Financial Liberalization and Macroeconomic Policy in India

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Financial sector reform, involving substantial liberalisation of regulatory control over markets, institutions and instruments, is at the centre of the engineered transition that developing countries have been through over the last two decades. It is now widely acknowledged that the process of financial reform has had economy-wide implications, not just for the relations between financial institutions and their clients and for the nature of operations of financial institutions, but for the manoeuvrability of the state when it comes to macroeconomic policy.

There are three broad objectives that the process of financial liberalization serves: (i) it opens the country to new forms and larger volumes of international financial flows, in order to attract a part of the substantially increased flows of financial capital to the so-called "emerging markets" since the late-1970s; (ii) to facilitate these inflows it liberalizes to differing degree the terms governing outflows of foreign exchange in the form of current account investment income payments and in the form of capital account transfers for permitted transactions; and (iii) it transforms the structure of the financial sector and the nature and operations of financial firms in a manner that makes the financial system resemble that in countries like the US and the UK.

It is now widely accepted that the first two of these, involving liberalization of controls on inflows and outflows of capital respectively, have resulted in an increase in financial fragility in developing countries, making them prone to periodic financial and currency crises. Analyses of individual instances of crises have tended to conclude that the nature and timing of these crises had much to do with the shift to a more liberal and open financial regime. What is more, crises rarely lead to controls on capital inflows and reduced dependence on them. Rather adjustment strategies emphasise further financial liberalization, resulting in a history of periodic financial failure.

India, however, has not witnessed a currency crisis of the kind which afflicted a range of developing countries during the 1990s and thereafter. In fact, it has been argued that, because India (like China) has not liberalised its capital account to the extent done by many other developing countries, it managed to avoid or stave off the contagion that afflicted many East Asian countries in the late 1990s. However, India did experience a balance of payments crisis in 1990-91, resulting in it being subjected to an IMF-style adjustment programme that heralded the transition from a creeping process of liberalisation that characterised the 1980s to a more accelerated process of economic reform starting in 1991.

It needs to be noted that this crisis was almost entirely speculative in origin. By March 1991 when emergency import restrictions were imposed (which soon converted the trade deficit into a surplus), it was not the trade or current account deficit as such which was responsible for the foreign exchange crunch, but the speculative outflow of funds, partly in the form of non-repatriation of exchange earnings in violation of the country's laws, and partly in the form of non-resident Indians taking money out of the country, which

was not illegal but constituted speculation nevertheless.[1] Even after March 1991, when import compression began to reduce the trade deficit, the balance of payments continued to be under severe pressure because the speculative outflows persisted and even got enlarged. Finally, the Indian government succumbed to the option of turning to the IMF for balance of payments support accompanied by conditionalities that triggered the accelerated reform of the 1990s.

The reasons why the economy was caught in this speculative trap are to be found in the dependence on debt that the liberalisation of the 1980s, adopted with support from an IMF loan in 1981, resulted in. Briefly, three new features characterized the economic policies of the eighties, especially its latter half. First, there was a significant increase in the magnitude of the government's deficit as a proportion of the GDP at current market prices. The gross fiscal deficit of the Central and State governments averaged 9.5 per cent of GDP during 1985/86-1989/90 and touched 10.1 per cent in 1990/91. However, this was not due to any increase in the share of public investment, but largely to a decline in the share of public savings, reflected in the burgeoning revenue deficit (which rose from an average of 2.8 per cent of GDP during 1985/86-1989/90 to 4.5 per cent in 1990/91), with the current expenditure of the State growing at a rate far outstripping the growth in tax as well as non-tax revenues, despite hikes in indirect taxation and in administered prices. Partly this was because of the government's refusal to garner larger direct tax revenues.[2] Partly this was because of the growing expenditure on interest payments (the sins of past deficits catching up with the government), and on subsidies, especially on fertilizers (caused primarily by wrong technological choices involving the setting-up of plants with extraordinarily high capital costs). And partly this was because of the general profligacy which characterized the then Government to an unprecedented extent.

The second feature was the liberalization of imports of capital goods and components required for a number of commodities catering to luxury consumption, especially of electronics and automobiles. This was justified in the name of "marching to the 21st century." And important government officials unashamedly put forward the argument that since even the small segment of the population that demanded such goods, amounted in absolute terms to a fairly large number, the country could go forward on the basis of such an industrialization strategy whose benefits would "eventually trickle down" to the poorer sections of the population as well.

The remarkable aspect of the policy of import liberalization of the late 1980s was that it was not necessarily tied in to a larger export effort; its main immediate thrust was towards producing more goods, especially luxury goods, for the domestic market. In 1985/86, the very first year that the policy was introduced, there was a dramatic increase in the trade and current account deficits, the latter form 1.24 per cent of GDP to 2.26 per cent. True it reached a plateau thereafter (1.99, 1.89 and 2.66 per cent in the three subsequent years), because of which many have argued that it would be unfair to blame the Rajiv Gandhi government for import profligacy. But this argument misses two

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[1] The World Bank's suggestion in a report in October 1990 that the rupee should be devalued by 20 percent may have started the speculative outflow. The flight of capital from the Foreign Currency Non-Resident Accounts alone added up to $1.33 billion between October 1990 and June 1991. See C.T.Kurien **Global Capitalism and the Indian Economy**, Delhi, 1994, p.100.

[2] Figures from Reserve Bank of India, **Annual Report 1994-95**, Bombay, 1995

important points: first, the high absolute level of the trade and current deficits were sustained despite the fact that owing to the development of the Bombay High oilfields, India's oil import bill came down in absolute terms between 1984-85 and 1988-89. But for the import profligacy, in other words, the trade deficit should have declined significantly in absolute terms since mineral oil and related products accounted for nearly a third of India's import bill on the former date. Secondly, over two fifths of the increase in import value between 1984/85 and 1988/89 (barring what are virtually re-exported) was on account of machinery and transport equipment, which went to a significant extent into the production of a variety of goods for the "elite" market.

The third new feature was a systematic resort to commercial borrowing abroad including from non-resident Indians (NRIs). As the trade and current account deficits went up in the latter half of the 1980s, commercial borrowings were increasingly resorted to which in turn contributed with a lag to keeping up the current account deficit itself (owing to interest payments) and necessitated further borrowing, both for this reason as well as for amortising past loans. Debt has a habit of escalating rapidly, feeding upon itself; and as fresh debt is contracted to pay off old debt, the terms at the margin become stiffer, the maturity period shorter and hence the rate of escalation of debt even steeper. And this is precisely what happened. The debt in dollar terms nearly quadrupled during the 1980s, from $20,582 million in 1980 to $81,994 million in 1990: debt to banks and private individuals increased more than 10 times from $1,997 million to $22,387 million. India's debt-service payments absorbed 31.2 per cent of her exports in 1990.[3]

The enormous external debt, a growing portion of it being in the form of short-term borrowing, made the economy acutely vulnerable to currency speculations and "confidence crises" of international investors, a vulnerability that was an entirely new phenomenon for the Indian economy. The liquidity build up in the domestic economy which inevitably followed made it acutely vulnerable to sudden inflationary upsurges. The consequence of both these phenomena was the crisis of 1991. In sum, the use of external debt, now easily available to countries like India because of changes in the international financial system, was used to pump-prime the economy in a manner that rendered it vulnerable to a speculation-induced balance of payments crisis.

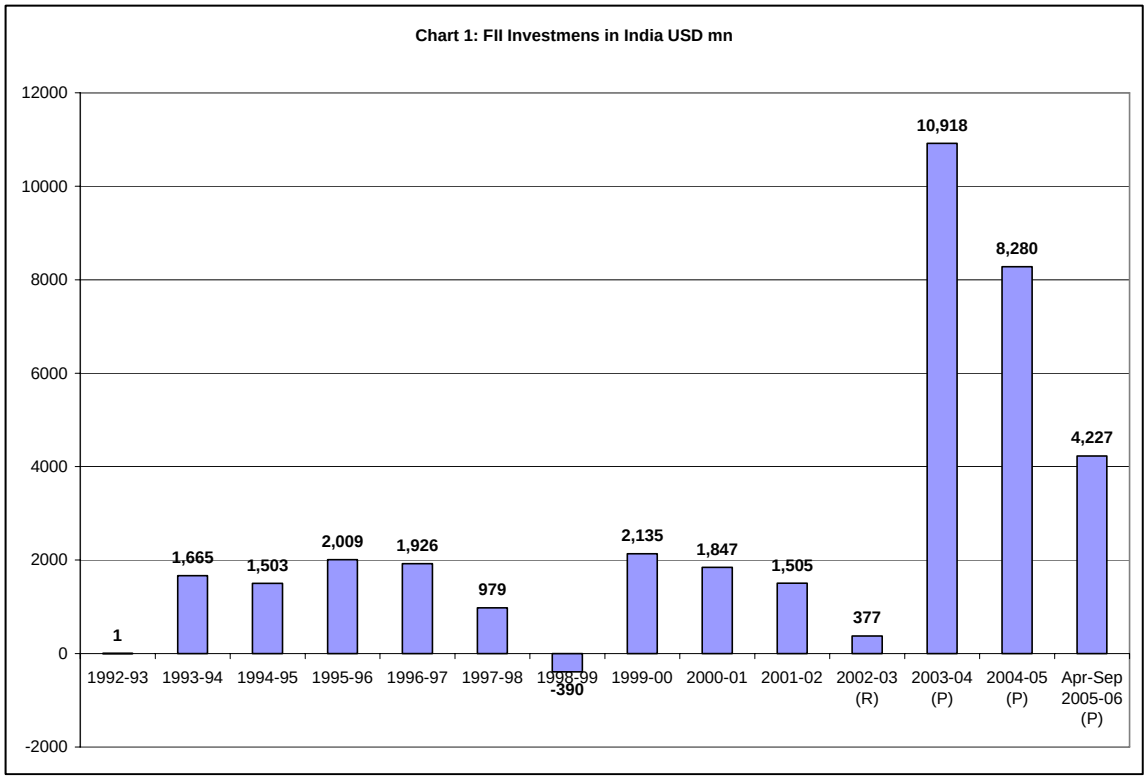
The financial sector and reform

From the point of view of this paper, what is crucial is that the crisis triggered a major reform of the financial sector that has been unfolding since. In the wave of neo-liberal economic reform unleashed in developing countries during the 1980s and 1990s, there has been a relatively new and substantial emphasis on the liberalization of financial sector polices. Prior to the 1980s economic liberalization was primarily concerned with stabilizing the balance of payments through contractionary monetary and fiscal policies and structurally adjusting these economies by liberalizing trade and removing controls on domestic capacity creation, production and pricing by domestic and foreign firms. While retaining these features, neo-liberal reform in the 1990s has combined them with a range of policies liberalizing the operations of financial markets and encouraging regulatory forbearance in supervising their operations. Supervision and prudential regulation is

[3] Figures from World Bank**, World Debt Tables: External Finance for Developing Countries, 1994/95**, World Bank, Washington D.C., 1994.

intensified in the aftermath of financial failure, only to be diluted subsequently, subject to the adherence to a broad set of guidelines relating to capital adequacy, accounting practices and disclosure norms.

As mentioned earlier, for countries implementing financial liberalisation as part of an adjustment package, the first step is the loosening of controls on the inflow of foreign capital, accompanied by a shift to a more liberalised exchange rate regime. India too adopted such policies, even though exchange rate liberalisation did not involve the transition to full convertibility on the capital account.

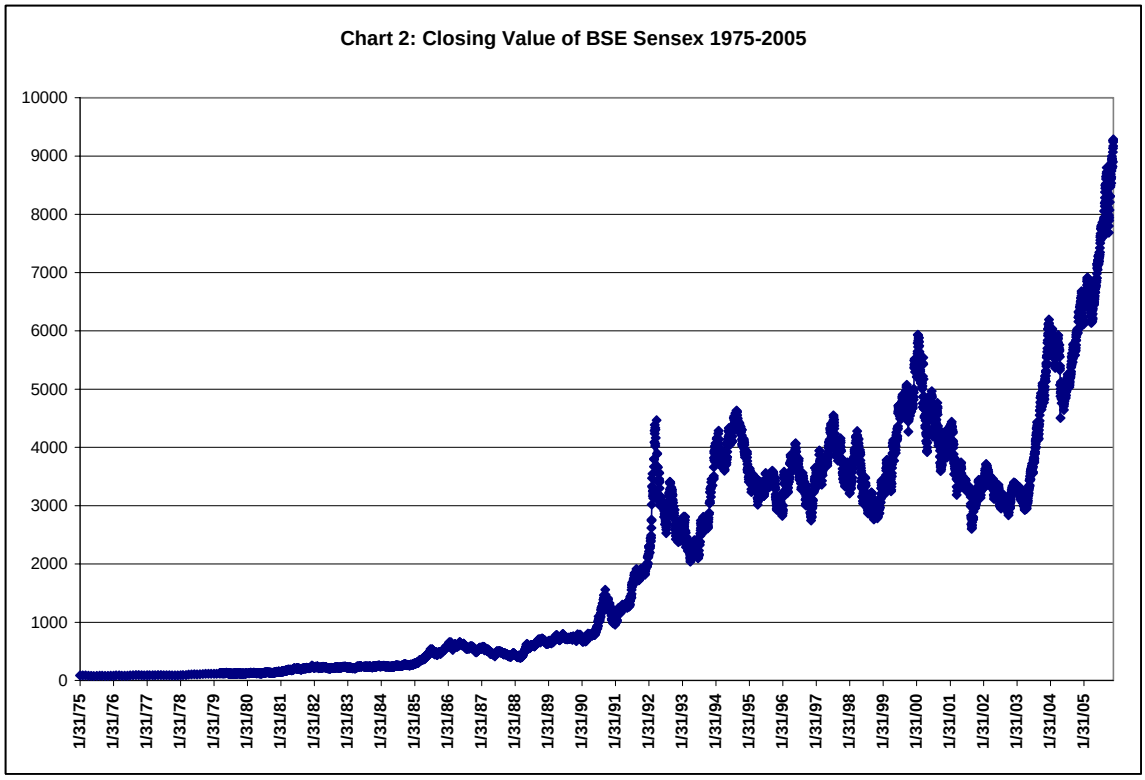


One consequence has been a significant increase in the inflows of foreign capital into India. However, having reached a peak in 2001-02, FDI inflows have remained below that year's level since. Further, even at its peak, FDI inflows at $6.1 billion was far short of the $10 billion target set by the government and way below inflows into China. While FDI has not risen to expected levels, the external liberalisation that has been justified in its name has resulted in large inflows of portfolio capital in particular years. As Chart 1 shows, net portfolio inflows have been extremely volatile. In the period since April 2003, India has witnessed an extraordinary surge in foreign institutional investments. Having averaged $1776 million a year during 1993-94 to 1998-97, net FII investment dipped to an average of $295 million during 1997-99, influenced no doubt by the Southeast Asian crisis. The average rose again to $1829 million during 1999-2000 to 2001-02 only to fall $377 million in 2002-03. The surge began immediately thereafter and has yet to come to an end. Inflows averaged $9599 million a year during 2003-05 and are estimated at

$9429 million during the first nine months of 2005-06. Going by data from the Securities and Exchange Board of India (SEBI), while cumulative net FII flows into India since the liberalisation of rules governing such flows in the early 1990s till end-March 2003 amounted to $15,804 million, the *increment* in cumulative value between that date and the end of December 2005 was $25,267 million.

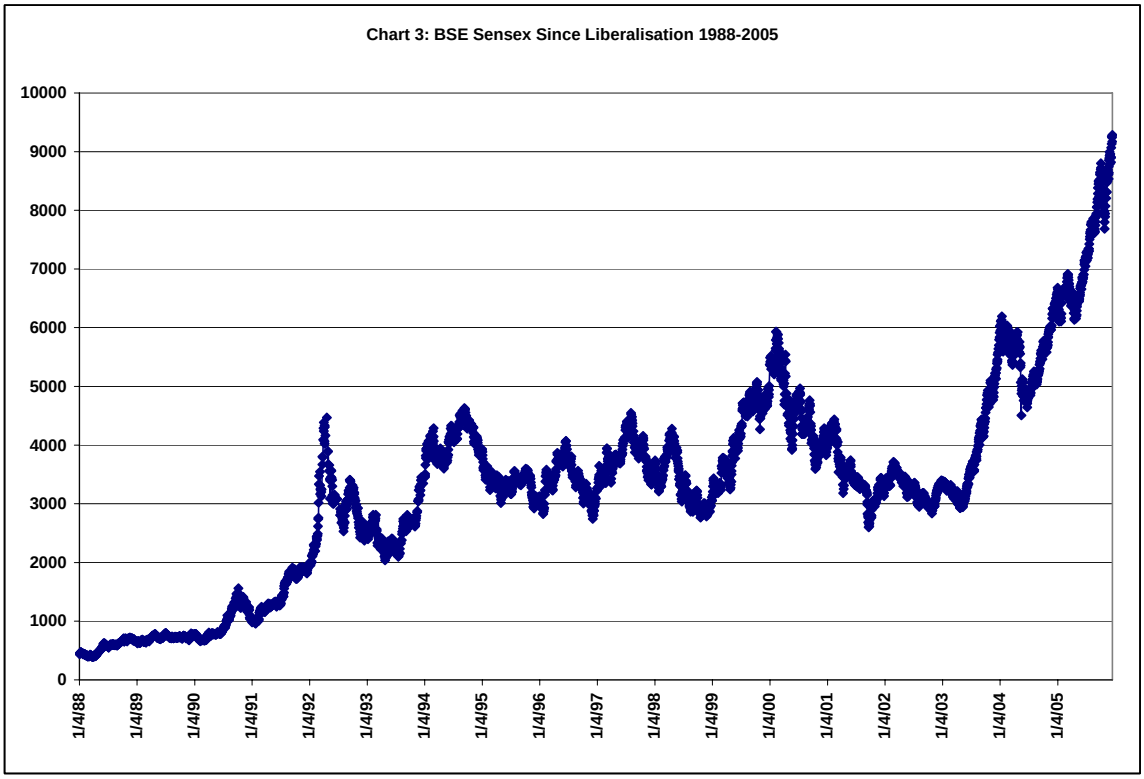
It is not surprising that the period of surge in FII investments was also one when, despite fluctuations, the stock market has been extremely buoyant. The Bombay Sensex rose from 3727 on March 3, 2003 to 5054 on July 22, 2004, and then on to 6017 on November 17, 2004, 7077 on June 21, 2005, 8073 on November 2, 2005 and 9323 on December 30, 2005. The implied price increases of more than 80 per cent over a 17-month period and 50 per cent over just more than a year are indeed remarkable. Market observers, the financial media and a range of analysts have concurred that FII investments have been an important force, even if not always the only one, driving markets to their unprecedented highs.

Underlying the current FII and stock market surge is, of course, a continuous process of liberalisation of the rules governing such investment: its sources, its ambit, the caps it was subject to and the tax laws pertaining to it. It is well recognized that stock market buoyancy and volatility has been a phenomenon typical of the liberalization years. Till the late 1980s the BSE Sensex graph was almost flat, and significant volatility is a 1990s phenomenon as Chart 2 shows.



An examination of trends since 1988, when the recovery began, points to the extreme volatility in the Sensex during the liberalization years (Chart 3). And judging by trends

since the early 1990s the recent surge is remarkable not only because of its magnitude but because of its prolonged nature.



Those acquainted with the recent history of the market know that most peaks in the volatile 1990s scenario were the result of market manipulation of one kind or another, amplified by the role of foreign institutional investors who have discovered the Indian market since liberalization and targeted the country with large and volatile flows since the early 1990s.

It could, however, be argued that the liberalisation began in the early 1990s, but the FII surge is a new phenomenon which must be related to the returns now available to investors that make it worth their while to exploit the opportunity offered by liberalisation. The point, however, is that while the good profit performance of domestic firms may partly explain the high returns of recent times, there were other factors that may have been more crucial.

In particular, returns on stock market investment were also hiked through state policy. Just before the FII surge began, and influenced perhaps by the sharp fall in net FII investments in 2002-03, the then Finance Minister declared in the Budget for 2003-04: "In order to give a further fillip to the capital markets, it is now proposed to exempt all listed equities that are acquired on or after March 1, 2003, and sold after the lapse of a year, or more, from the incidence of capital gains tax. Long term capital gains tax will, therefore, not hereafter apply to such transactions. This proposal should facilitate investment in equities." Long term capital gains tax was being levied at the rate of 10 per cent up to that point of time. The surge was no doubt facilitated by this significant concession.

Once the FII increase resulting from these factors triggered a boom in stock prices, expectations of further price increases took over, and the incentive to benefit from untaxed capital gains was only strengthened. In the circumstances, there is reason to believe that the herd instinct so typical of financial investors played a role in sustaining the boom, with a rush of investors into the country. The number of FIIs registered in India stood at 502 at the end of March 2003, many of whom had registered immediately after the rules were liberalised to permit their entry. As many as 353 FIIs had registered by the end of March 1996. The second spike in FII registration is more recent. Thus, the number of FIIs registered in the country rose by 321 between end 2002-03 and end of December 2005, when the figure touched 823.

Even a cursory assessment of recent development would, therefore, lead to three tentative conclusions. First, that even though India like China was not affected by the Southeast Asian contagion of 1997, it is an economy that has experienced a speculative attack on its currency in the wake of the 1980s liberalisation. Second, that FII investment does seem volatile even when annual average figures are considered. Third, while an initial promise of high returns triggered FII interest, speculative objectives and the herd instinct have played a role in keeping investment high and the markets buoyant. And, fourth, given the massive and concentrated inflows in recent times there are reasons to be concerned with their macroeconomic implications and the danger of an equally sudden reversal.

The behaviour of foreign institutional investment

As has been noted earlier, stock markets in India have been extremely volatile. For example, from a low of 2924 on April 5, 2003, the Mumbai Stock Exchange Sensitive Index (Sensex) had risen to 6194 on January 14, 2004, only to fall to 4505 on May 17, before rising to close at a peak well above 8000 in September 2005 and then turning downwards once again. These wild fluctuations have meant that for those who bought into the market at the right time and exited at the appropriate moment, the average return earned through capital gains were extremely high.

There are two messages that this experience sends out. The first is that, if market expectations can turn so whimsically, the signals or rumours on which they are based must lack any substance since any “fundamentals” on which they could be anchored have not shifted so violently. The second is that there must be some unusually strong force that is determining movements in the market which alone can explain the wild swings it is witnessing. If some force has the ability to lead the market and the others can be taken along without much resistance, the market is in essence being subjected to manipulation, even if not always consciously.

Movements in the Sensex during the last few years have clearly been driven by the behaviour of foreign institutional investors (FIIs). At one level this influence of the FIIs is puzzling. The cumulative stock of FII investment in the Bombay Stock Exchange, totalling $ 30.3 billion at the end of 2004, amounted to just 8 per cent of total market capitalisation ($383.6 billion). However, FII transactions were significant at the margin. Purchases by FIIs of $31.17 billion between April and December 2004 amounted to around 38.4 per cent of the cumulative turnover of $83.13 billion in the market during that period, whereas sales by FIIs amounted to 29.8 per cent of turnover. Not surprisingly there has been a substantial increase in the share of foreign stockholding in leading Indian

companies. According to one estimate, by end-2003, foreigners (not necessarily just FIIs) had cornered close to 30 per cent of the equity in India's top 50 companies — the Nifty 50. In contrast, foreigners collectively owned just 18 per cent in these companies at the end of 2001 and 22 per cent in December 2002.

An analysis by Parthaprathim Pal estimated that at the end of June 2004 FIIs controlled on average 21.6 per cent of shares in Sensex companies. Further, if we consider only free-floating shares, or shares normally available for trading because they are not held by promoters, government or strategic shareholders, the average FII holding rises to more than 36 per cent. In a third of Sensex companies, FII holding of free-floating shares exceeded 40 per cent of the total.

In September 2004, FII (Table 1) shareholding in the 30 companies included in the Sensex stood at an average of 19.6 per cent. What is noteworthy, however, is that this proportion varied from a low of 2.52 per cent to a high of as much as 54 per cent in the case of Satyam Computers and 63.17 per cent in the case of HDFC. If FIIs as a group chose to move out of the stock concerned, a collapse in the price of the equity is inevitable.

Table 1: FII Holding in Sensex Companies End-September 2004

	FII Holding	Total stock	FII Share
ASSOCIATED CEMENT COMPANIES LT	40900718	178277669	22.94
BAJAJ AUTO	16330247	101183510	16.14
BHARTI TELE	221015179	1853366767	11.93
BHEL	53591202	244760000	21.90
CIPLA LTD.	52682658	299870233	17.57
DR.REDDY'S LABORATORIES LTD.	12809188	76518949	16.74
GRASIM INDUSTRIES LTD.	19113076	91671233	20.85
GUJARAT AMBUJA CEMENTS LTD.	41620922	179399951	23.20
HDFC BANK LT	76402122	286232913	26.69
HEROHONDA M	46161349	199687500	23.12
HINDALCO IN	17828040	92475275	19.28
HINDUSTAN LEVER LTD.	278289559	2201243793	12.64
HINDUSTAN PETROLEUM CORP. LTD.	66559789	339330000	19.62
HOUSING DEVELOPMENT FINANCE CO	156482326	247703418	63.17
I T C LTD	37548907	247924902	15.15
ICICI BANK L	359488564	735928149	48.85
INFOSYS TECHNOLOGIES LTD.-ORDI	108676702	267860670	40.57
LARSEN & TOUBRO LTD.	24048087	129902937	18.51
MARUTI UDYOG	34644938	288910060	11.99
ONG CORP LTD	93054697	1425933992	6.53
RANBAXY LABORATORIES LTD.	41321691	185831140	22.24

RELIANCE	319138099	1396377536	22.85
RELIANCE ENR*	32896582	185572799	17.73
SATYAM COMP	171632507	317593572	54.04
STATE BANK OF INDIA	60294540	526298878	11.46
TATA IRON AND STEEL CO. LTD.	66306238	553472856	11.98
TATA MOTORS	76364625	358485286	21.30
TATA POWER	26069920	197897864	13.17
WIPRO LTD.	17630021	698951673	2.52
ZEE TELEF LT	154980521	412505012	37.57
Total Sensex Cos	2723883014	14321168537	19.02

Table 2, which provides the frequency distribution of Sensex companies according to the size class of FII shareholding proportions at the end of the first three quarters of 2004, suggests that FIIs do shift in and out of particular shares, just as they are known to shift in and out of particular markets. Between end-March and end-June FIIs were reducing their exposure in Sensex companies, whereas by end-September they had once again begun to increase their exposure. If at the end of June there were 5 companies in which the share of FIIs in total equity was less than 10 per cent, this figure had fallen to 2 by end-September, whereas the number of firms in which FII exposure was 10-20 per cent had risen from 12 to 14 and those with 20-30 per cent exposure from 8 to 9. Given the short period in which this had occurred and the small proportion of floating shares in the case of many companies, these changes are indeed significant.

Table 2: Frequency Distribution of FII Holdings in Sensex Companies

	1-Mar-04	1-Jun-04	1-Sep-04
< 10 per cent	3	5	2
10-20 per cent	13	12	14
20-30 per cent	9	8	9
30-40 per cent	1	2	2
> 40 per cent	4	3	3

Given the presence of foreign institutional investors in Sensex companies and their active trading behaviour, their role in determining share price movements must be considerable leading to volatility. Volatility is of course a result of the structure of India's financial markets as well. Markets in developing countries like India are thin or shallow in at least three senses. First, only stocks of a few companies are actively traded in the market. Thus, although there are more than 5000 companies listed on the stock exchange, the BSE Sensex incorporates just 30 companies, trading in whose shares is seen as indicative of market activity. Second, of these stocks there is only a small proportion that is routinely available for trading, with the rest being held by promoters, the financial institutions and others interested in corporate control or influence. And, third the number of players trading these stocks is also small. According to a late 1990s Report of the SEBI's Committee on Market Making, "The number of shares listed on the BSE since 1994 has remained almost around 5800 taking into account delisting and new listing. While the number of listed shares remained constant, the aggregate trading volume on the

exchange increased significantly. For example, the average daily turnover, which was around Rs.500 crore in January 1994 increased to Rs.1000 crores in August 1998. But, despite this increase in turnover, there has not been a commensurate increase in the number of actively traded shares. On the contrary, the number of shares not traded even once in a month on the BSE has increased from 2199 shares in January 1997 to 4311 shares in July 1998." The net impact is that speculation and volatility are essential features of such markets.

These features of Indian stock markets induce a high degree of volatility for four reasons. In as much as an increase in investment by FIIs triggers a sharp price increase, it would provide additional incentives for FII investment and in the first instance encourage further purchases, so that there is a tendency for any correction of price increases to be delayed. And when the correction begins it would have to be led by an FII pull-out and can take the form of an extremely sharp decline in prices.

Secondly, as and when FIIs are attracted to the market by expectations of a price increase that tend to be automatically realised, the inflow of foreign capital can result in an appreciation of the rupee vis-à-vis the dollar (say). This increases the return earned in foreign exchange, when rupee assets are sold and the revenue converted into dollars. As a result, the investments turn even more attractive triggering an investment spiral that would imply a sharper fall when any correction begins.

Thirdly, the growing realisation by the FIIs of the power they wield in what are shallow markets, encourages speculative investment aimed at pushing the market up and choosing an appropriate moment to exit. This implicit manipulation of the market if resorted to often enough would obviously imply a substantial increase in volatility.

Finally, in volatile markets, domestic speculators too attempt to manipulate markets in periods of unusually high prices. For example, the SEBI had issued show cause notices to four entities relating to their activities in and around Black Monday, May 17, 2004, when the Sensex recorded a steep decline.

All this said, the last three years have been remarkable because, even though these features of the stock market imply volatility, there have been more months when the market has been on the rise rather than on the decline. This clearly means that FIIs have been bullish on India for much of that time. The problem is that such bullishness is often driven by events outside the country, whether it be the performance of other equity markets or developments in non-equity markets elsewhere in the world. It is to be expected that FIIs would seek out the best returns as well as hedge their investments by maintaining a diversified geographical and market portfolio. The difficulty is that when they make their portfolio adjustments, which may imply small shifts in favour of or against a country like India, the effects it has on host markets are substantial. Those effects can then trigger a speculative spiral for the reasons discussed above, resulting in destabilising tendencies.

These aspects of the market are of significance because financial liberalisation has meant that developments in equity markets can have major repercussions elsewhere in the system. With banks allowed to play a greater role in equity markets, any slump in those markets can affect the functioning of parts of the banking system. For example, the forced closure (through merger with Punjab National Bank) of one bank (Nedungadi

Bank) was the result of the losses it suffered because of over exposure in the stock market,

On the other hand if FII investments constitute a large share of the equity capital of a financial entity, as seems to the case with the Housing Development Finance Corporation (HDFC), an FII pull-out, even if driven by developments outside the country can have significant implications for the financial health of what is an important institution in the financial sector of this country.

Similarly, if any set of developments encourages an unusually high outflow of FII capital from the market, it can impact adversely on the value of the rupee and set off speculation in the currency that can in special circumstances result in a currency crisis. There are now too many instances of such effects worldwide for it to be dismissed on the ground that India's reserves are adequate to manage the situation.

The case for vulnerability to speculative attacks is strengthened because of the growing presence in India of institutions like Hedge Funds, which are not regulated in their home countries and resort to speculation in search of quick and large returns. These hedge funds, among other investors, exploit the route offered by sub-accounts and opaque instruments like participatory notes to invest in the Indian market.. Since FIIs permitted to register in India include asset management companies and incorporated/institutional portfolio managers, the 1992 guidelines allowed them to invest on behalf of clients who themselves are not registered in the country. These clients are the 'sub-accounts' of registered FIIs. Participatory notes are instruments sold by FIIs registered in the country to clients abroad that are derivatives linked to an underlying security traded in the domestic market. These derivatives not only allow the foreign clients of the FIIs to earn incomes from trading in the domestic market, but to trade these notes themselves in international markets. By the end of August 1995, the value of equity and debt instruments underlying participatory notes that had been issued by FIIs amounted to Rs. 78,390 crore or 47 per cent of cumulative net FII investment. Through these routes, entities not expected to play a role in the Indian market can have a significant influence on market movements. In October 2003, *The Economist* reported that: "Although a few hedge funds had invested in India soon after the country began liberalising its financial markets in the early 1990s, their interest has surged recently. Industry sources estimate that perhaps 25-30 per cent of all foreign equity investments are now held by hedge funds."

Financial flows and fiscal contraction

Growing FII presence is disconcerting not just because such flows are in the nature of "hot money" which renders the external sector fragile, but because the effort to attract such flows and accommodate any surge in such flows that may occur has a number of macroeconomic implications. To start with, inasmuch as financial liberalization leads to financial growth and deepening and increases the presence and role of financial agents in the economy, it forces the state to adopt a deflationary stance to appease financial interests. Those interests are against deficit-financed spending by the state for a number of reasons. First, deficit financing is seen to increase the liquidity overhang in the system, and therefore as being potentially inflationary. Inflation is anathema to finance since it erodes the real value of financial assets. Second, since government spending is

"autonomous" in character, the use of debt to finance such autonomous spending is seen as introducing into financial markets an arbitrary player not driven by the profit motive, whose activities can render interest rate differentials that determine financial profits more unpredictable. Third, if deficit spending leads to a substantial build-up of the state's debt and interest burden, it may intervene in financial markets to lower interest rates with implications for financial returns. Financial interests wanting to guard against that possibility tend to oppose deficit spending. Finally, the use of deficit spending to support autonomous expenditures by the state amounts to an implicit legitimisation of an interventionist state, and therefore, a de-legitimisation of the market. Since global finance seeks to de-legitimise the state and legitimise the market, it strongly opposes deficit-financed, autonomous state spending.

Efforts to curb the deficit obviously result in a contraction of public expenditure, especially expenditure on capital formation, which adversely affects growth and employment; leads to a curtailment of social sector expenditures that sets back the battle against deprivation; impacts adversely on food and other subsidies that benefit the poor; and sets off a scramble to privatise profit-earning public assets, which render the self-imposed fiscal strait-jacket self-perpetuating. All the more so since the finance-induced pressure to limit deficit spending is institutionalised through legislation like the Fiscal Responsibility and Budget Management Act passed in 2004 in India, which constitutionally binds the state to do away with revenue deficits and limit fiscal deficits to low, pre-specified levels.

Implications of curbing the monetised deficit

This macroeconomic fall-out and its effects are aggravated by the perception that accompanies the financial reform that macroeconomic regulation should rely on monetary policy pursued by an "independent" central bank rather than on fiscal policy. The immediate consequence of this perception is the tendency to follow the IMF principle that even the limited deficits that occur should not be "monetised". Fiscal reform was not concerned only with reducing the size of the deficit, but also with the manner in which any given level of the deficit should be financed. In this regard, fiscal reform involved a sharp reduction of the "monetised deficit" of the government, or that part which was earlier financed through the issue of short-term, *ad hoc* Treasury Bills to the Reserve Bank of India, and its subsequent elimination.[4] Until the early 1990s, a considerable part of the deficit on the government's budget was financed with borrowing from the central bank against *ad hoc* Treasury Bills issued by the government. The interest rate on such borrowing was, at around 4.6 per cent, much lower than the interest rate on borrowing from the open market. The reduction of such borrowing from the central bank to zero resulted in a sharp rise in the average interest rate on government borrowing.

The reduction, in fact the elimination, of *ad hoc* issues, was argued to be essential for giving the central bank a degree of autonomy and monetary policy a greater role in the

[4] This was more or less "successfully" implemented in a two stage process, involving initially a ceiling on the issue of Treasury Bills in any particular year, and subsequently the abolition of the practice of issuing Treasury Bills and substituting it with limited access to Ways and Means advances from the central bank for short periods of time.

economy. This in turn stemmed from the premise that monetary policy should have a greater role than fiscal manoeuvrability in macroeconomic management. The shift away from borrowing from the central bank was advocated on three grounds. First, that such borrowing (deficit financing) is inflationary. Second, that it undermines the role of monetary policy by depriving the central bank of any autonomy. And, third, that it undermines much needed fiscal discipline by providing ready access to credit to the government at a low rate of interest. We need to consider each of these in some detail.

The notion that the budget deficit, defined in India as that part of the deficit which is financed by borrowing from the central bank, is more inflationary than a fiscal deficit financed with open market borrowing, stems from the idea that the latter amounts to a draft on the savings of the private sector, while the former merely creates more money. In a context in which new government securities are ineligible for refinance from the RBI, and the banking system is stretched to the limit of its credit-creating capacity, this would be valid. However, if banks are flush with liquidity (as has been true of the Indian economy since at least 1999), government borrowing from the open market adds to the credit created by the system rather than displacing or crowding out the private sector from the market for credit.

But more to the point, neither form of borrowing is inflationary if there is excess capacity and supply side bottlenecks do not exist. Since inflation reflects the excess of *ex ante* demand over *ex ante* supply, excess spending by the government financed through either type of borrowing, is inflationary only if the system is at full employment or is characterised by supply bottlenecks in certain sectors. In the latter half of the 1990s, the Indian industrial sector was burdened with excess capacity, and the government was burdened with excess foodstocks (attributable to poverty and not true food “self-sufficiency”) and high levels of foreign exchange reserves. This suggests that there were no supply constraints to prevent "excess" spending from triggering output as opposed to price increases. Since inflation was at an all time low, this provided a strong basis for an expansionary fiscal stance, financed if necessary with borrowing from the central bank. So in the late-1990s context a monetised deficit would not only have been non-inflationary, but it would also have been virtuous from the point of view of growth.

This brings us to the second objection to a monetised deficit, namely, that it undermines the autonomy of the central bank. This demand for autonomy, which is a central component of IMF-style financial reform, assumes that once relieved of the task of financing the government's deficit, the RBI would be "free" to use monetary policy as a device to control inflation, manage the balance of payments, and influence growth. The two interrelated means to realising these objectives are seen as controlling liquidity and influencing interest rates. There are strong grounds for scepticism regarding the efficacy of this policy, which is examined and critiqued later. At this point it is relevant to note that the decision to eliminate the practice of monetising the deficit hardly affected the fiscal situation. Fiscal deficits remained high, though they were financed by high-interest, open-market borrowing. The only result was that the interest burden of the government shot up, reducing its maneuverability with regard to capital and non-interest current expenditures. As a result the Centre's revenue expenditures rose relative to GDP, even when non-interest expenditures (including those on subsidies) fell, and the fiscal deficit continued to rise.

This effect of financial reform on the fiscal maneuverability of the State can be assessed by comparing actual fiscal trends during the 1990s with a hypothetical situation where the government had continued financing the same share of its deficit (around 30 per cent) with central bank borrowing as it did in 1989-90. We can engage in a simple simulation exercise assuming the interest rate on central bank borrowing to be 4.6 per cent, and the interest rate on open market borrowing to be the same as actually prevailed in each year of the 1990s. With these parameters, the interest burden in the budget would have risen from Rs. 17757 crore to only Rs. 88464 crore in 2000-2001 as compared with the estimate of Rs. 101266 crore recorded in the 2000-01 Budget papers. This amounts to a hypothetical saving of close to Rs. 13000 crore or 12.6 per cent of interest payments in 2000-01. Note that this does not even include the additional benefit that would have accrued if we assume that less public debt would have been required in each year because of lower interest payments.

Obviously, this cumulative saving would have implied a significant reduction in the size of the fiscal deficit, even assuming that expenditures remained the same. Our estimates show that the fiscal deficit to GDP ratio would have been lower to the extent of 0.55 of a percentage point in 1999-2000. This together with the benefit obtained from keeping the tax-GDP ratio at its 1989-90 level would have brought the deficit down to 4.88 per cent as compared to the 7.03 per cent figure at which it stood. This 2.15 percentage points reduction in the fiscal deficit would have amounted to Rs.41534 crore in absolute terms in 1999-2000, which was more than double the outlay (Rs. 17950 crore) on food and fertiliser subsidies in that year. Another way of looking at this would be to note that, with this role of borrowing from the central bank and the same level of fiscal deficit, food and fertiliser subsidies could have been tripled in that year with no adverse fiscal consequences, or the government would have had additional resources to undertake crucial investments in the agricultural, infrastructural and social sectors.

Indeed, while many complain that the current fiscal problem stems from the burden placed by past accrual of public debt, the more significant problem is actually that of higher interest rates on public borrowing. These have contributed to a situation which, by the turn of the decade, was perilously close to that of Ponzi finance, in which the government borrows simply in order to pay interest.

This is especially important because macroeconomic circumstances at the end of ten years of reform cried out for deficit financed spending. In a context where growth in the commodity producing sectors was sluggish and where there was little progress on the poverty reduction front during the 1990s, the budget should have been treated above all as means to trigger growth and alleviate poverty. The obsession with the fiscal deficit and expenditure reduction amounted to downplaying these more fundamental objectives.

An obvious lesson from that experience is that if the government had not frittered away resources in the name of stimulating private initiative, if it had continued with earlier levels of monetising the deficit and also dropped its obsession with controlling the total fiscal deficit, especially at the turn of the decade when food and foreign reserves have been aplenty, the 1990s would have in all probability been a decade of developmental advance. Yet the policy choices made ensured that neither was this achieved, nor were the desired targets of fiscal compression met. It is evident that the failure of the

government to realise its objective of reining in the fiscal deficit was a result of this type of economic reform rather than of abnormal expenditures.

Financial flows and exchange rate management

The question that remains is whether this "abolition" of the monetised deficit in order to appease financial capital actually results in central bank independence. On September 9, 2005 India's foreign exchange reserves exceeded $145 billion and it foreign currency assets alone stood close to $140 billion. The foreign exchange assets of the central bank rose sharply, from $42.3 billion at the end of March 2001 to 54.1 billion at the end of March 2002, $76.1 billion at the end of March 2003, $113 billion at the end of March 2004 and $142 billion at the end of March 2005. This implies that even after discounting for the increase in reserves resulting from the appreciation of the dollar value of the Reserve Bank of India's (RBI's) Sterling, Yen and Euro reserves, the foreign exchange assets of the central bank were rising by around $980 million a month in 2001-02, $1.8 billion a month in 2002-03, $2.5 billion a month during 2003-04 and $3.1 billion a month during 2003-04 and $2.4 billion a month during 2005.

The process of reserve accumulation is the result of the pressure on the central bank to purchase foreign currency in order to shore up demand and dampen the effects on the rupee of excess supplies of foreign currency. In India's liberalized foreign exchange markets, excess supply leads to an appreciation of the rupee, which in turn undermines the competitiveness of India's exports. Since improved export competitiveness and an increase in exports is a leading objective of economic liberalization, the persistence of a tendency towards rupee appreciation would imply that the reform process is internally contradictory. Not surprisingly the RBI and the government have been keen to dampen, if not stall, appreciation. Thus, the RBI's holding of foreign currency reserves rose as a result of large net purchases.

Unfortunately, the RBI's ability to persist with this policy without eroding its ability to control domestic money supply is increasingly under threat. Increases in the foreign exchange assets of the central bank amount to an increase in reserve money and therefore in money supply, unless the RBI manages to neutralise increased reserve holding by retrenching other assets. If that does not happen the overhang of liquidity in the system increases substantially, affecting the RBI's ability to pursue its monetary policy objectives. Till recently the RBI has been avoiding this problem through its sterilisation policy, which involves the sale of its holdings of central government securities to match increases in its foreign exchange assets. But even this option has now more or less run out. Net Reserve Bank Credit to the government, reflecting the RBI's holding of government securities, has fallen from Rs. 1,67,308 crore at the end of May 2001 to Rs. 4,626 crore by December 10, 2004. There was little by way of sterilisation instruments available with the RBI.

There are two consequences of these developments. First, the monetary policy of the central bank, that has been delinked from the fiscal policy initiatives of the state, with adverse consequences for the latter, is no more independent. More or less autonomous capital flows influence the reserves position of the central bank and therefore the level of money supply, unless the central bank chooses to leave the exchange rate unmanaged, which it cannot. This implies that the central bank is not in a position to use the monetary

lever to influence domestic economic variables, however effective those levers may be. Secondly, the country is subject to a drain of foreign exchange inasmuch as there are substantial difference between the repatriable returns earned by foreign investors and the foreign exchange returns earned by the Reserve Bank of India on the investments of its reserves in relatively liquid assets.

While partial solutions to this problem can be sought in mechanisms like the Market Stabilisation Scheme (which places government securities in a market stabilisation facility that increases the interest costs borne by the government), it is now increasingly clear that the real option in the current situation is to either curb inflows of foreign capital or encourage outflows of foreign exchange. As the RBI's survey of monetary management techniques in emerging market economies reported in its Survey of Currency and Finance 2003-04 makes clear, countries have chosen to use stringent capital control measures or market-based measures such as differential reserve requirements and Tobin-type taxes to restrict capital inflows. Others have loosened capital outflow norms to expend the foreign exchange "acquired" through large capital inflows.

The RBI's view, is that confronted with its growing inability to sterilise capital inflows, but under pressure to prevent any "unbridled" appreciation of the rupee, what needs to be done is to ease conditions governing capital outflows. It justifies this on the grounds that empirical evidence on capital controls and other prudential measures suggest that "these are unable to reduce the volume of capital flows. The expected effect vanishes over time as market participants find ways to evade the controls. Alternatively, the effectiveness would require progressive widening of the scope of the controls with long-run costs which may outweigh the short-run benefits." This view, it must be emphasised, is valid if at all only with reference to certain market-based measures. And even in the case of such measures it does not capture their short-run efficacy. However, unwilling to experiment with these or stronger measures the RBI concludes that, while "central banks must inoculate themselves against whimsy and keep their eyes on the fundamentals", monetary policy cannot alter the movement of capital flows; it can only hope to fashion a credible response to its effects.

If sterilisation as a response is increasingly difficult to sustain and capital controls are unacceptable, then efforts to increase outflows of foreign exchange may be necessary. The RBI outlines the policies adopted in India in this area so far. They include: substantial expansion of the automatic route of FDI abroad by Indian residents; greater flexibility regarding pre-payment of external commercial borrowings by private sector firms; liberalisation of surrender requirements for exporters enabling them to hold up to 100 per cent of their proceeds in foreign currency accounts; extension of foreign currency account facilities to other residents; and allowing banks to liberally invest abroad in high quality instruments. Implicit in its analysis is the argument that similar new measures need to be adopted.

Thus, the RBI's answer to the difficulties it faces in managing the recent surge in capital inflows, which it believes it cannot regulate, is to move towards greater liberalisation of the capital account. Full convertibility of the rupee is presumably the final goal. The problem with that judgement is that it ignores the relative degree of reversibility of the

inflows and outflows involved – a factor influencing the depreciation of the rupee at the time this article is being written.

Financial liberalization and financial structures

But besides these difficulties resulting from external financial liberalisation, there are a number of adverse macroeconomic effects of what could be termed internal financial liberalisation. There are a number of aspects and consequences to such liberalisation as implemented in practice. To start with, it involves reducing or doing away with controls on the interest rates or rates of return charged or earned by financial agents. In practice this never means that the range of interest rates are completely "market determined". The central bank influences or administers that rate structure through adjustments of the bank or discount rate at which it lends to the banking system and through its own open market operations. The government influences interest rates by altering administered interest rates offered on small savings and pension/provident fund depositors.

While liberalization does not, therefore, fully "free" interest rates, it has other kinds of consequences. It encourages competition between similarly placed financial firms aimed at attracting depositors on the one hand and enticing potential borrowers to take on debt on the other. Competition in these spheres not only takes non-price forms, but leads to price competition that squeezes spreads and forces firms to depend on volumes to shore up their bottom line. That is, within the range implicitly set by the central bank (and at times the government) banks can be encouraged by liberalization of rates to accept lower spreads in the hope of neutralising the effects on profits by attracting larger volumes of business.[5]

The second feature of financial liberalization is that it removes or dilutes controls on the entry of new financial firms, subject to their meeting pre-specified norms with regard to capital investments. This aspect of liberalization inevitably applies to both domestic and foreign financial firms, and caps on equity that can be held by foreign investors in domestic financial firms are gradually raised and done away with. Easier conditions of entry does not automatically increase competition in the conventional sense, since liberalization also involves freedom to acquire financial firms for domestic and foreign players and extends to permissions provided to foreign institutional investors, pension funds and hedge funds to invest in equity and debt markets. This often triggers a process of consolidation.

Thirdly, liberalization involves a reduction in controls over the investments that can be undertaken by financial agents. This can take two forms. Financial agents could be permitted to invest in areas they were not permitted to enter earlier. Most regulated financial systems sought to keep separate the different segments of the financial sector such as banking, merchant banking, the mutual fund business and insurance. Agents in one segment were not permitted to invest in another for fear of conflicts of interest that could affect business practices adversely. Financial liberalization involves the breaking down of the regulatory walls separating these sectors, leading in the final analysis to the emergence of the so-called "universal banks" or financial supermarkets. The consequent

[5] Non-price competition can also result in a reduction in spreads since it may involve higher costs in the form, for example, of larger investments in a wider Automatic Teller Machine (ATM) network or higher labour costs to provide "relationship banking" services to high value clients.

ability of financial agents to straddle multiple financial activities implies that the linkages between different financial markets tend to increase, with developments in any one market affecting others to a far greater degree than they did before.

Further, liberalization also involves the expansion of the sources from and instruments through which firms or financial agents can access funds. This not only leads to the proliferation of instruments such as commercial paper and certificates of deposit issued in the domestic market, but the liberalization of the rules governing the kinds of financial instruments that can be issued and acquired in the system. Financial instruments allow agents to share to differing degrees financial gains and risks, where the gains involved are incomes and asset price appreciation and the risks are, therefore, income and capital risks. These assets can either be issued directly by those looking for capital for productive investments or by intermediaries expecting to obtain a part of the incomes in return for carrying part of the risk.

Fourth, the universalization of banking and the proliferation of financial assets that liberalization involves, transforms the traditional role of the banking system of being the principal intermediary bearing risks in the system. It played this role by accepting relatively small individual liabilities of short maturities that were highly liquid and involved low income and capital risk and made large, relatively illiquid and risky investments of longer maturities. The protection afforded to the banking system and strong regulatory constraints on it were meant to ensure its viability given the role it played.

The way that role is transformed is captured, for example, in the following description of the bank in today's more liberalised financial system: "There was a time when a bank would lend to a business or provide a mortgage, would take the asset and put it on their books much the way a museum would place a piece of art on the wall or under glass – to be admired and valued for its security and constant return. Times have changed. Banks now take those assets, structure them into pools, and sell securities based on those pools to institutional investors and portfolio managers. In effect, they use their balance sheets not as museums, but as parking lots – temporary holding spaces to bundle up assets and sell them to those investors who have a far greater interest in holding those assets for the long term. The bank has thus gone from being a museum where it acquired only the finest assets and held and exhibited them in perpetuity into a manufacturing plant which provides a product for the secondary market. Just as Henry Ford did 80 years ago, banks today are focusing on producing a standardised product at a predictable rate, under standard norms of quality, and are teaching their workforces to produce that product as quickly and as efficiently as possible." (OECD, 2000). Thus, liberalisation triggers a shift in the role of the "pure" banking system as the principal bearer of financial risk to one where its focus is that of generating financial assets that transfer risks to the portfolio of institutions willing to hold them.

Fifth, liberalisation involves the withdrawal of the state from the activity of financial intermediation with the conversion of the "development banks" into regular banks and the privatization of the publicly owned banking system, on the grounds that their presence is not conducive to the dominance of market signals in the allocation of capital. In India, for example, all three major development financial institutions (the Industrial Finance Corporation of India, the Industrial Development Bank of India and the

Industrial Credit and Investment Corporation of India) have been or are being dismantled, converted into multi-purpose banks and privatised.

Sixth, financial liberalization eases conditions for the participation of both firms and investors in the stock market by diluting or doing away with listing conditions, by providing freedom in pricing of new issues, by permitting greater freedoms to intermediaries such as brokers and by relaxing conditions with regard to borrowing against shares and investing borrowed funds in the market. In addition, conditions relating to the need to declare share acquisitions that can lead to takeovers are also relaxed.

Finally, rather than resort to regulation through direct intervention, liberalization involves the shift to a regime of voluntary adherence to statutory guidelines with regard to capital adequacy, accounting norms and related practices, with the central banks role being that of supervision and monitoring.

Implications for interest rates

One of the favourite predictions of the proponents of financial liberalization measures in the 1990s was that the eventual result of such reforms would be reductions in real interest rates. It was argued that there would be an initial rise in such rates to redress the excessively low interest rates created by policies of "financial repression". This was argued to be both necessary and welcome because it was supposed to lead to more efficient use of borrowed resources and higher rates of domestic saving. But it was further argued that subsequently the greater access to capital from international markets, would bring Indian real interest rates closer to world levels and so Indian entrepreneurs would face lower real rates of interest. This in turn would obviously act as a spur to investment. Thus financial liberalization was seen as a means of generating lower real interest rates and higher real investment rates.

Neither of these outcomes was realised. Investment and savings rates did not increase significantly over the 1990s. Nor did real rates of interest decline over the decade. While gross domestic savings rose slightly in the mid-1990s (a period when, interestingly, real interest rates were relatively low) they declined slightly thereafter, to levels that were more or less comparable to those at the beginning of the decade. The decline from the mid-1990s was also associated with a decline in household financial savings. Meanwhile, nominal interest rates fell from the peak rates of 1993-94, but real interest rates actually rose quite sharply from the middle of the decade, to levels well in excess of 8 per cent. This is clear from Table 3, in which the representative nominal interest rate is taken to be the State Bank of India's Advance Rate. The real interest rate is here defined as that minus the rate of change in the Wholesale Price Index. (The nominal interest rates facing entrepreneurs, such as the term lending rates of the non-bank financial institutions, tended to be substantially higher.)

Table 3: Real and nominal interest rates

(per cent)

	SBI Advance rate	Estimated real rate of interest

1990-91	16.5	6.24
1991-92	16.5	2.76
1992-93	19	8.94
1993-94	19	10.65
1994-95	15	2.5
1995-96	16.5	8.41
1996-97	14.5	9.89
1997-98	14	9.6
1998-1999	14	8.05
1999-2000	12	8.73

Source : RBI Handbook of Statistics, various issues.

The apparent imperviousness of real interest rates to the greater access of domestic agents to international capital markets requires closer consideration. The floor rate of interest is the basic monetary policy instrument of the government. Earlier it was assumed that the RBI's discount rate determined the floor level of the interest rate. But in India over the 1990s, the mechanism for determining the level of the interest rate was not the basic bank rate of the RBI, but the interest rate on government securities, which effectively became the floor for other credit transactions. However, the government could not therefore choose to keep interest rates low to promote economic activity and reduce its own cost of borrowing. Since financial liberalization also involved the liberalization of external flows, this made the government sensitive to the possibility of capital outflows and therefore restricted its ability to determine the level of the interest rate autonomously. This meant that the nominal interest rate on government securities could not be lowered enough to generate substantial declines in the real interest rate.

However, for neoliberal reformers this persistence of high real interest rates despite external financial liberalization has been difficult to explain. One attempt to explain this was based on the possibility of diversion of household savings to small savings schemes floated by the Government, in the form of Public Provident Fund, Post Office deposits, National Savings Schemes and so on. Since these were seen as relatively risk-free and also offered various tax benefits, it was argued that they became attractive alternatives to bank deposits. Consequently banks were forced to maintain high deposit rates, which meant that their lending rates also remained high. But in fact there was no discernible time trend in the proportion of bank deposits in the total financial assets of households over the 1990s. The share of bank deposits was substantially higher in the last three years of the decade (at more than 38 per cent) than in the first three years of the decade (at only 32 per cent). While the share of small savings increased slightly (from 32.3 in 1990-91 to 35.9 in 1999-2000) this was at the expense of the share of household savings held as

shares and debentures, which fell from 10 per cent in 1992-93 following the stock market boom immediately after the initial liberalization, to only around 2 per cent in 1998-99.

Another explanation that has been offered for the persistence of high real interest rates relates to the supposed inefficiency of banks, due to "inadequate liberalization" and the fact of public ownership, because of which the spreads between deposit and lending rates remained high. Actually, however, the spread between deposit rates for term deposits of one to three years' duration, and the State Bank of India's Advance Rate, declined quite sharply from the peak reached in 1993-94. The decline was most marked for public sector banks, which implies that, if anything, their "efficiency" increased over this period. This was because of the high proportion of term deposits in commercial banks' deposit portfolios, which meant they still had to pay high rates of interest on a significant part of their deposits. Meanwhile, depressed investment conditions and the fact that the prime borrowers had access to capital from abroad in the form of GDRs, ADRs and ECBs implied less demand for credit from the preferred borrowers. In the circumstances, banks turned to relying on increasing certain forms of high-value lending such as consumer credit, and on safe government securities which offer relatively high rates of return because the interest rates on most government debt remained high.

This demand-driven process meant that bank holding of government securities increased substantially by the end of the decade, rising from an average of 26 per cent of total deposits at the beginning of the decade to an average of 34 per cent for the three closing years of the decade. Credit deposit ratios fell from the already low levels of the early 1990s, to abysmally low levels of just above 50 per cent. This is more than an interesting irony, given that the reduction of the Statutory Liquidity Ratio was a major plank of the domestic financial reforms. This measure was designed to free commercial banks from necessarily holding more than one-third of their assets in the form of government securities, since the SLR was lowered to 26 per cent in 1993. But by 2000-01, commercial banks were holding more than Rs. 100,000 crore as government securities. This amounted to 35 per cent of the deposits, which is well in excess of the minimum holding that was required, of 25 per cent, and back to the level that existed prior to the financial reform measures!

At the time when they were first implemented, these financial liberalization measures were widely described as working to increase the access of private borrowers to bank credit. Instead, banks voluntarily held government securities (for which the government paid much higher interest rates than earlier) and credit to the private sector was further reduced in proportion to deposits. This reflected the poor state of aggregate demand which in turn reduced the demand for credit from acceptable borrowers. So in practice this measure did not lead to greater access of the private sector to bank credit.

Homogenisation of financial sectors

Financial liberalization of the kind adopted in India not only results in changes in the mode of functioning and regulation of the financial sector, but a process of institutional change. It inevitably involves the reshaping of relatively “immature” financial systems in developing countries in the image of the increasingly ‘market-based’ systems characteristic of the developed capitalist world, especially the US. There are a number of implications of this process of institutional change. First, it implies that the role played by the pre-existing financial structure in developing countries, characterised by the presence

of state-owned financial institutions and banks, is substantially altered. In particular, the practice of directing credit to specific sectors at differential interest rates is undermined by reduction in the degree of pre-emption of credit through imposition of sectoral targets and by the use of state banking and development banking institutions as instruments for mobilising savings and directing credit to priority sectors at low real interest rates. The role of the financial system as an instrument for allocating credit and redistributing assets and incomes is also thereby undermined.

Second, by institutionally linking different segments of financial markets by permitting the emergence of universal banks or financial supermarkets of the kind referred to above, the liberalization process increases the degree of entanglement of different agents within the financial system and increases the impact of financial failure in units in any one segment of the financial system on agents elsewhere in the system.

Third, by allowing for the proliferation of financial institutions and instruments it not merely increases liquidity in the system but it also allows for an increase in the practice of risk transfer through processes such as securitization, especially credit risk transfer by banks. For example, in India, which has recently introduced interest rate futures, Citigroup has concluded three securitization deals worth Rs. 570 crore ($126.6 billion), where yields on government securities or the call money rate, are used as the benchmark for pricing floating rate payments for investors.[6] The underlying receivables arise from a large number of fixed rate loan contracts made for financing commercial vehicles and construction equipment. The risk here is being shared with mutual funds, who are reportedly the major investors.

Fourth, it allows for a process of segment-wise and systemic consolidation of the financial system, with the emergence of larger financial units and a growing role for foreign firms in the domestic financial market. This does mean that the implications of failure of individual financial agents for the rest of the financial system is so large that the government is forced to intervene when wrong judgments or financial malpractice results in the threat of closure of financial firms.

Institutional change and financial fragility

The above developments go contrary to the argument that liberalisation is a process of infusing competition into the financial sector and increasing the flexibility of individual institutions to respond to that competition. This changed competitive scenario is expected to lead to a greater degree of "efficiency" of the financial sector, resulting in a better allocation of investible resources, between alternative investment options.

One problem with this perception is that it privileges questions of allocative efficiency relative to those concerned with the factors determining the size of aggregate investment itself, especially in situations where resources are unemployed. In fact, investment increases in this perception because it erroneously expects increased efficiency to release "surplus" resources that in pre-Keynesian fashion would be automatically reinvested, leading to higher growth. In doing this, critics of financial liberalization argue, it reduces the investment and growth potential of the system, relative to what would prevail within a more interventionist regime.

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[6] Joshi, Anurag, "Citgroup securities deal benchmarking g-sec yield", **The Economic Times**, New Delhi, Friday 6 February 2004.

The more serious difficulty is that it fails to take account of the fact that the practice of rendering the financial structure more competitive through liberalization involves institutional changes that unleash a dynamic that endows the financial system with a poorly regulated, oligopolistic structure, which could increase the fragility of the system. Greater freedom to invest, including in sensitive sectors such as real estate and stock markets, ability to increase exposure to particular sectors and individual clients and increased regulatory forbearance all lead to increased instances of financial failure. In addition, by institutionally linking different segments of financial markets by permitting the emergence of universal banks or financial supermarkets, the liberalisation process increases the degree of entanglement of different agents within the financial system and increases the impact of financial failure in units in any one segment of the financial system on agents elsewhere in the system. Such possibilities are all the greater because liberalization implies a degree of regulatory forbearance of the kind described earlier.

Financial markets left to themselves are known to be prone to failure because of the public goods characteristics of information which agents must acquire and process (Stiglitz 1993, Rodrik 1998). They are characterised by insufficient monitoring by market participants. Individual shareholders tend to refrain from investing money and time in acquiring information about managements, hoping that others would do so instead and knowing that all shareholders, including themselves, benefit from the information garnered. As a result there may be inadequate monitoring leading to risky decisions and malpractice. Financial firms wanting to reduce or avoid monitoring costs may just follow other, possibly larger, financial firms in making their investments, leading to what has been observed as the “herd instinct” characteristic of financial players. This not merely limits access to finance for some agents, but could lead to overlending to some entities, failure of which could have systemic effects. The prevalence of informational externalities can create other problems. Malpractice in a particular bank leading to failure may trigger fears among depositors in other banks, resulting in a run on deposits there.

Disruptions may also occur because expected private returns differ from social returns in many activities. This could result in a situation where market-driven players take on unnecessary risks in search of high returns. Typical examples are lending for investments in stocks or real estate. Loans to these sectors can be at extremely high interest rates because the returns in these sectors are extremely volatile and can touch extremely high levels. Since banks accept real estate or securities as collateral, borrowing to finance speculative investments in stock or real estate can spiral. This type of activity thrives because of the belief that losses if any can be transferred to the lender through default, and lenders are confident of government support in case of a crisis. This could feed a speculative spiral that can in time lead to a collapse of the bubble and bank failures.

These kinds of tendencies effect real investment in two ways. First, inasmuch as speculative bubbles lead to financial crises, they squeeze liquidity, induce distress sales of assets and result in deflation, all of which adversely impacts on employment and living standards. Second, inasmuch as the maximum returns to productive investment in agriculture and manufacturing are limited, there is a limit to what borrowers would be willing to pay to finance such investment. Thus, despite the fact that social returns to agricultural and manufacturing investment are higher than that for stocks and real estate,

and despite the contribution that such investment can make to growth and poverty alleviation, credit at the required rate may not be available.

The point is that while financial liberalization leads to these kinds of macroeconomic risks, the evidence suggests that the expected microeconomic gains are not really realised. Even in the US, the role of stock markets as a source of capital was limited. Between 1970 and 1989, the ratio of profit retention, bank finance and bonds to the net sources of finance of non-financial corporations in the US amounted to 91.3, 16.6 and 17.1 per cent respectively. The contribution of equity was a negative 8.8 per cent. The first two of these sources played an overwhelming role even in the U.K. and Germany during this period. (Stiglitz 1993). Thus bond markets play a limited role and equity markets virtually no role at all in financing corporate investment in these countries. The stock market is primarily a site to exchange risks rather than raise capital for investment. In India too the new issues market is small or non-existent expect in periods of a speculative boom, and bank lending post-liberalisation privileges risky high-return investment rather than investment in the commodity producing sectors like manufacturing and agriculture. The effects on those sectors of liberalisation is indirect, being realised through the demand generating effects of housing and personal finance booms, which too in many circumstances tends to increase the fragility of the system.

The capital inflow effects of financial liberalization only aggravate these consequences of the institutional change component of the process. It does not just increase liquidity and permit access to funds that can be played with, it brings in players more adept at dealing with the opportunities offered by the new financial context. When the potential of financial failure becomes or threatens to become a reality, the funds dry up and capital flight occurs, increasing the intensity of the ensuing crisis. Capital controls seen as measures to control the volume and volatility of cross-border capital flows in a liberalized financial system, even if successful, do not deal with the essential fragility of the system. It can at most alleviate the intensity of crises.

Implications for the real economy

The institutional change associated with financial liberalization not merely increases financial fragility. It also dismantles financial structures that are crucial for economic growth. The relationship between financial structure, financial growth and overall economic development is indeed complex. The growth of output and employment in the commodity producing sectors depends on investment that expands capital stock. Traditionally, development theory had emphasized the role of such investment. It argued, correctly, that given production conditions, a rise in the rate of "real capital formation leading to an acceleration of the rate of physical accumulation", is at the core of the development process. Associated with any trajectory of growth predicated on a certain rate of investment is, of course, a composition or allocation of investment needed to realise that rate of growth given a certain access to foreign exchange.

Once the Keynesian Revolution popularised the notion that the lack of adequate financial savings cannot be the constraint on investment and growth, it appeared that the role of financial sector in mobilizing and channelling savings was secondary and inevitably fulfilled. As Joan Robinson put it: "Where enterprise leads, finance follows".

Conventionally, therefore, the issue of financing for development is a question of mobilising or creating real resources: of mobilising surplus labour (Nurkse *et. al.*); of overcoming the wage goods constraint (Kalecki); or of dealing with the problem that underdevelopment is in part the result of the lack of adequate capital stock to employ the labour force in full and the fact that this capital stock cannot be imported because of the foreign exchange constraint (Feldman/Mahalanobis). Finance in the sense of money or financial assets came in only when looking at the ability of the state to tax away a part of the surplus to finance its development expenditures, and the obstacles to deficit-financed spending, given the possible inflationary consequences if real constraints to growth were not overcome.

In this framework, the financial sector is seen as adjusting to the requirements of the real sector. However, if the financial sector is left unregulated, in economies with substantial private assets and an important role for private agents in investment decision-making, market signals would determine the allocation of investible resources and therefore the demand for and the allocation of savings intermediated by financial enterprises. This could result in the problems conventionally associated with a situation where private rather than overall social returns determine the allocation of savings and investment.

To start with, the allocation of investment may not be in keeping with that required to ensure a certain profile of the pattern of production, needed to raise the rate of saving and investment as emphasised by the Feldman-Mahalanobis model. An obvious way in which this happens is through inadequate investments in the infrastructural sector characterised most often by lumpy investments, long gestation lags, higher risk and lower profit. Given the "economy-wide externalities" associated with such industries, inadequate investments in infrastructure would obviously constrain the rate of growth.

While factors such as these could limit the rate of growth, the private-profit driven allocation of savings and investment could also affect variables such as the balance of payments, the employment elasticity of output growth, and the flow of credit to poverty-prone sectors, which also affect the pursuit and the efficacy of the poverty reduction effort. It could aggravate the inherent tendency in markets to direct credit to non-priority and import-intensive but more profitable sectors, to concentrate investible funds in the hands of a few large players and direct savings to already well-developed centres of economic activity.

Diversion of funds away from essential to luxury goods industries could result in or aggravate a wage goods constraint, leading to increases in the prices of wage goods that worsens income distribution and dampens the pace of poverty alleviation for any rate of growth. If, however, the government were to want to influence the sectors and agents to whom credit is directed and the prices at which such credit is to be provided, in order to realise a particular allocation of investment, a given rate of investment, and an income-wise and region-wise redistribution of incomes, it may choose to impose restrictions on the financial sector to realise these goals.

The importance of these features of financial policies from the point of view growth and poverty reduction cannot be overstressed. Further, even in developing countries which choose or are forced to choose a more mercantilist strategy of growth based on a rapid acquisition of larger shares in segments of the world market for manufactures, these

segments have not only to be identified by an agency with greater seeing power than individual firms, but that agency must ensure an adequate flow of cheap credit to these entities so that they can not only make investments in frontline technologies and internationally competitive scales of production, but also have the wherewithal to sustain themselves during the long period when they build goodwill in the market, which is a function of time. The state must not merely play the role of investment coordinator, but use the financial system as a means to direct investment to sectors and technologies at scales of production it considers appropriate. Equity investments, directed credit and differential interest rates are important instruments of any state-led or state-influenced development trajectory. Stated otherwise, although financial policies may not help directly increase the rate of savings and ensure that the available *ex ante* savings are invested, they can be used to influence the pattern of investment.

Such a framework is crucial because in a large number of developing countries development occurs in a mixed economy framework where private initiative and investment are significant. In others, the transition is ensuring a growing role for private agents. This implies that independent of whether the government adopts a strategy of growth based on the home market or one of protecting and building the home market while targeting in mercantilist fashion the world market, it would have to play a major role in: (i) channelling large volumes of cheap capital to the selected units: and (ii) using the leverage provided by this activity to coordinate and influence investment decisions across the industrial sector.

To play these roles the state would have to choose an appropriate institutional framework and an appropriate regulatory structure. That is the financial structure – the mix of contracts/instruments, markets and institutions – is developed keeping in mind its instrumentality from the point of view of the development policies of the state. The point to note is that this kind of use of a modified version of a historically developed financial structure or of a structure created virtually anew was typical of most late industrializing countries. Financial structures in these countries were created to deal with the difficulties associated with late industrial entry: capital requirements for entry in most areas were high, because technology for factory production had evolved in a capital-intensive direction from its primitive industrial revolution level; competition from established producers meant that firms had to concentrate on production for a protected domestic market or be supported with finance to survive long periods of low capacity utilisation during which they could find themselves a foothold in world markets. Not surprisingly, late industrialisers created strongly regulated and even predominantly state-controlled financial markets aimed at mobilising savings and using the intermediary function to influence the size and structure of investment. This they did through directed credit policies and differential interest rates, and the provision of investment support to the nascent industrial class in the form of equity, credit, and low interest rates.

By dismantling these structures financial liberalisation destroys an important instrument that historically evolved in late industrialisers to deal with the difficulties of ensuring growth through the diversification of production structures that international inequality generates. This implies that financial liberalisation is likely to have depressing effects on growth through means other than just the deflationary bias it introduces into countries opting for such liberalization.

Indian Banking in transition

The fact that such structures are being dismantled is illustrated by the transition in Indian banking driven by a change in the financial and banking policy regime of the government. The shift in regime is justified on three grounds. The first is that the practices of pre-empting bank resources and directing them to chosen sectors at controlled interest rates leads to financial repression that is not conducive to growth and development. The second is that the banking sector that had evolved under a regime which considered it an instrument to achieve varied development goals is now populated by non-competitive agents (burdened with non-performing assets) that survive because of state support and is incapable of "efficiently" mobilising savings and channelling it to the best possible uses. And third, that, while changes in technology and the inevitable process of globalisation are transforming the nature of banking, banks that grew under the old policy regime are unable to restructure themselves to face up to the new situation.

Arguments of this kind present the change in banking policy as being motivated by the need to correct for the inadequacies and failures of the earlier regime. Nobody can hold that the banking system as it evolved in the post-Independence period was perfect and flawless. However, it would be a travesty of the truth to hold that the sector is a moribund structure which is not contributing to development and is surviving on life support from the government. On the contrary, there is evidence to suggest that it is the change in banking policy currently underway that is eroding the role of the banking sector as an instrumentality for more rapid and broad-based development. The change also seems to be worsening the difficulties being faced by domestic banks and creating new ones, leading to an increase in fragility. Above all, there is a danger that banking "reform" is paving the way for a decline of domestic control over banking operations as a result of international takeovers, with attendant adverse implications for economic sovereignty.

The Consequences of Banking Reform

The changes introduced by banking obviously impinge upon the nature of the institutions, operations and instruments that constitute the sector. Institutional changes include: a rapid increase in the number of new private sector banks; a process of consolidation of banks that thus far has principally affected the private banking sector but is now being consciously promoted in the public sector as well; privatization of equity in public sector banks; mergers of banks and other financial institutions, particularly development banking institutions; and the creation of universal banks that are in the nature of financial supermarkets, offering customers a range of products from across the financial sector such as debt products, investment opportunities in equity, debt and commodity markets and insurance products of different kinds.

Implicit in these institutional changes are changes in the operations of the increasingly "universalized" banks. The most crucial change, as noted earlier, has been an increasing reluctance of banks to play their traditional role as agents who carry risks in return for a margin defined broadly by the spread between deposit and lending rates. Given this crucial role of intermediation conventionally reserved for the banking system, the regulatory framework which had the central bank at its apex, sought to protect the banking system from possible fragility and failure. That protective framework across the globe involved regulating interest rates, providing for deposit insurance and limiting the areas of activity and the investments undertaken by the banking system. The

understanding was that banks should not divert household savings placed in their care to risky investments promising high returns. In developing countries, the interventionist framework also had developmental objectives and involved measures to direct credit to what were "priority" sectors in the government's view.

In India, this process was facilitated by the nationalization of leading banks in the late 1960s, since it would have been difficult to convince private players with a choice of investing in more lucrative activities to take to a risky activity like rural banking where returns were regulated. Nationalization was therefore in keeping with a banking policy that implied pre-empting banking resources for the government through mechanisms like the statutory liquidity ratio (SLR), which defined the proportion of deposits that need to be diverted to holding specified government securities, as well as for priority sectors through the imposition of lending targets. An obvious corollary is that if the government gradually denationalizes the banking system, its ability to continue with policies of directed credit and differential interest rates would be substantially undermined.

"Denationalization", which takes the form of both easing the entry of domestic and foreign players as well as the disinvestment of equity in private sector banks, forces a change in banking practices in two ways. First, private players would be unsatisfied with returns that are available within a regulated framework, so that the government and the central bank would have to dilute or dismantle these regulatory measures as is happening in the case of priority lending as well as restrictions on banking activities in India. Second, even public sector banks find that as private domestic and foreign banks, particularly the latter, lure away the most lucrative banking clients because of the special services and terms they are able to offer, they have to seek new sources of finance, new activities and new avenues for investments, so that they can shore up their interest incomes as well as revenues from various fee-based activities.

In sum, the processes of liberalization noted above fundamentally alter the terrain of operation of the banks. Their immediate impact is visible in a shift in the focus of bank activities away from facilitating commodity production and investment to lubricating trade, financing house construction and promoting personal consumption. According to the study *Consumer Outlook 2004*, conducted by market research firm KSA Technopak, Indian consumers no longer fear taking credit for financing purchases of durable consumption goods. "Personal credit offtake has increased from about Rs 50,000 crore in 2000 to Rs 1,60,000 crore in 2003, giving an unprecedented boom to high-ticket item purchases such as housing and automobiles," the study reportedly found.[7]

But there are changes also in the areas of operation of the banks, with banking entities not only creating or linking up with insurance companies, say, but also entering into other "sensitive" markets like the stock and real estate markets. The exposure of banks to the stock market occurs in three forms. First, it takes the form of direct investment in shares, in which case, the impact of stock price fluctuations directly impinge on the value of the banks' assets. Second, it takes the form of advances against shares, to both individuals and stock brokers. Any fall in stock market indices reduces, in the first instance, the value of the collateral. It could also undermine the ability of the borrower to clear his dues. To

[7] Bhattacharya, Sindhu J. (2004), "They want more ", **The Hindu Business Line**, August 19 retrieved from http://www.blonnet.com/catalyst/2004/08/19/stories/2004081900200100.htm February 4, 2005.

cover the risk involved in such activity banks stipulate a margin, between the value of the collateral and the amounts advanced, set largely according to their discretion. Third, it takes the form of "non-fund based" facilities, particularly guarantees to brokers, which renders the bank liable in case the broking entity does not fulfil its obligation.

The effects of this on bank fragility became clear after the 2000 scam. The RBI's Monetary and Credit Policy Statement for the year 2001-2002 had noted that: "The recent experiences in equity markets, and its aftermath, have thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It has become evident that certain banks in the cooperative sector did not adhere to their prudential norms nor to the well-defined regulatory guidelines for asset-liability management nor even to the requirement of meeting their inter-bank payment obligations. Even though such behaviour was confined to a few relatively small banks, by national standards, in two or three locations, it caused losses to some correspondent banks in addition to severe problems for depositors." Since that initial assessment, the experience with the enforced closure-cum-merger of banks such as Nedungadi Bank and Global Trust Bank suggest that the problem did not remain confined to "a few relatively small (cooperative) banks" in a few locations.

Finally, the process of liberalization has resulted in the emergence of new instruments in the banking sector. Derivatives of different kinds are now traded in the financial system. But from the point of view of the transformation of banking what are of significance are credit derivatives. Most derivatives, financial instruments whose value is based on or derived from the value of something else, are linked to interest rates or currencies. Credit derivatives are based on the value of loans, bonds or other lending vehicles.

Credit derivatives are seen as helping banks manage the risk arising from adverse movements in the quality of their loans, advances, and investments by transferring that risk to a protection seller. Using credit derivatives banks can: (1) transfer credit risk and, hence, free up capital, which can be used in other opportunities; (2) diversify credit risk; (3) maintain client relationships, and (4) construct and manage a credit risk portfolio as per their risk preference. It should be expected that as banking activity increases the fragility of the banking system, the reliance on credit derivatives to hedge against growing risk would increase.

Following market sentiment, a working group of the Reserve Bank of India had recommended in 2003 that scheduled commercial banks may be permitted to use credit derivatives only for managing their credit risks, but not for trading purposes. Banks in India have quickly responded to this opportunity.

Changes in Banking Practices

Financial reforms have also resulted in a disturbing decline in credit provision. The first of these has been visible evidence of these banks turning reticent in undertaking their principal task, that of intermediation. Reform, through its stress on reducing the pre-emption of bank assets in the form of the cash reserve ratio, the statutory liquidity ratio and directed credit programmes, was expected to substantially increase access to credit for commercial borrowers in the system.

Interestingly, however, following the reforms, the credit deposit ratio of commercial banks as a whole declined substantially from 65.2 per cent in 1990-91 to 49.9 per cent in

2003-4, despite a substantial increase in the loanable funds base of banks through periodic reductions in the CRR and SLR by the RBI starting in 1992. It could, of course, be argued that this may have been the result of a decline in demand for credit from creditworthy borrowers in the system. However, three facts appear to question that argument. The first is that the decrease in the credit deposit ratio has been accompanied by a corresponding increase in the proportion of risk free government securities in the banks major earning assets i.e. loans and advances, and investments. Table 4 reveals that the investment in government securities as a percentage of total earning assets for the commercial banking system as a whole was 26.13 per cent in 1990-91. But it increased to 32.4 per cent in 2003-04. This points to the fact that lending to the commercial sector may have been displaced by investments in government securities that were offering relatively high, near risk-free returns.

Table 4: Credit Deposit Ratio and Investment in Government Securities as percentage of Total Earning Assets during 1990-91 to 2003-04 (For scheduled commercial banks)

Year	Credit Deposit Ratio	Investment in Govt. Securities (as percentage to total earning assets)
1990-91	65.2	26.13
1991-92	60.6	29.06
1992-93	58.9	29.47
1993-94	55.5	34.08
1994-95	61.6	32.61
1995-96	58.2	31.57
1996-97	55.1	33.88
1997-98	53.5	34.4
1998-99	51.7	33.8
1999-00	53.6	33.4
2000-01	53.1	33.2
2001-02	53.4	28.1
2002-03	78.6	31.6
2003-04	49.9	32.4

Source: Estimated from various issues of Performance Highlights of Banks in India, IBA and Report on Trend and Progress of Banking in India, RBI.

Second, under pressure to restructure their asset base by reducing non-performing assets, public sector banks may have been reluctant to take on even slightly risky private sector exposure that could damage their restructuring effort. This possibly explains the fact that

the share of public sector banks in 2002-3 in total investments in government securities of the scheduled commercial banks was very high (79.17 per cent), when compared with other sub-groups like Indian private banks (13.41 per cent), foreign banks (5.7 per cent) and RRBs (1.74 per cent).[8]

Finally, with all banks now being allowed greater choice in terms of investments, including corporate commercial paper and equity, even private banks in search of higher profitability would have preferred investments rather than lending. The observed rise in investments by banks would be partly due to bank preference for credit substitutes.

This increased attraction of government securities in comparison to loans and advances in the reform period points to the growing risk-aversion on the part of banks, which might have resulted from the increasingly stringent prudential regulations such as income recognition, asset classification, provisioning, capital adequacy norm, etc. that have been implemented since 1992. It needs to be noted here that government securities were classified as risk-free and thus did not carry any provisioning requirements. Investment in government securities also carried the advantage of requiring a lower amount of capital to be set aside to fulfil capital adequacy norms (due to lower risk) and also not requiring provisions for bad loans. For instance, while the risk-weightage assigned to government securities in the capital to risky assets ratio was zero, regular balances were assigned a weightage of 100 per cent with the exception for some advances such as loans guaranteed by government of India and state governments (weightage 0), loans guaranteed by DICGC/ECGC to the extent of insurance cover available (weightage 50), advances against own bank deposits (weightage 0) and advances to bank staff (weightage 0). Further, in a regime of stringent provisioning for non-performing assets, the ineffective and cumbersome recovery systems for defaulting borrowers were also discouraging banks from making loans that involve even a moderate risk of non-recovery. Finally, the preference for government securities was also driven by the reduction in the wedge between the return on loans to firms and individuals and the return on government securities in recent years. (Jayati Sarkar and Pradeep Agarwal, 1997).

FDI in banking

Another major and controversial area of reform has been with respect to foreign ownership in banking. In February, 2005, the Reserve Bank at the instance of the Finance Minister, released a roadmap for the presence of foreign banks in India. The RBI notification formally adopted the guidelines issued by the Ministry of Commerce and Industry almost a year earlier, 2004 which had raised the FDI limit in Private Sector Banks to 74 per cent under the automatic route, and went on to spell out the steps that would operationalize these guidelines.

The RBI roadmap demarcates two phases for foreign bank presence. During the first phase, between March 2005 and March 2009, permission for acquisition of share holding in Indian private sector banks by eligible foreign banks will be limited to banks identified by RBI for restructuring. RBI may, if it is satisfied that such investment by the foreign bank concerned will be in the long term interest of all the stakeholders in the investee bank, permit such acquisition subject to the overall investment limit of 74 percent of the

[8] Bank group-wise Liabilities and Assets of SCBs in Statistical Tables relating to Banks in India, RBI, 2002-3.

paid up capital of the private bank. *Appropriate amending legislation will also be proposed to the Banking Regulation Act, 1949, in order to provide that the economic ownership of investors is reflected in the voting rights.* Further, the notification announces that foreign banks will be permitted to establish presence by way of setting up a wholly owned banking subsidiary (WOS) or conversion of the existing branches into WOS. A clause on one-mode-presence, i.e. one form of banking presence, either as branches or as WOS or as a subsidiary with a foreign investment in a private bank, has been added as the only safeguard against concentration. There are no caps specified for individual ownership (except the 74 per cent overall limit), which in the first phase would be left to RBI's discretion.[9]

The second phase will commence on April 2009 after a review of the experience of the first phase. This phase would allow much greater freedom to foreign banks. It would extend national treatment to WOS, permit dilution of stake of WOS and allow mergers/acquisitions of any private sector banks in India by a foreign bank subject to the overall investment limit of 74 percent.

While there was no specific policy announcement on consolidation of banks, the other major focus area of the reformers, the notification made it clear that foreign bank presence and consolidation of banking were part and parcel of the two-track approach for `further enhancing efficiency and stability to the best global standards.'

`One track is consolidation of the domestic banking system in both public and private sectors. The second track is gradual enhancement of the presence of foreign banks in a synchronised manner. The policy decisions announced on March 5, 2004 on FDI, FII and the presence of foreign banks will be implemented in a phased manner. This will also be … consistent with India's commitments to the WTO.'[10]

In fact, over the past years a number of foreign banks have already evinced an interest in acquiring a stake in Indian banks. Bank Brussels Lambert, a subsidiary of the Dutch ING group, expressed intent to take control of Vysya Bank. BBL currently holds a 20 per cent stake in Vysya Bank. The promoters of Global Trust Bank are believed to have approached ABN Amro Bank, to sell more than 26 per cent stake held by them in the bank. Citibank and ABN Amro are reportedly negotiating for a stake in Bank of Punjab. And, Citibank, ABN Amro and HSBC have been eyeing a stake in Centurion Bank.

There are a number of implications of such an expansion of foreign presence. To start with, even with the diluted regulation that currently is in place, it is clear that private banks in general and foreign banks in particular have been lax in meeting regulatory norms. The takeover trend would result in a sharp reduction in the extent of regulation of

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[9] Para 2.4 of RBI Press Release, Road map for presence of foreign banks in India, 28th February, 2005. says, **"**In considering an application made by a foreign bank, for acquisition of 5 % or more in the private bank, RBI will take into account the standing and reputation of the foreign bank, globally as well as in India, and the desired level and nature of presence of the foreign bank in India. RBI may, if it is satisfied that such investment by the foreign bank concerned will be in the long-term interest of all the stakeholders in the investee bank, permit acquisition of such percentage as it may deem fit. The RBI may also specify, if necessary, that the investor bank shall make a minimum acquisition of 15 per cent or more and may also specify the period of time for such acquisition. The over all limit of 74 per cent will be applicable."

[10] ***RBI Press Release, Road map for presence of foreign banks in India, 28th February, 2005.***

banking sector operations by the RBI. The implications of this for the priority sectors, especially agriculture can be quite damaging. Second, the expansion in foreign bank presence, by subjecting public sector banks to unfair comparisons of "profitability" and "efficiency", would force these banks to change their lending practices as well.

The difficulty is, faced with the demands made on them by the advocates of liberalization and the effects of competition from the private sector banks, banks in the public sector are also being forced to change. Public sector banks that account for 79.5 per cent of total assets of all commercial banks earn only 67.2 per cent of aggregate net profits, whereas the older private sector banks with 6.5 per cent of total assets earn 8.1 per cent of aggregate net profits, the new private sector banks with 6.1 per cent of assets obtain 10 per cent of the aggregate net profits and foreign banks with just 7.9 per cent of total assets garner 14.7 per cent of aggregate net profits.

Among the factors that account for this differential in profitability, there are two that are important. One is that the operating expenses for a given volume of business tend to be higher with public sector banks. The other is that income generated out of a given volume of business tends to be lower in the case of the public sector banks. These are the two areas in which changes are being made as part of the effort of the public sector banks to "match up" to the performance of private domestic and foreign banks. The expansion of foreign presence would only accelerate this tendency.

Neoliberal Banking Reform and Credit Delivery

The effects of neoliberal banking reform on pattern of credit delivery in India are now quite clear. Since 1991 there has been a reversal of the trends in the ratio of directed credit to total bank credit and the proportion thereof going to the agricultural sector, even though there has been no known formal decision by government on this score. At the same time, serious attempts have been made in recent years to dilute the norms of whatever remains of priority sector bank lending.

Since the mid-1960s, credit has been seen as an important instrument of development policy in India. The agrarian crisis of 1964-66, the industrial deceleration and overall economic stagnation that followed and the political instabilities these generated, brought home the point that crucial institutional constraints to growth had not been addressed during the early planning years. This had not only resulted in a development impasse, but necessitated attention to the deep inequities that characterised whatever development that had occurred.

Though this realisation did not trigger any fundamental institutional reform, such as the redistribution of land, it ensured the adoption of at least some much-needed policy initiatives, among which was a programme of priority sector lending. It was clear by then that India's then predominantly privately owned banking system was not geared to or interested in delivering credit to a range of sectors outside of large industry. Influenced by the fact that credit was an important component of the Green Revolution "package" aimed at stimulating agricultural growth, and confronted by the sectoral and unit-wise concentration of credit delivery, a decision was taken in 1967-68 to consciously direct credit to priority sectors such as agriculture, small-scale industry and exports.

After 1969, when 14 major commercial banks were nationalised, the government went much further in this direction. In the event, the priority sector was defined to include

Agriculture, Small Scale Industry, Small Road and Water Transport Operators, Retail Trade, Small Business, Professional and Self Employed Persons, State sponsored schemes for Scheduled Castes/Scheduled Tribes, Education, Housing and Consumption.

However, among these sectors the emphasis was to be on agriculture, small industry and small business. At present, the programme requires that priority sector advances should constitute 40 per cent of net bank credit (NBC) of domestic banks. The sub-target for the agricultural sector stands at 18 per cent of total advances. Further, 60 per cent of advances to the small scale sector are expected to be directed to the tiny sector. And, 10 per cent of net bank credit has to be directed towards weaker sections. (The requirement set for foreign banks was lower—at 32 per cent—and the sectoral composition too was more lenient.)

However, over the last decade, financial liberalisation has been diluting the directed credit programme. While the authorities have allowed the target for priority sector lending to remain unchanged, they have widened its coverage. At the same time, shortfalls relative to targets have been overlooked. In agriculture, both direct and indirect advances to agriculture were clubbed together for meeting the agricultural sub-target of 18 per cent in 1993, subject to the stipulation however that "indirect" lending to agriculture must not exceed one-fourth of that lending sub-target or 4.5 per cent of net bank credit. It was also decided to include indirect agricultural advances exceeding 4.5 per cent of net bank credit into the overall target of 40 per cent. The definition of priority sector itself was also widened to include financing of distribution of inputs for agriculture and allied sectors with the ceiling raised to Rs. 5 lakh initially and Rs. 15 lakh subsequently. Further, financing of distribution of inputs for allied activities such as dairy, poultry and piggery up to Rs. 5 lakh were also made eligible for treatment as indirect agricultural advances. Finally, the scope of direct agricultural advances under priority sector lending was widened to include all short-term advances to traditional plantations including tea, coffee, rubber, and spices, irrespective of the size of the holdings.

So far as small scale industries were concerned, the authorities extended the coverage for priority sector lending by re-defining it in terms of the level of investments in plant and machinery together with an increase in working capital limits. Initially, the SSI sector included those industries whose investment and machinery did not exceed Rs. 35 lakh. In the case of ancillary units, the investment limit was Rs. 45 lakh. In May, 1994, these limits were raised to Rs. 60 lakh and Rs. 70 lakh respectively. This has gone up to Rs. 3 crore in some cases. All advances to SSIs as per revised definition were to be treated as priority sector advances which indirectly encouraged term finance loans.

Apart from this, there were also totally new areas under the umbrella of priority sector for the purpose of bank lending. In 1995-96, the Rural Infrastructural Development Fund (RIDF) was set up within NABARD and it was to start its operation with an initial corpus of Rs. 2000 crore. Public sector banks were asked to contribute to the fund an amount equivalent to their short fall in priority sector lending, subject to maximum of 1.5 per cent of their net credit. Public sector banks falling short of priority targets were asked to provide Rs. 1000 crore on a consortium basis to the Khadi and Village Industries Commission (KVIC) over and above what banks were lending to handloom co-operatives and the total amount contributed by each bank was to be treated as priority sector lending.

The outcome of these new policy guidelines could not but be that banks defaulting in meeting the priority sector sub-target of 18 per cent of net credit to agriculture, would make good the deficiency by contributing to RIDF and the consortium fund of KVIC.

Another method to avoid channelling of credit to priority sectors has been to ask banks to make investments in special bonds issued by certain specialised institutions and treat such investments as priority sector advances. In 1996, the RBI asked the banks to invest in State Financial Corporations (SFCs), State Industrial Development Corporations (SIDCs), NABARD and the National Housing Bank (NHB). Investments made by banks in special bonds issued by these agencies were also to be treated as priority sector advances. The changes thus made in the policy guidelines on the subject of priority sector lending were obviously meant to enable the banks to move away from the responsibility of directly lending to the priority sectors of the economy.

Yet, special targets for the principal priority areas have been missed. Thus, during the period 2001-04, the total outstanding credit to the agricultural sector extended even by public sector banks was within the range of 15-16 per cent of NBC as against the target of 18.0 per. Though in respect of private sector banks, the ratio of agricultural credit to NBC increased from 7.1 per cent to 11.8 per cent, it still was below target.

Further with banks allowed to lend to seed and input supplying companies or invest in RIDF bonds, the share of direct finance to agriculture in total agricultural credit declined from 88.2 per cent in 1995 to 71.3 percent in 2004. The share of credit for distribution of fertilizers and other inputs which was at 2.2 per cent in 1995 increased to 4.2 per cent in 2004 and the share of other types of indirect finance from 4.8 per cent to 21.0 per cent. Further, credit to the SSI sector as a percentage of NBC declined from 13.8 per cent to 8.2 per cent. Much of this credit went to larger SSI units, as suggested by the fact that the number of SSI accounts availing of banking finance declined from 29.6 lakh to 18.1 lakh.

The most disconcerting trend was the sharp rise in the role of the “other priority sector” in total priority sector lending. This sector includes: loans up to Rs. 15 lakh in rural/ semi-urban areas, urban and metropolitan areas for construction of houses by individuals; investment by banks in mortgage backed securities, provided they satisfy conditions such as their being pooled assets in respect of direct housing loans that are eligible for priority sector lending or are securitised loans originated by the housing finance companies/banks; and loans to software units with credit limit up to Rs. 1 crore. Not surprisingly, the ratio of “other priority sector” lending to net bank credit rose from 7.4 per cent in 1995 to 17.4 per cent in 2005.

In sum, the principal mechanism of directed credit to the priority sector that aimed at using the banking system as a instrumentality for development is increasingly proving to be a casualty of the reform effort.

Credit to Agriculture and Small-scale Industries

The functioning of the system of credit delivery by scheduled commercial banks, the largest component of the financial sector in India, is a good example of the extent and nature of the neglect of agriculture, small-scale industries and small borrowers, the correction of which is most crucial (Shetty 2004). A large-scale study undertaken by the EPW Research Foundation on sector-wise, state-wise and district-wise spread of commercial banking in India (including Regional Rural Banks) for 32 years from 1972 to

2003 has yielded extremely significant information in this regard. The neglect of the informal sectors since the 1990s appears glaring when juxtaposed against the achievements made in the 1970s and 1980s after bank nationalization.

The share of agriculture in total bank credit had steadily increased under impulse of bank nationalization and reached 18 per cent towards the end of the 1980s, but thereafter the achievement has been almost completely reversed and the share of the agricultural sector in credit has dipped to less than 10 per cent in the late 1990s—a ratio that had prevailed in the early 1970s. Even the number of farm loan accounts with scheduled commercials banks has declined in absolute terms from 27.74 million in March 1992 to 20.84 million in March 2003.

Similarly, the share of small-scale industry accounts and their loan amounts in total bank loans has fallen equally drastically. The number of accounts has dropped from 2.18 million in March 1992 to 1.43 million in March 2003, and the amount of credit as a percentage of the total has slumped from 12 per cent to 5 per cent, that is, less than one-half of what it was three decades ago, that is, in the early 1970s.

The neglect of agriculture, small-scale industries and other informal sectors is reflected in the sharp bias against small-sized borrowers. A distinct feature of the credit delivery record in the 1990s has been the persistent and drastic decline in the number and amounts of small loan accounts. As depicted in Table 10, the number of small borrowal accounts with credit limit of Rs 25,000 or less had reached 62.55 million in March 1992, but it was followed by a steep downward trend to reach 36.87 million—a loss of nearly 26 million accounts or 60 per cent by March 2003. Correspondingly, their credit outstanding as a proportion of total bank credit has fallen form over 25 per cent in the late 1980s to 5.4 per cent in March 2003.

This had important implications for borrowers in rural areas and those engaged in agriculture. In 1993 agriculture was the main occupation of 42.4 per cent of borrowers who had availed of credit under this facility. The distribution of this category of accounts by population groups showed that 49.2 per cent of the credit below Rs. 25,000 was availed of in the rural areas basically for agricultural activities as against only 14.6 per cent in urban areas.

When reporting data collected through its Basic Statistical Returns (BSR), the RBI has periodically revised the ceiling credit limit for what is defines as Small Borrowal Accounts (SBAs). The cut-off point, which was set at Rs. 10,000 at the time of inception of the BSR in 1972 was revised upwards to Rs. 25,000 effective from June 1984 and Rs. 2 lakh effective from March 1999 (March 2002 in the case of Regional Rural Banks). Even in 2001, by when the cut-off limit had been raised to Rs. 2 lakh, nearly two-fifths of the small borrowal accounts (38.8 per cent) were from agriculture, which accounted for 32.1 per cent of the credit outstanding in such accounts. The change in the nature of banking activity is partly reflected in the fact that personal loans accounted 30.9 per cent of SBAs and 36.7 per cent of outstanding credit. The average outstanding loan per small borrowal account was the lowest for agriculture at Rs.17,435 while it was Rs.23,284 for transport operators, Rs. 20,719 for industry and Rs.25,004 for personal loans.

It must be noted, however, that even in 2001 about two-fifths (39.3 per cent) of the small borrowal accounts were sanctioned under various loan schemes of the Government and

claimed about one-third (30.5 per cent) of the amount outstanding. The Integrated Rural Development Programme (IRDP) was the largest loan scheme forming about one-sixth (16.6 per cent) of the small borrowal accounts and accounting for 6.9 per cent of the amount outstanding. Accounts under the Prime Minister's Rojgar Yojna (PMRY) were fewer in number (2.4 per cent) with a 4.2 per cent share in the amount outstanding. Thus the collapse of the share of credit provided through small borrowal accounts during the 1990s would have adversely affected rural development and employment generation.

This EPWRF study provides a vast number of other details on interregional state-level and district-level disparities in the development of scheduled commercials banks. As summarized in Table 7, some achievements made in the post-nationalization period in improving credit-deposit rations of underdeveloped states have been reversed rather sharply in the 1990s. This is so even when based on utilization of bank credit (sanctioned in one place but utilized in another based on location of economic activities).

Table 7: Credit-Deposit Ratios of Selected States

	C-D Ratio as per Sanction of Credit				C-D Ratio as per Utilisation of Credit			
State	**1980**	**1990**	**2000**	**2003**	**1980**	**1990**	**2000**	**2003**
Rajasthan	67.4	57.3	46.7	50.8	72.8	61.5	50.1	55.3
Bihar	41.2	36.8	22.5	23.1	49.3	39.0	23.2	23.7
Orissa	58.5	90.0	41.5	48.2	66.1	92.5	42.8	56.9
West Bengal	61.4	56.8	45.5	47.9	56.1	53.9	44.9	50.0
Madhya Pradesh	55.2	66.1	49.1	46.6	57.6	68.1	52.5	51.7
Uttar Pradesh	43.2	40.0	28.2	30.6	46.7	43.1	30.9	36.0

Source: Shetty (2004)

Impact on Development Banking

Besides adversely affecting rural income and employment growth, the reforms can be expected to impact adversely on private investment by damaging the structure of development banking itself. On March 30 2002, the Industrial Credit and Investment Corporation of India (ICICI) was, through a reverse merger, integrated with ICICI Bank. That was the beginning of a process that is leading to the demise of development finance in the country. The reverse merger was the result of a decision (announced on October 25, 2001) by ICICI to transform itself into a universal bank that would engage itself not only in traditional banking but investment banking and other financial activities. The proposal also involved merging ICICI Personal Financial Services Ltd and ICICI Capital Services Ltd with the bank, resulting in the creation of a financial behemoth with assets of more than Rs 95,000 crore. The new company was to become the first entity in India to serve as a financial supermarket and offer almost every financial product under one roof.

Since the announcement of that decision, not only has the merger been put through, but similar moves are underway to transform the other two principal development finance institutions in the country, the Industrial Finance Corporation of India (IFCI), established in 1948, and the Industrial Development Bank of India (IDBI), created in 1964. In early February 2004, Finance Minister Jaswant Singh, announced the government's decision to merge the IFCI with a big public sector bank, like the Punjab National Bank. Following that decision, the IFCI board approved the proposal, rendering itself defunct.

Finally, the Parliament approved the corporatisation of the IDBI, paving the way for its merger with a bank as well. IDBI had earlier set up IDBI Bank as a subsidiary. However, the process of restructuring IDBI has involved converting the IDBI Bank into a stand alone bank, through the sale of IDBI's stake in the institution. Now IDBI has been merged with IDBI bank. With this creation of a universal bank as a new entity, that has multiple interests and a strong emphasis on commercial profits, it is unclear how the development banking commitment can be met.

These developments on the development banking front do herald a new era. An important financial intervention adopted by almost all late-industrialising developing countries, besides pre-emption of bank credit for specific purposes, was the creation of special development banks with the mandate to provide adequate, even subsidised, credit to selected industrial establishments and the agricultural sector. According to an OECD estimate quoted by Eshag (1983), there were about 340 such banks operating in some 80 developing countries in the mid-1960s. Over half these banks were state-owned and funded by the exchequer, the remainder had a mixed ownership or were private. Mixed and private banks were given government subsidies to enable them to earn a normal rate of profit.

The principal motivation for the creation of such financial institutions was to make up for the failure of private financial agents to provide certain kinds of credit to certain kinds of clients. Private institutions may fail to do so because of high default risks that cannot be covered by high enough risk premiums because such rates are not viable. In other instances failure may be because of the unwillingness of financial agents to take on certain kinds of risk or because anticipated returns to private agents are much lower than the social returns in the investment concerned.

It must be said that development banks have played an important role in the Indian context. In his deposition before the Parliamentary Standing Committee on Finance 1999-2000 (Standing Committee on Finance 2000), on 18 September 2000, the Managing Director of ICICI stated: "disbursement by FIs constituted around fifty per cent of gross fixed capital formation by the private corporate sector in the pre-liberalised era. If you see the financial institutions disbursement versus bank credit to industry right from 1951 to the last year, we see that financial institutions have provided significantly more credit for creation of capital in industry in India. It has grown year after year … thus, the FIs have played a pivotal role in the development of Indian industry and have fulfilled their initial objective i.e. to spur industrialisation in the country over the last three to four decades."

The corporatisation, transformation into universal banks and subsequent privatisation of the DFIs is bound to undermine this role of theirs. The justification for the conversion to universal banking as provided by the Industrial Investment Bank of India (IIBI) in a written reply to the Parliamentary Standing Committee indicates this: "Since compartmentalisation of activities leads to greater transactions cost and inefficiency, no financial intermediary can survive competition if it does not allow itself flexibility to change. In the new financial environment, IIBI is of the opinion that a financial player may be either placed naturally for resources like a commercial bank, or may be a pure financial service provider and retailer like the NBFCs. Still another option is to build a financial supermarket where all the services are available under a single umbrella. The advantages are that they would be free to choose the product mix of their operations and configure activities for optimum allocation of their resources."

The CEO of ICICI made clear what this means in terms of emphasis: "When we were set up, our role was to meet long term resource requirements of the industry. With liberalisation the role has slightly changed. It became developing India's debt market, financing India's infrastructure development, etc. With globalisation, I think, the role is set to change further. Now we have to stress on profitability, shareholder value, corporate

governance, while at the same time not losing sight of our goals – the goals that were originally set for us – and the goals that were set up in the interim with liberalisation." Unfortunately, the emphasis on those goals would remain only with regulation. But regulation is diluted by liberalisation.

There is another way in which the gradual dissolution of the core of India's development banking infrastructure is related to the process of liberalisation. This was the effects of liberalisation on the profitability of an institution like the IFCI, for example. According to the D. Basu Expert Committee, which was appointed by IFCI's governing board to examine the causes of the large NPAs accumulated by the institution and suggest a restructuring, immediately following its corporatisation and initial public offering in 1993, IFCI embarked upon a programme of rapid expansion of business. To scale up the volume of business it increasingly raised resources from the debt markets. This was at a time when interest rates were relatively high. In order to cover the high cost borrowings, the institution was forced to make investments in what were considered high yielding loan assets.

Unfortunately, this occurred at a time when financial liberalisation had put an end to the traditional consortium mode of lending, in which all major financial institutions collaborated in lending to a single borrower as per a mutually agreed pattern of sharing. Liberalisation was introducing an element of competition among financial institutions. In the event, in search of high returns IFCI chose to take relatively large exposures in several greenfield projects (notably in the steel and oil sectors).

For a number of reasons these projects did not deliver on their promise. Many of these projects had expected to raise substantial equity from the capital market as well as from the internal resources of group companies. Depressed conditions in the capital market put paid to the first. Recessionary conditions limited the second. Many of these groups were in the traditional commodity sectors such as iron and steel, textiles, synthetic fibres, cement, sugar, basic chemicals, synthetic resins, plastics, etc. Besides the general recessionary environment, some of these sectors were particularly affected by the abolition of import controls and the gradual reduction of tariffs. Internal resource generation, therefore, fell short of expectations. As a result, with inadequate own-financing, many of these projects suffered from cost- and time-overruns.

Unlike other financial institutions, IFCI had not diversified into other types of businesses. Project finance still accounted for 94 per cent of IFCI's business assets. As a result, the impact of NPAs arising from the factors cited above was the greater in the case of IFCI than in the case of other institutions. In addition, there was sharp rise in IFCI's gross NPA level in 1998-99 (Rs 5,783.56 crore as against Rs 4,159.84 crore in the previous year) as a result of the implementation of the mandatory Reserve Bank of India guidelines for classifying non-performing assets. In the event, certain loans, particularly those relating to projects under implementation, which had been treated as performing assets in earlier years, had to be classified as non-performing.

The Basu Committee had noted that some of the factors referred to above such as impact of trade policy liberalisation and tariff reduction, recessionary conditions in the late 1990s, depressed conditions in the capital market, etc, affected other DFIs and banks as well. However, the impact was particularly pronounced in the case of IFCI, as the

concentration of risk relative to net worth was much higher. Also, as already stated, other DFIs had started diversifying into non-project related lending and business. It was difficult to survive as a development finance institution in the new environment. Thus the decline of development finance is clearly related to the process of economic liberalisation.

Financial Reform and Bank Fragility

While the process of reforms is damaging "development banking", another area of concern is the structural change it has wrought in the financial sector that has substantially increased its fragility.

The reform initiatives, as has been partly delineated above, had an immediate impact on the functioning of banks, with banks choosing to modify their credit portfolio and diversify out of their overwhelmingly dominant role as credit-providing intermediaries. The shift was to areas such as provision of loans to individuals for purchases of consumer durables and investment in housing and towards lending against real estate and commodities. While this shift increased the interest incomes that could be garnered by the banks, it also increased their exposure to the euphemistically-termed 'sensitive' sectors, where speculation is rife and returns volatile.

Secondly, as mentioned earlier, investment in securities of various kinds gained in importance, bringing in it wake a greater exposure to stock markets. This was indeed a part of the reform effort. As an RBI-SEBI joint committee on bank exposures to the stock market noted: "Globally, there is a shift in the asset portfolio of banks from credit to investments keeping in view the fact that investments are liquid and augment the earnings of banks. The Committee feels that banks' participation would also promote stability and orderly growth of the capital market."

Initially, the investments were largely in safe government and other approved securities, which, in the wake of financial and fiscal reform, were offering banks relatively high returns. As noted earlier, bank holdings of these securities crossed the floor requirement set by the SLR. But in time, with the returns being offered by non-SLR securities of different kinds on the rise, banks have tended to move in the direction of sensitive sectors as well. In the aggregate the sum total of such exposure of the scheduled commercial banks appears limited. As the RBI's technical committee on bank financing of equities noted, as on January 31, 2001: "The total exposure of all the banks by way of advances against shares and debentures including guarantees, aggregated Rs. 5,600 crore, comprising fund based facilities of Rs. 3385 crore and non fund based facilities, i.e., guarantees, of Rs. 2,215 crore". Such exposure constituted 1.32 per cent of the outstanding domestic credit of the banks as on March 31, 2000.

However, there is much that these figures conceal. To start with, the aggregate level of exposure across the banking system hides the fact that the "overall" exposure on the part of some of the private sector banks, whose "dynamism" has been much celebrated and used as the basis for privatization of public sector banks, has been far in excess of 5 per cent. As figures collated by the RBI's Technical Committee reveal, at the end of 2000, the exposure to the stock market by way of advances against shares and guarantees to brokers stood at 0.5 per cent of total advances in the case of public sector banks, 1.8 per cent in the case of old private sector banks, 4.8 per cent in the case of foreign banks and a

huge 15.3 per cent in the case of 8 new private sector banks. *Thus, the so-called "dynamic" private banks which are seen as setting the pace for the rest of the banking sector, and are attracting depositors by offering them better terms and better services, are the most vulnerable to stock market volatility.*

When it comes to non-performing assets (NPAs), however, the differentials seem to point in a completely different direction. The ratio of NPAs to total assets was higher in the case of the older public sector and private sector banks, and was lower in the case of the new private sector banks and the foreign banks, most of which are new entrants into the banking scene in India. But these differences are more because of the effects of age, with the older banks having over the years accumulated such NPAs at a slow pace, and not having been subjected to provisioning and prudential norms of the kind that have been put in place after the process of liberalisation began.

What would be more crucial is to assess whether, in recent times, the rate of increase of NPAs has tended to be faster among the private sector banks that have a greater exposure to sensitive sectors in general and the capital market in particular. Adequate evidence to make such an assessment is not available yet. But there is some evidence to that effect. Thus, Nedungadi Bank, which was one of those with a high exposure to capital markets and had to be merged with Punjab National Bank to rescue it, had seen an increase in the ratio of its gross NPAs to assets from 4.6 per cent in 1996-97 to 8.4 per cent in 1999-2000

However, the fact that the exposure of banks to the stock market has not on average been too high, has encouraged the RBI to be lax with regard to restricting the movement of banks into such 'sensitive' activities. Till very recently, RBI guidelines regarding bank exposure to the stock market applied only to direct investment in shares. Even these had been substantially relaxed not too long ago. According to guidelines issued in October 1996, when banks were being encouraged to investment in stocks as part of the process of financial liberalization, banks were permitted to invest up to 5 per cent of their incremental deposits in the previous year in stock markets. Initially, investments in debentures/bonds and preference shares were included within this five per cent ceiling. However, as stock market performance was increasingly accepted as an indicator of the success of reform, and the government was under pressure in 1997 to revive flagging markets, it sought to encourage banks to invest more in the markets. This was done, in April 1997, by taking debentures/bonds and preference shares out of the calculation of the limit. This made the ceiling only relevant for investment in equities. Further, the 5 per cent ceiling on investments in equity shares was to include loans to corporates to help them meet the promoters' contribution to the equity of new companies. That is, banks could provide "bridge finance" against shares, for companies planning to raise resources from the market for new projects, on the expectation that the loan will be repaid when such resources are raised.

In an associated move, the minimum maturity on commercial paper issued by corporates was brought down from 3 months to 30 days, allowing them to use such instruments for extremely short term accommodation. The net result of all this was a substantial increase in the flexibility banks enjoyed with regard to making 'corporate' investments, especially in financial instruments that are known to be risky.

In September 2000 these guidelines were relaxed even further based on the recommendations of a committee comprising of senior executives of the RBI and the Securities and Exchange Board of India (SEBI). The committee held that instead of setting a ceiling on bank investments in equity relative to incremental deposits, banks' exposure to the capital market by way of investments in shares, convertible debentures and units of mutual funds should be linked with their total outstanding advances and may be limited to 5 per cent of such advances. This was subsequently accepted by the RBI and is the guideline that prevails now.

As a result of these changes banks were vying with each other to invest their funds in the corporate sector and were picking up all forms of corporate paper - including bonds, debentures and preference shares. Driven by these signals a group of 21 public sector banks increased their investments in equities from Rs. 1,488 crore in 1997 to Rs. 2,293 crore in 1998. However, the RBI was sanguine about the risk of bank exposure to capital markets because such exposure was well below the much-relaxed ceiling. According to its Technical Committee set up to review guidelines regarding bank financing of equities, "The total investment in shares of the 101 scheduled commercial banks aggregated Rs.8,771.60 crore as on January 31, 2001 and constituted 1.97 per cent of outstanding domestic advances as on March 31, 2000 and was well within the norm of 5 per cent of the domestic credit stipulated in the RBI Circular of November 10, 2000. The total investments in shares of all the banks aggregated Rs. 6,324.11 crore as on March 31, 2000 and constituted 1.42 per cent of the domestic credit."

This overconfidence has been subjected to a corrective in the form of growing fragility in the banking system. On the surface, the RBI still maintains a brave face while accepting that there are problems of fragility in the system. This emerges from the following paragraph in the RBI's Monetary and Credit Policy Statement for the year 2001-2002, that reveals the central bank's reading of the problem. "The recent experience in equity markets, and its aftermath, has thrown up new challenges for the regulatory system as well as for the conduct of monetary policy. It has become evident that *certain banks in the cooperative sector* did not adhere to their prudential norms or to the *well-defined regulatory guidelines* for asset-liability management nor even to the requirement of meeting their inter-bank payment obligations. *Even though such behaviour was confined to a few relatively small banks, by national standards, in two or three locations*, it caused losses to some correspondent banks in addition to severe problems for depositors. In the interest of financial stability, it is important to take measures to strengthen *the regulatory framework for the cooperative sector by removing "dual" control by laying down clear-cut guidelines for their management structure and by enforcing further prudential standards in respect of access to uncollateralized funds and their lending against volatile assets*."

Clearly, the RBI poses the problem as being largely restricted to the cooperative banking sector, where it arises not because the regulatory mechanism is not well defined, but because the structure of management and control has worked against the implementation of those guidelines. But its decisions in practice point to a greater degree of concern. Not only has bank scrutiny been tightened, leading to revelation regarding banks like the Nedungadi Bank, but bank exposure to stock markets is being curtailed.

As argued above, bank investments in equity constitute only one form of bank exposure to the stock markets. Advances against shares and guarantees to brokers provide other forms. Secondly, this exposure of the banking system and of those that lead the pack in lending against shares, is dominantly to a few broking entities. The evidence on the relationship between Global Trust Bank and Ketan Parekh only begins to reveal what the RBI's monetary policy statement describes as "the unethical 'nexus' emerging between some inter-connected stock broking entities and promoters/managers of some private sector or cooperative banks." The problem clearly runs deep and has been generated in part by the inter-connectedness, the thirst for quick and high profits and the inadequately stringent and laxly implemented regulation that financial liberalization breeds.

Thirdly, the liquidity that bank lending to stock market entities ensures, increases the vulnerability of the few brokers who exploit this means of finance. Advances against equity and guarantees help them acquire shares that then serve as the collateral for a further round of borrowing to finance more investments in the market. These multiple rounds of borrowing and investment allow these broking entities to increase their exposure to levels way beyond what their net worth warrants. Any collapse in the market is therefore bound to lead to a payments shortfall that aggravates the collapse, and renders the shares that the banks hold worthless and the advances they have provided impossible to redeem.

Finally, by undertaking direct investments in shares while providing liquidity to the market, the banks are further endangered. To the extent that the liquidity they provide encourages speculative investment and increases stock market volatility, any consequent collapse of the boom would massively erode the value of the banks' own direct investments.

Conclusion

The Indian experience indicates that fiscal contraction; monetary policy constraints created by sterilisation requirements; a credit squeeze for the commodity producing sectors; decline in access for rural India and small scale industry; and increased fragility are the consequences of the environment created by reform. Liberalisation, while it did appear to have resulted in financial deepening, was accompanied by the loss of even the limited access to savings and credit available to sectors like agriculture and small scale industry, whose development had a crucial role in the poverty-reduction effort. Financial liberalisation occurred in a context in which there was a shift in emphasis in macroeconomic management from fiscal to monetary policy. This required greater central bank independence from the government, ensured by curtailing or doing away with government access to central bank credit. Further, monetary policy inevitably focused on inflation targets, resulting in tight money conditions, which were also favoured because the resulting higher interest rates helped attract foreign capital inflows in the more liberalised environment. All of these implied a deflationary stance that was aggravated most often by the process of financial liberalisation. The deceleration in growth that this led to was obviously inimical to the poverty reduction effort. To boot; the process of liberalisation does seem to have increased financial fragility.