growing services sector[5]; and the large incidence of tax evasion and avoidance. Another reason for sustained high expenditure is the political economy of the country (Rajaraman, 2004; Khemani, 2000). The country has had multi-party coalition governments at the Centre and frequent changes of governments since March 1977,

[3] The conventional budget deficit had two obvious limitations - first, the concept was narrow by definition, as it excluded all borrowing other than through *ad hoc* Treasury bills (91 days). Secondly, the conventional deficit did not reflect the full liquidity impact of RBI financing of the government. In contrast, the internationally used gross fiscal deficit includes all forms of government borrowing, capturing the overall macroeconomic impact of the size and nature of fiscal operations – the overall gap.

[4] The share of agriculture in GDP is 21.9 per cent in 2002-03 having declined from 46.2 per cent in 1970-71.

[5] The share of services in GDP is 56.0 per cent in 2002-03 having increased from 38.2 per cent in 1970-71

which have contributed to the lack of fiscal discipline. Earlier, from 1947-1977, a single party – Congress - held power (detailed discussion follows in Section – III).

TABLE – 2: MAJOR FISCAL INDICATORS OF GOVERNMENT FINANCES

(per cent)

Item	1981-82 to 1989-90		1990-91 to 1996-97		1997-98 to 2003-04	
	Average Growth	Ratio to GDP*	Average Growth	Ratio to GDP*	Average Growth	Ratio to GDP*
1	2	3	4	5	6	7
Revenue Receipts	16.1	19.0	14.2	18.6	11.7	17.9
Total Expenditure	16.2	28.8	13.1	27.0	14.6	28.4
Capital Expenditure	12.9	8.2	6.6	4.8	22.4	4.4
Revenue Expenditure	17.8	20.6	14.6	22.2	13.2	24.0
Gross Fiscal Deficit	17.8	8.0	11.6	7.4	17.5	9.2
Gross Primary Deficit	15.5	5.0	2.7	2.5	30.2	3.3
Revenue Deficit	31.4	1.6	19.9	3.6	21.7	6.2
Development Expenditure	15.6	18.1	11.0	15.3	13.2	14.5
Non-Developmental Expenditure	17.2	10.5	16.1	11.7	13.8	13.1
GDP	*14.5*		*15.9*		*10.6*	

* Annual Average.

Source: Union and State Governments' Budget.

II.I.I. CENTRAL AND STATE GOVERNMENTS

The fiscal deterioration in the early eighties was mainly on account of the Central Government. The rising revenue deficit from 1979-80 steadily led to the rise in the gross fiscal deficit (GFD), which resulted in an accumulation of public debt (61.4 per cent of GDP by end March 1990) with interest burden rising to four per cent of GDP and twenty per cent of expenditure (Table - 3). In India, on an average during 1981-91, about one- third of the fiscal deficit of the Central Government was absorbed by the RBI (details in sub-section on Monetary and Fiscal Co-ordination).

TABLE – 3: SELECT FISCAL INDICATORS OF THE CENTRAL GOVERNMENT

(As percent of GDP)

Year	Gross Fiscal Deficit	Moneti-sed Deficit	Direct tax	Indirect tax	Non-Tax Revenue	Interest Payments	Subsidies	Defence (Revenue + Capital)	Capital Expenditure
1	2	3	4	5	6	7	8	9	10
1970-71	3.1	0.5	1.9	5.1	1.8	1.3	0.2	2.6	5.5
1975-76	3.6	-0.4	2.7	6.5	2.2	1.5	0.6	2.9	6.5
1980-81	5.8	2.5	2.0	7.1	2.1	1.8	1.4	2.5	5.8
1985-86	7.9	2.2	2.0	8.3	2.5	2.7	1.7	2.9	6.7
1990-91	7.9	2.6	1.9	8.2	2.1	3.8	2.1	2.7	5.6
1991-92	5.6	0.8	2.3	7.9	2.4	4.1	1.9	2.5	4.5
1995-96	5.1	1.7	2.8	6.5	2.4	4.2	1.1	2.3	3.2
2000-01	5.7	0.3	3.3	5.7	2.7	4.7	1.3	2.4	2.3
2003-04	4.8	-2.7	3.7	5.5	2.7	4.5	1.6	2.2	4.0

Source: Economic Survey and Union Budget, Various Issues, Government of India.

Since the beginning of reforms, GFD has been declining due to the concerted efforts made by the Central Government to reduce expenditure on subsidies, grants to state governments, defense and capital formation. An increase in expenditure on subsidies in 2000-1 and 2003-04 reflects the increase on food subsidy on account of drought conditions in 2000-01 and 2002-03 and dismantling of the Administered Price Mechanism for petroleum goods in 2002-03. To reduce expenditure, the government has curtailed recruitment, resorted to a voluntary retirement scheme, and introduced a contributory pension scheme. Major changes were introduced in the area of direct taxes by simplification, rationalization, lowering of the tax slabs and widening of the tax base. In the case of indirect taxes, to encourage competitiveness of Indian industry, custom tariff rates were lowered to compare favorably with those in competitor countries,[6] the dispersion of tariff rates was reduced and the excise duty structure was rationalized.[7] The restructuring of taxes coupled with the structural shift in the composition of GDP towards the less-taxed services sector, have dampened the growth of tax revenue (Table - 4). Tax buoyancy has declined in the post-reform period and the Central Government is making efforts to improve tax collections through better tax administration and use of information technology.

TABLE - 4: GROSS TAX REVENUE OF THE CENTRAL GOVERNMENT

(% of GDP)

Years	Income Tax	Corporation Tax	Excise Duties	Customs Duties	Gross Tax Revenue
1	2	3	4	5	6
1990-91	0.9	0.9	4.3	3.6	10.1
1991-92	1.0	1.2	4.3	3.4	10.3
1995-96	1.3	1.4	3.4	3.0	9.4
2000-01	1.5	1.7	3.3	2.3	9.0
2003-04	1.6	1.9	3.5	1.8	9.2

Source: Economic Survey and Union Budget, Various Issues, Government of India.

[6] Average import duty was reduced from 72.5 per cent in 1991-92 to 24.6 per cent in 1996-97, but raised again to 35.7 per cent in 2000-01, mainly in agriculture and consumer goods (details in Section on External Sector).

[7] Reforms in the industrial sector initiated in 1991 were expected to yield higher revenue. Since July 1991, industrial licensing has virtually been abolished; industries restricted to the public sector have been reduced to 3 as compared with 17 in 1991; Reforms in Monopolies and Restrictive Trade Practices Act have been enacted; abolition/restriction of reserved list for production of items of small scale industry is being considered; and restrictions on provisions under Foreign Direct Investment have been relaxed.

The deficits at the State level have been widening in contrast with that of the Central Government. The revenue deficit, consistently recorded since 1987-88, rose from 0.9 per cent of GDP in 1990-91 to 2.6 per cent in 2003-04 while the gross fiscal deficit rose from 3.3 per cent to 5.1 per cent of GDP over the period. The interest payments and pension liabilities as a percentage of revenue receipts have increased from 13.0 per cent and 5.4 per cent in 1990-91 to 25.6 per cent and 12.5 per cent in 2003-04, respectively, but expenditure on administrative services has been declining. States own revenue receipts and current transfers from the Central Government (two major sources of revenue) as percentage of total expenditure has declined from 43.4 per cent and 29.5 per cent to 37.7 per cent and 18.6 per cent, respectively, over the same period. The buoyancy in the collection of sales tax and States own tax revenue has declined generally for all states. The two most important reasons for low tax collections are the competitive reductions by States to attract trade and industry and inadequate taxation of the rapidly rising services sector. The State Governments have also initiated measures to curtail expenditure - restrictions on fresh recruitment/creation of new posts, curbs on administrative expenditures, and introduction of contributory pension schemes.

On non-tax revenue, user charges are very low - in case of water charges, costs are higher than the recovery in 76 major cities; electricity companies could recover only 68.6 per cent of their costs; fare-freight ratio of railways at 0.31 in India is lowest in the world; and major state road transport corporations are also recording losses. The returns on investment in central public sector enterprises (state owned and managed) also continue to be low, though improvement is recently noted (Table - 5). In the case of state-level public sector enterprises, the returns are inadequate to cover the cost of funds, the bulk of which are invested in State Electricity Boards (SEBs).[8] The high level of losses is due to various factors – low plant load factor, high transmission and distribution losses, low user costs and high establishment costs. Reforms in the power

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[8] In 834 enterprises, total investment is estimated at Rs.1,722 billion. The negative returns on assets in SEBs have increased from -12.7 per cent in 1992-93 to -43.1 per cent in 1999-2000. The losses of SEBs in 2000-01 account for 1.2 per cent of GDP and dues payable by SEBs to central enterprises as of February 2001 amount to 2 percent of GDP (Rao, 2004).

sector have been undertaken since 1999, outstanding dues are being cleared, cost-based pricing is being introduced and average tariff rates are being raised. Twenty-one states have constituted State Electricity Regulatory Committees to determine the power tariff structure – of which seventeen are operational. Further reforms that are being considered are introduction of 'time-of-day' pricing, explicit targeting of subsidies and 'power pooling' arrangements.

TABLE – 5: PERFORMANCE INDICATORS OF CENTRAL PUBLIC SECTOR UNDERTAKINGS

Year	Capital Employed (Rs.billion)	Profit after Tax (Rs.billion)	Returns on Capital (%)	Average Interest Paid by Govt. (%)
1	2	3	4	5
1980s	435	14	2.5	7.0
1990-91 to 1995-96	1364	40	2.8	8.8
1996-97 to 2001-02	2624	129	4.9	10.2

Source: Economic Survey, Various Issues, Government of India.

The process of disinvestment in Public Sector Enterprises (PSEs) and of privatization has also been initiated. The Government of India has also set up a new Department of Disinvestments to establish a systemic policy approach and emphasize strategic sales of identified Public Sector Undertakings.[9] The process of disinvestments has also been initiated at the State level.[10] Though progress in the 1990s was slow due to pricing problems, sensitivity of the issue of labor reforms and the sluggishness of the capital market, it had begun to yield results by 2003. In 1992-93, when the issue began to be discussed, the size and pricing of the shares in PSEs emerged as important concerns for the following reasons – under-pricing due to desperate nature of sale, lack of competitive bidders/purchasers and under-developed capital markets. It however has to be noted that for the process of disinvestments to succeed, the environment has to be conducive and the schemes have to be innovative (Howes and Murgai, 2004).

[9] Out of the 62 PSUs considered for disinvestments, the government has taken decision on 49 PSUs; out of 919 PSUs, the process of disinvestments/winding-up/restructuring has been initiated in 221 units, and the process of privatization has been completed for 33 units. Realization through disinvestments during 1991 to 2003 stood at Rs.309 billion against the target of Rs.783 billion. The change in the Central Government in May 2004, is not expected to slow down the process of disinvestments, though the Department no more enjoys an independent status and operates under the Ministry of Finance.

II.I.II. TRENDS IN GOVERNMENT LIABILITIES

The annual fiscal operations of the government finally reflect in public debt. In India, since 1951, when the five-year plans were introduced, domestic debt has been incurred with the main objective of enhancing public investment for economic development. The impact of domestic debt on economic growth has been analyzed theoretically in the context of two contrasting views – Keynesian (Ferguson, 1964), which considers it a burden, and Ricardian (Barro, 1978 and 1989), which considers it neutral. In the Indian context, Rao (1953) and Brahmananda ((1980) argue that deficit financing is useful for economic development while Minhas (1987) and Singh (1999a) conclude empirically that debt and growth are unrelated.

The long-term trend in the growth of public debt reveals a substantial increase during 1980s. Public debt of the country increased from 32.1 per cent of GDP in 1952[11] to 76.7 per cent in 2004, mainly due to domestic debt, which rose from 30.8 per cent to 74.9 per cent over the period.[12] (Table - 6). Increasing reliance on domestic debt emerged in the early 1980s, with a persistent revenue deficit, implying utilization of borrowings for consumption purposes. The major reason why domestic debt was increasingly used as a revenue instrument was the limited scope for further expansion of tax revenue and low

TABLE – 6: PUBLIC DEBT OF THE GOVERNMENT

	As per cent to the Total			As per cent of the GDP		
Year (end-Mar)	Domestic Debt	External Debt#	Public Debt	Domestic Debt	External Debt#	Public Debt
1	2	3	4	5	6	7
1952	95.8	4	100.0	30.8	1.4	32.1
1960	92.1	7.9	100.0	42.2	3.6	45.8
1970	69.8	30.2	100.0	35.8	15.5	51.3
1980	82.2	17.8	100.0	42.3	9.2	51.4
1990	90.5	9.5	100.0	55.5	5.8	61.4
2000	95.1	4.9	100.0	59.2	3.3	62.2
2004	97.8	2.2	100.0	74.9	1.7	76.7

Note: * estimates. # At historical exchange rates.
Sources: (a) Annual Report, Various Issues, Reserve Bank of India.
(b) Economic Survey, Government of India.
(c) Union and State Governments' Budget.

[10] 19 States have identified 290 public enterprises for disinvestments.
[11] Figures for debt refer to end-March, the end of the fiscal year.

returns from large investments made in public enterprises (non-tax revenue) to meet the growing expenditure. Further, restrictions on external borrowing mainly due to uncertainty in availability and high servicing cost, especially since 1971, led to increasing reliance on domestic borrowing.[13]

In order to introduce fiscal discipline, the Central Government has legislated the Fiscal Responsibility and Budget Management Act (FRMBA) on August 26, 2003. The objective of the Act is to ensure reduction in deficits, prudent debt management consistent with fiscal sustainability through limits on borrowings, transparency in fiscal operations, and conduct of fiscal policy in a medium-term framework. The State Governments are increasingly being encouraged to enact similar legislation.[14] The States are also being encouraged to establish consolidated sinking funds to meet the obligation of debt payments.[15] Also, the separation of Debt Management from the Reserve Bank of India is being considered, though it would depend on the fulfillment of three pre-conditions – reasonable control over fiscal deficit, development of financial markets and necessary legislative changes (Singh, 2005).

The imposition of strict fiscal controls, reduction in transfers from the Central Government since 1992 and discontinuation of the allocation of market borrowings to state level undertakings by the Central Government since 1996-97 have led the States to issue higher volumes of explicit guarantees (Table - 7). In view of low user charges and inefficient operations of state public sector undertakings, these contingent liabilities, mainly held in the form of bonds by CBs and DFIs with a potential impact on their balance-sheets, are a cause of concern. Therefore, in recent period, the rising trend and its implications have been examined by the state governments and remedial

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[12]Domestic debt of the Government is computed from the debt of the Central (Federal) Government and the State (Provincial) Governments. The debt position of the State Governments is available only from 1952 onwards.

[13]Major reasons for the foreign exchange crunch were the oil shocks as also a political argument - difficulties in getting foreign aid in the early seventies (due to the Indo-Pak war of December 1971). India has, since 1971, increasingly adopted the policy of self-reliance.

[14] Karnataka (2002), Kerala (2003), Punjab (2003), Tamil Nadu (2003) and Uttar Pradesh (2004). Maharashtra has introduced the Bill in the Assembly.

measures undertaken - eight states have legislated ceilings on guarantees[16] and seven states have set up a guarantee redemption fund.[17]

TABLE – 7: CONTINGENT LIABILITIES OF THE GOVERNMENT

(per cent of GDP)

Year	Central Government	State Government	Total
1	2	3	4
1992	7.7	6.1	13.9
1996	5.5	4.4	9.6
2001	4.1	8.0	12.1
2003	3.7	7.5	11.2

Source: Annual Report, Reserve Bank of India.

II.I.III. MONETARY AND FISCAL CO-ORDINATION

The monetary system in India till 1991 was mainly characterized by an administered interest rate regime that was oriented to the goal of raising financial resources for the Government at low cost. The overall implication of the administered interest rate system on fiscal policy in India can be summarized as follows – *(a)* low profitability of the captive investors (state-owned banks and insurance companies) resulting in low transfers to the Central government budget in terms of profits and dividends and low levels of contingency reserves in their respective balance-sheets; *(b)* increased incidence of monetization, as the narrow investor base mainly consisted of captive investors; *(c)* underdeveloped capital and debt markets, resulting in inefficiency in allocation of resources; and *(d)* unviable projects undertaken in the public sector, resulting in wasteful expenditure and low returns on public investment.

The prevalence of administered interest rates resulted in the deficit of the Government being generally accommodated by the RBI. In economic literature there has been a continuous debate on the central bank credit to the government. Cottarelli (1993) and Kopits and Symansky (1998) argue that the central bank credit to the Government, which has implications for price stability, should be formally limited. Cukierman

[15] Eleven States have them already– Andhra Pradesh, Arunachal Pradesh, Assam, Chattisgarh, Goa, Maharashtra, Meghalaya, Mizoram, Tripura, Uttaranchal, and West Bengal. Kerala is considering.

[16] Statutory Ceiling – Goa, Gujarat, Karnataka, Sikkim and West Bengal. Administrative Ceiling – Assam, Orissa and Rajasthan.

[17] Andhra Pradesh, Goa, Gujarat, Himachal Pradesh, Karnataka, Orissa and Rajasthan.

(1992) explains the arguments: – The government prefers central bank credit to current or future taxation because of its ease and certainty, and also because the distributional effect of seignorage is difficult to detect. Secondly, in view of the short-term trade-off between price stability and output, political forces prefer the short-term output effect. In India, many studies have emphasized the applicability of monetarist theory, and also empirically tested the robustness of the demand function whereby a rise in the money supply directly affects the price level (Brahmananda, 1972; Bhalla, 1981; Minhas, 1987; Rao, 2000; Buiter and Patel, 1992; and Singh, 1999b).

In India, the main source of reserve money from 1970 to 1991 was the net RBI credit to Government (NRBICG),[18] mainly on account of Central government securities increasingly held by RBI. The Central Government resorted to borrowings from the RBI regularly[19] in addition to periods of wars[20] and droughts.[21] The annual average growth rate of NRBICG exceeds that of Reserve Money (RM) for the period 1971 to 1991 and of broad money (M3)[22] during 1981 to 1991 (Table - 8). Since 1991, a

[18] RBI credit to Government, both Central and the State Governments, specifically, comprises: - *(i)* Rupee securities held in Issue Department, *(ii)* Treasury bills purchased and discounted, *(iii)* Investments in government securities, *(iv)* Rupee coins in Issue and Banking Departments, and *(v)* Loans and advances to State Governments. Item *(iv)* needs further clarification. The RBI comes to acquire the government currency as the Central Government's agent for distribution of currency to the public as well as a backing against its own currency. The government currency appears as an asset in the balance sheet of the Reserve Bank of India. It is an insignificant component.

[19] RBI provided substantial support to the government's borrowing program during 1956 and 1957, as a result of slack market conditions. Monetized deficit accounted for 24.4 per cent of total plan outlay in the Second Five Year Plan (1956-61). The expansionary fiscal policy during 1977 and 1978 led to the increase in NRBICG during 1979-81.

[20] The spurts in 1962-63 and 1965-66 were due to the war expenditure with China and Pakistan, respectively. The other big spurt in NRBICG during 1971-1973 was due to the war with Pakistan and the influx of refugees from Bangladesh in 1971. The number of refugees from Bangladesh had reached ten million by December 1971. Seven million of these were housed in government camps (p.44, Government of India ,1972).

[21] In 1979, national income, at real prices, declined by 5.3 per cent while agricultural and industrial production declined by 15.5 per cent (due to drought) and 1.4 per cent, respectively. In view of the decline in production, but increased expenditure on drought and natural calamities' relief and certain committed plan expenditures, and decline in external aid, increasing reliance was placed on NRBICG. Since 1985, increase in NRBICG was mainly due to increased relief expenditure on agriculture in the form of subsidy (food and fertilizer), because of a negative growth rate in the agriculture sector during 1984-85, 1986-88, and 1991-92.

[22] Broad Money (M3) consists of *(a)* M1 (narrow money, consists of *(i)* Currency with the public, *(ii)* Demand deposits of all commercial and co-operative banks and *(iii)* Other deposits held with the Reserve Bank of India), and *(b)* Time deposits of all commercial and co-operative banks.

concerted effort was successfully made by the Government to control the increase in NRBICG (discussed in the sub-section on Automatic Monetization).

TABLE - 8: MONEY, INCOME AND PRICES

Year	GDP	Reserve Money (RM)	Net RBI Credit to Government (NRBICG)	Broad Money (M3)	Inflation Rate (WPI) (%)	RM	NRBICG	M3
	Annual Average Growth Rate (%)					Annual Average as per cent of GDP		
1	2	3	5	4	6	7	9	8
1971-81	3.2	15.3	15.8	17.7	10.3	11.5	10.3	30.9
1981-91	5.7	16.4	18.5	16.9	7.2	12.9	13.9	40.3
1991-92	1.3	13.4	5.8	19.3	13.7	14.4	14.4	44.8
1992-01	6.2	13.4	5.8	17.1	7.2	14.1	9.6	49.7
2001-02	5.8	11.4	-1.1	14.1	3.6	13.8	6.7	62.2
2002-03	4.0	9.2	-20.7	14.7	3.4	13.9	4.9	66.7
2003-04	8.2	18.3	-62.8	16.6	5.4	14.1	1.6	67.3

Source: Annual Report, Various Issues, Reserve Bank of India.

II.I.IV. STOPPAGE OF AUTOMATIC MONETISATION

In India, the monetized deficit had been increasing rapidly, mainly on account of the Central Government, since the late seventies but the genesis of borrowing from the RBI can be traced to the agreements between the Government of India and the RBI, regarding creation of *ad hoc* Treasury bills (91 days), in November 1937 and January 1955. In these agreements, it was agreed that the Government shall maintain certain minimum cash balance with the RBI and when the balance falls below the minimum agreed limit, the account would be automatically replenished by the creation of *ad hoc* Treasury bills in favor of the Bank. However, over time, issuance of such *ad hoc* Treasury bills became a permanent and increasing means of financial support to the Central Government from the RBI. This automatic monetization of the fiscal deficit, representing unlimited borrowing from the Reserve Bank, severely restricted the operation of monetary policy.

In literature, discretionary control of monetary tools by the central bank is considered an important component of independence (Grilli, Masciandaro and Tabellini, 1991). In the Maastricht Treaty, central bank credit to government is entirely discretionary and only indirect credit is permitted. In OECD countries, though no formal constraints

on indirect central bank credit to government are imposed, nevertheless there are often informal constraints on indirect central bank credit: open market operations can only be done for monetary policy reasons. Carracedo and Dattels (1997) mention, based on survey results, that many countries prohibit borrowings from the central bank.

Thus, it was considered necessary to insulate RBI from the fiscal pressure of the Government and to impose some limit on credit to the Government. With this objective in view, the Government of India and the Reserve Bank signed the first Supplement Agreement in September 1994 to phase out the issue of *ad hoc* Treasury bills by the end of fiscal year 1996-97. Pursuant to this, the issuance of *ad hoc* Treasury bills was discontinued with effect from April 1, 1997. The existing ad *hoc* Treasury bills, amounting to more than Rs. 1,200 billion by the end of March 1997 or 9.6 per cent of GDP, carrying a rate of discount of 4.6 per cent per annum since July 1974 (substantially lower than the interest rates prevailing in the market), were converted into special securities (at 4.6 per cent) and issued to RBI (Singh, 2005).

To meet the short-term temporary financing needs of the Central Government, the Reserve Bank of India now provides Ways and Means Advances (WMA) at Bank rate (rate at which the RBI lends to CBs), as it has been providing to state governments since 1937. The Central Government did not resort to this instrument during 1943-1997. Since 1997, the RBI and the Government, annually agree on a fixed amount of financial resources to be provided by the RBI to the Central Government. If the accommodation exceeds the agreed amount, then the RBI provides an overdraft facility for a maximum period of ten consecutive working days, but at a penal rate of interest.

II.II MONETARY POLICY AND BANKING SECTOR REFORMS

In addition to the accommodative monetary policy, the banking sector also had to contribute to the development process by statutorily investing in government securities and meeting the targets of directed lending. In view of the underdeveloped money and government securities market, monetary policy had to rely on direct

instruments, and had to accomplish a very difficult task in containing aggregate demand in the short term and to develop the operational efficiency of the financial system including the development of securities market in the long run. The banking sector reforms in 1991 aimed at liberalizing interest rates, creating a deregulated environment, strengthening the prudential norms and the supervisory system, changing the ownership pattern of banks and introducing competition in the banking industry. The reforms were first initiated for the CBs and then extended to others – DFIs, CPBs and NBFCs - some of the important reforms are discussed here.

II.II.1 INTEREST RATE POLICY

The interest rate structure in the economy, with the objective of cross - subsidization between sectors, became increasing complex as both lending and deposit rates of the banks were prescribed by the RBI while coupon rates on government securities and interest rates on public sector bonds, provident funds and postal saving schemes were fixed by the Central Government. To undertake reforms in the financial sector, the interest rates were liberalized in a co-coordinated way. The approach has been gradual, so that CBs are not tempted to lend at higher rates, assuming higher risk, as that would be detrimental for overall growth and development of the economy. CBs now generally charge rates of interest in accordance with their perception of creditworthiness of the borrowers and have the freedom to price their loan products based on time-varying term premia and relevant transaction costs. CBs have also been allowed to price their floating rate products by using market benchmarks in a transparent manner but floating rate products have yet to become popular. Consequently, the spreads have generally narrowed since the beginning of reforms. In order to impart greater flexibility in the interest rate structure relating to DFIs, the prescription of ceiling rates of interest on lendings by these institutions was replaced by a system of minimum rate effective from August 1991.

The Bank Rate (BR), as an instrument of monetary policy, had been dormant and unchanged from July 12, 1981 to July 3, 1991. To ensure a benchmark rate, the BR was activated by developing it as an effective signaling rate with several interest rates

of significance and majority of accommodation extended by the RBI linked to it (Table - 9).

II.II.II PRE-EMPTION OF BANK DEPOSITS

The banks in India were also subject to high level of prescribed reserve requirements – cash reserve ratio (CRR) and statutory liquidity ratio (SLR). CRR was initially intended as an instrument to contain liquidity growth in an exigency, while SLR was prescribed to impose financial discipline on banks and to provide protection to depositors. Over time, SLR was increasingly being used to mobilize resources exclusively for the government. In 1991, effective preemptions on incremental deposits through the two instruments amounted to 63.5 percent (Table - 9). The public sector banks were increasingly becoming unprofitable (mainly government securities were eligible for SLR purposes and these had low coupon rates; interest was not paid on CRR balances; and 40 per cent of credit was extended to priority sector at concessional rates), with rising non-performing assets and erosion in their capital. The reforms initiated in 1991 began by lowering the reserve requirements, again gradually. CRR at present is 4.50 percent while SLR is the lowest prescribed by the RBI Act at 25.0 percent. The immediate objective, indicated by the RBI, is to lower CRR to 3 percent and to amend the RBI Act to lower the minimum prescribed SLR.

TABLE - 9: USE OF BANK RATE AND BANKING RATIOS

(per cent)

Year	Bank Rate		Cash Reserve Ratio*		Statutory Liquidity Ratio**	
	Range/ Rate in %	No of times changed	Range/Rate in % - Period /end –March	No of times changed	Range/Rate in % - Period /end –March	No of times changed
1	2	3	4	5	6	7
1950-60	3.0-4.0	2	5.0 and 2.0+	1	20.0	0
1960-70	4.0-6.0	4	3.0	3	25.0-26.0, 26.0	2
1970-80	5.0-9.0	3	4.5-6.0, 6.0	11	27.0-34.0, 34.0	7
1980-90	9.0-10.0	1	6.5-15.0, 15.0@	23	34.5-38.0, 38.0	8
1990-00	8.0-12.0	10	15.0@ - 9.0	26	38.5#-25.0	12
2000-04	6.0^ – 8.0	7	9.0-4.5^	12	25.0^	0

* Cash Reserve Ratio as percentage of Net Domestic Time Liabilities (NDTL); +separate rates for demand and time liabilities, respectively; @ Excluding 10 per cent additional reserve requirements of CRR on incremental NDTL; ** Till March 29, 1985 Statutory Liquidity Ratio as proportion of gross DTL as on every Friday in the following week on daily basis. Thereafter, on a fortnightly basis as a proportion of net DTL as on last Friday of second preceding fortnight; # In addition, 30% SLR on the increase in net DTL over April 3, 1992 level. ^ As on January 31, 2005.

Sources: (a) Annual Report, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.

II.II.III DIRECTED LENDING AND DEPLOYMENT OF CREDIT

In the case of directed lending, in consideration of the government's program of developing the rural sector and reducing poverty, especially since 1977, the RBI prescribed that a specific proportion of the net bank credit should go to priority sectors (gradually rose from 33.0 to 40.0 per cent), comprising mainly agriculture, specified small scale industry and weaker sections of the society, at concessional rates of interest. The scope for advances under priority sector lending has been enlarged, interest rates deregulated though still concessional and alternate avenues of investment have been permitted under the reforms. All new loans granted by banks to non-banking finance companies, for the purpose of on-lending to small scale industries have been reckoned under priority sector lending. Since February 2000, the RBI has regularly been advising banks to mainstream micro-finance and to enhance the outreach of micro-credit providers, in the belief that micro-finance interventions can serve as an effective tool for poverty alleviation. This program is also of benefit to the banks as it externalizes the credit delivery process and in the past has recorded more than 95 per cent recovery. Morduch (1999) highlights the fact that, generally, profitability in micro-finance operations depends on the continuous availability of subsidized financial support while Singh and Srinivasan (2004) argue that directed lending reflects continuation of financial repression. However, these measures helped to reduce poverty in rural areas though it pre-empted major resources of the banks (Burgess and Pande, 2004).

Since the reforms, the deployment of credit has increased in non-traditional 'other' sectors, with the banks penetrating into retail and housing, with lending rising more than ten-fold to housing from 1995 to 2004 (Table –10). In the case of industry, the share has declined since 1991. In the annual studies, published by the RBI, of select private limited companies (PRLC), public limited companies (PULC) and large public limited companies (LPULC), a distinct trend in bank financing is noted – *(a)* In the case of PRLC the share of bank finance declined from 16.0 per cent in 1995-96 to 14.1 per cent in 1999-00 and since then has been increasing to reach 15.8 per cent in 2002-03 (latest study available), and *(b)* In the case of PULC and LPULC, a steady

increasing trend is witnessed with the share rising from 13.1 per cent and 11.5 per cent in 1995-96 to 16.0 per cent and 14.8 per cent, respectively, in 2002-03. The trend in credit flow reflects the fear of bank managers in extending funds to the private sector and incurring non-performing assets (NPAs) while the credit to public sector is considered safe as it is perceived to be guaranteed by the government (Banerjee, Cole and Duflo, 2004).

TABLE - 10: SECTORAL DEPLOYMENT OF NON-FOOD CREDIT BY COMMERCIAL BANKS

(per cent to Total)

Year	Priority Sector	*of which* Agriculture	SS Industry	Industry (Medium & Large)	Wholesale Trade	Others	Total Non - Food Credit
1	2	3	4	5	6	7	8
Outstanding							
1980-91	40.7	16.9	15.2	39.2	6.4	13.8	100.0
1991-95	36.2	14.2	14.9	40.2	5.1	18.6	100.0
1995-04	34.9	12.2	12.9	38.7	4.4	22.0	100.0
Incremental							
1980-91	42.2	17.0	15.9	36.9	3.7	17.2	100.0
1991-95	38.7	14.3	20.5	30.8	5.0	25.5	100.0
1995-04	37.1	12.3	9.3	32.7	3.1	27.0	100.0

Source: Handbook of Statistics on Indian Economy, Reserve Bank of India.

II.II.IV PRUDENTIAL NORMS

The scaling down of the prescribed statutory ratios and widening the scope of the priority sector lending released large amount of funds, which could be invested on the basis of commercial viability. Therefore, to strengthen the banking system, prudential norms were introduced gradually to meet the international standards. The definition of NPAs has progressively been tightened in India. Although gross NPAs have declined from 24.8 per cent in 1993-94, they are still high at 7.2 per cent of gross advances at end-March 2004 as compared with the international standards of about 2 per cent. Efforts have been made to deal with the stock of NPAs, by setting-up debt recovery tribunals. In 2002, the Parliament approved the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act (SARFAESI), which empower the CBs and DFIs to recover NPAs. The Act has

already had a salutary effect in this regard and the NPAs of CBs have declined substantially; but those of DFIs and CPBs continue to be high (Table - 11).

TABLE - 11: NON-PERFORMING ASSETS OF BANKS AND FINANCIAL INSTITUTIONS

(per cent to Total Assets)

Year	Commercial Banks		DFIs	Co-operative Banks – G. NPA			NBFCs	
	G. NPA	N. NPA	N. NPA	State	Urban	Central	G. NPA	N. NPA
1	2	3	4	5	6	7	8	9
1993-94	24.8	..	..	..	..	..	..	..
1997-98	14.4	7.3	..	..	11.7	..	11.4	6.7
2001-02	10.4	5.5	8.8	13.4	21.9	19.7	10.6	3.9
2002-03	8.8	4.4	10.6	18.0	19.0	22.0	8.8	2.7
2003-04	7.2	2.9	..	..	17.6	..	..	..

G – Gross; N – Net; N.NPA = G.NPA adjusted for provisions; .. - Not Available.
Source: Report on Trend and Progress of Banking in India, Various Issues, RBI.

Since 1997, action was initiated on a time-table basis to increase capital adequacy ratios, assign risk weights to government-approved securities, provide for market risk, and provide risk weights to open positions in foreign exchange and gold. Asset classification is being further strengthened and banks are being prepared for tightening of the norms for asset classification with convergence to international standards by March 2005. As a result, capital levels of the banking sector have improved markedly, with the overall capital adequacy of CBs rising from 10.4 per cent as at end-March 1997 to 12.9 per cent as at end-March 2004, owing mainly to ploughing back of profits into reserves (Table - 12). The CBs are now preparing for the implementation of Basel-II from 2006.

TABLE - 12: CAPITAL ADEQUACY RATIO OF COMMERCIAL BANKS AND DEVELOPMENT FINANCIAL INSTITUTIONS

	1997	2000	2003	2004
1	2	3	4	5
Banks	*Number of commercial banks*			
Below 4 %	5	3	2	2
Between 4-8%	1	2	0	0
Between 8-10 %	30	12	4	3*
Above 10 %	64	84	87	88
DFIs				
IDBI	14.7	14.5	18.7	18.3
SIDBI	31.5	27.8	44.0	51.6
EXIM	31.5	24.4	26.9	23.5
NABARD	40.4	44.4	39.1	39.4

* between 9-10 per cent.
Source: Report on Trend and Progress of Banking in India, Various Issues, RBI.

II.II.V COMPETITION

To enhance efficiency in the banking sector, foreign banks and private entrepreneurs are being invited to commence banking operations in India. The entry of foreign banks was restricted earlier, but since 1991 a number of foreign banks have been allowed to operate in India. To enhance competition, foreign direct investment up to 74 per cent of ownership has been allowed in private banks and up to 20 per cent in nationalized banks. The banks have also been allowed to enter into insurance business either as joint venture participants or to take up strategic investment for providing infrastructure and services. Consequently, the number of foreign and private banks operating in India increased from 21 and 23 in 1991 to 33 and 30, respectively, in 2004.

II.II.VI SUPERVISION

To ensure balanced growth of the banking sector, the supervisory function has been strengthened within RBI. A Board for Financial Supervision (BFS) set up in November 1994 under the aegis of the Reserve Bank exercises integrated supervision over the financial system. The focus of the BFS, consistent with international practice, is on off-site inspections and on control systems internal to the CBs. The BFS had set up an off-site surveillance system for CBs in 1995 to ascertain the financial condition between on-site examinations, identify institutions showing financial deterioration and act as a trigger for supervisory actions. In 1997, RBI also introduced a comprehensive regulatory framework in respect of NBFCs.[23]

The reforms aimed to first recapitalise the CBs and then initiate privatization. The ownership pattern of public sector banks is now beginning to change. The amendment in the State Bank of India Act, 1955 as well as the banking Companies (Acquisition and transfer of Undertakings) Acts 1970/1980, have enabled state-owned public sector banks (SOPSBs) to increasingly take recourse to capital markets to shore up

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[23] The strategy consists of four pronged mechanism – *(i)* on-site inspection on the CAMELS (Capital Adequacy, Asset Quality, Management, Earnings, Liquidity and Systems) pattern; *(ii)* off-site monitoring through periodic control returns from NBFCs; *(iii)* effective market intelligence network; and *(iv)* submission of exception reports by statutory auditors of NBFCs.

their capital, subject to the maintenance of 51.0 per cent of public ownership. Of the 27 SOPSBs, 20 have raised equity capital from the market since 1996-97 and in case of three major CBs the share of Government/RBI has already gone down to less than 60.0 per cent.[24] The process has been slow due to the depressed conditions in the stock market.

The reduction in the statutory requirements and freedom to fix the interest rates helped the CBs to mobilize resources – deposits have increased since 1991 (Table – 13). The investment in government securities has also increased though, mainly due to the fear of incurring higher NPAs – an incident of risk aversion by the commercial bankers (Banerjee, Cole and Duflo, 2003 and 2004). The reforms have led the CBs, mainly those in public sector, to recover their health and record higher profits (Table - 14).

TABLE - 13: SELECT AGGREGATES FOR COMMERCIAL BANKS

(Outstanding as ratio of GDP)

Year	Deposits		Investments		Credit		Balances	
	Demand	Time	Govt. Sec	Other App	Food	Non-Food	in hand	RBI
1	2	3	4	5	6	7	8	9
1980-91	5.6	24.9	7.5	3.9	1.3	18.3	0.4	3.9
1991-95	6.8	29.7	10.8	3.7	1.0	18.9	0.3	5.1
1995-04	6.9	37.2	15.8	1.7	1.3	22.8	0.3	3.2

Source: Handbook of Statistics on Indian Economy, Reserve Bank of India.

TABLE - 14: OPERATING PROFIT RATIO OF BANKS AND FINANCIAL INSTITUTIONS

Year	CBs	DFIs	State CPBs	Urban CPBs	Central CPBs
1	2	3	4	5	6
1990-91	0.3	..	..	..	..
1992-93	-1.1	..	..	..	..
1996-97	1.8	..	1.4	..	1.5
2000-01	1.5	2.0	1.7	1.6	1.7
2002-03	2.4	1.4	2.0	1.5	1.9
2003-04	2.7	1.3	..	1.8	..

Source: Report on Trend and Progress of Banking in India, Various Issues, RBI.

[24] These banks are Allahabad Bank, Andhra Bank, Bank of Baroda, Bank of Maharashtra, Bank of India, Canara Bank, Corporation Bank, Dena Bank, Indian Overseas Bank, Oriental Bank of Commerce, Punjab National Bank, State Bank of India, State Bank of Bikaner and Jaipur, State Bank of Indore, State Bank of Mysore, State Bank of Travancore, Syndicate Bank, UCO Bank, Union Bank of India and Vijaya Bank.

However, a number of critical issues emerge – *(a)* The improvement in performance in terms of reduction in NPAs and increase in profitability of the CBs is mainly because of widening gap between lending and deposit rates in recent years and increased investment in government securities (more than 35.0 per cent of deposits since 1997 as against 25.0 per cent stipulated statutorily). This implies that credit to productive sectors like industry and retail market sector has been restricted. However, this trend cannot be sustained on a long-term basis, especially of investing in government securities, if the government initiates measures to minimize and then eliminate gross fiscal deficit; *(b)* The reforms have led the CBs, especially those in the public sector, to restructure their operations to improve profitability. The branches in rural areas, the majority of which were opened after 1977, are beginning to close shop. A geographical analysis reveals that though the rural sector accounts for nearly half of total branches of CBs as at end of March 2003, it accounts for less than 14.0 per cent of deposits and 10.2 per cent of credit (Appendix Table –1). This restructuring is a healthy trend and is expected to continue. The rural sector can be serviced mainly by the CPBs, which already have more than 113,000 branches in the rural areas and the Government is making efforts to revive them, and NBFCs. The RBI is strengthening the regulation and supervision of CPBs and NBFCs and has also permitted the CBs to consider the amount lent to CPBs and NBFCs as a component of priority sector lending, which will still ensure flow of resources to the rural sector even if the CBs totally withdraw from the rural areas. It needs to be mentioned here, though a minor digression, that the post offices in India, with more than 135,000 branches in rural areas, also perform basic banking operations of saving deposits and withdrawals, as well as offering more advanced products like time/recurring deposits/money transfers (across the country) and investment instruments ranging between 6 and 15 years. The competition amongst these entities may not augur well for business volumes and profitability (Appendix Table –2); *(c)* The role of micro-credit also needs to be analyzed in the context of the existing scheme of priority sector lending, and the network of CPBs and NBFCs in rural areas; and *(d)* The continuation of stipulated limits on priority sector lending, vestiges of the earlier regime of

financial repression, may have to be dismantled to help the CBs to further improve their balance sheet.

II.III EXTERNAL SECTOR

In view of the need to conserve limited foreign exchange reserves for essential imports (petroleum goods and food grains) and to protect domestic industry, tariff barriers on imports had traditionally been high. This restrictive trade policy led to a limited growth in external trade. In addition, capital mobility had been strictly restricted and entry of multinationals was discouraged. After 1991, the liberalization of the external sector was gradual, in consideration of the domestic and external situation.[25] The strategy in 1991 shifted from import substitution to export promotion and the reach of export incentives was broadened to cover numerous non-traditional items. The strategy for external sector reforms had the following key elements – *(a)* sufficiency of reserves, *(b)* stability in the foreign exchange market, and *(c)* prudent external debt management. The trade policy was rationalized; export subsidies, licenses and other quantitative restrictions were abolished, the tariff structure was simplified and tariff rates were progressively reduced (Table - 15). Although the average tariff rate declined steadily from 1991-92 to 1996-97, thereafter, it edged up again, *inter alia*, due to the imposition of various surcharges, predominantly in agriculture and consumer goods sectors.

Table – 15: WEIGHTED AVERAGE IMPORT DUTY RATES IN INDIA

(per cent)

Year	Agriculture	Mining	Consumer	Intermediate	Capital	All Commodities
1	2	3	4	5	6	7
1991-92	47.0	56.9	97.8	69.5	94.8	72.5
1995-96	16.7	29.9	36.1	22.9	29.1	25.9
2000-01	58.6	16.1	56.2	36.2	34.4	35.7
2001-02	57.7	15.8	67.1	34.8	31.8	35.1

Source: Report on Currency and Finance, 2001-02, Reserve Bank of India.

As a result of the measures, the share of India's imports in world trade increased from 0.6 per cent in 1993 to 0.9 per cent in 2003, while that of the exports increased from 0.6 per cent to 0.8 per cent. However, India's share in global export markets is still low as compared to its share at 2.2 per cent in 1948 (Srinivasan, 2003). Trade

[25] Gourinchas and Jeanne (2003) show that direct benefits from international financial integration may not be large for the emerging economy though indirect channels could affect the policies and governance.

openness (measured in terms of imports and exports to GDP) increased from 12.7 per cent in the 1980s and 18.9 per cent in the 1990s to 23.6 per cent in 2004. The importance of primary products in the export basket has declined, while petroleum products and manufactured goods, particularly engineering goods, and chemicals and related products have shown a marked increase. In the case of imports, petroleum goods continue to dominate, followed by capital goods and intermediate products.

II.III.I BALANCE OF PAYMENTS AND EXTERNAL DEBT

A number of measures have been initiated since 1991 to liberalize capital inflows. Foreign investment policy also underwent a radical change to encourage foreign direct investment to India. A foreign investment promotion board was established to invite, negotiate and facilitate substantial investment by non-resident corporations involving high technology transfer. Free repatriation of disinvestment proceeds, profits and dividends was allowed and the rate of withholding tax was aligned to international levels. The Foreign Exchange Regulations Act (1973) was amended and later replaced by the liberal Foreign Exchange Management Act (2000). Convertibility of foreign direct investment was extended to portfolio investments by foreign institutional investors in Indian stock exchanges. Indian corporations were allowed access to overseas financial markets in the form of Global/American Depository Receipts and Foreign Currency Convertible Bonds. New deposit schemes for non-residents were introduced and all those with exchange guarantees were phased out. Also, access to external commercial borrowings was made flexible.

The restrictions on current account transactions were also relaxed in a phased manner. India adopted Current Account Convertibility of the Rupee on August 20, 1994. However, India has been following a cautious approach on Capital Account Convertibility, because of its criticality for a developing country (McKinnon, 1973; McKinnon and Pill, 1998; Prasad, Rogoff, Wei and Kose, 2003; and Wolf, 2004).[26]

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[26] Rodrik (1998) observes that capital account convertibility should not be thrust on every country as it may worsen the situation. Aghion, Bacchetta and Banerjee (2003), argue that economies at an intermediate level of financial development are less stable than either very developed or underdeveloped economies. These economies may become unstable with capital account liberalization.

As a result of liberalized external sector policy measures, BOP indicators have improved with the current account turning from a deficit of 3.1 per cent of GDP in 1990-91 to a surplus since 2001-02 (Table – 16). The debt indicators have also improved since 1991 as short-term debt was avoided by the authorities (Table – 17).

TABLE – 16: BALANCE OF PAYMENTS – SELECT INDICATORS

(as per cent of GDP)

Year	Trade		Current Account		Foreign
	Exports	Imports	Receipts	Deficit	Investment
1	2	3	4	5	6
1970-71	3.1	4.0	3.9	1.0	0.1
1975-76	5.0	6.4	6.6	0.2	0.0
1980-81	4.6	8.9	8.1	1.5	0.0
1985-86	4.1	7.6	6.8	2.1	0.0
1990-91	5.8	8.8	8.0	3.1	0.0
1991-92	6.9	7.9	10.3	0.3	0.1
1995-96	9.2	12.4	14.1	1.7	1.4
2000-01	9.8	12.9	17.3	0.8	1.5
2003-04	10.4	13.2	18.9	-1.4	2.6

Sources: (a) Annual Report, Various Issues, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.

TABLE – 17: EXTERNAL DEBT OF INDIA

(As end of March; in per cent)

Year	Debt to GDP*	Debt service Ratio	Short term to Total Debt	Short term Debt to For. Ex. Reserves	Concessional Debt to Total Debt
1	2	3	4	5	6
1990	26.7	30.9	9.9	-	46.7
1991	28.7	35.3	10.2	146.5	45.9
1996	27.1	24.3	5.4	23.2	44.7
2001	22.4	17.2	3.6	8.6	35.5
2004	17.6	18.3	4.2	4.2	35.8

* Includes non-government borrowings, trade credit, and commercial borrowings. Differs from Table - 6, which included only government debt, amounting to 16.2 per cent in 1991 and 6.7 per cent in 2004.

Source: Annual Report, Various Issues, Reserve Bank of India.

II.III.II FOREIGN EXCHANGE RESERVES

India's foreign exchange reserves, as a result of measures initiated since 1991, have continued to record a healthy growth due to moderation in the trade deficit and strong

capital and other inflows - a rise of US $ 36.9 billion during 2003-2004 to $113 billion as at end-March 2004, as compared to US $ 21.9 billion in the previous year (Table – 18). The increase in reserves has been facilitated by Foreign Direct investment ($129 million in 1991-92 to $ 4.5 billion in 2003-04) and net invisibles ($1.6 billion in 1991-92 to $25.4 billion in 2003-04). Inward workers' remittances have increased from $2.1 billion in 1990-91 to $19.2 billion in 2003-04 while software exports have increased from $0.7 billion in 1995-96 to 12.2 billion in 2003-04. The foreign exchange reserves of the country, at present, exceed 17 months of imports or about five years of debt servicing. The policy to build an adequate level of foreign exchange reserves has been based on a number of considerations - size of the current account deficit and short term liabilities, and the composition and risk profile of capital flows.

TABLE – 18: FOREIGN EXCHANGE RESERVES

(end-March; In US Dollar million)

Year	SDRs	Gold	Foreign Currency Assets	Total	Import Cover (months)
1	2	3	4	5	6
1970-71	148	243	584	975	4.8
1975-76	234	281	1,657	2,172	4.2
1980-81	603	370	5,850	6,823	5.2
1985-86	131	417	5,972	6,520	4.4
1990-91	102	3,496	2,236	5,834	2.7
1991-92	90	3499	5,631	9,220	5.6
1995-96	82	4,561	17,044	21,687	6.1
2000-01	2	2,725	39,554	42,281	8.6
2003-04	2	4,198	1,07,448	1,12,959	17.0

Sources: (a) Annual Report, Various Issues, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.

II.III.II.I QUALITY OF INFLOWS

An important issue that emerges pertains to the quality of rising inflows (portfolio and foreign direct investment). India, in pursuit of its objective to accumulate reserves as well as to globalize, has been encouraging foreign participation by liberalizing the regulations for investment in various economic activities, including banking and insurance. Thus far, such investment has been permitted with minimum monitoring,

but with increasing volumes it may be necessary to adopt a cautious approach in the interest of financial sector stability (Roubini and Hemming, 2003).

II.III.II.II UTILISATION OF RESERVES

The rising volumes of foreign exchange reserves in some countries raises the important issue of utilization of these reserves – an area marked by lack of empirical and theoretical literature. In India, in recent months, the use of foreign exchange reserves to finance government expenditure for infrastructure has been debated. China, which has accumulated the largest volume of reserves, has recapitalized two of the four major state-owned commercial banks using reserves but the foreign exchange has not been used to fund government expenditure.[27] In discussions with experts on this issue, two views, both guarded, emerge, which are as follows:-

(a) Richard Cooper, in principle, though cautiously, agrees that such "excess foreign exchange reserves" can be used for productive purposes, if assets were purchased abroad and imported to avoid any short-term macroeconomic effect, or in long-term investment abroad.[28] Cooper further explains that the reserves could be thought of as India's assets, in this case held in liquid claims on foreigners. If adequate liquidity is maintained, where "adequate" includes the various dimensions prudently decided by the authorities in India, then anything beyond that might be better placed in other assets that lack liquidity and "presentability" to financial markets, but yield much more. Singapore and some of the OPEC countries have separated some of their official foreign earnings into investment accounts, for placement in lower liquidity but higher yielding assets. An extension of this idea would be to invest in foreign-produced capital goods which might be used productively in India - part of a port-expansion or improvement project, i.e. infrastructure. *There would be no short-run macroeconomic effect so long as the goods were purchased abroad, and imported, and therefore no "inflationary" effect.* How ownership is arranged is essentially an accounting matter between the Government and the RBI.

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[27] The banks are the Bank of China and the China Construction Bank, each of which received $22.5 billion in December 2003 through a special purpose vehicle (Huijin Corporation) established on December 16, 2003 for the purpose by the People’s Bank of China.
[28] Prof. Richard Cooper, Harvard University, confers in private correspondence.

(b) Ronald McKinnon[29] argues against using foreign exchange reserves to fund domestic expenditures. Rather than spending official foreign exchange reserves domestically, it would be better, but perhaps still not desirable, to finance new infrastructure investments by issuing government rupee bonds directly, implying a transparent and direct budgetary transaction. Using foreign exchange *round tripping* disguises the true nature of the transactions, confuses monetary policy, and would give the erroneous impression that there is a "free lunch" to be had when there isn't any. McKinnon explains further that reserve accumulation occurs because private parties are net sellers of dollars for rupees at the existing exchange rate. To prevent undue appreciation of the rupee, the RBI is then forced to intervene to buy the excess dollars overhanging the market. This creates excess base money in rupees that could be inflationary unless the RBI sterilizes the monetary consequences by selling domestic bonds and mopping up the excess liquidity from the market. If these official dollar reserves acquired by the RBI are then re-cycled back into the foreign exchange market to finance domestic infrastructure investments, the RBI must then repurchase the dollars (to maintain its exchange rate obligation) to prevent further appreciation of the rupee. The incidental effect of this *round tripping* would be to further expand the monetary base—necessitating sterilization through further sales of government bonds by the RBI. The net result is that new issues of government bonds in rupees are really financing the infrastructure investments. However, the foreign exchange side effects make domestic monetary management more difficult.

In the argument made by Cooper, the stress is on imports of physical assets, which would imply that imports of heavy equipment/services could affect adversely the Indian domestic industry/service sector within the economy. Another problem that could arise from the utilization of reserves is misutilisation (misuse or overuse), as had happened in the case of *ad hoc* Treasury bills during 1955 to 1997.

[29] Prof. Ronald McKinnon, Stanford University, confers in private correspondence.

II.III.III EXCHANGE RATES

India had a fixed exchange rate from 1947 till 1975 with the currency pegged to the pound sterling.[30] From 1975 to 1991, the exchange rate of the rupee was adjusted regularly on the basis of the weighted average of the exchange rate movements of the currencies of the major trading partners of India, with pound sterling as the intervention currency. Despite these regular adjustments, the exchange rate was overvalued and resulted in erosion of international competitiveness by 1990-91.[31] Therefore, it was adjusted downward in two stages on July 01 and 03, 1991 to effect about 18 percent reduction in the external value of the rupee (Table – 19). The exchange rate regime, soon thereafter transited from a basket-linked managed float to a market-based system in March 1993, after a short experiment with a dual exchange rate between March 1992 and February 1993. The exchange rate of the Rupee (end-year), as compared with US$ and NEER (export and trade weighted), has depreciated annually, on average, by 2.9 per cent for the period 1992-04, while depreciation against other major currencies, on average over the same period, has been higher – Pound (3.6 per cent), Euro (11.0 per cent) and Yen (5.7 per cent). In the last two years, the Rupee has appreciated by 5.6 per cent annually against the US$ while recording sharp depreciation against Pound (7.1 per cent), Euro (12.1 per cent) and Yen (6.8 per cent). Exchange rate policy is guided by the need to reduce excess volatility, prevent the emergence of destabilizing speculative activities, help maintain an adequate level of reserves and develop an orderly foreign exchange market, and is not governed by any predetermined target/band.[32]

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[30] During this period, major revisions in the exchange rate were made in June 1966, July 1972 and July 1975. In view of the instability in the exchange rate of the pound sterling during the early 1970s, the Indian rupee was delinked from the pound sterling with effect from September 25, 1975 and its value began to be determined with reference to a basket of currencies.

[31] The exchange rate of the rupee as measured by the real effective exchange rate (REER) appreciated by about 2 percent as a result of widening inflation differentials between India and major industrial countries despite continuing depreciation in the nominal effective exchange rate (NEER) by 2.4 percent during October 1990 - March 1991.

[32] The reason being that in the very short-run, expectations about the likely behavior of a currency can play a major role in determining the rate and given the bandwagon effect, expectations can become self-fulfilling, especially in thin markets. The day-to-day movement in currency markets is further complicated by volatility in private capital flows, which are sensitive to short term developments.

TABLE – 19: EXCHANGE RATE AND INDICES OF INDIAN RUPEE

(Base: 1985 = 100)

Year	Exchange Rates US $ (Year-end)	Export – based weights		Trade – based Weights	
		REER	NEER	REER	NEER
1	2	3	4	5	6
1975-76	8.9730	107.31	100.28	106.27	97.95
1980-81	8.1900	106.15	106.48	104.48	103.46
1985-86	12.3061	97.85	98.52	98.27	98.50
1990-91	19.6429	73.33	66.19	75.58	67.20
1991-92	31.2256	61.36	51.12	64.20	52.51
1995-96	34.3500	60.94	38.74	63.62	39.73
2000-01	46.6400	62.47	34.24	66.53	35.52
2003-04	43.4450	69.66	34.88	74.14	36.25

Notes: 1. Data up to 1991-92 are based on Official Exchange Rates and data from 1992-93 onwards are based on FEDAI (Foreign Exchange Dealers Association of India) Indicative Rates. 2. Real Effective Exchange Rate (REER) and Nominal Effective Exchange Rate (NEER) are based on 36 – country bilateral weights calculated on Annual Average (Financial Year) with 1985=100. 3. REER Indices have been recalculated from 1994-95 onwards using the new Wholesale Price Index (WPI) series (Base: 1993-94 = 100).

Sources: (a) Annual Report, Various Issues, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.
(c) RBI Monthly Bulletin, Reserve Bank of India.

II.IV FINANCIAL MARKETS

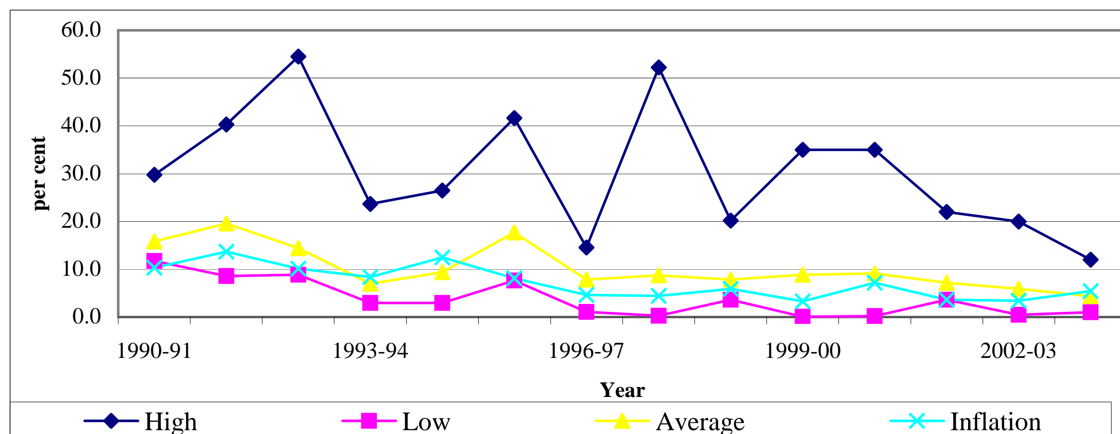
The development and regulation of money, government securities and foreign exchange markets is the responsibility of the Reserve Bank that emerges out of its role as monetary authority and debt manager for the Government and its interest in maintaining stability of the financial system. The emphasis has been on removal of structural rigidities, encouragement of wider participation, introduction of new instruments and development of legal, regulatory, institutional and technological infrastructure for orderly market activity.

II.IV.I MONEY MARKET

To facilitate the operation of monetary policy the efficiency of the transmission mechanism has to improve. Therefore, RBI initiated measures to develop the money market. The reforms included introduction of new instruments (different maturities of Treasury bills, commercial paper, certificates of deposits and inter-bank participation certificates) and development of dealers (primary and secondary).

In the call money market, major reforms were undertaken from 1991 onwards, though some measures had been initiated in 1987. To develop the call market, non-bank participants were allowed to operate and inter-bank liabilities were freed from reserve requirements to facilitate emergence of a smooth yield curve and reduce volatility in the call rates. The objective of making the call market a purely inter-bank market has been pursued since 2001 as other markets and instruments for non-bank participants have developed. To regulate short-term liquidity in the system, the RBI introduced Repurchase Agreements (Repo) on December 10, 1992 and a Liquidity Adjustment Facility (LAF) on June 5, 2000 under which it absorbs (repo) or injects liquidity (reverse repo) in the system on a daily basis. The repo rate has become an important signaling instrument for the financial markets, along with the CRR and the BR (Table - 20). The operations of LAF have been successful in reducing the volatility in the call rate (Graph - 1).

GRAPH –1: BEHAVIOUR OF CALL RATES - 1991 - 2004



Source: Handbook of Statistics on Indian Economy, Reserve Bank of India.

TABLE – 20: CHANGES IN BANK RATE, CASH RESERVE RATIO AND REPO RATE

(rates in per cent)

Year	Date	Bank Rate	Date	CRR	Date	Repo
1	2	3	4	5	6	7
2000-01	22.7.2000	8.00	29.7.2000	8.25	10.10.2000	8.50
	17.2.2001	7.50	12.8.2000	8.50	24.10.2000	8.25
	2.3.2001	7.00	24.2.2001	8.25	25.10.2000	8.00
			10.3.2001	8.00	20.2.2001	7.50
					2.3.2001	7.00
2001-02	23.10.2001	6.50	19.5.2001	7.50	27.4.2001	6.75
			3.11.2001	5.75	28.5.2001	6.50
			29.12.2001	5.50	5.3.2002	6.00
2002-03	29.10.2002	6.25	1.6.2002	5.00	27.6.2002	5.75
			16.11.2002	4.75	30.10.2002	5.50
					28.2.2003	5.00
2003-04	29.4.2003	6.00	14.6.2003	4.50	25.8.2003	4.50
2004-05					27.10.2004	4.75

Sources: (a) Annual Reports, Various Issues, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.
(c) RBI Monthly Bulletin, Reserve Bank of India.

The development of the money market has led to the emergence of an interest rate structure that is market related (Table - 21) and a narrowing of the spreads between different segments of the Treasury bills market (Graph-2). In the secondary market, the share of repo has generally been low as compared to outright transactions. Since 1997-98, 364 day Treasury bills have accounted for more than three-fourth of total transactions in Repo and more than half in the outright market, generally reflecting the trend in the amount of bills outstanding. Turnover ratio was marginally higher (ratio of turnover to outstanding bills at end of year) for 364-day Treasury bills in the Repo market and substantially higher for 91-day bills in the outright market (Singh, 2005).

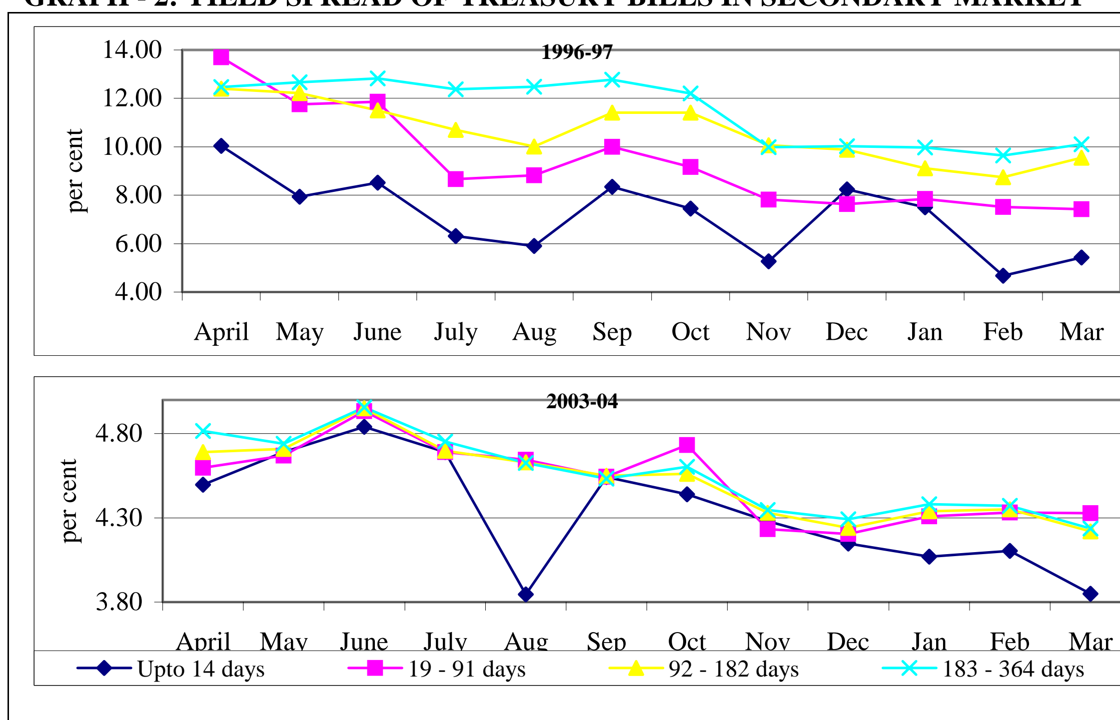
TABLE – 21: STRUCTURE OF SHORT TERM INTEREST RATES

(per cent)

Year	Bank Rate	Treasury Bills - 9-day	Call Money Rate - Bombay
1	2	3	4
1960-61	4.00	2.65	4.24
1970-71	6.00	3.08	6.38
1980-81	9.00	4.60	7.12
1990-91	10.00	4.60	15.85
2000-01	7.00	8.74	9.15
2003-04	6.00	4.38	4.37

Sources: Handbook of Statistics on Indian Economy, Reserve Bank of India.

GRAPH - 2: YIELD SPREAD OF TREASURY BILLS IN SECONDARY MARKET



II.IV.II GOVERNMENT SECURITIES MARKET

The fiscal policy compulsions rendered internal debt management policy passive before 1991. The RBI, as a debt manager, had little control on some of the essential features of debt management like the volume, maturity profile, term structure or the yield curve but had to support the floatation in terms of initial subscription. In the 1980s, the volume of long-term debt expanded rapidly (Singh, 2005). The maturity of

market loans remained highly skewed at the longer end, with the weighted average maturity of 16.1 years of outstanding loans in 1991. Total amount of debt securities increased from Rs.185.4 billion (or 12.9 per cent of GDP) at end-March 1981 to Rs.861.4 billion (15.2 per cent) at end-March 1991 and to Rs.8,811.5 billion (31.8 per cent) at end-March 2004. Government debt accounted for 78.9 per cent of the total outstanding debt in the market as at end of March 2004.

To develop the government securities market, an active internal debt management policy was pursued from 1992. To offer market-related yields to suit investor expectations, 5-year and 10-year dated securities were auctioned, for the first time, on June 3 and August 3, 1992 respectively. Since then the auction system has increasingly been used and new instruments have regularly been introduced, including zero coupon bonds, floating rate bonds and capital indexed bonds. The maturity profile of government bonds underwent a change and the maximum maturity between 1991 and 1992, was reduced from 20 years to 10 years. On improvement in the market conditions and in consideration of the absorptive capacity of the market, the maximum maturity of Central government securities was extended to 20 years in 1997-98, 25 years in 2001-02, and finally to 30 years in 2002-03, while that for the State government loans continues at 10 years. The State Governments continue to raise resources from the market through a traditional (non-auction) method but the coupon on these securities is fixed slightly higher (25 to 50 basis points) than the Central Government bond of similar maturity - an illiquidity premium (due to lower volumes of outstandings and therefore low tradability). Since January 1999, even some states have begun to raise a partial amount of their allocated market borrowings through auctions. The coupon rates on government securities rose in the initial years of reforms but have been declining since 1996, partly ascribed to efficiency in financial markets (Table - 22).

In view of the dormant government securities market till 1992, the RBI could not use open market operations (OMO) as an instrument of monetary policy. The reforms in the government securities market have now facilitated active use of OMO as a tool of

market intervention through auctions. The market-related rates, both in the primary auction as well as the OMO, have also helped to achieve diversification of the investor base, with the share of non-captive investors increasing, though statutorily, CBs, insurance companies and provident funds continue to invest in government securities (Singh, 2005).

TABLE – 22: INTEREST RATES ON CENTRAL AND STATE GOVERNMENT DATED SECURITIES

(per cent)

Year	Central Government Securities Range	Central Government Securities Weighted average	Inflation Rate (Wholesale Price Index)	State Government Securities Range	State Government Securities Weighted average
1	2	3	4	5	6
1980-81	5.98-7.50	7.03	18.2	6.75	6.75
1990-91	10.50-11.50	11.41	10.3	11.50	11.50
1995-96	13.25-14.00	13.75	8.1	14.00	14.00
2000-01	9.47-11.70	10.95	7.2	10.50-12.00	10.99
2003-04	5.03-6.33	5.71	5.4	5.78-6.40	6.13

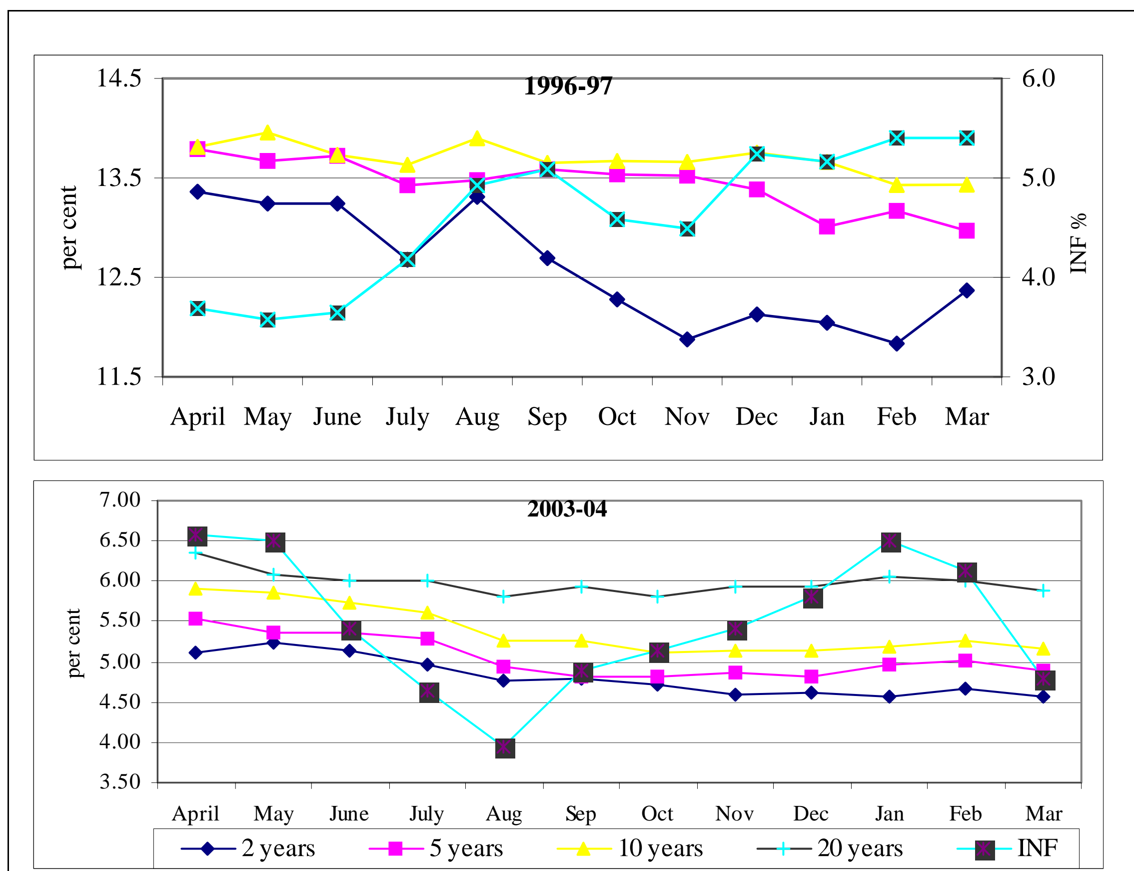
Sources: (a) Annual Report, Various Issues, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, 2004, Reserve Bank of India.

To develop the secondary market, primary and satellite dealerships were established in 1995 and 1996, respectively, and in January 2003, trading of Government securities on the stock exchange was also initiated. A highly liquid and vibrant secondary market requires a transparent system of trading and a secure system of payment and settlement. A negotiated dealing system (NDS) operationalized from February 15, 2002, provides on-line electronic bidding in primary/OMO/ LAF auctions, screen-based electronic dealing and reporting of transactions in money market instruments, secondary market transactions in government securities, and dissemination of information on trades in real time. NDS facilities paperless settlement of the transactions in government securities with connectivity to the Clearing Corporation of India Ltd (established in April 2001 and operational since February 15, 2002) and the Delivery Versus Payment settlement system at the Public Debt Office. The Real Time Gross Settlement system has been operational since March 2004.

In the secondary market for dated securities, Central government securities dominate trading while the share of state government paper is marginal (0.5 to 1.0 per cent)

(Singh, 2005). Turnover ratio (turnover to outstanding at end of year) though rising recently is still very low for both outright sales at 2.2 and Repo at 1.2. The reforms have led to the emergence of a yield curve that is market–related and is increasingly used as a benchmark for other instruments in the debt market. The spreads between different segments of the government securities market are narrowing in the recent years (Graph -3) though not as much as in developed markets like the US.

GRAPH - 3: YIELD SPREAD OF GOVERNMENT DATED SECURITIES



The interest rate is significantly influenced by the measures taken by the RBI and the prevalent market conditions. The different financial markets have begun to integrate since the onset of reforms (Jena, 2004), with the coupon rates on government securities aligning with other rates in the market (Table - 23).

TABLE – 23: STRUCTURE OF INTEREST RATES – LONG TERM

(per cent)

Year	Advances Rate-SBI	CB Deposit Rates*		Coupon Rates on Market Loans and Bonds		
		3-5 yrs	Over 5 yrs	0-5 yrs	6-10 yrs	over 10 yrs
1	2	4	5	6	7	8
1960-61	5.00	4.00	4.50	-	3.50	4.00
1970-71	8.50	7.00	7.25	-	4.50	5.75
1980-81	16.50	10.00	10.00	-	6.00-6.50	6.75-7.50
1990-91	16.50	11.00	11.00	10.50	10.75	11.25-11.50
2000-01	11.50	9.50-10.00	9.50-10.00	9.47-10.95	9.88-11.69	10.47-11.70
2003-04	10.25	5.25-5.50	5.25-5.50	4.69	4.62-5.73	5.18-6.35

* refer to 5 major public sector banks as at end March. SBI – State Bank of India.
Sources: (a) Handbook of Statistics on Indian Economy, Reserve Bank of India.
(b)RBI Monthly Bulletin, Reserve Bank of India.

II.IV.III FOREIGN EXCHANGE MARKET

The foreign exchange market in India originated in 1978 when CBs were allowed to undertake intra-day trading in foreign exchange but was dormant till 1993. Since 1993, several measures have been introduced progressively to widen and deepen the foreign exchange market. First, CBs have been given freedom to fix their overnight position/gap limits, initiate trading positions in the overseas markets, determine the interest rate on NRI deposits and use derivative products for asset-liability management. Secondly, to facilitate integration of domestic and overseas money markets, Authorized Dealers (ADs, mainly CBs) have been allowed to borrow abroad within prudent limits. Finally, corporates have been given freedom to manage their foreign exchange exposures.

The foreign exchange market continues to be thin, localized, and expectations-driven and exhibits ‘herding’ behavior. The average daily turnover increased to US$ 6.3 billion in 2003 from US$ 5.2 billion in 1998. The medium-term endeavor is to develop the foreign exchange market in terms of depth and liquidity, introduce new instruments and pricing strategies, and encourage greater integration with other segments of the financial market. As a result of the reforms and the policy to restrict volatility through intervention if necessary, the exchange rate has been reasonably

stable (Table - 24). RBI intervention, however, is small in terms of volume – less than 3.0 per cent of turnover in 2002-03, a year argued to be of high intervention, which demonstrates the predominant role of market forces in determination of the external value of the rupee (Mohan, 2004).

TABLE – 24: MOVEMENTS IN EXCHANGE RATE OF THE RUPEE PER US DOLLAR AND PARTICIPATION BY RBI IN THE MARKET

Year	Range (Rs.)	Average Exchange Rate (Rs.)	Coefficient of Variation (%)	RBI's Purchase of US $ (billion)	RBI's Sale of US $ (billion)
	1	2	4	5	6
1993-94	31.21-31.49	31.37	0.1	..	..
1994-95	31.37-31.97	31.40	0.3	..	..
1995-96	31.32-37.95	33.45	5.8	..	..
1996-97	34.14-35.96	35.50	1.3	11.2	3.4
1997-98	35.70-40.36	37.16	4.2	15.1	11.2
1998-99	39.48-43.42	42.07	2.1	28.7	26.9
1999-00	42.44-43.64	43.33	0.7	24.1	20.8
2000-01	43.61-46.89	45.68	2.3	28.2	25.8
2001-02	46.56-48.85	47.69	1.4	22.8	15.8
2002-03	47.51-49.06	48.41	0.9	30.6	14.9
2003-04	43.44-47.46	45.92	1.6	55.4	24.9

Sources: (a) Report on Currency and Finance, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.
(c)RBI Monthly Bulletin, Reserve Bank of India.

II.IV.IV CAPITAL MARKETS

In terms of financial sector reforms, it was considered necessary for investor confidence that capital markets should be encouraged to grow under the supervision of a strong regulatory framework. Therefore, in January 1992, the Securities and Exchange Board of India (SEBI), was accorded statutory status as an autonomous body to protect investors' interest and to promote the development of the capital market. In the primary market, all government controls relating to pricing of equity issues and their timing have been removed since then. Interest rate restrictions on debentures and bonds issued by public sector enterprises, was rescinded in August 1991. In the secondary market, the traditional open outcry system has been replaced with a transparent, screen-based computerized trading system, which can be accessed by trading members (9,368 as at end of March 2004) across India (from 357 cities as

at end of March 2004) to meet the requirements of nearly 21 million investors (during 2000-01, according to a Survey conducted by SEBI), mainly located in urban areas. The process of dematerialization of physical securities is completed. To reduce risks in the market and protect the interest of investors, in line with international best practices, rolling settlement on T+2 basis is in use since April 1, 2003. The clearing and settlement system is being emphasized by SEBI and many stock exchanges in India are setting it up now. The disclosure standards are being strengthened to protect the interests of the investors. The number of stock exchanges increased from 11 in 1990 to 23 in 2003 while listed companies on the stock exchanges have increased from 6,299 in 1990-91 to 9,413 in 2002-03. In March 2001, the government proposed that all the 23 stock exchanges that are owned and managed by the brokers would be corporatised whereby ownership, management and trading membership would be segregated. Consequently, the boards of some stock exchanges in India have been revamped and broadened so that they represent diversified interests.

Consequent to the reforms, resource mobilization in the primary market increased from 2.5 per cent of GDP in 1990-91 to 3.8 percent in 2000-01, but since then the markets have been depressed for multiple reasons – high real interest rates, poor performance of mutual funds, lack of confidence of the investors due to high incidence of vanishing companies and consequently stringent conditions imposed by the regulator on public issues (Table - 25). In the primary market, corporates prefer the private placement route, which has accounted for more than four-fifth of total resources mobilized since 1997. Since then, the share of debt issuance has also been more than nine-tenth of total resources raised from the market. The corporate bond market, accounting for less than a quarter of the primary market and less than one-tenth of the secondary market, is under-developed, and marked by a low investor base and an absence of variety in instruments. The share of finance raised from the market in total external finance of the corporate entities increased from 19.2 per cent in 1990-91 to 53.2 per cent in 1993-94 but since then has declined due to the adverse market conditions.

In the secondary market, reforms have led to increased activity except for some period during March 2000 to May 2003 because of domestic reasons (border tension, uncertainty in dis-investment plan of the Central Government, slowdown in industrial production and bad monsoons) and international reasons (tension in Middle east and rise in international oil prices). Market capitalization increased from Rs.4,000 billion in 1993-94 to reach a peak at Rs.11,926 billion in 1999-00 and after declining for three years increased to Rs.12,105 billion in 2003-04 while the turnover increased from Rs.2,037 billion in 1993-94 to peak at Rs.28,810 billion in 2000-01 and since has been low (Table - 26).

TABLE - 25: RESOURCE MOBILISATION FROM THE PRIMARY MARKET

(per cent of GDP)

	1990-91	1991-92	1992-93	1995-96	2000-01	2002-03
1	2	3	4	5	6	7
Total Corporate Securities	2.5	2.5	3.1	3.1	3.8	2.8
1. Domestic Issues	2.5	2.5	3.1	3.0	3.6	2.7
a)Non-Govt. Public Companies	0.8	0.9	2.6	1.4	0.2	0.1
b)PSU Bonds	1.0	0.9	0.1	0.2	0.0	0.0
c)Govt Companies	0.0	0.0	0.1	0.1	0.0	0.0
d)Banks and FIs	0.0	0.0	0.0	0.3	0.1	0.1
e)Private Placement	0.7	0.7	0.2	1.1	3.2	2.5
2. Euro Issues	0.0	0.0	0.1	0.1	0.2	0.1

Sources: (a) Report on Currency and Finance, Various Issues, RBI.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.

TABLE - 26: SECONDARY MARKET – SELECTED INDICATORS

Year	Number of		Market Capitalization	Turnover Ratio
	Brokers	Listed Cos.	Ratio (% of GDP)	(% of Market Capitalization)
1	2	3	4	5
1990-91	..	6,229	20.6	..
1995-96	8,476	9,100	47.0	39.7
1999-00	9,192	9,871	84.7	173.3
2000-01	9,782	9,954	54.5	374.7
2001-02	9,687	9,644	36.4	119.6
2002-03	9,519	9,413	28.5	153.3
2003-04	9368	..	52.3	122.2

Source: Indian Securities Market Review, 2004, NSE, Mumbai.

II.IV.VII CONSENSUS BUILDING OF REFORMS

Rodrik and Subramanian (2004) correctly isolate attitudinal shift since 1991 as an important factor in the reforms process in India. The pledging of gold to the Bank of

England in June 1991 was a sensitive issue and the opportunity that the situation created helped in initiating reforms - even those that were un-acceptable till then - but to sustain the process, a consensual effort was required. Therefore an institutionalized framework was established to involve all the stakeholders in the formulation of policy and its implementation in the financial sector. Several specialized groups were constituted that continue to ensure consensus building for reforms. In the Government securities market, the Cash and Debt Management Group consisting of officials from the Government of India and the RBI deliberate and advise on the borrowing program of the Government. In view of the ever changing market conditions, officials of the Central and State Governments, the Planning Commission and the RBI meet twice a year to discuss the finances of the State Governments, with special reference to cash and debt management. In the context of growing integration of the financial markets, a Technical Advisory Committee, comprising academicians, professionals and financial market participants, meets regularly to review the developments in the foreign exchange, money and government securities markets, and make suitable recommendations. Self-regulatory bodies, operational since 1997, in these markets have also been playing an important role in their development and providing feedback to the regulator.

SECTION-III: CONSEQUENCES OF REFORMS

In view of the on-going multi-sector reforms being undertaken in India, especially the financial sector, the structure of the economy has undergone a significant change. The sectoral composition of national income has changed with services accounting for 56.2 per cent of GDP in 2003-04 as compared to 46.1 per cent in 1990-91. The share of banking and insurance in the services sector has increased from 7.5 per cent during 1981-85 to 11.8 per cent during 1993-99. The finance ratio, as the ratio of total financial claims to national income, increased from 0.3 during 1981-85 to 0.5 in 1995-96, according to the latest data available.

The economic indicators of the economy after the initiation of reforms reflect a positive impact with the average annual growth rate of GDP rising to 6.1 per cent for the period 1992-04 (Table- 27).[33] During this period, the economy has successfully been able to cushion four years of negative growth in agriculture, high oil prices and tension in Middle-East (affecting remittances), a shift in export destinations with the collapse of Soviet Union, and recessionary global goods and capital markets. The interest rates are now market determined and the impact is noted on domestic savings and investment. The savings by the household (in the financial assets - bank deposits, mutual funds) and private sector has increased as has the investment. The performance of the public sector has been dismal though – savings have been negative since 1998-99 and the share of investment has been declining since 1992-93. The economy is increasingly getting monetized and inflation has consistently been low.

TABLE – 27: CHANGE IN THE INDIAN ECONOMY

Years/	GDP	GDP Per capita	GDS	GDCF	GDP/M3	GDP/M1	Inflation
Period	Constant prices		Current prices				
1	2	3	4	5	6	7	8
1951-61	3.9	1.9	10.2	11.7	..	..	1.8
1961-71	3.8	1.3	12.9	14.8	..	..	6.2
1971-81	3.2	0.8	17.9	18.1	3.6	6.5	10.3
1981-85	5.3	2.7	18.3	19.6	2.7	7.0	7.1
1985-91	5.9	3.5	20.8	23.3	2.4	6.7	7.3
1991-92	1.3	-1.5	22.0	22.6	2.2	6.3	13.7
1992-04	6.1	4.1	23.4	24.3	1.9	6.0	6.4

Sources: (a) Report on Currency and Finance, Various Issues, Reserve Bank of India.
(b) Handbook of Statistics on Indian Economy, Reserve Bank of India.

A Necessary Digression

Rodrik and Subramanian (2004) argue that the shift in the growth rates occurred in early 1980s, implying, therefore, that the higher growth rates recorded by the economy in the 1990s may not be emanating from the reform process. The data does demonstrate that the shift of growth rates to a higher orbit did occur in 1980s but the comparison with the shift since 1991 may be inappropriate. In fact, there is a political economy aspect that ushers a structural break in the long-term trend - financial emergency from June 1975 to March 1977 when capacity utilization in industry and

[33] Prof. Ronald McKinnon, Stanford University, terms this growth rate as the Sikh rate of growth.

services improved substantially. India had its first non-Congress Prime minister in March 1977, representing a multi-party coalition, quickly followed by another in July 1979. The multi-party coalition introduced a new dimension in economic policies that were being followed earlier, nearly unaltered, for three decades in the socialist mould, emphasizing the role of public sector. The gandhian principles of development of rural sector, emphasis on *Swadesi* (domestically made goods), development of village, cottage and small-scale industry, and decentralization of power, as against capital-intensive large industries and expansion of the public sector, were emphasized by the new regime. The co-operative movement in rural sector gained momentum, rural co-operative banks were re-organized and commercial banks were required to extend credit to the rural sector on priority basis. The growth rates recorded by the economy were high, especially in industry and services, due to higher capacity utilization and introduction of the new paradigm, but constrained by limitations of infrastructure, especially power. The fiscal deficit scaled new peaks and for the first time a deficit was recorded on the revenue account.

In January 1980, Congress returned to power and the policy measures following gandhian principles initiated by the previous regime were continued and more added in the spirit of competitive populism. The capital market, industrial and import policies were liberalized, and a long-term fiscal policy aiming to create a conducive environment for growth, was introduced. In December 1989, once again India had a non-Congress Prime Minister followed by another in November 1990, both representing a multi-party coalition. The emphasis generally continued on public sector, import substitution and export promotion. The economy continued to suffer from shortages of power and infrastructure, uneven built-up of capacity in industry still constrained by licenses and permits, directed lending, high fiscal and current account deficits, and strongly regimented exchange controls. The unsustainability of such selective liberalization became apparent in the foreign exchange crises of June 1991.

The structural reforms that were initiated in 1991 certainly benefited from the attitudinal shift caused by various waves of policy liberalization since 1977. The economy has recorded consistently high growth rates since 1991-92, despite various shocks. The macro-data summarized in Appendix Tables 3-6, based on the time-periods of changes in the government broadly substantiates the above argument.

Back to the Basics

Consequent to reforms in the banking sector, the profitability of the CBs in India is now comparable with those in the developed countries. The non-performing loans of the banks in India though high compared to the developed countries have rapidly declined to 7.2 per cent in March 2004. The profitability of major banks in India has improved and is comparable with international standards with pre-tax profits having increased to 1.0 per cent in 2002-03 and operating costs having declined to 2.2 per cent. The capital markets in India have also been developing. India has been ranked 17th by Standard and Poor's in terms of market capitalization, 16th in terms of turnover and second in terms of listed companies on Stock exchanges after the USA.[34]

The financial sector reforms have helped to develop the markets, which have been integrating too. The economy benefited from these reforms and could withstand some of the shocks that impacted it in recent years, pre-pay some of its high cost external debt and undertake domestic debt restructuring.

III.I SOUTH EAST ASIAN CRISES

India was not insulated from the South East Asian crises of 1997. The Reserve Bank of India responded to the crisis, when the pressure on rupee in November/December 1997 was noted, by altering the course of easing of monetary policy as per the measures announced earlier in April 1997. As demand for US$ exceeded supply, one month forward premia (which in India reflects demand-supply pressure and not

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[34] The number of listed companies reported by Standard and Poor's is lower than that reported by SEBI (refer Table - 26).

necessarily interest rate differentials) rose from 4.3 per cent on October 14, 1997 to 10.4 per cent on December 16, 1997. The exchange rate of the Rupee per US$ depreciated from Rs.36.2 to Rs.39.4 over the similar period. The liabilities of the RBI in terms of net forward market commitments rose from US$ 944 million as at end of September 1997 to US$ 1,956 million as at end of December 1997. In order to reduce volatility, curb speculative activity and ward off any threat of contagion, several monetary measures were promptly taken in December 1997 - *(a)* raising of CRR, *(b)* imposition of restrictions on the facility extended to ADs to offer forward contracts, and *(c)* introduction of steps affecting the cost of rupee funds to importers and exporters to minimize the lag in import payments and export realizations. As these proved ineffective and the one month forward premium after a dip to 7.9 per cent (exchange rate at Rs.39.3) on December 31, 1997 continued to rise to 23.8 per cent (exchange rate at Rs.40.4) on January 15, 1998, another package of monetary measures was announced on January 16, 1998. These measures included - *(i)* raising of the BR by 200 basis point, *(ii)* raising of CRR by 50 basis points, *(iii)* reduction of general refinance limits to CBs from the RBI, *(iv)* reduction in liquidity support to primary dealers, and *(v)* raising the cost of money for the importers. These measures finally succeeded in restoring normalcy in the markets with the exchange rate appreciating to Rs.38.7 on January 21, 1998 though the forward premium was stubborn and returned to 3.3 per cent by April 13, 1998.

The RBI also resorted to continued use of 3-4 day Repos to manage short-term liquidity in the system during this period. Repo auctions with cut-off repo rate varying between 2.9 and 5.0 per cent were conducted up to December 3, 1997. The repo rates were sharply raised to 6.5 per cent on December 4, 7.0 per cent on December 11 and further to 9.0 per cent on January 17, 1998.

III.II THE PERIOD AFTER SEPTEMBER 11, 2001

The position in the call money market was tight following the events of September 11, 2001 and was accompanied by pressures in foreign exchange and gilt segments as financial markets in the US were affected for more than a week as also across the

world. In India too, the markets were beginning to show signs of nervousness immediately after the attack. The one-month forward premium rose from 4.3 per cent (exchange rate Rs.47.4 per US$) on September 12, 2001 to 7.5 per cent (Rs.48.2) on September 17, 2004. The announcement of opening of a purchase window for select Government securities by RBI, on an auction basis, on September 18, 2001 and sale of foreign exchange by RBI restored market sentiment – the forward premium declined to 6.0 per cent immediately on the same day while the exchange rate recovered to Rs.47.9 on September 19, 2001. The Reserve Bank continued to conduct regular auctions for open market purchases aggregating Rs.50 billion during September 18 - October 10, 2001 to support the gilt market in the face of the steep fall in the government security prices due to adverse external developments.

In a related development, the difficult situation in the Gulf area since 2002 and higher oil prices have not affected the Indian economy as had been the case in 1991, though the imports of oil and POL continue to account for more than one-fourth of total imports since 1999-2000 as compared to 15.1 per cent in 1998-99. In 1990-91, in a similar situation of price escalation, the share of oil and POL had increased from 17.7 per cent in 1989-90 to 25.0 per cent of total imports, precipitating a crisis.

III.III FOREIGN EXCHANGE INFLOWS AND STERILISATION

In recent years, India has experienced a significant spurt in foreign exchange inflows, with the foreign exchange reserves rising to US $113 billion by end-March, 2004. The Foreign Currency Assets of the Reserve Bank rose by US $ 20.8 billion (Rs.924 billion) during 2002-03 and US $ 35.6 billion (Rs.1,247 billion) during 2003-04.

The liquidity impact of large inflows was managed mainly through the daily LAF. Liquidity absorption through LAF on a daily average basis amounted to Rs.112 billion during 2002-03 and around Rs.300 billion during 2003-04. The LAF operations were supplemented by sales through OMO amounting to Rs.537 billion

during 2002-03 and Rs.418 billion during 2003-04. To stabilize the market and to continue to undertake the sterilization measures, the Market Stabilization Scheme (MSS) was introduced in April 2004. The overall ceiling of Rs. 800 billion is stipulated for 2004-05 under MSS and the paper issued till November 13, 2004 amounted to Rs.557 billion.

The high foreign exchange reserves have also been used to pre-pay some of the high cost external debt. In February 2003 and then during 2004, the Government pre-paid a part of its high cost external debt amounting to US $ 5.63 billion to the Asian Development Bank and the World Bank. Similarly, high cost bilateral loans (especially Canada and Netherlands) amounting to US$1.1 billion have also been pre-paid. The possibility of further prepayments of external debt is being explored.

III.IV DEBT RESTRUCTURING

Debt restructuring which was sought as a part of fiscal consolidation included - (*i)* pre-payment of external debt (explained earlier), (*ii)* buy-back of government securities by the Central Government from the banks, and (*iii)* restructuring of State Governments' debt to the Centre through a debt swap scheme. The scheme of debt buy-back was implemented on July 19, 2003. The Government of India bought back high cost, illiquid securities by paying a premium. In lieu of these illiquid securities, four liquid securities were issued. The buy-back was conducted for CBs and select DFIs, and the CBs were allowed additional income-tax deductions to the extent such business income was used for provisioning of their NPAs. The repurchase of securities was through a live interactive electronic platform where bids could be revised while the reissue of fresh securities in lieu of auctioned securities was at a pre-announced fixed price notified a day in advance. In the auction process, the offer price for each security emerged, and the difference between the market value and face value was shared between the government and market participants.

Under the mutually agreed debt-swap scheme between the Central and the State

Governments, all State loans from the Centre bearing coupons in excess of 13.0 per cent are to be swapped with market borrowings and small savings proceeds at prevailing interest rates over a period of three years ending in March 2005. The scheme has been successful as the States have been able to raise resources from the market at interest rates, which are nearly half the rate at which the original loan was incurred and as a consequence, are expected to save a substantial amount of interest payments in future.

SECTION – IV: LOOKING AHEAD

The reforms are an on-going process with many measures that were initiated being incomplete while others have begun to show encouraging results. The financial markets have developed, regulatory and supervisory institutions have been established, and the general attitude towards reforms has also changed. The pace of reforms in the real sector, including the issue of disinvestments and pricing of public utilities, and those pertaining to labor regulations and compensation, including pensions and provident funds, have been rather slow, as they are difficult to implement.

Reforms in fiscal policy have been slow to yield results. The persistence of the fiscal deficit and the rise in domestic debt relative to GDP remain a concern, despite attempts at fiscal correction. On the issue of returns to investment in public sector enterprises, one can suggest, however, that innovative schemes should be considered, where assets are not sold but services emerging from those assets are privatized. Illustratively, these measures could include contracting out such services as: *(a)* metering, billing and collection of power and water charges; *(b)* specific routes and operations of state road transport corporations; *(c)* catering, sanitary and security services in railways; and *(d)* collection, sorting and distribution of postal mail in selected areas. These measures would help to improve competitiveness in the public sector, increase the availability of services, and thereby enhance the welfare of the people.

The administered interest rate regime has been dismantled, facilitating development of the financial markets and more broad-based ownership of government securities. With the elimination of automatic monetization in 1997, the Central and State Governments are provided short-term financial resources by the RBI, while long-term financial resources are being raised at market-related rates of interest directly from the market. Therefore, the issue of separating debt from monetary management can now be considered - a step that would provide independence to the RBI to pursue the goal of price stability.

The RBI regulates and supervises the financial system. In the banking sector, measures on prudential norms, income recognition, asset classification, provisioning, supervision and regulation are beginning to meet international standards. The CBs have begun to restructure their operations in view of the need to strengthen their balance sheets to raise capital from the market. The CBs now need to acquire professional skills to identify users, assess risk and extend credit to the private sector, and refrain from investment in government securities and guaranteed bonds beyond the statutory requirements. Also, the role of CBs in rural areas needs to be redefined; by 2008 the government expects that the CPBs will be revived and logically, given the spatial spread, CPBs should be encouraged to operate in the rural areas, while CBs can emphasize in urban areas.

Since 1991, external sector management has helped to build foreign exchange reserves through non-debt creating flows, to restrict short-term debt, and to maintain an acceptable level of current account deficits. The proposed initiative to utilize reserves to finance government expenditure needs to be cautiously examined to avoid an inflationary spiral and misutilisation of resources.

India was successful in avoiding the impact of the South East Asian Crises and in pre-paying some of its external debt and restructuring its internal debt in recent years. The lessons that emerged from the experiences of 1997-98 and September 2001 show that

monetary policy has to be continuously alert to market developments both at home and abroad, and appropriate corrective measures have to be taken promptly.

India continues to maintain steady growth since the initiation of the multi-sector reforms undertaken since 1991. Therefore, the crucial issue is whether the financial sector reforms have raised India's growth rate? The evidence presented in this paper strengthens the belief that carefully designed and diligently sequenced reforms undertaken since 1991 have led the economy to consistently record high growth rates, despite various domestic and external shocks. Thus, the evidence seems to add to the growing body of empirical literature, which indicates that development of the financial sector facilitates economic growth.

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Appendix Table - 1: Performance of Scheduled Commercial Banks in India

(per cent to Total)

	Offices				Deposits				Credit			
	1969	1981	1991	2003	1969	1981	1991	2003	1969	1981	1991	2003
1	2	3	4	5	6	7	8	9	10	11	12	13
Rural	22.2	48.0	56.9	47.4	6.4	13.0	15.5	13.8	3.3	11.4	15.0	10.2
Semi-Urban	40.4	24.5	18.7	22.1	21.8	23.2	20.7	18.9	13.1	17.4	16.3	11.3
Urban	19.2	15.7	14.3	16.8	26.5	24.7	24.5	22.8	21.8	22.8	22.4	16.4
Metropolitan	18.2	11.8	10.0	13.7	45.3	39.1	39.4	44.5	61.8	48.4	46.3	62.1

Sources: a)Statistical Tables relating to Banks in India, Various Issues.
b) Report on Trend and Progress of banking in India, Various Issues.

Appendix Table – 2: Different Banking Institutions in the Rural Sector

(Outstanding as percent to GDP)

Year (End)	Total Postal Savings					State Co-operatives			Commercial Banks	
	Deposits	*Of which* Savings	Certificates	PPF	Total	Saving Deposits+	Time	Total	Deposits Rural Sector	Credits
1	2	3	4	5	6	7	8	9	10	11
1970-71	2.59	2.17	0.20	0.01	2.80	0.11	0.19	0.30	1.18	0.56
1977-78	4.07	1.65	0.63	0.06	4.75	0.15	0.27	0.42	2.27	1.20
1980-81	4.61	1.62	0.98	0.14	5.73	0.14	0.30	0.43	3.66	2.13
1990-91	2.99	0.74	5.85	0.46	9.30	0.14	0.24	0.38	5.45	3.27
2000-01	3.86	0.42	6.61	0.31	10.77	0.10	0.37	0.46	6.67	2.42
2002-03	5.67	0.47	6.61	0.41	12.69	0.09	0.40	0.50	7.14	3.03

+ Excluding inter-bank deposits.
Sources: a) Handbook of Statistics on Indian Economy,
b) RBI Monthly Bulletin, Various Issues.
c) Report on Trend and Progress of banking in India, Various Issues.
d) Statistical Tables relating to Banks in India, Various Issues.

Appendix Table – 3: Composition and Growth Rates of GDP

Year	GDP	Agriculture & Allied Activities	Industry	*of which* Manufacturing	Services	*of which* THTC	FIRB	CSP
1		2	3	4	5	6	7	8
Composition of GDP in per cent to Total								
1970-71	100.0	45.9	15.9	13.7	38.3	12.7	10.3	10.5
1976-77	100.0	39.2	18.7	15.8	42.1	15.3	10.2	11.7
1979-80	100.0	37.0	20.8	17.4	42.2	16.3	9.8	11.7
1983-84	100.0	36.6	21.1	16.3	42.3	16.8	9.3	11.5
1988-89	100.0	32.7	21.2	16.3	46.0	18.1	10.1	12.4
1990-91	100.0	31.3	22.0	17.1	46.7	18.4	10.4	12.3
1991-92	100.0	31.5	20.9	16.1	47.6	18.4	11.3	12.5
1995-96	100.0	28.2	23.0	18.1	48.8	20.2	11.7	11.8
2002-03	100.0	22.7	20.5	15.6	56.9	22.0	13.8	14.9
2003-04	100.0	22.2	20.4	15.8	57.3	22.6	13.9	14.8
Annual Average Growth Rates (%)								
1971-77	2.7	1.0	4.6	4.2	4.1	4.8	4.3	3.6
1977-80	2.4	-0.1	4.8	5.1	4.1	4.7	4.3	4.8
1980-84	6.1	6.8	6.7	6.2	5.3	5.3	7.6	4.7
1984-89	5.5	3.1	7.1	6.7	6.8	6.0	10.0	6.8
1989-91	6.1	2.8	9.0	8.9	7.3	6.1	10.1	6.2
1991-92	1.3	-1.5	-1.2	-3.6	4.5	2.5	12.0	2.6
1992-96	6.4	3.5	8.7	9.9	7.2	9.1	8.2	4.8
1996-04	5.9	3.0	5.2	5.3	7.8	8.2	7.5	7.9

THTC - Trade, Hotels, Transport and Communication Services; FIRB - Finance, Insurance, Real Estate and Business Services; CSP - Community, Social and Personal Services.

Appendix Table – 4: Gross Domestic Savings and Capital Formation

Year	Gross Domestic Savings				Gross Domestic Capital Formation			
	Total (% of GDP)	Household (Per cent to Total)	Private	Public	Total (% of GDP)	Household (Per cent to Total)	Private	Public
1	2	3	4	5	6	7	8	9
1970-71	14.6	69.7	10.1	20.2	15.4	45.2	14.5	40.4
1976-77	19.4	68.1	6.8	25.1	17.9	40.8	7.7	51.5
1979-80	20.1	68.6	9.9	21.5	20.6	41.1	11.9	47.0
1983-84	17.6	73.0	8.4	18.6	18.7	34.4	16.3	49.2
1988-89	20.9	80.4	9.7	10.0	23.8	43.5	16.3	40.2
1990-91	23.1	83.7	11.5	4.8	26.3	44.0	17.2	38.8
1991-92	22.0	76.9	14.1	8.9	22.6	33.9	25.8	40.2
1995-96	25.1	72.3	19.6	8.1	26.9	35.0	36.1	28.9
2002-03	24.2	93.6	14.1	-7.7	23.3	54.1	21.0	24.9

Appendix Table – 5: Select Fiscal Indicators of Central Government - Annual Averages

(per cent of GDP)

Year	Gross Fiscal Deficit	Direct Tax	Indirect Tax	Non-Tax Revenue	Revenue Expenditure	Interest Payments	Subsidies	Capital Expenditure	Capital Receipts
1	2	3	4	5	6	7	8	9	10
1970-77	3.4	2.3	6.1	1.9	7.9	1.4	0.5	5.8	4.7
1977-80	4.7	2.4	7.0	2.2	9.5	1.8	1.4	6.5	5.0
1980-84	5.6	2.0	7.3	2.1	9.8	2.0	1.3	6.0	5.9
1984-89	7.7	2.0	8.3	2.5	12.5	2.9	1.7	6.5	7.0
1989-91	7.6	2.0	8.4	2.5	13.1	3.7	2.1	5.7	6.5
1991-92	5.6	2.3	8.0	2.4	12.6	4.1	1.9	4.5	5.9
1992-96	5.8	2.6	6.7	2.5	12.2	4.2	1.3	3.7	5.7
1996-04	5.6	3.1	5.7	2.7	12.8	4.6	1.4	3.1	6.6

Appendix Table – 6: Balance of Payments Statistics - Annual Averages

(per cent of GDP)

Year	Exports			Imports		Invisibles	Current Account Deficit	Foreign Investment
	Total	*of which* POL	*of which* Manufactured	Total	*of which* POL			
1	2	3	4	5	6	7	8	9
1970-77	4.1	0.0	2.3	5.0	0.9	0.7	-0.2	0.1
1977-80	5.2	0.0	3.2	7.0	1.9	2.0	0.1	0.0
1980-84	4.7	0.4	2.6	8.4	3.0	2.1	-1.6	0.0
1984-89	4.6	0.3	2.8	7.6	1.4	1.1	-1.9	0.1
1989-91	5.8	0.2	4.1	8.6	1.6	0.1	-2.7	0.1
1991-92	6.9	0.2	5.0	7.9	2.0	0.7	-0.3	0.1
1992-96	8.3	0.1	6.1	10.7	2.1	1.3	-1.2	1.2
1996-04	9.3	0.3	7.0	12.5	2.8	2.9	-0.4	1.4