INDIAN FINANCIAL REFORMS: NATIONAL PRIORITIES AMIDST AN INTERNATIONAL CRISIS

Sir Purushotamdas Thakurdas Memorial Lecture organized by IIBF
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A. Introduction

It is an honour and a privilege for me to be delivering the Purushotamdas Thakurdas Memorial Lecture to this distinguished audience. We are in the midst of an international financial crisis, and I thought it apt to focus today's talk on the national priorities of financial sector reform. Any crisis is also a window of opportunity. We reacted very boldly to the Gulf crisis in 1990. That initial burst of policy reform set off a remarkable period of accelerated growth with macroeconomic stability. In sharp contrast, our reaction to the East Asian Crisis was very different. It was marked by considerable conservatism. While we did respond swiftly and effectively in 1991 with far reaching economic reforms, conservatism was a hallmark of Indian policy making around 1997. With more than 1.1 billion people, and many below the poverty line, there are obvious limits to the risk that we can afford to take in policy making. Yet, too much risk aversion in policy making can impede growth, and slow down our efforts to alleviate poverty.

A majority of historic economic crises were preceded by financial liberalisation.[1] Consequently, there is a tendency to blame all crises on liberalization, and for public and political opinion to turn against deregulation. It is a natural fall-out of an economic crisis anywhere in the world, for example in the contemporary US. We have seen it in the past after the East Asian Crisis of 1997. The report of the Committee on Capital Account Convertibility headed by S. S. Tarapore, submitted at the end of May, 1997, had a roadmap achieving some preconditions and moving towards capital account convertibility by 1999-2000. The report of the first Tarapore Committee, which we shall call Tarapore I, could not have come at a more inopportune time. Starting with Thailand in June 1997, the countries of East Asia – Indonesia, Korea, Malaysia, Philippines, Singapore and Thailand – the then most rapidly growing economies in the world, were hit by a severe and sudden financial crisis. Tarapore I's recommendations were pretty much put in the cold storage. Safety first became the watchword of financial sector reform in India. Some argue that we learnt the wrong lessons, and safety was not only the first but also the last consideration[2]. There were some reforms, such as, the introduction of the Fiscal Responsibility and Budget Management Act, 2003 and pension reforms. Nevertheless, with the benefit of hindsight, perhaps more could have been done to profit the Indian economy.

We are going through yet another period of seriously adverse external economic developments. The onslaught of a steep commodity boom followed by a severe global financial crisis may have raised doubts about the validity of the reform strategy drawn up in more tranquil times. The doubts need to be dispelled or a new strategy drawn up. Inaction is not the answer. Delivering high growth and rapid removal of poverty is an imperative for the government. In the run up to the last election to the Fourteenth Lok Sabha in 2004, the manifestos of the two major coalitions promised high growth. It is safe to assume that with rising popular aspirations in India and a constant benchmarking with China, political parties will have to promise high growth even in the run up to the next Lok Sabha elections. No matter who gets elected, there will be a host of reform issues that the new government will have to address.

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[1] See Kaminsky and Reinhart (1999).
[2] See for example, conclusion by Mistry (2008) "…overall, 1997-2007 was a lost decade for Indian finance".

There is a long and important pending agenda of financial sector reform already drawn up by very distinguished experts such as M. Narasimham, S.S. Tarapore, Percy Mistry and Raghuram Rajan. Is this long agenda going to be a victim of the current crisis? The answer to this question will determine the growth prospects of the Indian economy in the medium to long term. I want to share my thoughts on some of these pending reform issues. I shall start with a brief history of how three recent global crises have affected financial sector reforms in India and how we may have sacrificed medium-term reform for short-term considerations. Finally, I shall focus on five pending reform items: namely moving monetary policy to inflation targeting; modernizing the delivery of financial services to the priority sectors and vulnerable and weaker sections; introducing capital account convertibility; moving to a streamlined financial regulatory architecture; and restructuring the banking industry. .

I believe Sir Purushotamdas Thakurdas would have approved of the topic. To some of us who take an interest in monetary developments in India, Sir Purushotamdas Thakurdas, or Sir P.T. as he was more well-known as, is much more than just a name or a respected leader of the business community in pre-independence India. He was a stalwart in the evolution of monetary and credit policy and institutions in this country.

There is practically no debate on any issue of importance in the monetary field in India spanning across three decades from the mid-1910s to 1950 that Sir P.T. did not participate in. As early as August 1925, he was a member of the Hilton Young Commission.[3] And, almost a quarter century later, when the Government of newly independent India appointed the Rural Banking Enquiry Committee in November 1949,[4] Sir P.T chaired the committee.[5] In the interim, as a member of the Legislative Assembly, and as a member of the Central Board of the Reserve Bank of India (RBI) right from its inception in 1935, he participated in every debate on monetary and credit issues.[6] Sir P.T. played a critical role in the Indianisation of the RBI on August 10, 1943, when Sir C. D. Deshmukh succeeded first an Australian and then an Englishman as Governor.[7]

B. Contrast between the initial thrust after the Gulf Crisis and the troubled second round after the East Asian Crisis

Within less than a month of the first Tarapore Committee submitting its report, the East Asian Crisis was spreading from Thailand to other countries in the region. Tarapore I, more or less coinciding with the East Asian Crisis, started what we shall call the troubled second round of financial sector reform in India.

The troubled second round was dramatically different from the first round of financial sector reform of 1991-96. It is important to remember that the 1991 reforms were launched in the

[3] Formally, Royal Commission on Indian Currency and Finance, under the Chairmanship of Lt. Commander Edward Hilton Young.
[4] Reserve Bank of India (1970), p. 768.
[5] Reserve Bank of India (1970), p. 532.
[6] For example, back in 1927, speaking on the Gold Standard and Reserve Bank of India Bill in the Legislative Assembly, he along with Sir R. K. Shanmukham Chetty emphatically argued about how the Reserve Bank should be free from Government control and also from any influence of the legislature. See Reserve Bank of India (1970), p. 31. On the same grounds of protecting against political influence, Sir P.T. was opposed to the Governor General appointing the Governor and Deputy Governors of the Reserve Bank of India 'after considering the Central Board's (*of the Reserve Bank of India*) recommendations in this regard'. Of course, at that time, the Reserve Bank of India had not been nationalized. See Reserve Bank of India (1970), p. 91
[7] Reserve Bank of India (1970), p. 273.

midst of an international crisis. External shocks had deepened the problems of the economy in 1990. The Iraqi invasion of Kuwait in August 1990 resulted in a drying up of remittances, a massive airlift to repatriate the migrant Gulf labour, and a soaring import bill with a steep rise in the international petroleum prices. Inflation (on an end-of-period basis) was in double digits – 12.1 per cent – in 1990-91. Foreign currency assets of the RBI came down to US$975 million on July 12, 1991, equivalent to less than a month of import cover. A part of the Government's gold had to be transported and pledged to borrow abroad, and foreign loans had to be raised on a continuous – often on an overnight – basis to avert a default on external debt. The government responded to the crisis resolutely with a major structural reform programme. .

Table 1. Important Committees set up to draw up the Financial Sector Reform Agenda

			Year		
No.	Name of the Committee	Chairman	Set up	Submission	Set up by
Initial burst 1991-1996					
1	Committee to Review the Working of the Monetary System (*Chakravarty Committee*)	Sukhamoy Chakravarty	Dec-82	10-Apr-85	Reserve Bank of India
2	High Powered Committee on Financial System (*Narasimham I)*	M. Narasimham	14-Aug-91	Nov-91	Government of India
3	High Level Committee on Balance of Payments (*Rangarajan Committee*)	C. Rangarajan	19-Feb-91	26-Apr-93	Government of India
Troubled second round 1997-2006					
4	Committee on Capital Account Convertibility (*Tarapore I*)	S.S. Tarapore	28-Feb-97	30-May-97	Reserve Bank of India
5	Committee on Banking Sector Reforms (*Narasimham II*)	M. Narasimham		Apr-98	Government of India
Third round with untapped potential					
6	Committee on Fuller Capital Account Convertibility(*Tarapore II*)	S.S. Tarapore	20-Mar-06	31-Jul-06	Reserve Bank of India
7	High Powered Expert Committee on Making Mumbai an International Financial Centre (*PM Committee)*	Percy Mistry[8]	28-Nov-05	10-Feb-07	Government of India
8	Committee on Financial Sector Reforms (*Rajan Committee)*	Raghuram Rajan	17-Sep-07	07-Apr-08	Planning Commission

As part of the package of wide-ranging reforms launched after the 1991 crisis, financial sector reforms had progressed well in the initial years. The financial sector was one of the earliest to undergo significant changes. There was a clear recognition that for efficient mobilisation and allocation of resources, financial sector reforms had to keep pace with, and in some cases, even precede, policy reforms in the external and domestic industrial sectors. Reforms recommended

[8] Mistry resigned a few days before the submission of the report.

by the various committees (Table 1) in the first phase between 1991 and 1996 were implemented more or less in a satisfactory manner.

To better understand how the East Asian Crisis affected the pace of financial sector reforms, let us recall the three important reports that played a critical role in determining the financial sector reform agenda in India during the initial reform period: Chakravarty Committee, Narasimham Committee I, and Rangarajan Committee.[9] Following Chakravarty Committtee's recommendations, while the amount of RBI credit to Government for financing fiscal deficit may not have been curtailed with success during the initial years, the need for curbing such deficit for inflation control was well accepted. Government and RBI also implemented Chakravarty Committee's recommendation about adjustment of the administered rates of interest on Government borrowings.

Next came the recommendations of the High Powered Committee on Financial System headed by M. Narasimham, what we will call Narasimham I. In 1991, the cash reserve ratio (CRR) was an all-time high of 15 per cent and the statutory liquidity ratio (SLR) was also an all-time high of 38.5 per cent[10]. They were the main instruments of preempting banking sector funds. The fundamental recommendation of the Narasimham Committee was a change in the approach to banking development. It was a change from a supply-based, subsidy-linked and target-oriented one to a more demand-driven, self-sustaining, and market-friendly approach. This change in approach to banking development, Narasimham I argued, was essential for improving the financial sector's efficiency and effectiveness in responding to the emerging needs of the economy. The main recommendations were: (i) progressive deregulation of interest rates, (ii) reduction in SLR and CRR to reduce the pre-emption of bank funds, (iii) a phased achievement of capital-adequacy of 8 per cent for banks in line with Basle Committee[11] recommendations, and (iv) strengthening the balance sheets of banks through proper asset classification, income recognition, and provisioning norms. Most of these were implemented in what we call 'the initial burst' itself.

Prior to the initial burst, the rupee was considerably overvalued. There was a chronic shortage of foreign exchange at the 'official rate' and a scarcity premium reflected in the unofficial or black-market rate. Mirroring the permit-licence raj in industry, through its foreign exchange budget, the Government had an administrative mechanism for allocation of scarce foreign exchange. During the initial burst, when the Rangarajan Committee recommended a move to 'a realistic exchange rate' determined by market forces, the Government implemented the recommendations. This implementation was done in stages. The first was a move from an officially fixed overvalued exchange rate to the dual rate regime under Liberalised Exchange Rate Management System from March 1, 1992. Then, the dual exchange rates were unified on March 1, 1993. Finally, the rupee was made convertible under the current account from August, 1994.

The issue that remained was of capital account convertibility. Capital account convertibility implies the residents' relatively unrestricted right to transact in financial assets with foreign

[9] The RBI set up the Chakravarty Committee in 1982. On August 14, 1991, Government appointed the Committee on the Financial System, under the chairmanship of M. Narasimham. The High Level Committee on Balance of Payments under the Chairmanship of C. Rangarajan was set up by the Government on November 19, 1991. For a detailed discussion, see Lahiri (2006).

[10] Both the ratios are as a proportion of net demand and time liabilities of banks.

[11] In 1988, the Bank of International Settlements (BIS) based in Basle, the Central Bankers' bank, had set up a committee of several Governors of the Central Banks on Baking Regulations and Supervisory Practices. The broad framework of standards recommended by the Committee is known as Basle standards.

countries.[12] Such convertibility can reduce the cost of capital in a capital-scarce developing country and thereby stimulate investment and growth. By allowing residents to invest abroad, it can reduce the susceptibility of their income streams and wealth to domestic real and financial shocks. Thus, it can also diffuse the risk of an asset-price bubble. Capital account restrictions tend to turn progressively ineffective, costly and even distortive. However, capital account convertibility also exposes a country to booms-and-bust cycles in international capital flows.

On February 28, 1997, the RBI appointed Tarapore I for outlining a roadmap for moving towards capital account convertibility. Tarapore I, in its report submitted on May 30, 1997, recommended a sequenced withdrawal of controls in moving towards capital account convertibility over a period of three years starting in 1997-98 and ending in 1999-2000. It outlined certain pre-conditions for sequencing the move towards such convertibility (Box 1).

A month after the Tarapore Committee submitted its report, crisis erupted in East Asia. The most rapidly growing economies in the world were hit by a severe and sudden financial crisis, which in Dornbusch's (2001) terminology, was a 'new style' crisis. Investors' concerns about the creditworthiness of the balance sheet of a significant part of the economy caused the crisis. It was very different from an 'old style' or 'slow motion' crisis.[13] As a reaction, India adopted a relatively cautious and calibrated approach to capital account convertibility. The deadline of 1999-2000 for Tarapore I came and went, and what we made were some modest moves such as replacement of the Foreign Exchange Regulation Act (FERA), 1974, by a more progressive Foreign Exchange Management Act (FEMA), in 1999, and permission to Indian mutual funds to invest in overseas securities.

Box 1. Tarapore I (1997): Preconditions for Full Capital Account Convertibility

(a) Fiscal Consolidation -- reducing the Centre's Gross Fiscal Deficit to 3.5 per cent of GDP, establishing a Consolidated Sinking Fund for public debt and a 'public debt' office, and introducing a system of fiscal transparency.

(b) Mandated inflation rate -- inflation to be maintained within 3.0-5.0 per cent in the medium term.

(c) Consolidation in the Financial Sector -- full deregulation of interest rates, strengthening the financial system by bringing down gross non-performing assets (NPAs) of the banking sector to 5.0 per cent of total advances and the average effective CRR to 3.0 per cent.

(d) Exchange rate policy -- monitoring the exchange rate within a band of +/- 5.0 per cent around the neutral real effective exchange rate (REER), non-intervention by RBI within the band, disclosing the neutral REER regularly along with its base period, ensuring that forward exchange markets reflect interest rate differentials.

(e) Balance of Payments -- sustained increase in the current receipts/GDP ratio and reduction in debt service ratio to 20.0 per cent.

(f) Adequacy of reserves -- reserves at no less than six months of imports and no less than three months of imports plus 50 per cent of debt service payments plus one month of exports and imports; short term debt and portfolio stock at no more than 60 per cent of reserves and the net foreign assets /currency ratio at no less than 40 per cent.

[12] Although convertibility existed in respect of certain constituent elements of the capital account, such convertibility was, and is not complete, particularly with respect to residents borrowing abroad and acquiring large value foreign assets.

[13] Countries in East Asia had witnessed enormous capital flows during the early-1990s. Except in Malaysia, the bulk of the capital flows to the rest of the countries were in the form of offshore borrowing by banks and the private corporations. Capital inflows had remained strong through 1996 and in most cases until mid-1997. But things changed in 1997.

(g) <u>Strengthening of the financial system</u> -- uniform regulatory system for banks and financial institutions, reserve requirements on non-resident liabilities of banks on par with their domestic liabilities, RBI prescribed prudential norms for rupee mismatches, banks adopting best practices of risk management and following international accounting and disclosure norms, and an effective regulatory regime for the financial sector capable of detecting warning signals.

There was a widespread perception that that India was saved from the East Asian contagion because it had stringent capital controls. As Tarapore (2006b) has commented "This is totally erroneous. India was saved from the East Asian contagion of 1997-98 not because of a restrictive capital account but because of a sound macroeconomic situation. It bears recalling that with extremely tight capital controls in 1990-91, India was inflicted by the worst balance of payments crisis in its history."

In this troubled second phase, shortly after Tarapore I, in 1998, M. Narasimham was asked again by the Government to head the Committee on Banking Sector Reforms. Narasimham II suggested some wide-ranging reforms for the banking sector (Box 2). It had better luck than Tarapore I, but not as good as those under the initial burst, including Narasimham I. Many of its recommendations were accepted and implemented. But, there were notable exceptions (marked in red in Box 2).

Box 2. Narasimham II (1998): Main Recommendations

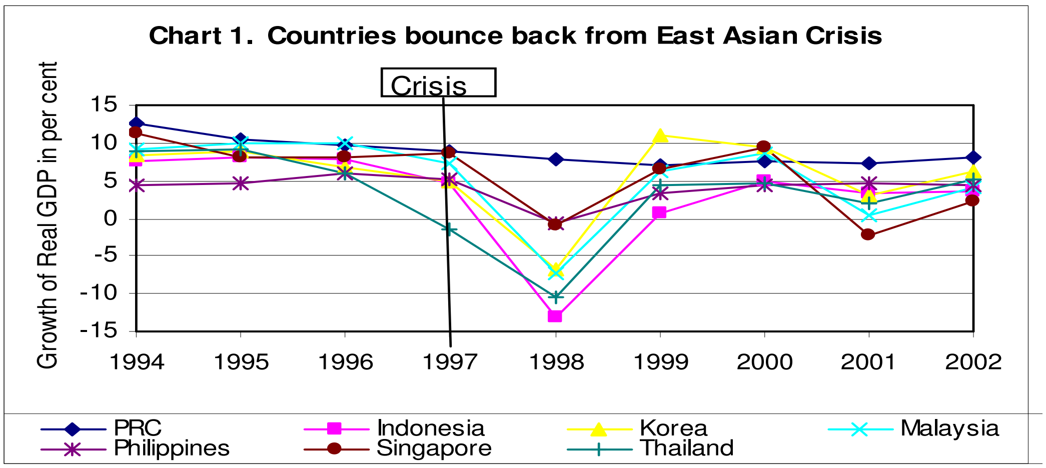
(i) Ensure orderly movements of the call money rate, by, if necessary daily, resetting Repo and Reverse Repo rates under RBI's Liquidity Adjustment Facility (LAF);
(ii) An integrated system of regulation and supervision of banks, financial institutions and non-bank finance companies (NBFC) under a Board for Financial Regulation and Supervision (BFRS);
(iii) A legal framework that clearly defines the rights and liabilities of parties to contracts and provides for speedy resolution of disputes, and suitable amendment of Transfer of Property Act 1882, Law on Mortgage, Indian Contract Act, and Banking Regulation Act.
(iv) Better balance sheet valuation, disclosure and stricter prudential standards.
(v) Reduce NPA of banks by setting up asset reconstruction companies (ARC);
(vi) Reform directed credit to priority sector, including by reducing its scope from 40 per cent;
(vii) Bank restructuring

- allow mergers of banks and NBFC, and among banks;
- convert development financial institutions (DFI) into banks or NBFCs;
- remove restriction of 10 per cent voting rights;
- allow foreign banks to set up subsidiaries or joint ventures in India;
- progressively raise the statutory minimum net worth requirement for registration of NBFCs from Rs. 25 lakh to Rs. 2 crore, and withdrawing deposit insurance from NBFCs;
- move from a flat to a risk-based or variable rate premium for deposit insurance;
- reduce the legally required public shareholding in public sector banks from 51 to 33 per cent;
- end the duality of control of urban cooperative banks by State Governments and RBI, and bring them under the sole jurisdiction of the Board of Financial Supervision;

(viii) Market reforms:

- restrict access to inter-bank call and notice money markets strictly to banks and primary dealers, withdraw RBI from the primary market in 91 days treasury bills, and impose prudential limits on reliance of banks on the call money market;
- reduce minimum duration of certificates of deposits, commercial paper, treasury bills and money market mutual funds to 15 days to develop an active, deep and liquid secondary market;
- integrate the forward exchange market with the spot forex market by allowing all participants in spot to participate in the forward market up to their exposures.

The recovery of the East Asian countries after the 1997 crisis was fairly rapid and spectacular (Chart 1). Why were the recommendations of Tarapore I and Narasimham II not implemented after the East Asian crisis blew over? I do not know the answer, but perhaps three factors contributed. First, the misperception that India was saved from the contagion because it had stringent capital controls. Second, there was no crisis and hence no compelling reasons for reforms. The relation between reforms and crisis, and its obverse – namely, the absence of reforms without a crisis – is well-known. Third, there was a significant decrease in risk-aversion among international investors towards emerging economies, including India, resulting in buoyant capital flows.



C. The problem of surfeit and the impossible trinity

By 2002, the East Asian crisis blew over, and the Indian economy also did well (Table 2). In fact, there were the problems of a surfeit on the foreign exchange front. After a gap of 24 years, the current account of the balance of payments recorded a surplus in 2001-02 (current account surplus was last recorded in 1977-78), and remained in surplus for the subsequent two years. It turned into a deficit subsequently, but albeit a small one. With buoyant capital flows, foreign exchange reserves were growing. The focus of monetary policy had to shift from protecting the economy from a precarious balance of payments situation to a problem of surfeit. Foreign exchange reserves almost doubled from US$76 billion at end-March 2003 to US$145 billion at end-March 2006.

As a matter of fact, by the end of 2003-04, the macroeconomic policy challenge had shifted dramatically from a problem of foreign exchange shortage to a problem of surfeit. It is well known that it is impossible to have the trinity of a fixed exchange rate, free capital movement, and autonomous monetary policy. They are inconsistent with each other. We have to choose at most two of the three. Indeed, India did not and does not have a fixed exchange rate regime or capital account convertibility. But, there was a commitment to orderly exchange market conditions and de facto there was enough convertibility on the capital account. By the middle of this current decade, India was facing the impossible trinity.

RBI was intervening to maintain orderly conditions in the foreign exchange market and prevent the rupee from appreciating suddenly. The RBI by end of March 2002 was in a position to pay every holder of every rupee note anywhere an equivalent amount in foreign exchange and meet its obligation of "I promise to pay". It may be recalled that Tarapore I had recommended a statutory minimum net foreign asset to currency ratio of 40 per cent. The minimum had been achieved and well surpassed by 2001.

Table 2. Growth Momentum with Macroeconomic Stability 2003-07

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
GDP growth	3.84	8.52	7.45	9.40	9.62	9.03
WPI Inflation (end of year)	6.49	4.64	5.70	3.98	5.94	7.75
Gross domestic savings as a per cent of GDP	26.4	29.8	31.8	34.3	34.8	…
Gross capital formation as a per cent of GDP	25.2	28.2	32.2	35.5	35.9	…
Current account deficit as a proportion of GDP	-1.25	-2.32	0.39	1.22	1.09	1.49
Fiscal deficit as a per cent of GDP	5.91	4.48	3.98	4.09	3.67	3.20
Foreign exchange reserves in billions of US dollars	76.1	113.0	141.5	151.6	199.2	309.7
BSE Sensex (end-March)	3,048.72	5,590.60	6,492.82	11,279.96	13,072.10	15,644.44

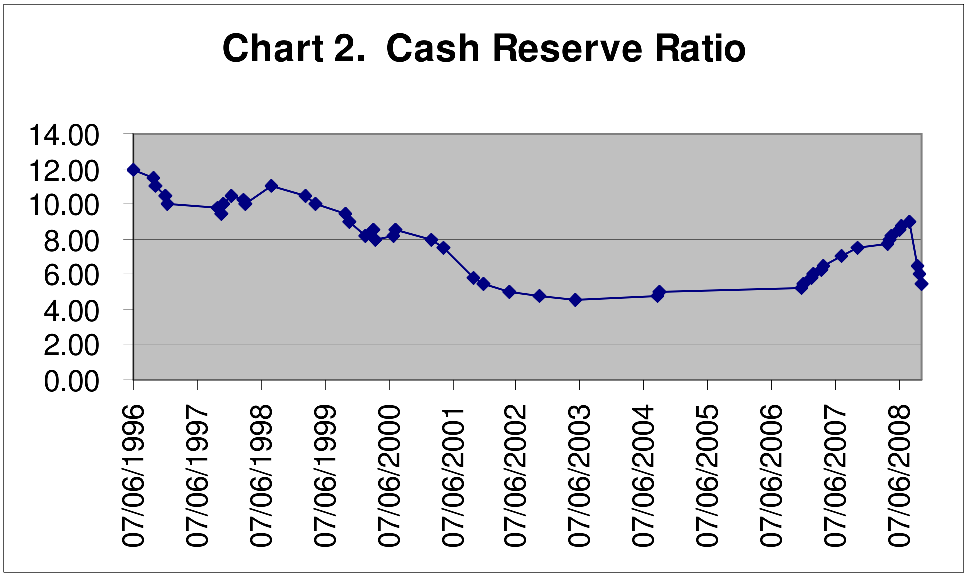
In the short-term firefight, initially, the strategy was that of sterilized intervention. First, the RBI bought the foreign currency by releasing rupees, and then sterilized it by selling bonds and mopping up the rupees released. The RBI could only sell Government bonds that it had in its kitty, and with fiscal consolidation the Government was borrowing a limited amount and there were not enough Government bonds to sell. To solve this problem, in 2004-05, the Government introduced the Market Stabilization Scheme (MSS) authorizing the RBI to issue treasury bills and bonds beyond the Government's own borrowing needs.[14] The cost of sterilization accruing to the Government, as a proportion of GDP, rose four-fold from 0.07 per cent (Rs. 2,056.6 crore) in 2004-05 to 0.28 per cent (Rs. 13,382.4 crore) in 2007-08 (RE).

Second, the CRR had been on a downward trend almost continuously since 1991 until late 2003. The CRR was doubled in stages from a low of 4.50 per cent of net time and demand liabilities of banks on June 14, 2003 to a high of 9.0 per cent on August 30, 2008 (Chart 2). The CRR has long been recognized as a blunt instrument of monetary policy for two reasons. First, without market-related remuneration on such cash reserves, it is a tax on financial intermediation. With a non-interest bearing CRR of 10 per cent, a bank to break even, will have to charge at least 11 per cent on its loan when it raises deposits at 10 per cent. If CRR goes up to 20 per cent, the loan rate will have to rise to 12.5 per cent. The CRR increases the spread between deposit and lending rates. Second, the CRR is an across-the-board levy which does not take into account the relative liquidity position of different banks. Although originally CRR was considered appropriate more for safety reasons, now with good prudential norms, CRR has lost its popularity and has been dispensed with in many countries[15]. CRR continues to be popular in countries with shallow financial markets and hence weak transmission mechanism for

[14] The Government of India and RBI formally signed a Memorandum of Understanding detailing the rationale and operational modalities of the Market Stabilisation Scheme (MSS) on March 25, 2004. The scheme became effective from April 2004. The MSS is subject to a maximum limit specified by the Government.

[15] Such countries include Australia, Canada, Mexico, New Zealand, Sweden and the UK,

transmission of monetary policy. Tarapore I had recommended the reduction of CRR to 3 per cent and even as late as 2005, the RBI had announced that it "….continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent."[16] In the event, this medium-term objective became a victim of short term exigencies.



Third, following the recommendation of Narasimham II, to stabilize short-term interest rates through an informal corridor, a Liquidity Adjustment Facility (LAF) was introduced on June 5, 2000. LAF is a daily exercise, in which only banks and Primary Dealers (PD) participate[17]. Acting as a banker of the last resort, RBI, under the LAF, injects liquidity by allowing participants to transfer securities to the RBI with a repurchase agreement at the repo rate, and absorb liquidity from them by getting into reverse repurchase agreement at the reverse repo rate. Like a bid-ask spread, the repo rate is always above the reverse repo rate.

The idea of Narsimham II behind LAF was to ensure orderly movements of the call money rate to "in a sense provide a reasonable corridor for market play", by resetting repo and reverse repo rates, if necessary daily. This was not achieved in any meaningful sense. With buoyant capital flows, the RBI was worried about multiple considerations beyond orderly movements of the call rate within the LAF corridor. It fixed both the quantum of liquidity to be absorbed or injected under LAF and the accompanying reverse repo and repo rates at the same time[18].

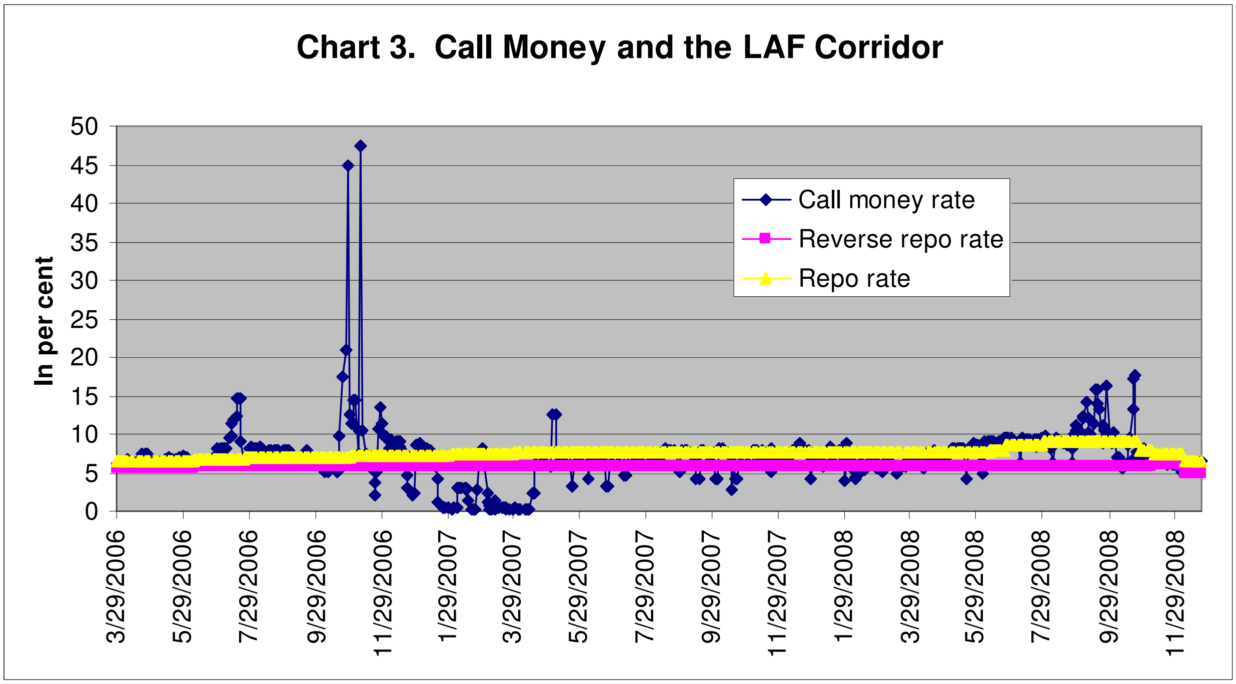
You can either fix the price or fix the quantity. Fixing both denies the LAF corridor any chance of containing the call money rate. For example, in the 678 days of active trading between March 29, 2006 and December 22, 2008, the call money rate was above the repo rate on 253 days, and below the reverse repo rate on 108 days (Chart 3). In other words, on more than half the days, call money rate was outside the LAF corridor. Furthermore, the LAF corridor with the repo

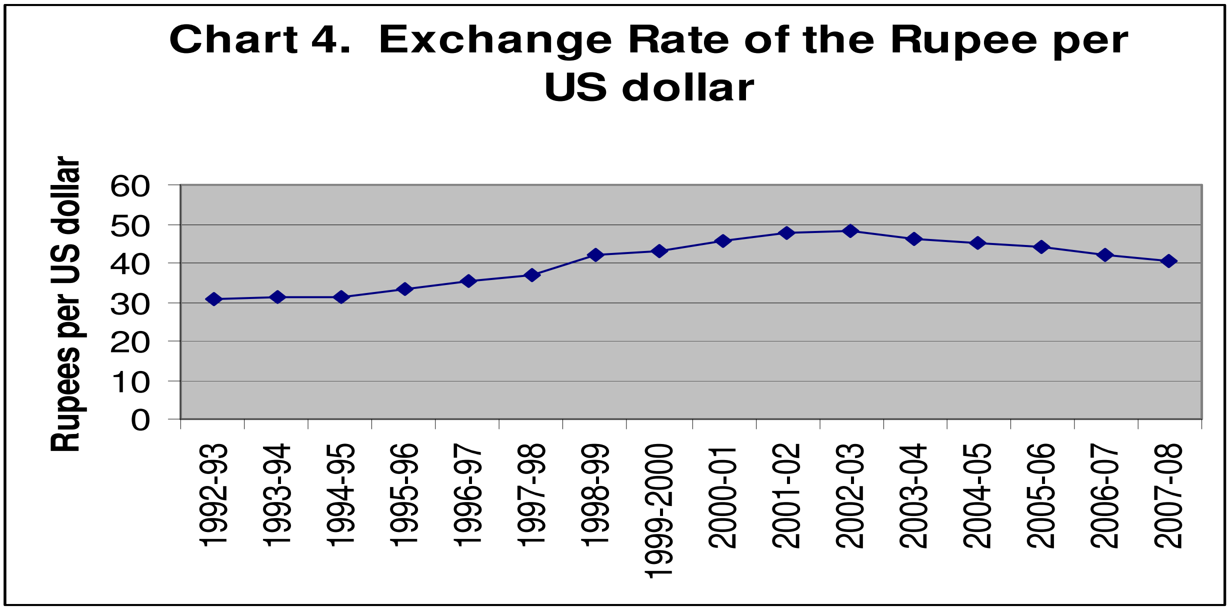
[16] See RBI (2005), Part II, Chapter 3, para III.9.

[17] RBI operates the LAF to inject/absorb liquidity through daily repos/reverse repos auctions in the forenoon between 9.30 A.M. and 10.30 A.M. For fine-tuning the management of bank reserves on the last day of the maintenance period, a Second LAF (SLAF) on reporting Fridays was introduced with effect from August 1, 2008.

[18] RBI entrusted the Financial Markets Committee, consisting of the operational Departmental Heads, to meet every day in the morning to assess market conditions, and make decisions relating to the LAF. The Committee meets again at 12 noon to assess the bids received under LAF. The exact quantum of liquidity to be absorbed or injected and the accompanying reverse repo and repo rates are determined by the Committee after taking into consideration, the liquidity conditions in the market, the interest rate situation and the stance of monetary policy.

rate as the ceiling with the statutory Bank Rate remaining unchanged at 6 per cent since April 30, 2003 raises some questions about the significance of the Bank Rate in RBI policies.



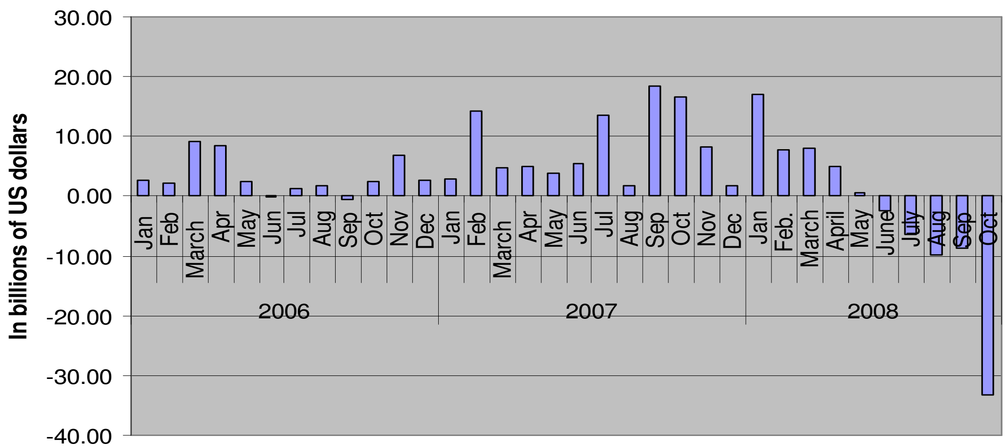


Overall, monetary policy had to shift gears with the remarkable turnaround of India's balance of payments situation between 2001-02 and 2005-06. The problem was no longer the traditional one of protecting the rupee from depreciating rapidly but one of preventing its rapid appreciation (Chart 4). With its multiple objectives of maintaining price stability, promoting growth by meeting the legitimate credit needs of trade and industry and also maintaining orderly conditions in the foreign exchange market, RBI faced the impossible trinity.

D. The latest round with untapped potential: 2006 onwards

By end-March 2006, the Indian economy seemed to demonstrate a transition to a higher growth trajectory with more secure macroeconomic fundamentals. Growth in 2005-06 had exceeded 9 per cent, inflation was below 4 per cent, and the foreign exchange reserves already in excess of 11 months of imports were growing (Chart 5). This comfortable situation started off the third phase with untapped potential.

Chart 5. Growth in foreign currency assets of the RBI



With most of the preconditions specified by Tarapore I (particularly in terms of inflation rate, consolidation and strengthening of the financial sector, exchange rate policy, external debt and reserve adequacy) having been achieved, there was a need to revisit the subject and consider a fresh roadmap for achieving full capital account convertibility. Accordingly, following the Prime Minister's directive to examine the issue afresh, the RBI, on March 20, 2006, appointed the second Tarapaore Committee (Tarapore II) to work out a framework for achieving the objective.

Tarapore II observed that there was progress towards capital account convertibility, but "….on an ad hoc basis and the liberalized framework continues to be a prisoner of the erstwhile strict control system."[19] The Committee recommended various measures such as reduction of the gross borrowing requirement of the government, adopting the public sector borrowing requirement (PSBR) as a clear indicator of the public sector deficit, setting up of an Office of Public Debt outside the RBI, and a clear setting out of monetary policy objectives jointly by the government and RBI, for fuller capital account convertibility. The Committee recommended a gradual approach towards fuller capital account convertibility consisting of Phase I (2006-07), Phase II (2007-08 and 2008-09) and Phase III (2009-10 and 2010-11). The substantive recommendations of Tarapore II are given in Box 3.

Two other important committees appointed in the third phase by Government and the Planning Commission are the High Powered Expert Committee on Making Mumbai an International Financial Centre headed by Percy Mistry and the Committee on Financial Sector Reforms,

[19] Tarapore (2006a), p. 130.

headed by Raghuram Rajan, respectively. We shall call the two reports submitted in February 2007 and April 2008, respectively, the PM Report[20], and the Rajan Report[21].

Box 3. Recommendations of Tarapore II (2006) for Fuller Capital Account Convertibility

i. External commercial borrowings (ECB) (then subject to an annual ceiling of $18 billion) –
- Raising the ceiling gradually in Phases II and III;
- Putting rupee denominated ECB outside the ceiling;
- Removal of end-use restriction[22] on ECB in Phase I;
- Removal of ECBs over 10-year maturity outside the overall ceiling in Phase I;
- Removal of ECBs over 7-year maturity outside the overall ceiling in Phase II;
- Raising the limit for automatic approval from $500 million to $750 million in Phase II and $1 billion in Phase III;

ii. Raising the limit of overseas investment by Indian companies from 200 per cent of net worth to 250 per cent in Phase I, 300 per cent in Phase II, and 400 per cent in Phase III;

iii. Prohibit foreign institutional investors (FII) from investing money through participatory notes (PNs);

iv. Raise the annual subceiling within overall ECB ceiling of FII investment in debt instruments
- For Government securities and treasury bills, from $2 billion to 6 per cent of total gross issuance by Centre and States in Phase I and further to 8 per cent of such issuance in Phase II and 10 per cent of such issuance in Phase III;
- For corporate debt, from $1.5 billion to 15 per cent of fresh issuance Phase II and further to 25 per cent of fresh issuance in Phase III;

v. Allow non-resident corporates to invest in Indian stock markets through SEBI-registered entities;

vi. Allow foreign institutions and corporates beyond multilateral institutions (such as International Finance Corporation and Asian Development Bank) to raise rupee bonds in India;

vii. Linking domestic banks' borrowings from overseas banks and correspondents to paid up capital and free reserves and not to unimpaired Tier I capital, and putting the limit at 50 per cent in Phase I, 75 per cent in Phase II, and 100 per cent in Phase III;

viii. Extending the permission for investment overseas by SEBI-registered Indian investors beyond mutual funds to all SEBI-registered portfolio management schemes and raising the annual aggregate ceiling on such investment from $2 billion to $3 billion in Phase I, $4 billion in Phase II and $5 billion in Phase III;

ix. Raise the annual limit on free remittance by resident individuals from $25,000 to $50,000 in Phase I, $100,000 in Phase II, and $200,000 in Phase III;

x. Allow non-residents (NRs) other than non-resident Indians (NRIs) also to open FCNR(B) deposit accounts without tax benefits in Phase I, and also NR(E)RA deposit accounts without tax benefits in Phase II; and

xi. Allow non-residents (NRs) other than NRIs to invest in companies in Indian stock exchanges through SEBI-registered mutual funds, and portfolio management schemes.

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[20] Speaking at the Asian Corporate Finance Conference in Mumbai on March 18, 2006, Prime Minister Dr. Manmohan Singh had said that making Mumbai a Regional Financial Centre was under the Government's active consideration. The Committee was also chaired by Percy S. Mistry until February 7, 2007.

[21] The Rajan Report submitted in April 2008 was a draft report. The final report came out as "A Hundred Small Steps" on September 12, 2008, and was due to be published in 2009.

[22] End use restrictions applied to working capital, repayment of rupee loans, investment in capital market, and investment in real estate.

As an aside, the PM Committee report may not have attracted the right attention it deserves perhaps because of its name. The name may have given the mistaken impression to some that the report is all about making Mumbai an enclave for a few 'super-rich investment bankers and bonus-obsessed currency-and-options traders' supplying international financial service to the rest of the world. On the contrary, the PM Committee makes it very clear that making Mumbai an International Financial Centre is as much or more about the whole of India as it is about Mumbai. In its report submitted on February 10, 2007, it made five substantive points (Box 4).

Box 4. Recommendations of PM Committee (2007) on Making Mumbai an International Financial Centre

1. Make Mumbai an International Financial Centre not only to capture the domestic and foreign market for international financial services, but to get the real advantage coming from rooting it in a 'large and efficient domestic financial market, … that operates on global lines.'[23]
2. Move aggressively on introducing full capital account convertibility.[24]
3. Have a monetary policy regime that targets inflation.
4. Shift financial regulatory regime from rules-based regulation to principles-based regulation by 2011.[25] Scrap subordinate law under a prescriptive approach.
5. Move from a fragmented to a unified financial sector regulatory architecture. In the interim, do a 'partial consolidation of extant regulators into a tightly knit quartet covering: (a) banking; (b) insurance; (c) pensions; and (d) capital, derivatives and commodities markets'. Transfer all regulation/supervision of any type of organised financial trading to SEBI.

Now, let us move to the Rajan Committee. Its very broad terms of reference included identification of the emerging challenges in meeting the financing needs of the Indian economy, examination of the performance of the various sectors of the financial sector, identification of changes needed in the regulatory and supervisory infrastructure. The Committee gave three reasons for financial sector reforms: for including more Indians in the growth process (or, more inclusive growth), more growth, and protecting the economy from external instability.[26] The Committee made 33 recommendations, of which the salient ones can be grouped into six categories (Box 5).

[23] See PM Committee, p. 76.
[24] See PM Committee, p. 226: "..the HPEC is of the view that the capital account needs to be liberalised more rapidly and in a time bound fashion than is presently envisaged. CAC needs to be achieved within the next 18–24 months – *i.e.*, by the end of calendar 2008 at the latest – preferably sooner."
[25] The prime examples of such principles-based regulation were UK (pioneer), Ireland, and Australia. The Committee also cited appropriate moves in more recent times by Singapore and Commodity Futures Trading Commission in the US.
[26] Rajan Committee (2008), p. 2.

Box 5. Recommendations of Rajan Committee (2008) on Financial Sector Reforms

1. Inflation-targeting by RBI through the repo and reverse repo rates.
2. Reform of regulatory architecture with principles-based regulation
3. Deregulation for more efficiency with opening up rupee bond markets to foreign investors, being more liberal in allowing takeovers and mergers, including by domestically incorporated subsidiaries of foreign banks, freeing banks to set up branches and ATMs anywhere, creation of a more innovation-friendly environment.
4. Deregulation for financial inclusion by allowing more entry of well capitalized deposit-taking small finance banks, liberalising banking correspondent regulation to allow local agents to extend financial services, allowing a system of exchangeable priority sector loan certificates (PSLC), and liberalising interest rate on loans subject to full disclosure, transparency and restrictions regarding eligibility under PSLC scheme.
5. Reforms for financial inclusion: to improve the collation of credit history, expedite the process of creating a unique national ID number with biometric identification, and open up credit bureau information to subscribers subject to verification of "need to know and authorization to use" of the subscriber; and improve land registration and titling. Re-examine restrictions on tenancy so that tenancy can be formalized in contracts and extend the powers of SRFAESI to all institutional lenders.
6. Restructure public sector banks (PSB): by selling small underperforming PSBs to strategic investors and observing outcome; strengthening board of directors, and either creating bank holding companies or bringing down Government's share below 50 per cent.

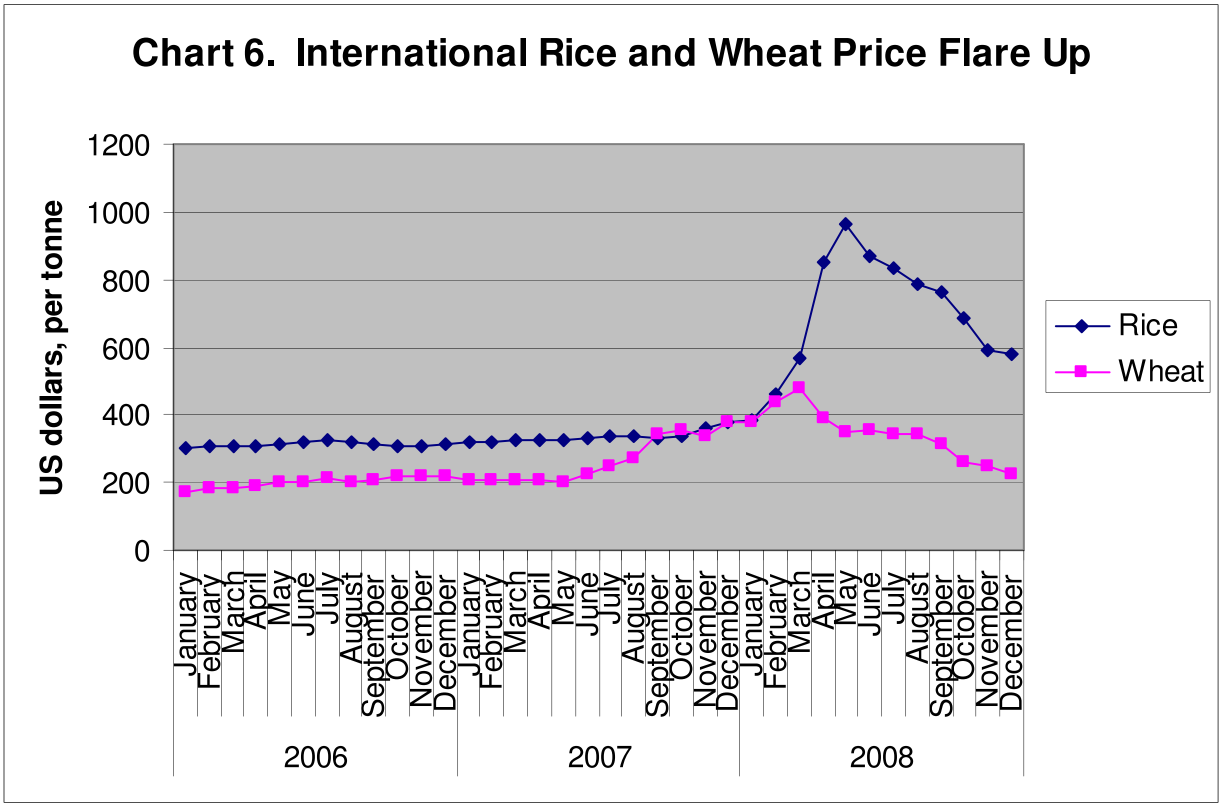
The three recent reports provide valuable inputs for policy making. What is striking is the commonality of recommendations. The two most recent committees, namely PM and Rajan, approach the issue of financial sector reform from two different angles – one for making Mumbai an international financial centre, and the other for accelerating growth and making it more inclusive. Yet, their recommendations are strikingly similar. This is not surprising since the PM Committee makes it very clear that development of Mumbai into an international financial centre has to be premised very differently from similar development of Singapore or Dubai. Mumbai is not just an entrepot, it has the vast Indian economy with immense potential behind its seagate. This advantage, which the PM committee calls 'the hinterland advantage', has to be fully utilized, and much of the advantage of developing Mumbai into an international financial centre will come from having a world-class financial sector that can serve the vast Indian economy. There are a large number of issues on which these two recent committees have reiterated not only much of what Tarapore II said in 2006, but also what Narasimham II had emphasized in 1998. There seems to be a lot of untapped potential in the three reports of the most recent period. I shall group the main pending recommendations under the following five headings:

1. Moving to an inflation-targeted monetary policy regime;
2. Modernising the delivery of financial services to the priority sectors and the vulnerable and weaker sections;
3. Introducing capital account convertibility;
4. Moving from a rules-based and fragmented regulatory architecture to a principles-based and unified architecture; and
5. Reform of the banking system in general and public sector banks, in particular.

I believe that some of these measures would have been taken to implement some of these recommendations had it not been for adverse external developments in the form of a large commodity price shock in the world market and for the ongoing global crisis.

E. First too hot to handle and then in the midst of a crisis

Before any action could be taken on the recommendations of the three committees of the latest sub-period, international petroleum prices started to rise steadily and food prices came under severe pressure. Relative to May 2007, the price of rice and wheat, for example, rose by 197 per cent and 137 per cent, respectively, by May 2008 and March 2008 (Chart 6). Simultaneously, with extremely buoyant capital inflows, foreign exchange reserves more than doubled again to $310 billion by end-March, 2008.



Rising world prices got transmitted to domestic prices of primary commodities. With primary commodity group prices rising, inflation continued to accelerate reaching a peak of 12.91 in the week ending August 2, 2008[27]. The inflation acceleration reflected not only a simultaneous flare up in the prices of both primary commodities and energy products but also a sharp rise in metal products, particularly those of iron and steel. Rising inflation became a matter of concern. India was described as "Too hot to handle" by some, as in The Economist dated November 25, 2006. Some alleged that India was 'too hot' or overheating, because it was growing beyond its growth

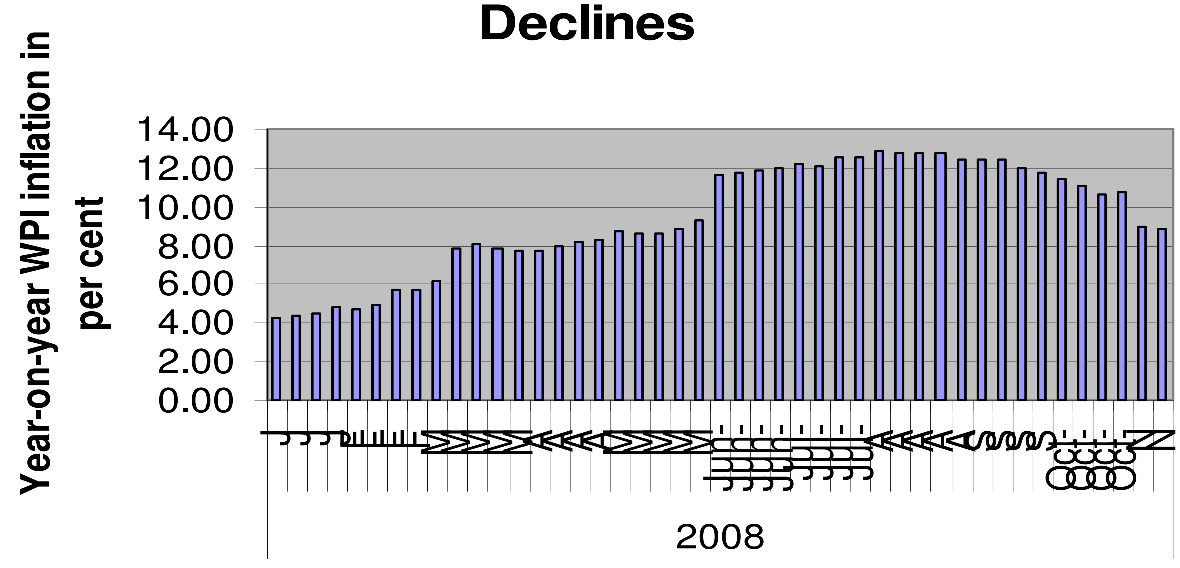
[27] With prices of primary commodities rising at an average annual rate of over 8 per cent between May 27, 2006 and June 23, 2007, the overall inflation rate, as measured by the year-on-year movement in the wholesale price index (WPI), crossed and remained above 5 per cent between the week ending August 9, 2006 and week ending June 2, 2007. Subsequently, after remaining subdued below 5 per cent until the week ending February 9, 2008, inflation reignited again to reach its peak on August 2, 2008.

potential thereby straining its labour force and capital stock and hence engendering inflationary instabilities.

In response to the inflationary surge, Government and RBI started to act on both the fiscal and monetary front. For example, the Government allowed the subsidy bill for petroleum products to balloon by not raising the retail prices of motor spirit, high speed diesel, kerosene and LPG in spite of a large rise in their import cost, reduced import duties on a host of commodities, and banned exports of some goods. In 2008, on the monetary front, the RBI increased the cash reserve ratio from 7.5 per cent to 7.75 per cent from April 26, to 8 per cent from May 10, 8.25 per cent from May 24, 8.5 per cent from July 5, 8.75 per cent from July 19; and 9 per cent from August 30, 2008. Between May 7, 2008 and June 25, 2008, out of 34 trading days, on 31 days, the call money rate consistently was above the upper band of the LAF corridor. The RBI also increased the fixed repo rate under LAF from 8.00 to 8.50 per cent on June 25, 2008 and to 9 per cent on July 29, 2008. Yet, the call money rate continued to pierce the repo rate almost as a matter of bad habit. Liquidity was in high demand and prices were rising. Many of these measures were not consistent with the stated long-term policy stance of the Government and the RBI. Governments and central banks all over the world have to take extreme measures to deal with extenuating circumstances of a temporary nature. With the benefit of hindsight, in the future, I believe economists will closely scrutinise the necessity of all these short-term measures, their consistency with medium-term reform policy, and, if inconsistent, the speed with which they were rescinded to make them consistent again.

Let me come back to the main story. Relief on the inflation front came from the middle of the third quarter of 2008. Inflation after peaking at 12.91 per cent in the week ending August 2, started to decelerate (Chart 7). But as inflation started to decelerate, there was another major problem at hand. The global financial crisis was in full bloom. As preoccupation with curtailing inflation subsided, short term concerns about risk-proofing the economy from the fall out of world recession became much more pronounced than financial sector reforms.

Chart 7. Success at Last -- Inflation Declines



Trouble had been brewing in the US economy for quite some time. As you will recall, after the dot-com burst, since November 2001, the world had lived through a prolonged period of prosperity and boom. But, macroeconomic imbalances had been growing. Consumers in the US, and partly also in UK, had been living beyond their means, borrowing money to buy houses and fund their other spending. Even the government in the US had been living beyond its means, and incurring large fiscal deficits. The excess of expenditure over savings in the US was getting reflected in large current account deficits, which reached a peak of US$811.5 billion, equivalent of 6.2 per cent of GDP in 2006. This current account deficit was financed by China and Japan, who invested their foreign exchange reserves in US paper. In other words, the US was paying for its excessive imports in dollars, which the Chinese and the Japanese in turn were investing in US securities. There were fears about a 'hard landing' of the US economy[28].

To cut a long story short, home prices in the US, which had risen sharply since the second quarter of 2002, with excessively permissive mortgage financing, started to fall in the first quarter of 2007. In the second quarter of 2007, defaults increased sharply and some subprime mortgage lenders entered bankruptcy. Trust and confidence in mortgage-backed securities were lost and the credit market seized up. In mid-July 2007, the TED spread – the difference between the three-month London interbank-offer rate and the yield on a virtually risk-free treasury bill rate, which is a measure of credit conditions – spiked to150-200 basis points. Banks faced problems in raising money in the money market. In August, 2007, the credit crisis was on with US banks taking $500 billion in write-downs. Soon the crisis spread to the UK and Europe.[29]

With the benefit of hindsight, now we know that the US had entered a recession by December 2007.[30] The peak in December 2007 marked the end of the expansion that began in November 2001 and the beginning of a recession. But, at the end of 2007, without the requisite data, the picture was far from clear. Even in mid-July 2008, there were even suggestions that the recession was only mental![31]

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[28] There were ominous predictions about brutal correction to the exchange value of the US dollar by Paul Volker. In 2005, he had said, "Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot….We are skating on thin ice." He had predicted presciently, "….it is more likely than not that it will be financial crises rather than policy foresight" that will correct the growing deficits of the US economy. See Volker (2005).

[29] On August 9, 2007, the European Central Bank and the US Federal Reserve injected $90 billion into jittery financial markets. On August 16, 2007, Countrywide Financial drew down $11.5 billion from its credit lines. On August 11, 2007, Gordon Brown had said that Britain was in "as good a shape as it could be to weather the storm,"[29] soon there was bad news from the UK. On September 14, 2007, British mortgage lender Northern Rock PLC ran into trouble and sought and received a liquidity support facility from the Bank of England. This led to loss of confidence among depositors and with customers queuing up outside branches to withdraw their savings, UK saw the first run on a British bank since the collapse of Overend and Gurney in 1866. On 22 February 2008, Northern Rock was taken into state custody.

[30] On November 28, 2008, the Business Cycle Dating Committee of the National Bureau of Economic Research determined that a peak in economic activity occurred in the U.S. economy in December 2007.The Business Cycle Dating Committee of the NBER maintains a chronology of the beginning and ending dates (months and quarters) of U.S. recessions. defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators." The last expansion ending in November 2007 lasted 73 months, much shorter than the previous expansion of 120 months in the 1990s.

[31] In July 2008, Republican presidential candidate John McCain's top economic adviser Phil Gramm said "You've heard of mental depression; this is a mental recession,…. We may have a recession; we haven't had one yet." See Washigton Times, July 9, 2008.

Meanwhile, the crisis continued. And around mid-September 2008, in the international financial markets, we lived through weeks when decades happened. In the US, regulators seized Fannie Mae and Freddie Mac on September 6, Lehman Brothers filed for bankruptcy on September 15. The crisis did not remain confined to the US. In no time almost, the Wall Street contagion swept across the Atlantic to Europe. And all hell broke loose in the western financial markets. House prices were down, stock markets faced a melt down and the credit markets seized up. The story is too well known to this audience to merit recounting.

Indian reaction to the crisis was an easing of monetary policy. Governor Reddy relinquished office on September 5, 2008, and one of the first acts of the new Governor Subbarao was to reduce the CRR from 9.0 per cent to 6.5 per cent on October 11, 2008. The global crisis was in full swing, and the RBI made the 2.5 percentage point reduction in CRR steeper than the 1.5 percentage points it had originally planned[32]. This was followed up by the introduction of a special fixed rate term repo at 9 per cent per annum on October 14, with a view to enabling banks to meet the liquidity requirements of Mutual Funds and a reduction in the repo rate from 9.00 per cent to 8.00 per cent on October 21 (Chart 7).[33,34] Measures followed fast and thick. The repo rate and the CRR were reduced again on November 3 and 8, respectively to 7.50 per cent and 5.50 per cent, respectively. The latest action of the RBI came on December 8, when it reduced the repo rate to 6.50 per cent, and for the first time since July 25, 2006, also reduced the reverse repo rate to keep the LAF corridor in order. Furthermore, the Government also announced some fiscal measures to stimulate the economy. Some of these measures, particularly the ones related to CRR, are more in line with the medium-term thrust of policies, yet overall they raise some fundamental questions about national priorities regarding financial sector reform policies amidst an international crisis.

With the decline in inflation, gone are the discussions of overheating of the Indian economy. Instead, the critical question has become: how do we avoid or minimize the backlash of the global crisis? Starting with the US, and the UK, a whole host of OECD countries have announced fiscal stimuli and monetary accommodation, including bail out packages. If the Indian economy was overheated in 2006, does it need a fiscal stimulus today? Or, if it needs a fiscal stimulus today, was the overheating an exaggerated problem? Or, is it simply that the external economic environment has become so adverse that there has been a regime-switch from a supply-constrained overheated situation to a demand-constrained scenario? Such a switch is possible, but needs a careful scrutiny before coming to a definitive conclusion.

F. Beyond the preoccupation with short-term concerns -- five pending reform issues in the financial sector

Let me be very clear that a natural preoccupation with short-run firefighting has characterized policies all over the world, particularly in the US. In every country, however, there is the need for a satisfactory reconciliation of the dilemma of policies appropriate for the short run with those suitable for the long run. It is critical to distinguish between the immediate steps needed to manage the present crisis and long-run reforms needed to sustain growth and reduce the

[32] In a circular (Circular DBOD. No. Ret. BC.55 /12.01.001/ 2008-09) dated October 10, 2008, the RBI had notified a reduction of the CRR from 9.0 per cent to 7.5 per cent with effect from October 11, 2008. On October 15, 2008, RBI notified (DBOD.No.Ret.BC.61/12.01.001/2008-09) the reduction not to 7.5 per cent but 6.5 per cent.

[33] Thus, there are three types of repos – standing facility, special LAF, second LAF.

[34] With effect from October 29, 2004, the nomenclature of repo and reverse repo had been changed in keeping with international usage. From October 29, 2004, reverse repo indicates absorption of liquidity and repo signifies injection of liquidity.

likelihood of future crises.[35] With the compelling need to grow and to ameliorate widespread poverty, the medium-term stakes of policies in developing countries such as India are very high, and policies need to have a longer-term vision. Allow me to focus on five of these medium-term issues.

Moving to an inflation-targeted monetary policy

Perhaps it would be appropriate to describe RBI's approach to monetary policy as a combination of monetary targeting and 'just do it' discretionary approach, rather than inflation targeting. The objective of overall policy in India is accelerated inclusive growth with macroeconomic stability. Admittedly, the overall objective of monetary policy has to be the same as overall economic policy. The issue, however, is essentially one of Tinbergen's 'assignment rule': what objective do we assign to which policy? Both the PM Committee and Rajan Committee have strongly recommended the move to an inflation-targeted monetary policy. In contrast, Tarapaore II has recommended a real effective exchange rate (REER) rule. It reiterated the earlier recommendation of Tarapore I in 1997 about intervening in foreign exchange market to contain the REER in the band of ±5 per cent around the 'neutral' REER. All the three committees in the third and latest sub-period of reform have been much clearer about the objective that monetary policy should follow than the earlier committees. It may be recalled, for example, that Chakravarty Committee had recommended a flexible monetary targeting with feedback, that is, a system of targeting money stock with the target being revised 'in the light of the information available on expected output performance.' While conceding that multiple objectives tend to dilute the effectiveness of monetary policy and therefore disperse responsibility, on grounds of pragmatism, earlier committees had rejected the goal of monetary policy pursuing the single objective of an inflation mandate. As late as in 2000, for example, the Narasimham Advisory Group on Transparency of Monetary Policy and Other Financial Policies had suggested that there should be a primary objective (ostensibly an inflation target) and subsidiary objectives with a clear ordering of priorities.

There are four concerns that normally are raised with regard to inflation-targeting. First is the issue of tradeoff between growth and price-stability, or the so-called Philips curve. The temporary nature of this trade-off has been well established in the literature[36]. Furthermore, there is evidence that inflation beyond a single-digit threshold of around 6 per cent actually hurts growth. Second is the fear of fixing too low an inflation target[37]. But, this objection is not sustained as it is possible to fix an inflation rate such as between 4 and 5 per cent, which is not too low. Third is the sacrifice of the nominal exchange rate anchor with the pursuit of an inflation

[35] Noble laureate Gary Becker (2008) has emphasized that "it is paramount to distinguish between the immediate steps needed to cope with the present crisis and the long-run reforms needed to reduce the likelihood of future crises." As an example, Becker cites the case of Bear Stearns. He says "The moral-hazard consequence for banks receiving a bailout now is worrisome since they may expect to get rescued again by the government if their future investments turn sour. Yet while I find helping these banks highly distasteful, moral-hazard concerns should be temporarily relaxed when the whole short-term credit system is close to collapse. Still, the bank bill with its huge bailout does suggest that the $29 billion bailout of the bondholders of Bear Stearns in March was a mistake."

[36] See Kannan and Joshi (1998).

[37] Indeed, it may not be desirable to target too low an inflation for four reasons. First, some inflation of say around 3-4 per cent allows enough room for relative prices to adjust without any prices declining in absolute terms, and hence act as a lubricant of growth. Second, some inflation helps the government to mop up revenues in terms of inflation tax, or what is called seignorage. What the holders of cash lose in terms of erosion of real value, is gain to the government or its extended arm, the RBI, as cash is a public sector liability. Third, some inflation reduces the pressure on reducing the administered nominal interest rates on items such as small savings and PPF. Fourth, it allows the maintenance of the nominal exchange rate of the rupee without real appreciation even when some major currency such as the dollar is softening.

target. Fourth is the sacrifice of a real exchange rate or REER rule. Let us turn to the last two objections one by one.

The advantages of maintaining a fixed exchange rate for the Indian rupee are well known. By eliminating exchange rate risk, it provides certainty to exporters and importers about their rupee income stream. Furthermore, it provides a nominal anchor to the economy. With a fixed nominal exchange rate, when inflation gets out of line with price rise in partner countries, the balance of payments adjusts to bring about equilibrium. If inflation is too high relative to partner countries, exports become uncompetitive and imports surge, money supply contracts through balance of payments deficits and inflation declines. The obverse happens when inflation is too low compared to partner countries. But, in reality, with exchange market intervention and the compulsions to avoid too much volatility in money supply for whatever reasons, including balance of payments, we know what happens is something else.

We know of many cases where a fixed exchange regime came to an end because the currency was overvalued. Central Bank intervened until it ran out of reserves, and then abandoned the fixed rate and devalued. There are enough examples of such unhappy ends to fixed exchange rate regimes in Latin America and East Asia. But, what happens when the currency is undervalued? In such a case, the central bank or the government has to purchase foreign exchange to defend the rate and sterilize the injected liquidity to contain the monetary impact. Ultimately the cost of sterilization becomes prohibitive, the peg has to be abandoned and the currency revalued. Though not as common as the breakdown of an overvalued peg, we know a few cases when an undervalued peg broke down in developed countries (Box 6).[38]

Box 6. Examples of breakdown of Undervalued Currency under a Fixed Exchange Rate Regime

1. Even under the Bretton Woods agreement about fixed exchange rate regime, Canada floated its currency from October 1950 under heavy upward pressures from rising commodity prices, improving trade balance, capital inflows and the speculation about a likely revaluation. The Canadian dollar floated through May 1962[39].
2. With strong inflationary pressure coming from the US and an increasing concern about excess liquidity created through currency intervention to maintain the fixed exchange rate, Germany floated its currency in May 1971. After a short period of the Smithsonian fixed exchange rate system from December 1971 through February 1973, Germany again floated the German mark in February 1973. This was an internationally coordinated float with other major currencies including the Japanese yen, finally ending the era of the fixed exchange rate regime.
3. Third, after the famous "Nixon Shock" of August 15, 1971, while all European countries immediately floated their currencies, Japan floated its currency only after two weeks. Japan resisted revaluation or float for about two weeks by intensified currency market intervention and exchange control, but the overwhelming capital inflows (or, surging current account

[38] I am grateful to Haruhiko Kuroda and Howard Brown for these examples. In Canada, the government and the central bank favored float rather than revaluation because of the changing and unpredictable international factors like commodity prices and capital inflows. Initially, the float was seen as temporary but actually continued for twelve years. It is interesting that the IMF somehow found it not illegal despite clear violation of the charter oblibgation of all members to adhere to the fixed exchange rate under the Bretton Woods system.

[39] Canada again floated its dollar from June 1970 before the demise of the Bretton Woods agreement in February 1973. This again was caused by similar factors like rising commodity prices, increasing current account surplus, capital inflows attracted by high interest rates in Canada and increasing international reserves. Inflation was a real concern. But this time the problem was a global one, brought about by the Vietnam war and expanded welfare program in the US. Eventually all major currencies were floated by 1971. .

surplus through "leads and lags") even under strict capital controls forced it to float the yen eventually[40].

Now we come to the pros and cons of the REER rule recommended by the Tarapore II[41]. The REER rule in effect is an indexation of the nominal exchange rate to the price level. What are the problems with following an REER rule?

First, is the problem of choosing the target REER. How do we know what the correct REER is? If we do not hit the bull's eye and fix the REER at anything but the equilibrium level, either there will be persistent deficits or surpluses in the balance of payments leading to persistent declines or rises in money supply, downward or upward price-nominal exchange rate spirals and a total loss of monetary control. This is not just a theoretical possibility, but a real one that has been observed in some countries, for example, in the former Yugoslavia. In the former Yugoslavia, with the emergence of external financing difficulties in the late 1970s, the dinar was devalued by almost 30 per cent in 1980, and throughout the 1980s there were successive devaluations in line with inflation aimed at maintaining the real effective exchange rate at the new lower level. With a large degree of dollarisation through foreign currency deposits, Yugoslav inflation, which was in double-digit levels throughout the 1970s and 1980s, unfolded as a classic wage-price-exchange rate spiral and exploded into hyperinflation in the last quarter of 1989[42].

Second, quite apart from getting the REER level wrong, an REER rule can exacerbate instabilities in output levels. In the late 1970s and early 1980s, for small open economies, such an indexation was quite popular to isolate the foreign trade sector from the vagaries of the macroeconomy. But, it can be demonstrated that such an indexation of the exchange rate not only creates potential instabilities in the price level, but also results, under realistic assumptions, from the supply side interactions, in increased instabilities in output as well.[43]

On the institutional arrangements, the PM Committee recommends "an explicit and legally mandated de jure inflation-target regime" over "a de facto pegged exchange rate regime ….or a de facto inflation targeting regime (as is the case in the US)".[44] What is needed is a debate as to whether we need to move immediately to an explicit and legally mandated inflation-target regime, or pending such legislation, to a de facto inflation target regime with adequate understanding between the Government and the RBI.

There are three very compelling reasons to shift to an inflation-targeting regime amidst the current international financial crisis. First, inflation, worldwide, is on a downward phase. Targeting moderate inflation when world prices are soft is easier to achieve than when the world commodity markets are flaring up. Reputation for delivering a modest inflation target is easier to build now than it was a year ago when world petroleum prices were around $150 per barrel. Second, targeting a moderate inflation rate will effectively also provide a floor to the extent the RBI will allow deflationary forces to operate. A modest inflation target, in case the world crisis

[40] Major reason for the government to float the currency appears to have been potentially large exchange loss from mushrooming foreign reserves rather than inflationary implications, though the Bank of Japan might have been more concerned about the loss of monetary control.

[41] It is interesting to note that Tarapore I had recommended (p. 62): ".. that there should be an early empowering of the RBI, on the inflation mandate. There should be a medium-term inflation mandate approved by Parliament and only Parliament should alter that mandate. Once the mandate is given, the RBI should be given freedom to use the instruments at its command to attain the medium-term inflation target."

[42] See Lahiri (1991).

[43] See Dornbusch (1982).

[44] See PM Committee, p. 95.

proves to be more severe than what is expected now, will act as a guarantee for reflation. Third, with aversion to risk growing among the international financial investors, capital flows have reversed direction. The rupee is no longer under upward pressure. Thus, choosing an inflation target need not necessarily mean an inevitable appreciation of the rupee in real terms.

Modernizing the delivery of financial services to the 'priority sectors', and vulnerable and weaker sections

Provision of adequate and timely institutional credit at competitive rates to the rural areas in general and agriculture, export and small-scale sector and weaker and vulnerable sections in particular has remained a major challenge for Indian banking for decades. As far back as 1933, when the Reserve Bank of India Bill was referred to the Joint Select Committee, two issues that have been a matter of some serious discussion have been (i) how to provide adequate finance in the rural areas, particularly for agriculture and (ii) the inclusion of indigenous bankers and other parties doing banking business in the country within the RBI's scope[45]. The legislature was very keen that the services of the indigenous bankers and moneylenders should be utilized in the scheme of provision of credit to the rural economy. By statute, the RBI, in its Central Office, has always had an Agricultural Credit Department.[46]

As a matter of record, however, it is important to note that starting from the Darling Report of June 1935, the emphasis has been on affording credit and other assistance through co-operative banks (including land mortgage banks). Other channels of assistance have been dealt with rather sketchily.[47] Indeed, there was reluctance on the part of indigenous bankers and moneylenders to collaborate with the RBI as well. The RBI had suggested the possibility of registering indigenous bankers and moneylenders 'carrying business on proper lines' and accepting the names of such parties 'as one of the names on two-name paper coming through scheduled banks' for rediscounting.[48] RBI was even willing to deal directly with the indigenous bankers provided they confined their business to banking proper and had a specified minimum capital. This proposal to use indigenous bankers either as agents for collection of cheques and bills or after some restructuring was, however, rejected by the indigenous bankers.[49]

The post-independence period with its emphasis on cooperative banking has not produced enough success in extending adequate and timely credit to the agricultural sector. It is in this context that the Rajan Committee recommendation of liberalising banking correspondent regulation to allow local agents to extend financial services[50] becomes important. This needs to be implemented.

After the two drought years and associated shortfall in food production in 1965-66 and 1966-67, under the concept of social control over banking introduced in December 1967 came the directed credit programme involving loans on preferential terms and conditions to priority sectors[51]. Priority sector was initially defined as agriculture, exports and small-scale industry[52].

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[45] See RBI (1970), pp. 111-114.
[46] Section 54, RBI Act.
[47] See RBI (1970), p. 201.
[48] RBI (1970), p. 204.
[49] See Bombay Shroffs Association's reaction and letter of Seth Fatichand Gokaldas of Madura dated September 27, 1937, RBI(1970), pp. 215-16.
[50] Rajan Committee (2008), p. 8.
[51] See RBI (2008), p. 100
[52] The definition of priority sector as well as that of small firms have undergone various changes over time.

Fourteen banks were nationalized and one of the objectives of nationalisation was to ensure that no productive endeavour in agriculture and small scale industries fell short of credit support.

As a matter of record, directed credit is an instrument that has been followed by many developing countries. Japan used direct government allocation of funds to industry during the reconstruction period of 1945-55, and in a less direct fashion, but with a rigidly segmented financial system under wide-ranging controls, between 1955 and 1970.[53] Korea used directed credit through government-owned banks for promoting exports and industrial investment in the 1950s and 1960s, and heavy and chemical industries during the 1970s. Unlike Japan, Korean directed credit involved heavy subsidization. With political democratization, in the 1980s credit was directed towards social programmes and income redistribution. The conclusion about directed credit programs appears to be that they should be small, narrowly focused, and of limited duration with clear sunset provisions. Experience in most countries shows that they stimulated capital-intensive projects, that preferential funds were often diverted for nonpriority purposes, and were associated with low repayment rates. Subsidies should be low to minimize distortion of incentives as well as the tax on financial intermediation that a directed credit program entails.

As far back as 1991, Narasimham I had recommended a re-examination of the continued relevance of directed credit programme and its phasing out. It also recommended that the priority sector be redefined to comprise small and marginal farmers, tiny sector of industry, small business and transport operators, village and cottage industries, rural artisans and other weaker sections and the credit target for this redefined priority sector should be reduced from 40 per cent of aggregate credit. The RBI rejected the proposal "…. to ensure that any changes in the policy on priority sector credit did not result in a disruption in the flow of credit for productive purposes."[54]

After Narasimham I, at least two committees have reiterated the recommendation about phasing out the system of directed credit. More than a decade ago, Narasimham II again recommended reduction of the scope of directed credit to priority sector from 40 per cent.[55] The effect of financial repression through micro-level controls on financial deepening and hence growth is also well-known.[56] Last year, Rajan Committee concluded that "India's experience with directed credit has been abysmal, with flows historically going into sectors with low productivity that happen to be favoured".[57]

The fact that important segments of the Indian economy are credit-constrained is well-accepted by most economists. Many farmers, and small and medium firms in developing countries such as India take loans at 60 per cent interest rates or more and defaults are rare showing that rates of return or marginal products of capital in related activities are sufficiently large[58]. Yet, some of these farmers or firms are credit-constrained. The productivity loss as a result of misallocation of capital due to credit constraints can be fairly large. The problem with a directed credit programme is essentially two-fold. First, how to price such directed credit at its 'true' market level? Second, how to avoid such directed credit going to farmers or firms or people who are

[53] See Vittas and Cho (1995)
[54] RBI (2008), p. 118.
[55] It also recommended inclusion of employment-oriented, important sectors like food processing and related service activities in agriculture, fisheries, poultry and dairying, under such lending; and consideration of the debt securitisation concept within the priority sector for improving efficiency and imparting a measure of flexibility.
[56] See for example, Demetriades and Luintel (1996).
[57] Rajan Committee (2008), p. 101 (new)
[58] See Banerjee and Duflo (2004)

not credit-constrained? The second problem becomes serious when directed credit is required to be cheap as well. That creates an incentive for even non-credit-constrained agents to avail such directed credit.

How do we solve the problem of credit inadequacy in the priority sectors and among the weaker sections? Can we have the desired results of financial inclusion through a more market-friendly hybrid approach with directed credit? Narasimham II clearly stated that "The Committee believes that it is the timely and adequate availability of credit rather than its cost which is material for the intended beneficiaries."

Box 7. Some Detailed Recommendations of Rajan Committee (2008) for improving financial sector inclusion

- Deregulate and allow more entry of well capitalized deposit-taking small finance banks subject to higher prudential norms;
- Liberalise banking correspondent regulation to allow local agents to extend financial services;
- Allow a system of priority sector loan certificates (PSLC) and make it exchangeable;
- Liberalise interest rate on loans subject to full disclosure, transparency and restrictions regarding eligibility under PSLC scheme;
- To improve the collation of credit history, expedite the process of creating a unique national ID number with biometric identification ;
- Open up the information of the credit bureau to subscribers subject to verification of "need to know and authorization to use" of the subscriber by the credit bureau ;
- Expedite ongoing efforts to improve land registration and titling—including full cadastral mapping of land, reconciling various registries, forcing compulsory registration of all land transactions, computerizing land records, and providing easy remote access to land records, with the Center playing a role in facilitating pilots and sharing experience of best practices. Explore the possibility of setting up special law courts to clear the backlog of land disputes;
- Re-examine restrictions on tenancy so that tenancy can be formalized in contracts, which can then serve as the basis for borrowing;
- Extend the powers of SRFAESI that are currently conferred only on banks, public financial institutions, and housing finance companies to all institutional lenders;
- Bring supervision of all deposit taking institutions under the RBI and ending the system of shared responsibility, such as with the State Registrar of Co-operative Societies; and
- Convert trade receivable claims of small and medium enterprises on large firms to electronic format, accepted by the large firms, and sold as commercial paper.

Directed credit with far below-market interest rate harms the priority sectors and the weaker sections by denying them adequate and timely institutional credit and compelling them to borrow from non-institutional sources at usurious rates. Too low a rate of interest denies the banks any incentive to lend. Perhaps, a good way of starting the reform for financial inclusion is retaining the directed credit programme to ensure that productive small farmers and small and medium firms are not credit constrained, while deregulating and increasing the interest rate that can be charged on such directed credit.[59] Allowing higher interest rates to be charged for such directed credit will create an incentive for banks to lend more to the priority sectors and also discourage non-credit-constrained farmers and firms from preempting such directed credit.

[59] Even the cost of administering credit is higher for priority sector loans. Labour and administrative cost of lending by banks to the priority sector has been estimated to cost them Rs. 1.50 more per Rs. 100 than lending to the unreserved sector, see Banerjee and Duflo (2000).

Furthermore, many of the recommendations of the Rajan Committee (Box 7), which is appropriately called “A Hundred Small Steps”, can be implemented to improve financial inclusion.

Introducing capital account convertibility

Tarapore I, Tarapore II, PM Committee and Rajan Committee have unanimously recommended a move towards fuller capital account convertibility. As already mentioned, capital account convertibility, by reducing the cost of capital, can stimulate investment and growth. By allowing residents to diversify their portfolio into foreign assets, such convertibility can reduce the variability of their income and wealth from domestic shocks and also diffuse the risk of an asset-price bubble. Capital account restrictions tend to turn progressively ineffective, costly and even distortive. The PM Committee has observed that India has a *de facto* open capital account for the real economy, but not for financial services.[60] Lack of capital account convertibility has reduced competition in the Indian financial sector and denied the country competition-induced efficiency gains. According to some experts, the benefits from capital account convertibility for the financial sector in India will be analogous to the benefits that accrued to the real sector from the policy of opening up in the early 1990s.

Many of the milestones recommended by Tarapore I have already been achieved. What about the others? While considerable progress has been made on the fiscal front both by the Centre and the States after the implementation of the FRBM Acts, some susceptibilities remain on account of off-budget liabilities such as oil bonds. It is also well-known that “Running a large fiscal deficit constrains a country’s ability to open its capital account without running undue risks. Countries that have opened capital accounts and stabilised or pegged their exchange rates – while running large fiscal deficits financed in foreign currencies – have triggered an economic crisis.”[61] Now, with the current global crisis, we need not look any further than the US for vulnerabilities on the external front from large fiscal deficits.

Is fiscal consolidation the right policy when most countries in the world are talking about fiscal stimuli? There seems to be a consensus among mainstream economists that there is no case for ‘one-size-fits-all fiscal expansions but for fiscal actions tailored to the circumstances of individual country and taken with a view toward the impact on the rest of the world.’[62] India does not have a trade or current account surplus and the case for a fiscal expansion in a country with a large trade deficit needs a careful examination.[63] A large part of any fiscal stimulus will spill over as benefits to the rest of the world. Furthermore, it is important to remember the long and variable lags with which policies affect the economy.

We need a clear deadline for solving the problem of attaining the necessary milestones, including removal of fiscal susceptibility, and introducing capital account convertibility. Here, it is also critical to remember the interdependence between institutions and capital account convertibility. It is possible that capital account convertibility, with its magnified penalty scheme for policy lapses, may become the cause for preferred institutional outcomes even with regard to fiscal prudence.

[60] PM Committee (2007), p. 99.
[61] PM Committee (2007), p. 88.
[62] See Eichengreen and Baldwin (2008).
[63] See Dani Rodrik in Eichengreen and Baldwin (2008).

The current crisis may provide an opportunity for introducing capital account convertibility. The dominant worry about introducing convertibility has been an upsurge of capital flows with large upward pressure on the exchange rate of the rupee followed by a sudden sucking out of such capital, precipitating a crisis. Risk aversion on the part of international investors is an all-time high now, and the risk of large inflows is limited. The residual risks, as the PM Committee has observed, can be managed given: (a) the proven skills and capabilities of the RBI in managing India's external accounts with extraordinary competence; (b) the trends that are now manifest in accelerating two-way financial flows at a very rapid rate – *i.e.*, at two or three times the output growth rate; and (c) the problems that will increase as the partially closed regime is maintained. Furthermore, according to the Committee "Opening the capital account decisively is not a matter of tweaking technical ratios and tinkering with the present limits of what is allowable and what is not. That process adds little of value."[64]

As immediate steps, what can be done are: (i) removing end-use restriction on external commercial borrowing or ECBs, (ii) removing ECBs over 10-year maturity and rupee-denominated ECBs outside the overall annual ECB ceiling, (iii) allowing non-resident corporates to invest in Indian stock markets through SEBI-registered entities; (iv) allowing foreign institutions and corporates beyond multilateral institutions (such as International Finance Corporation and Asian Development Bank) to raise rupee bonds in India; and (v) linking domestic banks' borrowings from overseas banks and correspondents to paid up capital and free reserves and not to unimpaired Tier I capital, and putting the limit at 50 per cent. Tarapore I recommended them for immediate implementation more than ten years ago.

Moving to a streamlined and principle-based financial regulatory architecture

The ongoing global financial crisis has raised important questions about the optimal regulatory architecture. This is best exemplified by the case of derivatives, which is a generic name for products such as futures, mortgage-backed securities or options and which 'derive' their value from underlying assets such as stocks, bonds or commodities. Derivatives market grew exponentially during the 1990s and quintupled between 2002 and 2008 to over $500 trillion under the regime of Alan Greenspan, the former Chairman of the US Federal Reserve. Greenspan saw derivatives as "an extraordinarily useful vehicle to transfer risk from those who shouldn't be taking it to those who are willing to and are capable of doing so." Warren Buffett, the legendary US investor, however, had presciently observed in 2003 that derivatives were "financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal."[65] There were demands for stricter regulation of derivatives, but Greenspan favoured self-regulation on Wall Street. In 1997, when Brooksley Born, the former chairperson of the Commodity Futures Trading Commission, a US government agency that regulates options and futures trading, began exploring derivatives regulation, Greenspan argued against it, and US Treasury came to the conclusion that even discussing new rules could threaten the booming derivatives market.

We know now the absence of rules requiring institutions to disclose their positions, to be adequately capitalized, to limit leveraging, and to set aside funds as a reserve against bad bets, and protection against counterparty risk in settlement, and stripping the Commodity Futures Trading Commission of regulatory authority over derivatives may not have been good ideas. At

[64] PM Committee (2007), p. 99.
[65] See Peter S. Goodman (2008).

the same time, there is a lot of force in Greenspan's argument that "You can have huge amounts of regulation, and I will guarantee nothing will go wrong, but nothing will go right either." The regulatory reform agenda is a complex one and there should be no hasty conclusions. Too much regulation can be as harmful as too little regulation. Nobel laureate Michael Spence has observed that "The longer term regulatory issues should await a careful analysis of the causes of the crisis."[66]

Table 3: Countries with a Single Supervisor, Semi-integrated Supervisory Agencies and Multiple Supervisors in 2002[a]

Single supervisor for the financial system		Agency supervises two types of financial intermediaries: Banks & securities firms	Banks & insurers	Securities firms and insurers	Multiple supervisors (at least 1 each for banks, insurers, and securities firms)	
1. Austria	12. Japan	23. Dominican Republic	29. Australia	40. Bolivia	47. Argentina	64. Jordan
2. Bahrain	13. Latvia	24. Finland	30. Belgium	41. Chile	48. Bahamas	65. Lithuania
3. Bermuda	14. Maldives	25. Luxembourg	31. Canada	42. Egypt	49. Barbados	66. Netherlands
4. Cayman Islands	15. Malta	26. Mexico[b]	32. Colombia	43. Mauritius[b]	50. Botswana	67. New Zealand
5. Denmark	16. Nicaragua	27. Switzerland	33. Ecuador	44. Slovakia[b]	51. Brazil	68. Panama
6. Estonia	17. Norway	28. Uruguay	34. El Salvador	45. South Africa[b]	52. Bulgaria[b]	69. Philippines[b]
7. Germany	18. Singapore		35. Guatemala	46. Ukraine	53. Cambodia	70. Poland
8. Gibraltar	19. Republic of Korea		36. Kazakhstan[b]		54. China	71. Portugal
9. Hungary	20. Sweden		37. Malaysia		55. Cyprus	72. Russia[b]
10. Iceland	21. Taipei[c]		38. Peru		56. Egypt	73. Slovenia
11. Ireland	22. UAE		39. Venezuela		57. France	74. Sri Lanka
	23. UK				58. Greece	75. Spain
					59. Hong Kong	76. Thailand
					60. India	77. Turkey
					61. Indonesia[b]	78. USA
					62. Israel	79. Viet Nam
					63. Italy	

Notes: [a]Sample includes only countries that supervise all the three types of intermediaries (banks, securities firms and insurers).

[b]Countries reported to be considering adopting partial or full integrated supervision as well.

[c]Established in 2004.

Source: Milo (2007)

Currently, in India, what we have is a regulation by silos with banks regulated by the RBI, stock markets by SEBI, pensions by Pension Funds Development and Regulatory Authority,

[66] See Spence in Eichengreen and Baldwin (2008).

insurance by Insurance Regulation and Development Authority, and commodity futures by Futures Market Commission. Regulation by independent authorities is not unique to India alone. India is not alone in having such a fragmented regulatory structure. In the US, for example, four regulators – Federal Reserve, Federal Deposit Insurance Corporation, Office of the Controller of Currency, and State regulators – regulate banks, two regulators – Securities and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) – control securities business, Federal Reserve and SEC regulate investment banks, and insurance is regulated by different State regulators.

Yet, the increasing dynamism and complexity of financial products have blurred the borders between financial products, and compartmentalizing them, for example, into pure banking, or pure security or pure insurance products has become increasingly difficult. The easiest example of such a hybrid product is a unit-linked insurance policy. Even in India, banks, insurance companies and securities firms are now competing in the same market for the same customers. They have similar and often even identical products, and compete via the same distribution channels. Individual financial institutions increasingly have comparable organisation and management structures. Consequently, the balance of the argument has moved away from retaining or creating multiple financial services regulators differentiated by the types of firm they regulate, the activities they regulate, or the objectives of regulation. Many countries have moved to unified regulation (Table 3).

While awaiting a careful analysis of the causes of the current global crisis from the regulatory angle, most experts seem to agree that the fragmented regulatory architecture in the US may have contributed to the problem. In the US, no regulator had the clear remit to regulate derivatives. It is in this context that it is important to note that the PM Committee has recommended a move towards unified regulation. Although the Rajan Committee has not stated such a move towards unification in explicit terms, the spirit of its recommendation appears to be in favour of unification. This is so when it recommends a statutory Financial Sector Oversight Agency (FSOA) to supervise and monitor the functioning of large, systemically important, financial conglomerates; anticipate potential risks, initiate balanced supervisory action by the concerned regulators to address those risks; it will address and defuse inter-regulatory conflicts, and look out for the build-up of systemic risks. (Proposal 25[67]).[68]

One of the major reasons behind unified regulation is the economies of scope and scale available from operating in all sub-segments of financial product/services markets. A fragmented regulatory architecture leads to contrived corporate structures (for example, through holding companies) to create virtual unified financial firms. Unified regulation will redress the segmentation of the financial market into banking, insurance, capital markets, asset management activities and derivatives market.[69]

In the interim, until we move to unified regulation, PM Committee has recommended a 'Partial consolidation of extant regulators into a tightly-knit quartet covering: (a) banking; (b) insurance;

[67] Rajan Committee (2008), pp 17-18.

[68] Rajan Committee also recommends a Financial Development Council (FDC) with the Finance Minister as the Chairman to focus on macro-risk assessment and developmental issues, with the FSOA as its secretariat (Proposal 26, p. 18). A Financial Sector Appellate Tribunal should be set up along the lines of, and to subsume, the Securities Appellate Tribunal, and make regulatory actions subject to appeal to the Tribunal (Proposal 22, p. 16). An Office of the Financial Ombudsman (OFO), incorporating all such offices in existing regulators, should be set up to serve as an interface between the household and industry. (Proposal 27, pp. 18-19).

[69] See PM Committee, pp.147-148, and 196-197.

(c) pensions; and (d) capital, derivatives and commodities markets'[70]. Thus, it urged the transfer of all regulation/supervision of any type of organised financial trading to SEBI. The Rajan Committee has also endorsed the recommendation that all regulation of trading should be brought under the Securities and Exchange Board of India (SEBI) (Proposal 13[71]).[72] The case for implementing these recommendations appears very strong.

Furthermore, both the PM Committee and Rajan Committee (Proposal 20)[73] have recommended a move from rules-based regulation to principles-based regulation, by redrafting securities and banking laws as well as re-skilling of all regulatory staff. PM Committee recommends scrapping the large repository of subordinate laws under a prescriptive approach. It argues against writing down every minute detail either into the basic legislation or into detailed subordinated rules and regulations. "Under such a system if something is not specified, it is proscribed; or conversely, if something is proscribed then non-proscribed activities remain contentious as to whether they are permissible or not."[74] The spirit of the recommended move towards principles-based regulation is to promote financial innovation and avoid the mistake of over-regulation[75]. Rajan Committee's specific recommendations included creating a more innovation-friendly environment, speeding up the process by which products are approved by focusing primarily on concerns of systemic risk, fraud, contract enforcement, transparency and inappropriate sales practices (Proposal 18[76]). What we need to debate is the extent of innovation that we shall allow. But, it appears that we may have been rather conservative in allowing innovation. Let the excesses of derivatives in the US not detract us from the fact that it was mortgage-backed securities issued by Fannie Mae and Freddie Mac – two much maligned institutions in the US today – that promoted widespread home-ownership in the US.

The transition from rules-based to principles-based regulation may require a graduated move. Principles-based regulation can succeed with only a very skilled set of staff in the regulatory bodies. Given the problems associated with salaries that can be paid to such staff in the regulatory bodies because of their public sector nature, attracting the appropriate skill set may prove to be a challenge. That challenge needs to be faced before the transition to a principles-based regulatory architecture. Nevertheless, while a full-fledged move to principles-based regulation may not be possible, the move should be towards such a regulatory architecture.

Finally, I must sound a word of caution about too hasty a move to principles-based regulation. The current crisis in North America and Europe has exposed some serious deficiencies in their regulatory architecture. The dust around the current crisis needs to settle a bit, before the

[70] Rajan Committee has recommended that Parliament should set a specific remit for each regulator, consistent with the principles enshrined in the relevant law, every five years. Every year, each regulator should report to a standing Committee (possibly the Standing Committee on Finance), explaining in its annual report the progress it has made on meeting the remit. The interactions should be made public (Proposal 21) (p. 12).

[71] Rajan Committee (2008), p. 13.

[72] It recommended the introduction of markets that are currently missing such as exchange traded interest rate and exchange rate derivatives should be encouraged (Proposal 14) (p. 13). It also recommended creating the concept of one consolidated membership of an exchange for qualified investors (instead of the current need to obtain memberships for each product traded). Consolidated membership should confer the right to trade all the exchange's products on a unified trading screen with consolidated margining (Proposal 16, p.13).

[73] See Rajan Committee (2008), p. 16. Furthermore, Rajan Committee has recommended allowing greater participation of foreign investors in domestic markets and reducing the extent to which regulators restrict a domestic institutional investor's choice of investments by moving gradually instead to a "prudent man" principle (Proposal 19). See Rajan Committee (2008), p. 13.

[74] See PM Committee, p. 132.

[75] PM Committee's recommended regulatory impact assessment for evaluating the cost-benefit of various aspects of the regulatory architecture and implementation is to guard against this error of over-regulation.

[76] Rajan Committee (2008), p. 13.

verdict on contemporary international best practice in regulation emerges. While this should not become an excuse for inaction on the regulatory reform front, it may be good to avoid any undue haste. In the interim, what we should focus on is to move towards unified regulation to prevent any financial institutions to slip past the regulatory net, insist on these institutions to be adequately capitalized, for them to limit leveraging, and for them to set aside funds as a reserve against bad bets, and have protection against counterparty risk in settlement,

Restructuring the banking industry

Many unexpected things have happened in the last six months in free market economies. For example, in the US, Fannie Mae and Freddie Mac have been taken over by the government. Starting with Northern Rock, and continuing with Bradford and Bingley, the British retail banking system has been partly nationalized. Iceland has nationalized three of its largest banks. Although such nationalization has often been described as conservatorship, the current crisis has posed a considerable threat to the free functioning of the market economy. The current crisis has even been seen as the death of capitalism. This is nothing new. As Gary Becker (2008), the Noble laureate, has noted, death of capitalism has been prophesied after every major recession and financial crisis since the mid-19th century. While the current global crisis is a reminder of the potential danger from market failure, given our knowledge of extensive cases of government failure, the merits of bringing dynamism to the functioning of the economy through enhanced competition and an appropriate incentive structure remain more or less unquestioned.

It is in this context that the pending recommendations of Narasimham II regarding restructuring the banking sector deserve attention. Out of these, the three major ones are: removing the restriction of 10 per cent voting rights; reducing the legally required public shareholding in public sector banks from 51 to 33 per cent, and allowing foreign banks to set up subsidiaries or joint ventures in India.[77]

Narasimham II argued that given that no promoter group's holding can exceed 40 per cent of a bank's equity, the voting right restriction of 10 per cent prescribed in section 12 (2) of the Banking Companies Act 1949 does not have much justification. It may be recalled that the last amendment to voting rights came into effect in 1994, when the ceiling was raised from 1 per cent to 10 per cent paving the way for entry of the new private banks that have grown rapidly in the last decade and a half. The Banking Regulation (Amendment) Bill, 2005 introduced in the Lok Sabha on May 13, 2005, seeks to remove the restriction on voting rights and introduce the requirement of prior approval of the RBI for acquisition of shares or voting rights above the specified limit. It empowers the RBI to satisfy itself that the applicant is a 'fit and proper person' to acquire shares or voting rights, and to impose such further conditions that the RBI may deem fit to impose. The passing of this amendment will pave the way for implementing an important pending recommendation of Narasimham II.

It is interesting to note that voting rights of shareholders of nationalized banks are capped at not ten but one per cent of the total voting rights (under Section 3(2E) of the Banking Companies (Acquisition & Transfer of Undertakings) Acts, 1970 & 1980). There are two different laws governing public sector banks and private banks. Treating shareholders of public sector banks differently from those of private banks is difficult to justify. There have been suggestions of corporatising the public sector banks and leveling the playing field for all. Corporatisation of

[77] In case of the State Bank of India (SBI), the Committee recommended bringing down the legal requirement of RBI shareholding from 55 per cent to 33 per cent.

public sector banks by bringing these banks under the purview of the Companies Act will not only help the process of consolidation – a cherished goal of public policy – but also be in line with the Rajan Committee's recommended major restructuring of public sector banks. The Committee also recommends strengthening the board of directors of PSBs by devolving more powers to outside shareholders and granting boards the power to appoint top executives, and delinking banks from oversight of Central Vigilance Commission and Parliament.

Public sector banks dominate the Indian banking scene, and getting the best out of them is of paramount importance. The legal minimum public shareholding in nationalized banks and State Bank of India are 51 per cent and 55 per cent, respectively. Majority shareholding by the government has created quite a few complications for public sector banks including revision of salary in line with market trends, oversight of Central Vigilance Commission and Parliament, and employees using Right to Information Act to harass management. Narsimham II has recommended bringing down this legal requirement to 33 per cent. Tarapore II has not only endorsed this recommendation but also added that majority public ownership should be given up in both public sector banks and the State Bank of India. Bringing down its shareholding to 33 per cent will allow the government to raise enough capital from the market for the public sector banks and also increase the efficiency of these banks through private-public partnership. All this will be achieved while, as a very large shareholder with the power to block special resolutions, retaining enough leverage to guide the affairs of these banks in a gentle and indirect way. Rajan Committee has endorsed this recommendation and suggested that the Government should either create bank holding companies or bring down its share in these banks below 50 per cent. Rajan Committee has also suggested selling small underperforming public sector banks to strategic investors and observing outcome.

In 1998, Narasimham II had recommended allowing foreign banks to set up subsidiaries or joint ventures in India. After a year of announcing it in the 2003-04 Budget, Government of India increased the foreign direct investment limit in private banking, which is under the automatic route, from 49 per cent to 74 per cent including investments by foreign institutional investors (FII), non-resident Indians (NRI) and overseas corporate bodies.[78] Press Note 2 (2004 Series), on March 5, 2004, also announced that foreign banks will be permitted to set up either subsidiaries or joint ventures but not both. Again after almost a year of the Press Note, on February 28, 2005, RBI announced a road map for a two-phased implementation of the Government decision[79]. The first phase, running from March 2005 to March 2009, allowed a one-mode presence of either though a wholly-owned subsidiary or branches, promised a more liberal approach than the WTO-commitment of 12 branches per year for existing and new foreign banks, and restricted acquisition by foreign banks of only in private sector banks identified by RBI for restructuring. The second phase is to start from April 2009, which is just three months away. It is supposed to accord full national treatment to wholly-owned subsidiaries of foreign banks 'after reviewing the experience with Phase I and after due consultations with all stakeholders in the banking sector'.

In China, by the end of 2007, 72 foreign banks, representing 23 different countries, had opened 126 branches and sub-branches; 193 foreign banks, from 47 countries, had opened up 242 representative offices; and a total of 24 foreign banks, with 295 branches and sub-branches,

[78] Under Portfolio Investment Scheme through stock exchanges, the individual holding of FIIs was limited to 10 per cent with an aggregate limit for all FIIs of 24 per cent. This limit could be raised to 49 per cent by the Bank through resolutions of its Board of Directors and General Body. The FIIs investment limit continued to be within 49 per cent. In case of NRIs, the individual holding was restricted to 5 per cent with an aggregate limit to 10 per cent. This again could be raised to 24 per cent by the Bank through special resolution of General Body.

[79] http://www.rbi.org.in/upload/content/pdfs/RoadMap.pdf.

had incorporated locally.[80] But, the Chinese permission to foreign banks was a part of its five-year commitment for entry into the WTO to be fulfilled by December 2006. The critical question is whether such an opening up is good for China and whether China should have done it anyway even without the WTO commitment. It is interesting to note that Narasimham II, PM Committee and Rajan Committee appear to believe that opening up to foreign competition will be good for the efficiency of the domestic banking industry. In 1991, faced with a severe balance of payments crisis, India opened up to external competition in the goods market. Proving the doomsday predictors wrong, it was Indian manufacturing that rose to the challenge of global competition, and improved its efficiency and performance. If this unanimous recommendation of all the three committees about opening up the banking sector is not to be implemented, we need to make a strong case to prove that the maturity of Indian banking in 2009, in terms of coping with competition and globalisation, is less than what Indian manufacturing had in 1991.

G. Conclusion

I have come to the end of my long discourse. I want to end with two observations. First, according to Kishore Mahbubani, the Chinese translate the western word crisis by combining two Chinese characters, “danger” and “opportunity”.[81] When looking at financial sector reform, let us look as much at the “opportunity” part of the current global crisis as to its “danger” part. Let us not forget that reform is all about destabilizing the status quo. A crisis often provides an excellent opportunity to destabilize the status quo.

Second, Finance Minister Chidambaram after promising in his budget speech for 2008-2009, measures to develop the bond, currency and derivatives markets, launched the NSE exchange traded currency futures on August 29, 2008. Let us hope that more measures will be forthcoming in the coming months and years to develop the missing bond, currency and derivatives markets with the right level of transparency and appropriate safeguards. This will be important to move to an inflation-targeted monetary policy. Furthermore, let us hope that the roadmap for financial sector reform suggested by the expert committees will be implemented in good earnest to ensure that a vibrant and robust financial sector aids accelerated growth and rapid amelioration of poverty rather than becoming a hindrance in the process. In particular, let us hope that we will consider moving to an inflation-targeted monetary policy regime; modernising the delivery of financial services to the priority sectors and the vulnerable and weaker sections; introducing capital account convertibility; moving from a rules-based and fragmented regulatory architecture to a principles-based and unified architecture; and reforming the banking system in general and public sector banks, in particular. The current global crisis provides an opportunity to think hard about financial sector reform. All and any change is not necessarily good, but neither is the status quo. We need to reform, and reform in the right way. Inaction is not the way forward.

Thank you.

[80] See China, Country Finance 2008, Economist Intelligence Unit,.
[81] See Mahbubani (2008), p.9.

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