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AN ANLYSIS OF FINANCIAL SECTOR REFORMS IN INDIAN ECONOMY

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ABSTRACT

India's banking reforms differ from those in other developing countries in one important respect, and that is the policy toward public sector banks that dominate the banking system. The government has announced its intention to reduce its equity share to 33.33%, but this is to be done while retaining government control. Improvements in the efficiency of the banking system will therefore depend on the ability to increase the efficiency of public sector banks. Skeptics doubt whether government control can be made consistent with efficient commercial banking because bank managers are bound to respond to political directions if their career advancement depends upon the government. Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability akin to civil servants, which tend to emphasize compliance with rules and procedures and therefore discourage innovative decision making. Regulatory control is also difficult to exercise. The unstated presumption that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This obviously weakens market discipline, since more efficient banks are not able to expand market share. If privatization is not politically feasible, it is at least necessary to consider intermediate steps that could increase efficiency within a public sector framework, these include shifting effective control from the government to the boards of the banks, including especially the power to appoint the chairman and executive directors, which is at present with the government; removing civil servants and representatives of the Reserve Bank of India from these boards; implementing a prompt corrective action framework that would automatically trigger regulatory action limiting a bank's expansion capability if certain trigger points of financial soundness are breeched; and acceptance of closure of insolvent public sector banks[1].

India's pre-reform period and financial reform

Since 1991, India has been engaged in banking sector reforms aimed at increasing the profitability and efficiency of the then 27 public-sector banks that controlled about 90 per cent of all deposits, assets and credit. The reforms were initiated in the middle of a "current account" crisis that occurred in early 1991. The crisis was caused by poor macroeconomic performance, characterized by a public deficit of 10 per cent of GDP, a current account deficit of 3 per cent of GDP, an inflation rate of 10 per cent and growing domestic and foreign debt, and was triggered by a temporary oil price boom following the Iraqi invasion of Kuwait in 1990.

[1] Dreze, Jean and Amartya Sen (eds.) (1990), The Poitical Economy of Hunger, Oxford, Clarendon Press.

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Prior to the reforms, India's financial sector had long been characterized as highly regulated and financially repressed. The prevalence of reserve requirements, interest rate controls, and allocation of financial resources to priority sectors increased the degree of financial repression and adversely affected the country's financial resource mobilization and allocation. After Independence in 1947, the government took the view that loans extended by colonial banks were biased toward working capital for trade and large firms (Joshi and Little 1996). Moreover, it was perceived that banks should be utilized to assist India's planned development strategy by mobilizing financial resources to strategically important sectors.

Reflecting these views, all large private banks were nationalized in two stages: the first in 1969 and the second in 1980. Subsequently, quantitative loan targets were imposed on these banks to expand their networks in rural areas and they were directed to extend credit to priority sectors. These nationalized banks were then increasingly used to finance fiscal deficits. Although non-nationalized private banks and foreign banks were allowed to coexist with public-sector banks at that time, their activities were highly restricted through entry regulations and strict branch licensing policies. Thus, their activities remained negligible[2].

Following the 1991 report of the Narasimham Committee, more comprehensive reforms took place from same year. The reforms consisted of (a) a shift of banking sector supervision from intrusive micro-level intervention over credit decisions toward prudential regulations and supervision; (b) a reduction of the CRR and SLR; (c) interest rate and entry deregulation; and (d) adoption of prudential norms. Further, in 1992, the Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning, and also adopted the Basle Accord capital adequacy standards. The government also established the Board of Financial Supervision in the Reserve Bank of India and recapitalized public-sector banks in order to give banks sufficient financial strength and to enable them to gain access to capital markets. In 1993, the Reserve Bank of India permitted private entry into the banking sector, provided that new banks were well capitalized and technologically advanced, and at the same time prohibited cross-holding practices with industrial groups. The Reserve Bank of India also imposed some restrictions on new banks with respect to opening branches, with a view to maintaining the franchise value of existing banks[3].

Diversification of banking activities

The second unique feature of India's banking sector is that the Reserve Bank of India has permitted commercial banks to engage in diverse activities such as securities related transactions , foreign exchange transactions and leasing activities. The 1991 reforms lowered the CRR and SLR, enabling banks to diversify their activities. Diversification of banks' activities can be justified for at least five reasons. First, entry deregulation and the resulting intensified competition may leave banks with no choice but to engage in risk-taking activities in the fight for

[2] Jalan, B (2000), 'Finance and Development-Which Way Now?' RBI Bulletin, January, 29-45.
[3] Rangarajan, C. (1998): "Indian Economy – Essays on Money and Finance", UBS Publishers' Distributors Ltd.

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their market share or profit margins. As a result, risk-taking would reduce the value of banks' future earnings and associated incentives to avoid bankruptcy (Allen and Gale 2000).

Second, banks need to obtain implicit rents in order to provide discretionary, repetitive and flexible loans.6 In addition, banks attempt to reduce the extent of Profitability is likely to be positively correlated with efficiency and soundness. The correlation is expected to be greater for public-sector banks that had long been performing poorly since the reform impact could be greater. For example, the average correlation coefficient between profitability and cost efficiency in 1993-2000 was -0.7 for public-sector banks, -0.48 for private domestic banks, and for -0.3 for foreign banks. The average correlation coefficient between profitability and soundness was 0.76 for public-sector banks, 0.59 for private banks, and 0.37 for private banks.

Third, banks can stabilize their income by engaging in activities whose returns are imperfectly correlated, thereby reducing the costs of funds and thus lending and underwriting costs. Fourth, diversification promotes efficiency by allowing banks to utilize inside information arising out of long-term lending relationships. Thanks to this advantage, banks are able to underwrite securities at lower costs than non-bank underwriters. Firms may also obtain higher prices on their securities underwritten by banks because of their perceived monitoring advantages. Further, banks can exploit economies of scope from the production of various financial services since they can spread fixed physical (i.e., branches and distribution channels) and human capital costs (Steinherr and Huveneers 1990)[4].

Some Critical Elements for Progress in Reforms

In spite of difficulties in prioritizing the elements relevant for reform, an attempt is made to mention some elements which present themselves as critical in the light of experience gained so far. First, as elaborated in Governor Jalan's recent statements on Monetary and Credit Policy, several legislative measures are needed to enable further progress. These relate in particular, to ownership, regulatory focus, development of financial markets, and bankruptcy procedures. Some of the serious shortcomings in the anticipated benefits of reform such as in credit delivery do need changes in legal and incentive systems. In particular, there is need to focus on reduction of transaction costs in economic activity, and enhancing economic incentives. Severe penalties in law, including criminal proceedings, may not be substitutes for increasing enforceability (i.e., probability of being caught, prosecuted, and punished adequately and in a timely fashion). In regard to institutions, there is need to clearly differentiate functions of owner, regulator, financial intermediary and market participant, to replace the joint-family approach that is a legacy of the pre-reform framework[5].

Second, fiscal empowerment appears to be essential for obvious reasons. While the existing level of fiscal deficit may be manageable, the headroom available for meeting unforeseen

[4] Reddy, Y.V. (November 2000): "Fiscal and Monetary Policy Interface: Recent Developments in India", RBI Bulletin, pp.1257-72.

[5] Reserve Bank of India, The Report on Currency and Finance (1998-99, 1999-00 and 2000-01)

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circumstances appears rather limited. The problem is somewhat acute in regard to finances of states, which have serious structural problems and their resolution is possible only through accelerated fiscal support from Central Government consistent with the fiscal soundness of Central Government. Some of the legal reforms may also be necessary for this purpose and the link for further progress in the financial sector is obvious. In particular, the nature of fiscal dominance does constrain the effectiveness of monetary policy to meet unforeseen contingencies as well as maintain price stability and contain inflationary expectations.

Third, the reforms in the real sector are needed to bring about structural changes in the economy. The liberalization of financial sector and of external sector can provide impetus for further growth and in turn help more rapid progress only when accompanied by reforms in the real sector, particularly in domestic trade.

Fourth, there are what may be termed as 'overhang' problems in the financial sector, such as non-performing assets of banks and financial institutions. There are similar overhang problems in other areas as well, and it is necessary to make a distinction between what may be termed as flow issues and overhang issues. There is merit in insulating the overhang problem from flow issues and demonstrably solve the flow problem upfront. Fifth, it will be useful to distinguish between what a financial sector can contribute and what fiscal action can contribute to matters relating to poverty alleviation. In the interest of efficiency and stability of financial sector, intermediation may have to be progressively multi institutional rather than wholly bank-centred. Social obligations may have to be distributed equitably among banks and other intermediaries but that would be difficult to achieve in the context of emerging capital markets and relatively open economy. In such a situation, banks which are special and backbone of payment systems, may face problems if they are subject to disproportionate burdens. Hence, mechanisms have to be found to reconcile these dilemmas.

Table 1.1: CAGR of Deposit Insurance and Credit Guarantee Corporation - Insured Deposits

CAGR (During Periodicals)	Total amount of insured deposits	Total amount of assessable deposits
2000-05	14.51	18.57
2005-10	21.55	23.56
2000-10	16.63	20.04

From the given table, CAGR has been calculated on different periodicals, during 2000-05 total amount of insured as well as assessable deposits was 14.51, 18.57 respectively . Again during 2005-10 it was 21.55 as well as 23.56. while it was 16.63, 20.04 respectively during 2010. Which represents fluctuation of insured deposits as well as assessable deposits.

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Table 1.2 : CAGR of Deposit Insurance and Credit Guarantee Corporation - Liabilities and Assets (Deposit Insurance Fund)

CAGR	Surplus Balance	Investment Reserves	Total Liabilities Assets	Investments in Central Government Securities (at Cost)
2000-05	20.42	12.64	18.75	16.96
2005-10	20.42	20.66	20.85	20.03
2000-10	20.83	24.92	21.01	18.17

From the given table, CAGR has been calculated on different periodicals, during 2000-05 Surplus Balance, Investment Reserves, Total Liabilities Assets as well as Investments in central Government Securities was 20.42, 12.64, 18.75, 16.96 respectively. Again during 2005-10 it was 20.42, 20.66, 20.85, 20.03 respectively. But during the decade it was 20.83, 24.92, 21.01, 18.17 respectively during 2010. Which represents fluctuation of insured deposits as well as assessable deposits.

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	234.511	2	117.256	23.976	.000[a]
	Residual	39.125	8	4.891		
	Total	273.636	10			

a. Predictors: (Constant), assassesable, insured

b. Dependent Variable: years

From the given table regression model as well as analysis of variance have been introduced, where the degree of freedom has been calculated, where in case of ANOVA test significance level is 0.000. Hypothesis is accepted which implies the insured people as well as deposits with Insurance Sector has been improved significantly. It again explain that the performance of Capital Market (Insurance Sector) in terms of Rupees has been improved due to economic reforms.

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1991.847	2.119		939.878	.000
	insured	3.520E-5	.000	4.464	2.617	.031
	assassesable	-1.519E-5	.000	-3.593	-2.107	.068

a. Dependent Variable: years

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From the given table coefficients of standard error as well as t-values (939.878, 2.617 and -2.107 respectively), where Beta is constant (0.000, 4.464 and -3.593 respectively) again the significance level is 0.000, 0.031 and 0.068 respectively, which implies there is significant difference between calculated value as well as tabulated values, which implies that null hypothesis is rejected.

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	1993.891	2.010		992.191	.000
	a2	.007	.005	6.699	1.298	.242
	a3	-.008	.005	-.694	-1.392	.213
	a4	-.004	.003	-7.411	-1.692	.142
	a5	.002	.002	2.250	1.024	.345

a. Dependent Variable: years

From the given table coefficients of standard error as well as t-values (992.191, 1.298, -1.392, -1.692 and 1.024 respectively), where Beta is constant (0.000, 6.699, -0.694, -7.411 and 2.250 respectively) again the significance level is 0.000, 0.242, 0.213, 0.142 and 0.345 respectively, which implies that there is significant difference between calculated values as well as tabulated values of a2, a3, a4, and a5, where null hypothesis is rejected while in case of a it is accepted due to no significant difference between calculated and tabulated values.

CONCLUSION

India's financial market has been gradually developing, but still remains bank-dominated in the reform period. The extent of financial deepening measured by total deposits in GDP has risen only modestly from 30 per cent in 1991 to 38 per cent in 1999. Capital market development has also been quite sluggish. Outstanding government and corporate bonds as a share of GDP rose from 14 per cent in 1991 to 18 per cent in 1999 and from only 0.7 per cent in 1996 to 2 per cent in 1998, respectively, while equity market capitalization dropped from 37 per cent in 1995 to 28 per cent in 1999.

The role of the capital market as a mechanism for channeling resources to the corporate sector changed in important respects through the 1990s. In the early years of the reforms, when individual investors flooded the market, public issues were a major means of mobilizing resources by non-government companies, and the amount raised through this avenue increased from a little over Rs. 6,000 crores in 1991–92 to over Rs. 26,000 crores in 1994–95. Subsequently, as investors confidence declined, public issues dried up but there was a sharp increase in private placements from Rs. 11,174 crores in 1994–95 to Rs. 64,950 crores in 2001–02, reflecting investments by institutional investors mainly in debt instruments. In relation to

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GDP, however, the total resources mobilized from the capital market, which had increased from 2.5 percent of GDP in 1990–91 to a peak of 4.3 percent in 1993–94, after which it declined to around 3.1 percent 2001–02.

The poor returns to equity investors in recent years are not entirely due to market failures. They are to some extent a reflection of the problems faced by the manufacturing sector (which is the sector mainly represented in market capitalization) in the second half of the 1990s, when the growth rate of manufacturing slowed down. The solution to this problem lies outside the financial sector and depends heavily on completing the unfinished agenda of reforms, which is holding back growth in the real sector.[i] However, further institutional development in the capital market is also important. A wider base of informed institutional investors would add depth to the market and increase the confidence of individual investors, encouraging them to shift back from investing in government savings schemes to the capital market.

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