125th Birth Anniversary

of

'LALA LAJPAT RAI'

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LALA LAJPAT RAI MEMORIAL LECTURE

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by

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On "FINANCIAL SCENARIO IN THE 1990s.

AN AGENDA FOR REFORM"

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THE FINANCIAL SCENARIO IN THE 1990s

- An Agenda For Reform

Introduction

I deem it a great privilege indeed to participate in this function organised for paying homage to the great leader Lala Lajpat Rai, on the occasion of his 125th Birth Anniversary. Mahatma Gandhi summed up the life and achievements of Lala Lajpat Rai in the obituary he wrote in Young India : I quote, "Men like Lala cannot die as long as the sun shines in the Indian sky. Lalaji means an institution. From his youth, he made of his country's service, his religion." [1]

Lalaji's deep interest in the financial and economic problems of the country is reflected in many of his speeches. In an emotionally charged speech in the Central Legislative Assembly of March 19, 1928, in the course of the general debate on the Indian Finance Bill, he asked the then Government: What have you done to mitigate the distress of the vast bulk of the people of this country, who do not get sufficient food ? Lalaji was a great believer in the Swadeshi principle and its application to the industrial and commercial spheres. His interest in the financial matters found a concrete expression in his taking a leading part in establishing the Pubjab National Bank and the Laxmi Insurance Company. I, therefore, thought that it would be appropriate to choose the subject, "The Financial Scenario in the 1990s -- An Agenda For Reform", for the lecture today.

The financial sector plays a critical role in the process of economic development. The question naturally arises as to how should a country's financial system be developed, by relying heavily on the private sector and on market forces, or, by active state intervention ? Economics seems to be a fashion-bound discipline and the great buzz word of contemporary financial policy *discussions is 'financial liberalisation'. The World Development Report, 1989*, of the World Bank, which has 'Financial Systems and Development' as its main theme, is not content by merely extolling the virtues of developing the financial system by market forces; it indicts the state regulated financial system. To quote from the Report: "In the past, governments' efforts to promote economic development by controlling interest rates, directing credit to priority sectors, and securing inexpensive funding for their own activities have undermined financial development."[2] In deriving this conclusion, the authors of the Report appear to suffer from selective amnesia because there is enough emperical evidence to the countrary. In fact, in any analytical study with claims to objectivity, it should be realised that the discussion on whehter the financial system should be ideally developed by market forces, or by state intervention, would be hardly meaningful without reference to a specific time frame.

In my lecture today, I would seek to draw some lessons from the Indian experience of building up of the financial system -- an experience which is unique in many respects. The main theme that emerges from the analysis is that in a developing country like India, the growth path of the financial system can be divided into three distinct phases: the first phase is characterised by active state intervention with a view to building up the institutional infrastructure. Developing countries are in a hurry to catch up with modern banking, and developments in money and capital markets and they cannot afford to wait for the spontaneous or autonomous growth of the financial system to take place. In such a context, the performance of the financial system is judged by the test of 'immediacy'. Thus, in developing economies at this stage of development, state initiative and active participation in the building up of institutional infrastructure, as also in directing the flow of resources, becomes a historical necessity. Admittedly, this process of hurried growth may give rise to some distortions; and the system may also end up by being over-regulated. The second phase would therefore be a phase of deregulation, of rationalisation and simplification of controls, a phase in which distortions inherited from the first phase also need to be corrected. It is only after the system settles down to a new equilibrium in an environment of a good degree of autonomy for different financial institutions, can one begin to think in terms of the third phase of total liberalisation.

Looked at from a macroeconomic perspective, the two decades 1970s and 1980s may be said to constitute the first phase in India's financial history. A quick review of the performance of the financial sector during this period also shows that the increased role of the public sector in the financial system has, far from retarding, actually accelerated financial growth. There is emperial evidence to support this thesis from the experience of other countries also. Furthermore, it would be my endeavour to show that the Indian financial system is poised to enter the second phase of its development in the 1990s; and to think in terms of total financial liberalisation, at this stage, would be premature, notwithstnding the current fashion.

In the process of assessing the growth of the financial system, ushered in by <u>dirigistc</u> policies adopted during the last two decades, it has also been possible to sketch the broad contours of the financial scenario as it would emerge in the 1990s; and as a corollary, an agenda for financial reform is also provided with a view to ensuring that financial sector plays its supportive role in sustaining economic growth in the 1990s.

The outlook for growth in the 1990s is on the whole encouraging, notwithstanding the balance of payments constraints and persistence of inflation evidenced during the last two years of the Seventh Plan. The Seventh Plan period withnessed a record average annual growth of around 5.5 per cent in real national income, perhaps signalling a breakthrough from the so called

'Hindu rate of growth of 3.5 per cent' for the first three decades of planning. Industrial growth was around 8 per cent and export growth around 10 per cent. Both these indicators are perhaps suggestive of sustainablility of high growth during the coming years, given the right mix of policies. The focus of our planning has been on 'growth with equity', but recently some apprehensions have been expressed whether the acceleration of growth during these last four or five years following industrial liberalisation, has resulted in a degree of de-emphasis on equity considerations. These characteristics of growth in the Seventh Plan period should therefore set the tone for shaping the financial system in the 1990s.

II. Banking Developments: The Indian Experience

The financial sector plays a crucial role in economic development. Monetary and credit policies accelerate the process of growth by influencing the supply and uses of credit, combating inflation, and maintaining balance of payments equilibrium. For monetary policy to be effective, however, developing countries must first improve their credit systems. Developing countries start with an initial handicap: their financial system is too narrowly restricted and is generally geared to provide credit only to large industries, plantations, and foreign trade.[3] Such credit facilities are not available to the farm sector, small industries, and retail trade. Banks and financial institutions should therefore both widen and deepen their operations so that credit facilities are greatly enlarged; and also that actual and potential savings are mobilised and channeled into productive uses.

At the initial stage of development of an economy, building up of the institutional framework thus needs to be accorded over-riding priority. Extension of the commercial banking network, cooperative credit institutions and mutual funds are designed to remedy the situation. Such efforts are particularly warranted in the rural sector. By evolving a well-differentiated institutional infrastructure, the imperfections of the money and capital markets would be reduced. Furthermore, remodelling of the financial system is also needed with a view to ensuring that resources flowing through it are allocated among different sectors/sub-sectors in consonance with the development strategies.

It is against the background of this conceptual framework that the growth of the financial system in India needs to be assessed. The last two decades 1970s and 1980s mark a distinct phase of active state intervention in the building up of the institutional infrastructure. Most remarkable is the progress that banking has made, during the last two decades since the nationalisation of 14 major commercial banks in 1969.

Banking has shed its erstwhile urban-elitist image and has emerged as a more potent instrument of economic growth and distributive justice. Even recognising the limitations of the ability of financial engineering to transform the economy, the dramatic growth of banking during this period deserves to be commended especially because, for the Indian pattern, there were no models to copy from or practices to emulate. The role of banks in India has been widened to such an extent that it has transcended the conventional concept of 'financial intermediation'.

Those of us who have been witnesses to the growth of banking in India during the last two decades do not seem to adequately appreciate the dramatic changes that have been brought about in the profile of Indian banking. Penetration of semi-urban and rural areas through extension of the branch network on a scale unprecedented in the history of world banking, bringing about a structural transformation in the sectoral distribution of credit, thereby augumenting sizeably the flow of credit to small farmers, small enterprises and the self-employed, and mobilisation of savings -- these are substantial changes indeed. The total number of functioning bank offices were only 8,262 in June 1969: this number soared to more than 56,000 branches in June 1988. Moreover, nearly 60 per cent of branches are in rural and semi-urban areas. The average population served by a bank office has declined from 64,000 in 1969 to 12,000 in 1988.

A significant structural transformation has also taken place in the sectoral distribution of credit.[4] The share of large and medium industries in total bank credit which was around 61 per cent in March 1968 has now declined significantly to about 38 per cent in 1982. Simultaneously, the share of priority sectors, which include agriculture and small industries, rose from a mere 11 per cent to nearly 46 per cent in 1988. Lending to the agricultural sector is particularly significant because in the pre-nationalisation era, commercial banks regarded that such lending was not their legitimate business. Today, the banking system is servicing more than 17 million agricultural accounts, and the total number of borrower accounts under priority sectors adds up to 31.6 million. The procedures and practices of lending have therefore been suitably modified to attune banks to lend to the rural sector and to small businesses.

Over these two decades, commercial banks have also emerged as the single most important channel through which savings of the household sector are being mobilised. In fact, in raising the rate of savings of the economy to an impressive level of 22 per cent of national income the role played by commercial banks has been critical. The dramatic rise in the gross domestic savings from hardly 10 per cent in the 1950s to more than 20 per cent in 1970s is largely attributable to the contribution of commercial banks. 5 Two indicators of this role may be given in this context. First, commercial banks' deposits as a percentage of national income at current prices rose from 17 per cent in 1970 to about 47 per cent in 1988. Secondly, commercial banks' deposits as a proportion of gross financial savings of the household sector rose from 18 per cent, to more than 62 per cent during this period.

The Indian experience of banking development may be regarded as unique for the following four reasons: first, for the Indian pattern of banking development there was no models to copy from or practices to emulate. Credit planning in the broad sense of planned allocation of credit among sectors has emerged as a strategic instrument for guiding both fixed and working capital allocation among sectors broadly in alingment with the plan priorities. Second, the role of banks has been widened to such an extent that it has transcended the conventional concept of 'financial intermediation'. In fact, banking has been converted into an instrument for economic and social development. 6 Banks are called upon to assume, and have actually assumed, a variety of tasks which in the pre-nationalisation period, may not have been regarded as the legitimate responsibility of a credit institution. Support extended to the various anti-poverty programmes like the Integrated Rural Development Programme (IRDP), Self-Employment Programme for Educated Unemployed Youth (SEEUY) is a case in point. Third, an element of cross subsidisation has been built into the administered interest rate structure. The extent of concessionality in interest rate is linked to the size of the loan and the degree of priority accorded to the sector. Lending to the rural sector in particular is characterised by a high degree of subsidisation. For instance, in contrast to the minimum lending rate of 16 per cent to large and medium industries, lending rates for agriculture vary from 10 to 14 per cent, depending on the size of the loan. The following sub-sectors attract only 10 per cent interest: short term loans to farmers upto Rs. 7,500; and also term loans for minor irrigation, and to small farmers; laons upto Rs. 25,000 for small scale industries in backward areas, and advances under the poverty alleviation programmes like the IRDP. Finally, this transformation in the profile of Indian banking has been brought about by conscious policy decisions. The growth of banking was supply-induced, rather than demand following. The switch away from the magic of market mechanism guided by the criterion of maximisation of profit to dirigiste financing has been an important contributory factor in this transformation.

Thus, Indian banking provides a unique example of blending harmoniously commercial banking with social banking, during the last two decades.

Such blending was, in a sense, a historical necessity because commercial banking prior to nationalisation was highly elitist catering primarily to large and medium industries, and wholsesale trade. The agricultural sector which used to contribute some 50 per cent of national income was virtually bypassed. The conversion of elitist banking into mass banking during the last two decades can thus be regarded as a correction of historical distortion. The phenomenal expansion of bank branches, extension of credit at concessional rates of interest to priority sectors and to weaker sections, and coverage of a large number of small borrowers -- all of these are achievements of which the banking system would justly be proud. In fact, wider disbursement of credit, both spatially and in terms of categories of borrowers, has to be viewed in the overall perspective of promoting a broad-based growth process in the sense of encouraging decentralised and dispersed development. The impact of banking development on the economy runs too deep to be measured by a couple of indicators: and it could be regarded as part of the process of modernisation of the economy. It is easy to take these changes for granted now, but they seem mountaineous in retrospect.

III. Emergence of Other Financial Institutions

Over the eyars, the financial system in India has also become more sophisticated, in response to the varied needs of the economy. The system comprises of a wide range and a large number of financial institutions. At the apex is the Reserve Bank of India (RBI) and commercial banks have a dominant role, holding as they do 40 per cent of the total financial assets. Other important financial institutions include development finance institutions at the all-India, regional and State level: the insurance corporaitons; mutual funds such as the Unit Trust of India (UTI); and the Post Office Savings Bank.

This institutional framework was further streamlined by the emergence, during the last couple of years, of new institutions designed to cater to the increasingly sophisticated needs of the economy. To being with, many banks set up in 1987-88 subsidiaries/joint ventures for undertaking specialised financial services such as merchant banking, leasing, mutual funds, venture capital and housing finance. The provision of these new financial services reflects the responsiveness of the financial system to the growing and varied needs of the economy, as also its endeavour to diversify and upgrade its services.

The National Housing Bank (NHB) was established in July, 1988: its responsibilities include, inter alia, promotion and development of specialised housing finance institutions, mobilisation of resources for housing, provision of refinance facilities for housing finance institutions and scheduled banks, extension of credit for housing, in particular for the economically weaker sections of the society.

Again, the RBI, in collaboration with commercial banks and financial institutions set up, in April 1988, the Discount and Finance House of India (DFHI) Ltd., as a first step towards developing a secondary for money market instruments. DFHI commenced its operations by providing initially a secondary market in two money market instruments, namely, 182-days Treasury Bills and short terms commercial bills. More recently, it has been functioning also as a broker in the inter-bank money market, attempting to equilibrate short term surpluses and deficits of individual banks.

Yet another institution set up in 1988 was the Credit Rating Information Services of India Ltd. (CRISIL), promoted jointly by the Industrial Credit and Investment Corporation of India (ICICI) Ltd. and the Unit Trust of India (UTI). Credit rating can play an important role in protecting investors by providing information on risk. It could also be beneficial to companies by helping them to raise funds more easily depending on their performance: companies with satisfactory performance would benefit in terms of lower costs of funds. Credit rating would thus foster financial discipline, improve financial information and facilitate larger direct mobilisation of funds by the corporate sector.

The Securities and Exchange Board of India (SEBI) which came into existence in April 1988 is designed to build up investors' confidence which is a necessary pre-condition for enabling the corporate sector to raise larger resources from the capital market. Its establishment is a major step towards correcting structural weaknesses, in the functioning of the stock exchanges which have been largely responsible for the violent swings in the share prices -- swings which are unwarranted by the underlying fundamentals. With the effective functioning of SEBI -- the necessary legislation is yet to be enacted -- it is hoped that a more orderly growth of the stock exchanges would be ensured.

At this stage, a word about the capital market for which the 1980s have been a period of phenomenal growth. The impetus to growth witnessed in the past decade was provided in the early 1970s, when a revision of the Foreign Exchange Regulation ACt (FERA) limited the expansion of the foreign-controlled companies and required them to dilute their equity. Spurred by this initial impetus, the market gained additional momentum in the 1980s, as a result of various measures introduced to stimulate both the demand for and supply of shares:

these measures included incentives for equity and debenture issues, including a reduction in the corporate tax, and raising of the permitted interest rate on debentures well above that for time deposits of banks. General fiscal incentives were also provided to investors.

The sea-change that has come about in the Indian capital market can be judged from the fact that resources raised jumped from only about Rs. 220 crores in 1980 to some Rs. 5,200 crores in 1988-89. The number of stock exchanges doubled from 8 to 16. In fact, in 1987, India's stock exchanges listed more companies (6,017) than the stock markets of any other country except the United States (7,181). The buoyancy of the market during the decade is also reflected in the manifold rise in market capitalisation from about Rs. 6,750 crores in 1980 to some Rs. 52,000 crores in 1988. Equally impressive has been the growth in the share holding population -- from about 3 million in 1983-84 to an estimated 40 million in 1989.

Finally, data relating to the evolution of the financial system since 1969 show the increased 'financialisation' of the Indian economy and indicate that the interventionist policy in the financial sector has, far from retarding development, actually assisted the acceleration of development. This is reflected in the ratio of assets of financial institutions to GDP which rose gradually from 38 per cent in 1950 to 73 per cent in 1975, then sharply to 103 per cent in 1980.[7] Moreover, between 1968-80, the growth rate of assets of financial institutions was 8.5 per cent per annum, as compared to the secular growth rate of 7.2 per cent for the period 1950-80. In fact, if the period 1975-80, when the impact of branch expansion of banks was at its peak, is taken separately, the growth rate was as high as 10.7 per cent. This deepening of the financial system is largely attributable to increase in the assets of commercial banks, and, to some extent, to emergence of other financial intermediaries discussed earlier.

IV. Distortions in the Growth of the Financial System

While the achievements in evolving a well-differentiated financial system during the last two decades have been undoubtedly impressive, it should be conceded, at the same time, that financial growth has been rather higgledy-piggledy; or to adopt a literary phrase, financial developments have tended to be episodic, fragmentary and structurally loose. This can be concretely illustrated with reference to some distortions which have erupted in the financial system. Again, in the first place, these are 'dynamic distortions' in the sense of their being a result of over-zealous attempts to develop a particular segment of the financial market. Secondly, the scenario of policy-making in India is replete with instances of ad hoc measures taken in isolation from the macro economic parameters and the financial sector is no exception. Some of the distortions, which we will discuss shortly, are a result of this ad hocism. Three such distortions have been chosen for discussion here: deemphasis on commercial banks, distortion in the interest rate structure, and mobilisation of resources by UTI. Although in terms of their impact there is an element of overlap, it is convenient to discuss them separately.

i) Deemphasis on Commercial Banks

The starting point of the discussion is the deemphasis on commercial banks witnessed in more recent years, as a result of which a sizeable slice of resources which would have been, in the normal course, mobilised by banks is now being diverted to mainly two areas: non-banking companies and the capital market.

In recent years, there has been a mushroom growth of the so-called finance companies. Such companies are classified as non-banking non-financial companies and non-banking financial companies, the deposit taking activities of which have gained momentum, particularly in the Southern States like Karnataka, Kerala and Tamilnadu. These companies offer significantly more attractive deposit rates than what banks are permitted to offer. Available data show that such deposits have doubled during the last four years to reach a level of around Rs. 24,000 crores in 1988. What is more, in recent years, the average incremental deposits have ranged between Rs. 3,000 to Rs. 3,500 crores per year. Some indepth studies have brought out clearly that, barring few good companies, there are various undesireable features of the operations of other companies, particularly the so called blade companies in Kerala. Ever apart from the flow of credit to non-priority areas and speculative activities, instances are not lacking where depositors have come to grief.

It is high time that such companies should be made to realise that permission given to them to accept deposits from the public is a privilege which should not be mis-used. The need for closer scrutiny and strict supervision of the operations of such companies cannot be over-emphasised. Mere credit rating of such companies is not the answer, because credit rating provides only a snap-shot picture of the financial position of the companies, whereas what is really required is a permanent machinery which conducts inspection and corrects the undesirable features on a continuing basis. At present, neither the Government, nor the RBI, has such an inspection apparatus. It is high time that the RBI is invested with the adequate powers for conducting such inspection, on a continuing basis.

In fact, the situation is potentially explosive and if suitable regulatory measures are not put in place immediately, investors' confidence might be shaken. In this context, it would not be out of place to refer to the recent savings and loan industry crisis in the US. It may be recalled that plans for the biggest federal bail-out of US savings and loan associations were given the go-ahead in August 1988: the cost was estimated to exceed $ 200 billion. In India, without adequate prudential supervision of a continuing basis, aggressive financial entrepreneurs are likely to rush into high risk areas with all its dire consequences. This aspect of establishing a regular supervision apparatus should therefore be accorded high priority in the 1990s.

Turning to the capital market, the decade of the 1980s has clearly established the cult of equity in India. The widening and deepening of the capital market, tax incentives and tax liberalisation, and issue of tax-free securities and the emergence of new mutual funds -- all of these have helped the process of strengthening the capital market. During the last year of the Seventh Plan 1989-90 alone, total resources of about Rs. 8,000 crores were raised. It is estimated that during the Eighth Plan period Rs. 50,000 crores could be raised, the share of the private sector being Rs. 35,000 crores and that of public sector undertakings some Rs. 15,000 crores.

While efforts towards development of the capital market are indeed necessary and laudatory, what should not be overlooked is that such development should be on healthy lines. Two worrying features of the capital markets need to be underlined in this context. First, during the stock market boom in 1985 and 1986, some fly-by-night entrepreneurs were able to pass on sub-standard issues to gullible investors. The average investor in India is not yet sophisticated enought to discriminate between the good and the not-so-good scrips, with the result that the investor once bitten is twice shy and this is hardly conducive to the promotion of savings in the long run. From this point of view, there was an imperative need for establishing a machinery for varifying the claims of companies issuing new shares and also for regulating trading practices of brokers, SEBI, when its starts functioning effectively, should be able to fill this lacuna and build investors' confidence.

The second feature relates to a 'kink' in the recent boom of the capital market. The so-called mega issues which figured prominently in 1989 -- for instance, a couple of issues in the month of October 1989 themselves exceeded Rs. 1,900 crores -- have resulted in the following distortions. First, resources raised are unrelated to the stream of investment expenditure, and hence, the corporate sector becomes highly liquid as a consequence of mega issues. The resources raised can be used for other purposes like takeover of existing companies than for development of new enterprises/companies. Secondly, such large issue at a point of time unsettling effects on the banking sector's liqidity. Apprehensions have been expressed that the recent buoyancy in the capital market has led to disintermediation in the sense of resources raised through the capital market by-passing the banking system and directly entering the inter-corporate market. Thirdly, resources raised by mutual funds, particularly the UTI, have also been sizeable: one scheme of UTI alone was able to net about Rs. 2,000 crores in 1989. Here is therefore a case of too much money chasing too few 'blue chips' with all its consequent distortions. Fourthly, when these mutual funds park their funds temporarily with banks, this 'hot' money itself casues 'noise' in the even pace of accrual and disbursal of resouces of the banking system; the dimensions of inflow and out-flow being both unpredictable and sizeable.

Overall, the current euphoria of the development of the capital market needs to be tempered by more pragmatic considerations. The demands put forward by those who are over-enthusiastic to develop the capital market -- that banks should be encouraged to lend with a view to enabling borrower, to acquire shares/stocks, or that they should be allowed to underwrite issues without any of the present limitations -- should be eschewed.

To put the role of the stock markets in a proper perspective, it should be underlined that throughtout the capitalist world the bulk of corporate investment is financed by retained earnings. Studies by OECD and economists like Professor Andrew Glyn of Oxford University suggest the irrelevance of the level of share prices for the determination of investment.[8] Thus, the role of stock markets in financing new investments, as against takovers, and other speculative operations, is very slight. Even its barometric role as a measure of business confidence has diminished in the developed economies. Especially in India, the the term lending institutions continue to play the lead role in propelling new investment: for instance, financial assistance sanctioned by Development Finance Institutions (DFIs) rose from only Rs. 1,360 crores in 1978-79 to Rs. 14,200 crores in 1988-89. In such a context, it is all the more necessary to proceed cautiously in developing the capital market on healthy lines.

ii) Distortions in the Interest Rates Structure

A number of new savings instruments have been introduced in recent years like the National Savings Scheme, deposits with the Post Office, Relief Bonds, and Indira Vikas Patra. In the case of many of these instruments, the element of fiscal concessions is substantial: the net return on some of these may work out to as high as 35 per cent for savers in the high income brackets. Even subsidiaries of commercial banks offer net yields of 15 to 18 per cent on deposits of five years, apart from company deposits to which a reference was made earlier. While the offer of a wide spectrum of savings instruments to cater to different target groups of savers is indeed welcome, what is undesirable is that the emerging yield pattern openly discriminates against banks.

If, in the past, commercial banks emerged as the single largest claimant of household sector's savings, this was due, to a great extent, to the fact that banks offered suitable avenues for investment of medium term savings. In fact, over the years, tghe five year deposit came to assume overwhelming importance in the deposit-mix of banks: deposits of three years and above formed only 25 per cent of term deposits in 1969, but, this percentage rose to more than 70 in 1984-85. The average saver, particularly in the semi-urban and rural areas is a 'one-institution man', and, over the years, banks have assiduously built up this relationship of trust and confidence. Unfortunately, this category of deposits of medium term maturity was abolished in April, 1987, since when banks began to offer a ceiling rate of 10 per cent interest on all deposits for periods of two years and above. This had a destabilising impact and the deceleration in deposits growth, in the subsequent period is largely attributable to this abolition. The crude elasticity of real deposits -- that is nominal deposits adjusted for inflation -- with respect to real national income has declined perceptibly over the recent period: the elasticity which was around 2.9 per cent in the Fourth Plan period, declined significantly to 1.7 per cent in the Seventh Plan period. In modern banking, it is pointless to argue about the so-called mis-match between maturity profiles of assets and liabilities. After all, the 'cash credit system' in India is a sort of perpetual credit system. In any case, taking the historical relationship between the average saver and the commercial banks, there is a strong case for restoring the five-year deposit category, with an appropriate rate of interest, say around 12 per cent.

At the same time, the net yields on the whole range of savings instruments should be brought broadly in alignment with this rate for medium-term deposits with banks. Some instruments of savings may have a marginal edge over the medium-term deposits but certinly not the unjustifiably high differential as at present. In fact, it is preferable to offer a clearly set out structure of relatively high <u>nominal</u> interest rates reflecting maturity and liquidity, without excessive fiscal concessions. Low nominal interest rates with large fiscal concessions, as at present, only raise unnecessarily the cost to the Government of mobilisation of resources. This reform in the interest rate structure is overdue.

The trouble with the financial system is that notwithstanding the progress made in the sphere of 'social banking', the system has continued to remain genrous to the large and sophisticated clientele. Two instances may be cited to substantiate this point. First, the interest rate on savings deposits -- a facility which the average individual saver uses -- has remained frozen at 5 per cent since 1977, notwithstanding the inflation in the subsequent period of 12 years. On the other hand, the interest rate on three months' deposit has been raised to 8 per cent since October 11, 1989. Furthermore, under the facility of Certificates of Deposits (CDs), introduced recently, bulk deposits of Rs. crore and above would attract significantly higher rates of interest, for maturity periods between 3 months and 1 year. There is thus a premium of bigness. The second instance pertains to the cost of borrowing to the corporate entities. Under the prevailing corporate tax system, interest paid on borrowed capital is deductible as business expenditure: and hence the effective cost of borrowed capital to the company is substantilly lower than the nominal rate of interest paid to banks or financial institutions. For instance, for working capital borrowed from banks, if a company is paying at present interest of say 16 per cent, effectively it is paying only say about one-half of the rate. In contrast, take the interest rate charged to Food Corporation of India whose operations of foodgrains procurement and distribution throughout the country form the sheet anchor of anit-inflationary policy. Distribution of foodgrains at fair prices is mainly designed to protect the vulnerable sections of the population from the ravages of inflation; and yet the interest rate was hiked up from the concessional rte of 10 or 12 per cent, to as high as 14 per cent. This was the impact of the newfangled zeal for evolving a 'market-related' interest rate regime !

iii) **Mobilisation of Resources by UTI**

There is an imperative need to lend a proper perspective to the euphoria about the massive flow of funds to the UTI, during the last couple of years. For instance, UTI's 1964 Scheme alone is estimated to have netted in something like Rs. 2,800 crores in 1989, as compared with about Rs. 2,000 crores in 1988. How does one reconcile this massive flow with the macro level state of stagnation in the savings rate at about 21 per cent for the last three years ? If one probes the underlying factors, the conclusion that emerges is that the fiscal concessions accorded to investment in UTI are a bundle of distortions and the massive flow is but largely illusory.

Without going into the details of the technicalities, the main elements of distortions may be sketched. Paradoxically enough, although UTI's ostensible objective is to mobilise investible resources from the household sector, the bulk of the resources appears to flow, in recent years, from the private corporate sector: the corporate sector's share in the total resouces mobilised for the 1964 Scheme was reported to be as high as 75 per cent in 1989, as compared to about 35 per cent in 1988. This is so because investment in UTI schemes blesses the corporate investor twice. The first aspect relates to the ability of a company to claim deduction under Sec. 80(M) of the Income Tax Act, 1961 under this provision, if the gross total income of the domestic company includes income by way of dividend from another domestic company, a straight deduction of 60 per cent of the amount is allowed. In other words, on such dividend income from UTI, the company pays only about 20 per cent of the tax.

The second aspect relates to the losses that a company can incur in the course of doing business and the permissibility to set off such losses. It is possible for a company to purchase

Units of UTI in the secondary market, at a point of time nearer to the declaration of dividend by the UTI, collect the dividend, and claim the benefit of Sec. 80(M). Subsequently, the company can sell the Units in the secondary market at a decidedly lower price and incur a loss. Such transactions are in the nature of 'non-speculative business' and hence can be adjusted against other income.

Both these are unmerited fiscal concessions to the corporate sector since there is apparently no 'additionality' element in the total genuine resources accruing to the UTI. The flow of funds from and to UTI, motivated by these considerations, represents 'hot money' and not funds genuinely intended for investment. Such flows artifically inflate the magnitude of funds accruing to UTI and create an illusion of massive flows. The whole range of transactions also necessarily implies a large float of Units in the secondary market and movements of funds into and out of Units also have an unsettling impact on the banking sector's resouces.

What is saddening is that the fiscal distortions built into UTI investments are not so much a tribute to the ingenuity of the private corporate sector to out-smart the regulatory framework but a concrete evidence of the authorities not taking an integrated view of the financial flows in the economy.

The earlier these special fiscal concessions accorded to UTI are done away with, the better it would be for the financial system. In fact, UTI should be placed on par with other mutual funds, so that, only those fiscal concessions available to all other mutual funds should be available to UTI.

V. Financial Liberalisation: Experience in other Countries

While the correction of these distortions should be the pre-occupation of the financial policy-makers in the 1990s, they have to contend with another important aspect of policy formulation, namely, the plea for financial liberalisation. The apostles of free market also advocate total financial liberalisation, as is clear from the World Bank Report, which I quoted earlier. It is contended that financial liberalisation would encourage efficient markets through 'deepening' and elimination of 'fragmentation' of markets, thereby leading to improvement in both mobilisation of savings and efficiency of investment. This current fashion in contemporary economic policy has also caught on in India, particularly in the wake of the wave of industrial liberalisation which swept the country in the mid-1980s. In this context, it is legitimate to pose the question: What has been the emperical experience ? One indepth study of financial liberalisation experiments of Argentina, Brazil and Uruguay in the 1970s comes to the conclusion that "... the profound changes which financial liberalisation and opening up brought about did not translate themselves, despite intentions, into systematically higher savings, or, into clearly improved resources allocation. Indeed, the three experiences came to a close with their financial systems in a shambles."10 It was realised, only later, that the advocates of liberalisation had totally ignored the unfavourable impact that liberalisation would have on savings and investment, through the release of the pent-up demand for consumption. The architects of the financial reforms failed to take into account the inevitable increases in consumption that liberalisation would inevitably bring about.

Another study relates to Korea which achieved a sustained growth of more than 8 per cent during the period 1962 to 1984. These growth rates are <u>not</u> explained by the existence of liberalised financial markets. To quote from the study: "...... the major commercial banks were all largely public enterprises....... with the result that there was direct Government control of virtually every aspect of banking operations. Second, as a means of allocating investment funds according to national priorities, the Government resorted to strict control of interest rates and provided extensive preferential credit at subsidised rates."

Even the World Bank Report admits: "Korea's heavily regulated financial system was a key instrument in the Government's industrial policy of the 1960s and 1970s. Interest rates were controlled and were kept low during this period. A substantial proportion of credit - well above one-third -- was directed by the Government to designated sectors."11 Although financial reforms were introduced in the early 1980s, the loans of commercial banks, even after privatisation continued, to be closely monitored and supervised. Full liberalisation of the financial system began only in the late 1988, with most lending rates being freed, although deposit rates are still controlled.

Again, in the case of Japan, during the high growth period between 1953 and 1972, the GNP rose by an average annual rate of 9.2 per cent. "What was particularly interesting for researchers in money and banking was that this rapid economic growth had taken place within a highly regulated financial framework. The time-deposit rate was regulated, entry into bond issue market was regulated, international asset transactions were virtually forbidden and so on." The 'artificial low interest policy pursued during this period appears to have promoted high growth rates.

These studies chosen from Latin America and Asia clearly indicate that financial liberalisation is not a simple panacea, as some would seem to believe, for improving financial efficiency. More importantly, the Korean experience, also chronicled by the World Bank Report, demonstrates the need for a properly phased programme of liberalisation and in offering an omnibus prescription of liberalisation, the World Bank Report has chosen to ignore this lesson. Michel Camdessus, Managing Director of the International Monetary Fund (IMF) has summed up the position appropriately in the following words: "... nowhere does there exist a final edition of the textbook describing the ideal role of the Government; on the contrary, the action of the state has to be particularly mindful of the particular circumstances of the country and of the international context. 12

My submission is that the Indian financial system suffers from over-regulation and the task in the 1990s would be to deregulate or unshackle the system from myriad regulations. The various distortions that have erupted in the system, which we discussed earlier, clearly indicate that the system is not ripe for liberalisation. Thus, financial liberalisation, no; financial deregulation, yes. That brings us to the agenda for financial reforms in the 1990s.

VI. An Agenda For Reform

If I have been bold enough to attempt to provide an agenda for financial reforms in the 1990s, my only excuse is that this is one way of sharing with you my own perception of the problems that the financial system would face during this decade, as we seek to raise our savings rate from the present stagnant level of about 22 per cent to say 24 per cent of national income, and to secure sustained non-inflationary growth. Some suggestions for reform have alreday emanated from the discussion on certain segments of the financial sector and hence I would be content here by merely focussing on the more important of the reforms needed. Basically, the financial sector should continue to remain, in the 1990s, the hand-maiden of growth in the real sectors as envisaged in the Plans and also of our objective of achieving growth with equity. The financial system would therefore continue to function in a broad regulatory framework and there need be no apologies for adopting this approach.

Foremost among the reforms, it seems to me, is the need to restore the centrality of commercial banks in the financial system, primarily by correcting the distortions in the interest rate structure, discussed earlier. Briefly, the suggestions are that banks be permitted to accept, as in the past, medium term deposits of say five-year maturity attracting a deposit rate of around 12 per cent. The interest rate on savings deposits could be raised to around 6 or 7 per cent. The net yields on other savings instruments should be brought into broad alignment with these rates. These changes in interest rates, coupled with the corrections of distortions in respect of investments in UTI discussed earlier, should go a long way towards restoring the pre-eminence of banks in the financial system.

There are two distinct advantages in restoring the preeminence of banks: first, the writ of the RBI in respect of sectoral deployment of credit runs on commercial banks and not on the resources mobilised by other institutions like the non-banking companies. Second, since the Statutory Liquidity Ratio (SLR) is applicable to resources mobilised by banks, the Government would stand to gain; the cost of borrowing to Government would be also relatively lower.

The concept of cross-subsidisation of interest rates, which appears to have taken a backseat in more recent years, should re-emerge as the idiom of the interest rate policy. This is the contribution that the financial sector could make towards realising the objective of growth with equity. Illustratively, the interest rate on food credit, that is, credit extended for procurement and distribution of foodgrains through the public distribution system should be brought down from the present level of 14 per cent to say 10 or 11 per cent. To the extent to which this would reduce the carrying costs, it may be possible to reduce the issue prices of foodgrains contributing thereby, directly and indirectly, to the containment of inflation.

Developments in the latter half of the 1980s appear to give the general impression that modernisation of banking means primarily mechanisation-computerisation and installation of automatic teller machines, credit cards and a host of new loan schemes desiged to enable borrowers to purchase consumer durables. The stiff competition, as is evidenced by the intense publicity campaigns between foreign banks and some public sector banks to finance purchase of cars, for isntance, makes one wonder whether the consumer durables segment is exempt from the laws of 'credit restraint' - the theme song of credit policy ! This heady mixture of technological rhetoric and consumerism contrasts sharply with the banking system's commitments of the previous 15 years, to priority sectors and the under-privileged sections of the population. Be that as it may, minimum that could be done at this stage, is to hike up the lending rates for consumer durables to say 18 per cent. This compares with the floor rate of 16 per cent to say, large industries.

Turning now to the areas of deregulation, it should be conceded that, over the years, the regulatory framework governing banks has become highly rigid. While this may have been necessary in the period immediately after nationalisation, at the present stage of banking development the rigidity is hampering individual bank's initiative and innovative approach. The RBI has recognised the need to unshackle banks from the regulatory framework: this is reflected in its recent measures of removing the ceiling on lending rate, virtual abolition of the Credit Authorisation Scheme (CAS), and facilitating clientele monbility. This process of deregulation needs to be taken further. First, the present highly complex administered system of interest rates needs to be simplified. Illustratively, the prescribed interest rates which now number about 65 could be easily reduced to some 10 or 12 rates. Second, under selective credit control, an over-elaborate and complex framework has been evolved: the regulations cover some 20 pages of the printed document and even under one commodity, there may be some seven or eight categories to which different margins are applicable. Historically, this may have been a necessity, but over the years, bank executives are familiar with the basic principle of not permitting bank credit to be used for speculative holding of commodities. This document need not be abridged but could be easily scrapped. Starting on a clean slate, simple new regulations, whenever necessary, can be issued for a specific period, say a season or a year, after which the directive should stand automatically terminated. The main purpose in proposing these reforms is to permit a greater degree of operational autonomy to individual banks, within a very broad regulatory framework. In our efforts to raise the savings rate, the thrust in the coming years will have to be on rural savings. The track record of financial institutions, in the area of mobilisation of rural savings is far from satisfactory. For instance, the savings mobilised by rural branches of commercial banks and the regional rural banks have not been commensurate with the expansion in the number of branches. New rural and semi-urban offices accounted for 77 per cent of the total new offices opened between 1964 and 1984, but they accounted for only 37 per cent of the total total incremental deposits during the period. Or, looking at the picture differently, although rural branches of commercial banks form some 60 per cent of the total number of offices, they account of only 14 per cent of total deposits.13 There is a sizeable savings potentional in the rural sector particularly in the agriculturally affluent areas and pockets; and if innovative instruments suited to the pattern of flow of rural incomes and expediture are devised, it should be possible to ensure larger mobilisation. The approach of financial institutions, particularly banks, to rural savings still remains somewhat alien to the rural milieu. This approach needs to be reoriented.

Finally, there is a medium term problem to which financial institutions will have address. This relates to employment generation. Employment in the organised sector is showing a decelerating trend: the compound growth rate of employment was 2.9 per cent per annum between 1970-71 to 1975-76; it declined to 2.6 per cent in the latter half of the 1970s. The rate fell further to 1.8 per cent in the first half of 1980s and to 1.5 per cent in the second half of the 1980s.[14] Even in the agricultural secotr, as Prof. Hanumanth Rao has pointed out, there has been a significant decline in the elasticity of employment with respect to agricultural output for the country as a whole.[15] The point is that, in furture, employment increses could come come about primarily through the promotion of a broad-based growth process in the sense of encouraging decentralised and dispersed development of small industries, self-employment, services, etc. In fact, the whole range of issues relating to the question of bringing the informal sector into the fold of the banking system needs to be fully explored. Financial institutions would have to suitably reorient ther lending procedures, practices and programmes, to facilitate such growth.

This also raises a whole range of issues pertaining to streamlining rural credit institutions.[16] First, a majority of regional rural banks, which had raised high expectations as a low cost institution, have proved to be non-viable. In the case of cooperatives, the ardour of cooperative spirit has no doubt dimmed and even in some States, which were in the forefront of the movement, the cooperatives have been superceded. Thus, the institutional structure supporting rural credit is passing through a critical stage, warranting a major reform: restructuring some of the non-viable institutions, establishing inter-institutional links, de-bureauratisation of the cooperative institutions and so on.

The hope for the financial sector in the 1990s seems top lie in taking an integrated view of the flow of resources at the macro level and in correcting the destortions which have erupted in some segments. Only thus could we ensure larger mobilisation of financial resources, and their more efficient deployment in broad alignment with the priorities enshrined in the Development Plans.

Table - I : Growth of Commercial Banks : Selected Indicators

	June 1969	June 1980	Latest
Number of Commercial Banks	89	153	289 (June 1988)
Scheduled Commercial Banks	73	148	275 (June 1988)
Of Which:			
Regional Rural Banks	-	73	196 (June 1988)
Non-Scheduled Commercial Banks	16	5	3 (Sep. 1988)
Number of Offices in India	8,262	32,419	56,282 (Dec. 1988)
Of Which: Rural	1,833	15,105	31,641 (Dec. 1988)
Population Per Office (In Thousands)	64	21	12
Deposits of Scheduled Commercial Banks in India (Rs. Crs.)	4,646	33,377	1,39,430 (Mar. 1989)
Credit of Scheduled Commercial Banks in India (Rs. Crs.)	3,599	22,068	83,805 (Mar. 1989)
Advances to Priotiry Sector (Rs. Crs.)	504	7,278	29,351 (Apr. 1988)
Share of Priority Sector Advances in Total Credit of Scheduled Commercial Banks (%)	14.0	33.0	45.7 (June 1988)