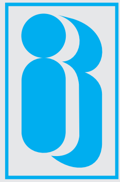

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GLOBAL FINANCIAL CRISIS

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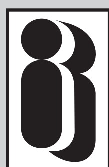

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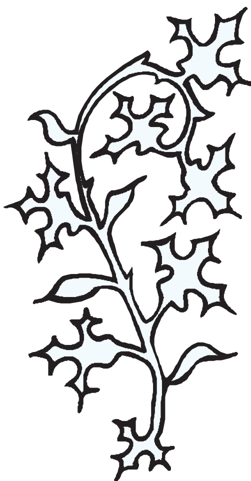
R. Bhaskaran
Chief Executive Officer, IIBF, Mumbai.

To say that the current global financial crisis (with its genesis in the sub-prime crisis of the US) has been extensively covered all over the media is stating the obvious! Yet, we decided to dedicate this issue of Bank Quest to the global financial crisis. Our motives were two-fold. As the journal of the premier Institute for banking education in India it would be an oversight if we didn't cover this issue at all, especially since it has caused a rethink world over on how the business of banking should be conducted. The other motive was to present to our readers the viewpoint of the Indian bankers. The fact that the Indian financial system was not affected by the financial crisis in a crippling way shows the robustness of our financial system and especially our banks. This makes it even more critical that we glean the lessons from our financial system and ensure to keep the financial system robust even in the future.

The issue has been organized to give a global perspective on the crisis, including a historical overview of various crisis that have afflicted the world so far and their resolution subsequently. The article by Dr. Vasant Godse 'US Financial Mess - How and Why?' provides an insight into the various crises that affected the world starting from 1800s. His article provides reasons behind the crises and also offers a glimpse into how they were resolved and what lessons the world drew from them.



That India is not isolated from the rest of the world and that there is no de-coupling of the Indian economy from the US economy is now well accepted. But what has been the impact and how best can we find a way out of it? These questions are sought to be answered by Dr. A. C. Shah in his article 'Global Financial Crisis : Its Impact on the Indian Economy'.

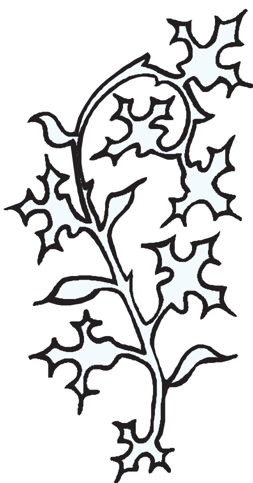
The origin of the current world recession was in the subprime crisis of the USA. Dr. Rupa Rege Nitsure's article 'Subprime Crisis and the

Liquidity Crunch" explains how the subprime crisis led to the liquidity crunch which finally plunged several parts of the world into recession and a slowdown in India. The article also discusses the policy responses to the crisis in India and how policy should respond in the future.

Though India has to put up with a slowdown in the economic growth the fact remains that our financial sector has been quite robust and our banking system has been insulated from the financial crisis in the USA. What have been the salient features of our banking system that has helped Indian banks stay strong and not succumb to any of ills that plagued the banks in the USA. In her article 'Indian and US Banking : Yogi and the Capitalist' Dr. Brinda Jagirdar explains the differences in the two banking systems and the way they have been regulated and how these differences have saved one system while dragging down another.

Other than the above special articles on the global financial crisis we have one article on a general theme. Narinder Bhasin's article on "Building Indian Infrastructure : Financing of Public Private Partnership Project' describes the modus operandi for PPP projects in infrastructure projects. The article gives examples from other countries to draw some lessons for our country and what would make a PPP project successful here.

This issue also contains three speeches. One is the text of the recent Sir Purshotamdas Thakurdas Memorial Lecture delivered by Dr. Ashok Lahiri, Executive Director, Asian Development Bank on 'Indian Financial Reforms : National Priorities amidst an International Crisis'. In addition we have two speeches on financial inclusion delivered by Dr. J. Sadakkadulla, Regional Director, RBI and the other by Smt. Elaben Bhatt of SEWA. Both the speeches were delivered at the Institute's seminars on financial inclusion held at Shimla and Ahmedabad respectively.



The issue also contains three book reviews. We hope you enjoy this issue. We look forward to your feedback.

(R. Bhaskaran)

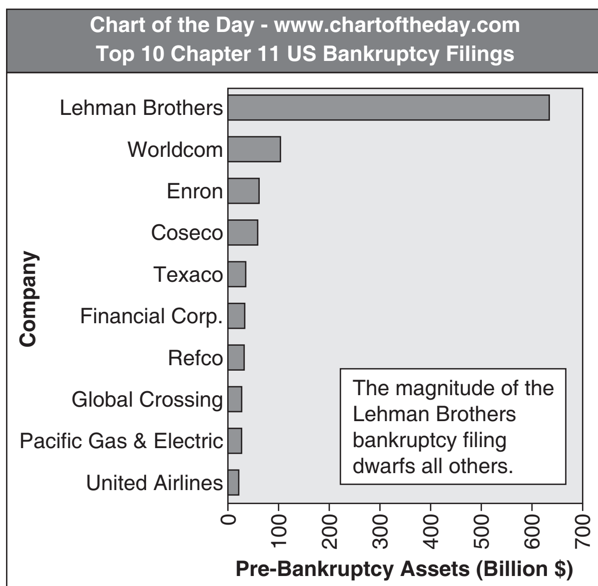
US Financial Mess - How and Why?

Dr. Vasant Godse *

Introduction

Prof. John Kenneth Galbraith in Great Crash (1954) said the following about the 1930s depression, "In the autumn of 1929 the mightiest of Americans were, for a brief time, revealed as human beings. Like most humans, most of the time, they did some very foolish things. On the whole, the greater the earlier reputation for omniscience, the more serene the previous idiocy, the greater the foolishness now exposed. Things that in other times were concealed by a heavy façade of dignity now stood exposed, for the panic suddenly, almost obscenely, snatched this façade away. We are seldom vouchsafed a glance behind this barrier; in our society the counterpart of the Kremlin walls is the thickly stuffed shirt… I have never adhered to the view that Wall Street is uniquely evil, just as I have never found it possible to accept with complete confidence the view, rather more palatable in sound financial circles, that it is uniquely wise."

Unfortunately, the same situation holds true for American adventurism (particularly the recent one) that resulted in the following bankruptcies as the result,



When Enron, Worldcom and the like happened, US sanctified the situation with the passage of Sarbanes Oxley Act whereby an effort was made to discipline the corporates more of whom were in non-financial sector. The latest is the catastrophe in financial sector.

This article covers the history of crises in the USA, provides the story of recent crisis, compared the crisis with 1930s, looks into the reason and impact, and visualizes the future before making concluding observations.

History of Crises

Between 1800 and 1970, credit crises, often caused or accompanied by real estate collapses, occurred in the United States on average once every 14 years, according to Prof. James Van Horne of Stanford University. Since 1970, the average has been once every eight years. Prof. Van Horne blames the wave of financial and corporate deregulation that began in the 1970s and accelerated over the past 10 years. One of the biggest changes was affording financial institutions the facility to securitize their loans. Although an important innovation for aiding economic growth, it also gave bankers an incentive to generate large volumes of loans and then move the loans onto somebody else without really worrying about what happens to them after that.

Prof. James Van Horne compares the recent lack of regulation to the late 1800s. That atmosphere culminated in the Bankers' Panic in 1907, a severe Wall Street crash that prompted the creation of the Federal Reserve and the modern system of financial regulations. The speculative bubbles that caused credit crises in the past included railroads in the late 1800s, electronics and autos in the 1920s and high-tech and Internet startups in the late 1990s. At the core of each crisis was real estate.

* *Dr. Vasant Godse is associated with Larsen & Toubro Infotech Ltd. Mumbai as Advisor. The views expressed herein are his personal views.*

During the Panic of 1819, the real estate speculation involved farmland on the Ohio frontier. In the Panic of 1837, there was a real estate bubble along the Mississippi. The Panics of 1873 and 1893 involved investments in land near rail lines. The Crash of 1929 was preceded by the bursting of real estate bubbles in Florida and Southern California.

In 1873, the crisis started in Europe, where cheap mortgage terms spurred a residential real estate bubble. When the bubble popped, bankers in London tightened their credit terms, triggering a financial crisis in the United States, where banks already were overextended with speculative loans to railroads and railroad-related real estate. The result in 1873 was an international depression that sparked double-digit unemployment rates, corporate bankruptcies, and widespread labor unrest. The United States did not fully recover until the mid-1890s, by which time it endured another credit crisis, known as the Panic of 1893. Scott Reynolds Nelson, a history professor at Virginia's College of William and Mary, suggests that 2008 may be much more like 1873 than 1929.

The response to the current crisis bears resemblance to past solutions. Most U.S. credit crises have been followed by expansion in credit, tightened trade restrictions, employment-boosting public works projects and, in some cases, direct aid to indebted borrowers. Until the present crisis came to the fore, the most prominent example of government intervention was Franklin Roosevelt's New Deal, which entailed massive infrastructure projects, tight regulation of the financial system and direct support to defaulting homeowners.

To prevent the current crisis from turning into a Great Depression, the Bush administration had allocated far more money than Roosevelt did during the Depression, mostly through direct injections into Wall Street investment firms and banks. University of San Diego real estate Professor Norm Miller said that “our children and grandchildren will hate us” for the amount of debt the government is incurring while trying to stave off the crisis. Some academics, however, consider that stimulus packages and other emergency measures may be the only way of keeping the economy from entering “something worse than recession.”

After 9/11 American people were encouraged to spend in the spirit of patriotism to help restart the failing economy.

The Crisis Story

After 9/11 American people were encouraged to spend in the spirit of patriotism to help restart the failing economy. To fuel that spending, in the extraordinary political and psychological climate of that time, U.S. policy makers actively encouraged levels of borrowing and lending that would never otherwise have been allowed. Federal Reserve was worried that the U.S. would face a severe recession and it began cutting interest rates down to 1% and kept them at that level until 2004, raising them slowly only 0.25% at a time thereafter. With interest rates so low, the financial services industry sensed that a lot of money could be made and went over-vigorously in real estate, seemingly unaware that low interest rates could be disguising large risks.

Commercial banks and investment banks lent vast sums-trillions of dollars - for house purchases and consumer loans to borrowers not really equipped to repay. The easy lending pushed up housing prices, which then went up still higher when speculators bought houses on the expectation of further price increases. The prices rose significantly because of easier access to funds / loans as also historically-low interest rates, looser lending and appraisal standards, low documentation (no income proof, etc), speculative fever, low teaser rates, *i.e.* below market mortgage rates for the first year, other creative structures and homeowners seeking extra profits from buying and flipping homes. Greater facilitation to the boom was provided by funding the mortgages, both traditional and creative (!), creation of mortgage based securities which were sold to investment banks, pension funds, insurance companies, foreign banks and other financial institutions, and individuals. This was in the midst of a situation of unregulated market for credit default insurance instruments.

Although Americans had been anticipating a downturn, they soon realized that money lost in the stock market could be more than offset by rising

home prices. As a result, while they continued to spend freely, the U.S. went further into debt with the rest of the world. Foreigners used their dollar IOUs from these debts to start their own bubbles too. Eventually, things started to unravel in 2006 when those that could least afford to purchase homes famously called subprime borrowers -- started to default in the U.S., prices having run well out of their range of affordability.

Many U.S. homeowners or rather borrowers found themselves stretched to the limit. Unable to meet their mortgage repayments, many of their homes were repossessed. When the easy lending initially slowed and eventually stopped during 2006-07, the housing prices peaked and began to descend. During 2007, nearly 1.3 million U.S. housing properties were subjected to foreclosure activity, up 79% from 2006, with about one of every 100 U.S. households at some stage or the other of the foreclosure process. The housing boom began to unknot and threatened an economy-wide bust. The worst of these mortgages were granted on very low interest rates that were to be adjusted to normal rates after an expiration of two to five years. There were some $350 billion of these in subprime, and an additional $385 billion in Alt-A loans. (An Alt-A mortgage, short for Alternative A-paper, is a type of U.S. mortgage that, for various reasons, is considered riskier than A-paper, or "prime", and less risky than "subprime," the riskiest category. 'Alternative A' interest rates, which are determined by credit risk, tend to be between those of prime and subprime home loans). As the rates reset, borrowers with questionable income and credit history were unable to meet the new, grossly enlarged payments based on the new rates. The result was a spurt of foreclosures that glutted the housing market, pushing prices further down.

In the meantime, during the boom period, banks and financial institutions had used their customers' mortgages and the value of their homes to create two new financial products known as mortgage backed securities and credit default swaps. Mortgages were rarely kept by the lenders on their books. Instead they were bundled into packages and sold to interested investors. This was done for regenerating resources to bring new sources of capital to market. These packaged

Mortgage investments were, until recently, widely considered to be among the safest investments because it was assumed that homeowners would do everything they can to avoid missing payments and losing their homes.

mortgages could be sold to yet more investors, creating a new series of mortgage-backed assets (and securities) that could be traded abroad. Although intention was to spread the risk of mortgage defaults, in reality, this just expanded the amount of debt in the system. Credit Default Swaps (CDSs) were to insure debt holders against default. They are fashioned privately, and are traded over the counter outside the purview of regulators.

When the decade-long property bubble began to deflate, the house of cards started tumbling down. With the mortgage backed securities and credit default swaps passing a variety of hands, no-one knew, who owns the risk, how much and who is managing it! The problem was that the complexity of the system was so great that possibly too few people understood how it worked and what its implications were. The U.S. government's seizure of the mortgage companies prompted an auction of their debt so that traders who bought and sold default protection (CDS) could settle contracts.

As market players chased after ever-shrinking returns, no one treated the dubious mortgages as anything different from normal mortgages and that included the rating agencies whose job is to evaluate products! Mortgage investments were, until recently, widely considered to be among the safest investments because it was assumed that homeowners would do everything they can to avoid missing payments and losing their homes. In February 2007, HSBC (Hong Kong & Shanghai Banking Corporation) issued the first major warning, an indication of things to come by writing down tens of billions in losses from their ill-timed 2002 acquisition of U.S. subprime lender Household International. Initially, things looked fine and policy makers convinced themselves and the

wider public that the problem was contained to subprime mortgages alone. However, when two Bear Stearns hedge funds with exposure to the U.S. housing market blew up in June 2007, people became concerned that the risks had been underestimated.

U.S. housing prices continued to decline. The result was massive losses in the mortgage-related derivative assets held by large global banks. The first wave of mortgage-related losses was concentrated in these instruments and investing vehicles like RMBSs (Residential Mortgage Backed Securities), CDOs (Collateralized Debt Obligations), SIVs (Structured Investment Vehicles) and CDOs of CDOs. Merrill Lynch was the first to report a large loss, at $5.5 billion on 5 Oct 2007 only to come back in less than three weeks later on 24 Oct 2007 to say that the losses were over $8 billion. Eventually, losses reached $500 billion for all global institutions.

The Merrill losses were followed by losses at most of the large global financial institutions. Many CEOs lost their jobs and the companies were forced to raise capital. By August 2008, the amount raised was to reach $350 billion. In March the failures of hedge funds Peloton and Carlyle Capital put the credit crisis back in full view. Another fright resulted in the sudden collapse of Bear Stearns, America's 5th largest investment bank as stated earlier. The Federal Reserve organized a takeover by JP Morgan Chase that was an appalling 90% loss for Bear's shareholders! Eventually the collapse of Bear Stearns faded and, for the third time, Americans were lulled into a false sense of security that the worst was over. However, write downs continued unabated. When Lehman Brothers announced a massive $3 billion loss on 9 Jun 2008, the crisis came into full view yet again -- much as it had when Bear Stearns' hedge funds collapsed the previous June. All financial shares generally came under assault. The ones considered the weakest came under the heaviest selling pressure, resulting in the collapse of Lehman Brothers. Without government support and unable to close a merger in around-the-clock negotiations at the weekend, the company filed for bankruptcy on Sep. 15.

Post-Lehman, market fears did not recede and the financial markets remained in a constant state of trauma. IndyMac, an aggressive mortgage lender, an American version of Northern Rock of UK, was taken over by the FDIC (Federal Deposit Insurance Corporation). Soon to follow were the conservatorship of GSEs (Government Sponsored Enterprises). The result of the market panic was a questioning of the very viability of GSEs (Fannie Mae and Freddie Mac are the two largest mortgage lenders in the United States and are at the core of the residential property market).

The result was mutual distrust amongst large banks operating in the global market for interbank loans which meant credit was hard to come by for many banks.

Merrill Lynch, the U.S. investment bank, sensing trouble, sought and received cover in a takeover by Bank of America that very same weekend when Lehman collapsed. Goldman decided to get converted into a full-fledged commercial bank. At this stage, the financial sector was in free fall and the entire banking system was on the verge of collapse in the United States. Global shocks had not ended either, as UK institutions were increasingly under attack as well, having been damaged by their own property bubble. At the urging of the British Prime Minister and the UK regulatory authorities, Lloyds TSB bought Britain's largest mortgage lender HBOS, which was in jeopardy of failing.

In Europe, it was in August 2007 when BNP Paribas, a large French bank, froze withdrawals in three investment funds that made the situation panicky. If a bank with zero obvious exposure to the U.S. mortgage sector could have this measure of difficulty, it was visualized that many could be hiding untold losses. This marked the official beginning of the credit crisis. The result was mutual distrust amongst large banks operating in the global market for interbank loans which meant credit was hard to come by for many banks. By September 2007, liquidity in the interbank market was so bad that rumors were spinning about various institutions which received most of their funding in wholesale markets. One of these was Northern Rock, an aggressive British mortgage lender. The British public panicked and began lining up to pull their money out of the institution.

The Bank of England was forced to bail out the company, subsequently nationalizing it altogether. The situation in European Union was no different.

Many were quick to blame irresponsible individual bankers for the crisis, but the reality was that the free market society encouraged risk taking and had created a complex system whereby losses in one sector, such as property, had implications for the entire economy. The crisis only illustrated just how intertwined political, philosophical, and economic issues are.

The Impact

The crisis created concerns on 7 Es. They included Economy, Energy, Exchange Rates and External imbalances, Europe / Euro / ECB, Emerging market economies, East as in Middle East, East as in Far East and Earnings / Equity markets. The U.S. economy faces four cascading threats:

First, the sharp decline in consumer spending on houses, autos and other durables, following the sharp decline in lending to households, causing a recession as construction of new houses and production of consumer durables nosedived.

Second, many homeowners defaulted on their mortgage payments and consumer loans, especially as house values fell below the mortgage values.

Third, the banking sector cut back sharply on its lending in line with the fall in its capital following the write-off of bad mortgage and consumer loans. Those capital losses pushed still more financial institutions into bankruptcy or forced mergers with stronger banks.

Fourth, the retrenchment of lending threatened even the short-term loans, which banks and other institutions lend to each other. Interbank transactions became extremely hard to place.

The financial crisis initially referred to in the media as a "credit crunch" or "credit crisis", began in July 2007 when a loss of confidence by investors in the value of securitized mortgages resulted in a liquidity crisis that prompted a substantial injection of capital into financial markets by the United States Federal Reserve and the European Central Bank. The TED spread, (difference between the interest rates on interbank loans and short-term U.S. government debt-"T-bills") an indicator of perceived credit risk in the general economy, spiked up in July 2007, remained volatile for a year, then spiked even higher in September 2008, reaching a record 4.65% on October 10, 2008. In September 2008, the crisis deepened, as stock markets world-wide crashed and entered a period of high volatility, and a considerable number of banking, mortgage, and insurance company failures in the following weeks.

Lehman Brothers expanded aggressively into property related investments including the sub-prime mortgages.

Next to follow was the collapse of Lehman Brothers, ranked among the world's top investment banks. Lehman Brothers expanded aggressively into property related investments including the sub-prime mortgages. The sub-prime crisis with the decline in value of housing forced the company to take huge write downs on the value of those assets and led to the loss of about U.S. $14 billion. This further led to Lehman's prime customers pulling out their monies into much safer investment avenues *e.g.* investing in government bonds. The collapse of the company put tens of thousands of jobs around the world at risk. The impact was also huge in other major economies considering the integration of the financial markets and the global nature of business today. Everything on Wall Street changed.

Dozens of banks and non-bank financial firms failed and / or were purchased in the past 18 months. Several primary dealers have been merged into other dealers, including Bear Stearns, Lehman Brothers, Merrill Lynch, and Countrywide. GSEs placed into a conservatorship. Washington Mutual was resolved via receivership and sale to JPM wiping out parent company shareholders and creditors. Wachovia was sold to Wells Fargo in open bank deal. The Federal Reserve System expanded its balance sheet to over $2 trillion to support markets from commercial paper to interbank loans. Markets for low-risk assets from municipal bonds to commercial paper to conventional mortgage pass-through paper disrupted due to continued uncertainty about price vs. “value” and reluctance of firms to place capital

at risk. There are some $50 trillion in outstanding CDS contracts. As default rates rise and these heretofore little understood or noticed instruments would go into the money and must be funded, demands for liquidity would grow significantly. Payout of extant CDS at face value suggests vast liquidity requirement for financial institutions / markets.

Difference with the past

History books are sure to take note of 2008. The Great American Mortgage Crisis of 2008 will go down as one of the nation's worst financial disasters. Some comments on the present crisis as different from the past crises are as follows,

- "This crisis is distinguished by its reach into the widespread market and the fact that residential real estate is so central to the problem."
- "All previous crises were contained to institutions, whereby participants could sit down, work out their accounting, and reach a solution. Not this one."
- "This is a situation where credit has been securitized, marketized, distributed, very difficult for the authorities to get their arms around the size, the shape, the magnitude of the problem."
- "In past crises, it took a little over two years to purge the system of the speculative excesses and get back really to a solid financial footing,"

In factual terms, how the recent one differed from the 1930s crisis can be assessed by the different asset classes,

1. Stocks : The 47 percent decline between October 2007 and November 2008 in the Dow Jones industrial average exceeded the Dow's 40 percent decline in the fall of 1929. The 50 percent peak-to-trough drop in the broader Standard & Poor's 500 index widely viewed as a more accurate gauge of the market was the worst in its five-decade history.
2. Commodities : The Standard & Poor's Commodities Index dropped 67 percent from its all-time high this summer of nearly 10,898 to its lows just above 3,500, the steepest peak-to-trough drop since the index was founded in 1970. One reason for the drop is that some commodities, such as oil, may have hit unsustainably high levels. The drop dwarfs the commodity movements of 1929, when Dun & Bradstreet's commodities index dropped a then-astounding 18 percent.
3. Housing prices : The 13 percent drop in home values in 2008 exceeds any of the drops that have been recorded in the past 50 years and may rival or even top the declines of the Depression. Economist Robert Shiller, who helped develop S&P's Case-Shiller index of housing prices, estimates that since the market peaked in 2006, the nationwide price has declined 20 percent, or 24 percent after adjusting for inflation, and prices may fall 10 percent further over the next year or so. In comparison, Shiller estimates that home prices fell 30 percent during the Depression.
4. Treasury bills : The best thing that can be said about T-bills is that they are not losing money. But they are not making much either. The yield on a three-month T-bill temporarily fell near zero percent. The yield on a 10-year T-bill is hovering around 2 percent. Not even in the Depression were yields so low. Nevertheless, the Treasuries are attracting a steady flow of investors.

During the time of crisis, the following joke used to make rounds on e mails.

At a banker meeting, one old gentleman makes the outrageous claim that "The market has stabilized." When pressed to explain his views, he goes on, "Forty years ago when I got into this business, I sold fifty shares of my company stock and had enough money to purchase a brand-new 1967 Ford pickup. Last week, I checked it out, and if I sold another fifty shares, I'd have enough money to buy a 1967 Ford pickup. So, the market has stabilized."

Possibly this is the true commentary on the post-crisis market situation!

Reasons for Crisis

The decade of benevolent economic conditions marked by low interest rates, low inflation, and less volatile asset markets, resulted in many to ignore the "risk". Investors around the world, who in preceding years had enjoyed above-historical returns on most assets, continued aspiring for ever-higher gains. The financial services industry created a variety of complicated new products

Regulators and investors alike showed a growing self-satisfaction towards risk.

to meet this demand. Regulators and investors alike showed a growing self-satisfaction towards risk. These factors blended into a dangerous mixture of underlying conditions that were ripe for instability. The imbalance between risk and reward was most evident in the U.S. housing market. Yet aggressive financial innovation went well beyond mortgages. Banks and brokers created complex and opaque investment products and structures. Credit-rating agencies responsible for assessing and rating these assets, as well as investors who purchased them, failed to question the chances of these underlying investments going bad.

The first impression on the reasons for melt down is generally seen as the greed, the triumph of free market ideology over prudence and the reckless economic policies of Federal Reserve. The current crisis has both domestic and global causes. Reckless 'deregulation' of domestic and international financial markets post-1980 period converted hedge to Ponzi finance. Unbridled growth of securitization and explosion in unregulated derivative securities in domestic financial markets of U.S. and Europe in particular led to unsustainable levels of leverage. It allowed massive growth in the unregulated 'shadow-banking system' fed by the mistaken belief that efficient markets could replace institutions and self-regulate. Greenspan expressed the state of 'shocked disbelief' when this model failed. Bank managements and regulators possibly did not understand fully the market 'products'. House of Commons Inquiry into Northern Rock and Congressional hearings in U.S. are the testimonies for this view.

'Originate and distribute' business model followed by the lenders involved the process of packaging individual loans and other debt instruments into other securities and enhancing their credit status to enable resale to third parties. Without an adequate theory or a conceptual clarity, market, regulatory and policy failures were inevitable. Securitization did lower the cost of finance but increased the fragility of the system. The former part was appreciated without understanding the latter. Speculative and Ponzi finance grew relative to hedge finance.

Derivatives increased the potential losses. CDSs were seen as easy money when first launched in early 1990s. Top 25 U.S. Banks held $13 trillion in CDSs in the 3rd quarter 2007. The 'market' in CDS magnified losses for all those 'insurers' who sold CDSs. For example, a CDS market in entity X may be $10 bn on only $1 bn of outstanding bonds/loans. In the event of default by entity X with 40c in $ of recovery, sellers of CDSs will lose $6 bn. This is just the very top layer of the credit pyramid which was in the trillions of dollars. This alone explains why the U.S., UK and European governments were required to 'nationalize' and / or contribute to the equity of many banks and other participants in these markets.

The preposterous executive compensation of the past decade or so, tied to stock market performance, coupled with golden parachutes to safeguard executives from risk, led to exactly what anyone would expect -- excessive risk-taking to maximize short-term gains and thus to exploit financial rewards for those in a position to benefit from taking these risks. Ideology also played its part. With the then prevailing ideology that "markets know the best," concern did not lead to adequate prudential regulatory measures to better protect the institutions and better safeguard the interests of consumers, including borrowers. U.S. economic policy played its part as well. The Bush administration, and, to some extent, its predecessor, and the Federal Reserve gave the U.S. the best economic expansion that money could buy - cheap cash, tax cuts and deficit spending. The imbalances between what the U.S. produced and what it consumed (the current account deficit) and between what its households earned and what they spent (the negative household savings rate) was a casualty by ignorance.

In perhaps the most sweeping indictment of fair-value accounting to date, the chairman of the Federal Deposit Insurance Corporation during the 1980s savings-and-loan debacle told the Securities and Exchange Commission that mark-to-market accounting rules caused the current financial meltdown. According to him, the fair-value

rules "have destroyed hundreds of billions of dollars of capital in our financial system, causing lending capacity to be diminished by ten times that amount."

In summary, the reasons for the crisis are,

1. Imprecise regulatory law allowed the financial institutions to carry too high a ratio of mortgage-backed securities to collateralized debt.
2. Banking regulators did not scream louder earlier regarding the ratio of assets to debt! Although there are many documented attempts from specific people that did warn of this problem, it was more a whisper than a scream.
3. New accounting regulations under Sarbanes Oxley Act are too conservative causing assets like mortgage-related securities to be valued less than their economic value (true worth), which caused the bank debtor run on the bank.
4. Private lenders (and their Chief Executive Officers) got greedy either lowering or violating their own lending standards in the hope of making more interest income by loaning to people who were very high risk bets.
5. Households borrowed more than they could afford. People that borrowed need to share the blame with lenders, although lenders need to be placed at a higher level than borrowers.
6. New law had been passed several years ago, urging institutions like Fannie Mae to make more loans to lower income households that carried much more risk.

The crisis had its origins in intellectual and policy failures. Efficient markets were confused with a perfect auction. Poor theory led to poor policy choices in domestic financial markets and the unavoidable market, regulatory and policy failures. Central bankers placed excessive faith in price stability as sufficient to ensure macroeconomic stability to the detriment of financial stability. From a financial perspective, the main cause of the debacle were boom and bust in the housing market speculation, high-risk mortgage loans and lending / borrowing practices, securitization practices, inaccurate credit ratings, flawed government and central bank policies, financial incentives, credit default swaps and the like. The melt down started as credit crunch, then moved on to become financial crisis and ended into solvency crisis!

Every forecaster is probably optimistic and no one expects a replay of the Great Depression.

The Future

The financial crisis in reality happened in phases, namely, U.S. sub-prime mortgage market calamity, the collapse of Lehman Brothers and the unraveling of credit default swaps (CDSs), recognition of a serious recession for most developed countries and a spreading of recession to emerging market economies. What the future has in store for world economy in general and USA in particular is an area for informed guesses and even speculation. Every forecaster is probably optimistic and no one expects a replay of the Great Depression. The present day realities are deepening U.S. recession, tightening credit thereby restraining the spending by households, businesses, and state and local governments, continuous sliding of housing market and hence uncertainty about recovery. IMF's World Economic Report of October 8, 2008 made the following forecasts,

- World growth will slow amid most dangerous financial shock since 1930s
- No growth in many advanced economies until at least mid-2009
- Global economy expected to stage modest recovery later in 2009

In December 2008, the Conference Board reported that its composite index of leading economic indicators declined 0.4 per cent in November, following a 0.9 per cent drop in October. The index is designed to provide clues on economic trends in the coming months. Only four of the 10 indicators that make up the board's leading index were on positive territory - money supply, the interest rate spread, manufacturers' new orders for non-defense capital goods, and manufacturers' new orders for consumer goods and materials. The negative contributors included building permits, stock prices, and average weekly initial

claims for unemployment insurance and weekly manufacturing hours. Despite significant downside risks, it said there was still a good chance the U.S. economy would experience a modest recovery by the second half of 2009. Scope of recession depends on effectiveness of financial rescue projects and fiscal stimulus. The following forecasts are provided by Conference Board, as updated on 15th January 2009,

inflationary pressures when economic conditions start to turn around.

The GDP forecasts by economists reveal a slight GDP contraction in 2009 with recovery in Q4 2009. Some analysts lowered 2009 growth estimates for industrial companies substantially, but still anticipate 3% top-line growth for the sector. 2009 growth expectations for the IT sector have fallen from over 8% to 5%.

	2008			2009			2010		2008	2009	2010
	III Q*	IV Q	I Q	II Q	III Q	IV Q	I Q	II Q	Annual	Annual	Annual
Real GDP	-0.5	-5.9	-3.4	-1.5	2.4	2.5	3.1	4.0	1.1	-1.7	2.9
Real Consumer Spending	-3.8	-2.5	-1.4	-0.6	1.7	2.0	2.5	2.2	0.3	-1.0	2.0
Housing Starts mil. Units	0.88	0.67	0.65	0.62	0.65	0.70	0.73	0.76	0.91	0.66	0.85
Real Capital Spending	-1.7	-15.0	-16.6	-12.5	-7.4	-0.9	6.6	8.9	2.1	-10.6	3.3
Net Exports	3.0	-15.6	-3.9	-5.5	-3.2	0.0	1.4	3.3	6.8	-4.4	1.3
Inventories	-29.6	-67.1	-90.1	-98.4	-59.9	-29.7	-3.6	25.4	-39.5	-69.6	21.5
Unemployment Rate (%)	6.0	6.9	7.5	8.2	8.6	9.0	9.0	8.9	5.8	8.3	8.8
* Actual data											

Another view expressed is, when the economic recovery begins an event that may take place sometime in late 2009, early 2010 it will be slow and will stretch over many quarters with below trend growth and accompanied with much higher unemployment levels. Given the continued deterioration of economic conditions, the unemployment rate above 7 percent is visualized by some experts. The root cause of the challenges, the housing sector, does not seem to show any signs of stability in the near future. Inflation may moderate significantly during 2009. The unprecedented liquidity that is currently being pumped into the market to shore up the financial sector and provide the much needed liquidity for the credit market, is likely to increase

The future performance of U.S. economy would ultimately depend on the success of bail out, level of consumer confidence, efficacy of global problem resolution mechanism that can impact U.S. and the like.

In meteorological terms the best possible forecast may be 'cloudy with chance of showers' at least up to 2010!

Conclusion

Tolstoy famously begins his classic novel Anna Karenina with “Every happy family is alike, but every unhappy family is unhappy in their own way.” While each financial crisis no doubt is distinct, all crises also share striking similarities, in the run-up of asset prices, in

debt accumulation, in growth patterns, and in current account deficits. The majority of historical crises are preceded by financial liberalization or deregulation.

The breadth of the 2008 crisis is unprecedented because it has touched nearly every form of investment, including stocks, corporate and municipal bonds, commodities and home prices. Most of the declines have been of historic proportions. The only things that really have not been hit are gold and Treasury securities. The ridiculously low yields on Treasuries points to the fear that has taken over the market.

During the past 200 years, there have been 16 credit crises in the United States, all marked by speculative excesses in the years immediately preceding. Following the 1907 and early 1930s crises, the Congress undertook substantial reform of the financial services industry. Again it is time for substantial regulatory / supervisory change. In 1970s, there began a period of deregulation of financial services in the United States. Much good came in lowering costs and inconvenience, but it came with greater risk taking and less disciplined behavior. Self-regulation and market discipline, frequently idealistic, can stem the type of systemic risk recently experienced.

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Enterprise-wide Risk Management

The five key elements of enterprise-wide risk management(ERM) for financial institutions are process and practice assessments of risk governance, operational risk, market risk, credit risk and liquidity and funding. In addition, economic capital assessment is also a key component of the ERM assessment process. Market risk assesses risk management practices for both trading risk and for asset-liability management (ALM) or interest rate risk. In credit risk, a firm's underwriting processes, credit risk analytics and portfolio management practices are evaluated. For funding and liquidity risk, funding composition, liquidity management and stress-testing practices are assessed. The methodology to assess and rate ERM is consistent with the Trading Risk Management (TRM) assessment methodology. ERM criteria includes assessment of the quality and robustness of an institution's risk culture, its risk appetite, how it aggregates risk at the enterprise level, its risk disclosure quality and the practices it uses to guard against business, legal and reputation risk.

While economic capital evaluation is presently outside the scope of the ERM assessment process, some banks have developed economic capital model to quantity these different risk types more consistently.

The relative importance of each aspect of ERM in formulating and opinion of the quality of a firm's risk management practices will depend on the complexity, size and range of risk for each individual firm. The factor sets are by no means exhaustive or static. As the ERM practices of organisations evolve, ERM assessment factors will most likely evolve as well.

Source : RBI's Report on Currency & Finance, 2006-08.

The Global Financial Crisis : Its Impact on Indian Economy

Dr. A. C. Shah *

Downturn Starts with America

The current Global Financial Crisis has its roots in the biggest housing and credit bubble in the USA. The crisis surface about 15 months ago with the sub-prime assets of the mortgage companies. The credit losses on the mortgages that financed these houses and further aggravated by the pyramids of complicated debt products started mounting. According to the estimate made by IMF recently, the worldwide losses would reach $1.4 trillions. Some $700 billions have been written down by American banks, insurance companies, hedge funds and others that own the debts. Among the well known institutions that have suffered are CITI Bank, American Insurance Group (AIG), Merrill Lynch, Morgan Stanley, Goldman Sachs, Bank of America and J. P. Morgan. To arrest the deteriorating situation, a bail-out package was announced by the U.S. Government known as TARP on October 3, 2008. Through various innovative measures liquidity has been injected in the banking system and other hard-pressed companies from time to time. On account of the crisis, interest rates have come down to near zero, the U.S. stock markets have witnessed the steepest falls, unemployment has been soaring and the consumer demand has been going down. The financial crisis is steadily engulfing the real sector, creating a wide-spread fear that the current recession may result in a depression.

The U.S. financial crisis first spread to other rich countries the U.K., Europe and Japan and later to emerging economies, including China and India. The impact, of course, has varied from country to country. The Governments have been responding with bail-out packages, through which more and more liquidity is being made available and interest rates are gradually brought down. Added to the measures taken by the monetary authorities, increasing use is being made of the fiscal stimulus.

The global financial crisis started visibly impacting the Indian economy from September 2008 onwards.

Countries like Japan, China and India have put up bail-out packages to arrest the impact of financial crisis. There is wide-spread awareness of the impending danger signals and corrective measures are being coordinated world over.

Impact on Indian Economy

The global financial crisis started visibly impacting the Indian economy from September 2008 onwards. Gradually it spread over all the sectors of the economy. Till the third quarter of the current fiscal year, both Reserve Bank of India (RBI) and the Finance Ministry were concerned about the accelerating inflation. It was also believed that the impact on Indian economy would be only marginal. However, as the crisis started impacting the GDP growth rate, the stock market, exports and capital inflows, the pressing need for appropriate policy measures has become pronounced. In this paper, an attempt is made to examine the impact sector by sector, the strategy followed so far and the lessons India can learn from the policy measures of other countries, particularly from China.

Slowing GDP

In the past 5 years, the economy has grown at an average annual rate of 8-9 per cent. Services which contribute more than half of GDP have grown the fastest. At the same time, Indian manufacturing has also done well. Its impressive run ended in January 2008.

Even before the global confidence dived, the economy was slowing. In August industrial output was up by only 1.4 per cent over a year ago. RBI then revised its forecast for GDP growth for 2008-09

* *Former CMD, Bank of Baroda.*

from 9 per cent to 7.5 per cent. According to the mid-year Review of the Economy presented to the Lok Sabha on December 23, 2008, Indian economy will grow at 7 per cent in 2008-09.

The fear of rich countries slipping from recession into depression in 2009, makes the scenario even gloomier for India. To illustrate the point, three widely differing forecasts made by eminent economists are considered for arriving at a reasonable figure.

Growth Forecasts for 2009-10			
1.	Arvind Virmani	Chief Economic Advisor Finance Ministry	8.5 per cent
2.	Raghuram Rajan	Economic Advisor to The Prime Minister	5 - 7 per cent
3.	Rajiv Kumar	Head of the Indian Council for Research on International Economic Relations (ICRIER)	3 - 5 per cent

Each of the above forecasts is based on certain assumptions. Mr. Virmani is of the opinion that the recovery should slowly start from the first quarter of 2009 and the third quarter of the year may see the growth process accelerated. He also believes that with the coordinated measures taken by the USA, the UK, Europe and Japan, the crisis should ease considerably again from the third quarter. The high rate of savings, 37.4 per cent can take care of the slow-down in Foreign Direct Investment (FDI). Savings and investment rates are high in India about 35 per cent. It is useful to note that FDI inflows remained healthy at $14.8 billion till August 2008. Further, India's net exports are very low compared to China. India's current account has more or less been in balance in the last five years. In these circumstances, India can effectively manage a fall in export demand. He underlines the different growth strategies followed by China and India; China has export-led growth while India has investment led growth. Mr. Virmani thus believes that it is possible to bring the economy back to 8.5-9 per cent growth path.

The basic assumption of both Mr. Rajan and Mr. Kumar is that the fast deteriorating situation in the rich countries is causing them to slip from recession to depression. Mr. Rajan believes that while the first half of 2009 may remain uncertain and depressed, the revival process may get accelerated in the latter half. However, he feels that 8.5 - 9 per cent growth appears unrealistic and that it is reasonable to expect 7 - 7.5 per cent growth. Mr. Kumar, on the other hand, goes by the gloomy outlook for the entire 2009. He also believes that it is difficult for India to sustain 9 per cent growth rate in view of certain inherent weaknesses of the Indian economy. Apart from the fire-fighting short-term measures, a strategy to remove road-blocks to the growth process should be spelt out and given priority and urgency should be given to its implementation.

The falling exports and the exchange value of the rupee are already a matter of serious concern.

Mr. Rajiv Kumar takes a very serious view of the global financial crisis and he presents a gloomy picture. Even if the world continues to face the financial crisis throughout 2009, the growth rate of India would not go as low as 3.5 per cent.

The factors which can adversely affect the growth rate could be divided into short-term and medium-long term. General elections will take place in April or May. Before and after the elections considerable uncertainty will prevail. Following the terrorist attack in Mumbai, relations between India and Pakistan have been strained. As a result, defence expenditure will rise, limiting the funds available for stimulating the economy. This is particularly a matter of concern as the deficit financing of both Union and States this year may reach around 8 per cent which will be almost double that of the last year. The coming monsoon further adds to uncertainty. The falling exports and the exchange value of the rupee are already a matter of serious concern. Much will depend on the course the global crisis may take during the year as also on the way monetary and fiscal measures taken so far are implemented.

Infrastructure has been one of the biggest handicaps in India. The shortage of power poses a serious problem to industry, services and agriculture. Last year the peak demand outstripped supply by 15 per cent. In some of the States, the position is all the more serious. According to the World Bank, 9 per cent of potential industrial output is lost due to power cuts.

For healthy economic growth, say around 9 per cent, well planned infrastructure is a primary necessity.

Poor roads are another stumbling block, making the movement of goods and products costly and irregular. Sanitation, urban slums and some minimum basic facilities in rural areas are awaiting large investments. Through the public-private partnership, the Government expects private investments to contribute three-quarters of the additional investment in infrastructure like power, roads and upgrading airports as also 40 per cent of the total. For healthy economic growth, say around 9 per cent, well planned infrastructure is a primary necessity. Here too India needs to take lessons from China.

Agriculture is another major drag on the economy. It heavily depends on the behaviour of the monsoon. As against the desired growth rate of 4 per cent, the actual growth rate varies widely from year to year. For instance, total crop production is expected to grow at 2.5 per cent during 2008-09, as against 5.8 per cent in the previous year. There are instances where one year records 6 - 7 per cent growth and in the following year, the negative growth. For a higher GDP growth rate, agriculture should be given the same priority as industry. This will help to alleviate rural poverty and the pressure of population on land. As high as 65 per cent of Indian population depends on agriculture which contributes only 18 per cent to GDP. It should be also remembered that 14 million people are added to the labour market each year with much of the burden falling on agriculture.

If India is to convert the present challenges into opportunities in the future, it needs urgently to reform the throttling labour laws as also the slow-moving bureaucracy. At the lower levels, it is increasingly becoming inefficient and corrupt. The message of transformation for the better has to percolate from the top to the bottom.

As against these unfavourable factors, there are some positive developments also. Inflation which was a major concern upto the first half of 2008, has declined to nearly 5.91 per cent by December 27 from the year's peak of 12.91 per cent owing mainly to the fall of crude and commodity prices. According to some economists it is expected that inflation may come down to 2 per cent by the end of March 2009 and even result in deflation in 2009-10. Although the fear of deflation appears to be far fetched, price stability will give considerable leeway to RBI, particularly in bringing down interest rates and help promote higher investment. Unlike in rich countries, Indian banking is quite sound, capable of taking the development role. The Government is also going planning to recapitalize weaker banks to the extend of Rs.20,000 crores. The monetary and fiscal policy measures taken so far (outlined below) will help improve liquidity and lower interest rates on one hand and provide relief to exports and adversely affected industries, particularly housing, auto and infrastructure projects.

Taking into consideration various favourable and unfavourable factors, the GDP growth rate in 2009-10 may work out to 6 - 6.5 per cent, if the global scenario does not show steady improvement.

RBI's initiatives

From the middle of October, RBI took a series of steps to create adequate liquidity in the financial market, lower interest rates and provide relief to exports and other most affected sectors of the economy. Compared to other countries, advanced as well as emerging, India was somewhat late in realizing seriousness of the fast accelerating global financial crisis. But till the middle of October, inflation control was the priority and there was a fear that any monetary liberalization might further aggravate inflationary pressures. The following table illustrates the changes made by RBI in the rate structure :

Time frame	Repo Rate	Reserve Repo rate	CRR	SLR
Prior to October, 2008	9	6	6.5	24
October 20, 2008	8	6	6.5	24
November 3, 2008	7.5	6	5.5	24*
December 6, 2008	6.5	5	5.5	24
January 2, 2009	5.5	4	5	24

**As against 24 per cent SLR requirements, PSU banks alone had 26.8 per cent in SLR and SBI had 28.31 per cent in SLR. If they maintain 24 per cent in SLR, they would release about Rs.40,000 crores to improve liquidity.*

Further, while maintaining the SLR at 24 per cent, temporary relaxations are allowed to banks to borrow for helping cash-stressed Mutual Funds (MFs) and Non-Banking Finance Companies (NBFCs).

Thus, there is enough liquidity in the system to take care of the normal credit demand as also of the specific sectors and companies.

As a result of lowering key rates, RBI has injected so far about Rs.3,00,000 crores to improve liquidity in the financial market. Thus, there is enough liquidity in the system to take care of the normal credit demand as also of the specific sectors and companies. The latest RBI data show that credit growth has slowed down in the third quarter, ending December 2008. Banks have reduced their prime lending rates (PLRs), providing lower lending rates to their clients. Simultaneously, banks have reduced interest rates on fixed deposits to maintain a reasonable spread between the return on advances and the cost of deposits.

RBI has also taken some special steps. Exporters facing payment problems are provided cheaper funds and the time allowed to realize export bills has been extended from 180 days to 270 days. Bank loans to housing finance companies are included in the priority sector. SIDBI has been given Rs.7,000 crores for funding small and medium enterprises (SMEs) as also micro-enterprises. A safety net is provided for loans to commercial property projects so that delayed payments are not treated as non-performing assets (NPAs), thus giving property developers a breather. Banks have been asked to charge lower interest rates to housing loans in the two slabs upto rupees 5 lakhs and between rupees 5 to rupees 20 lakhs. With a view to helping companies to reduce costly foreign debts, RBI now permits premature buy-back of foreign currency convertible bonds (FCCBs). Foreign Institutional Investors' (FIIs) limit in corporate bonds has been increased to $10 billion. Public Sector banks will get capital support of Rs.20,000 crores over next 2 - 3 years.

RBI has, thus, taken a series of measures, conventional and unconventional, in less than 3 months to provide adequate liquidity at lower costs, taking particular care of severely affected sectors of the economy. It is expected that banks will implement these measures, keeping the main objectives in mind. The Government, RBI, banks and the corporate sector leaders should jointly work to convert the challenges faced at present are converted into opportunities.

Fiscal Packages

Concerned about the economic slow-down in December 2008 the Government announced a Rs.30,900 crore fiscal stimulus package, mainly comprising additional spending that can boost investment and consumption. An across-the-board 4 per cent excise duty cut has been announced, amounting to Rs.8,700 crores and covering all products, barring petroleum products. The package provides Rs.1,450 crores to the export sector which, for the first time in last five years, saw at 12 per cent drop in October and further 9 per cent drop in November. The Government also hopes to precipitate infrastructure projects worth Rs.1,00,000 crore through faster clearances of public-private partnership projects. The India Infrastructure Finance Company (IIFCL), a specialist in the infrastructure sector, has been allowed to raise tax free bonds of Rs.10,000 crore, for re-financing long term loan for projects ike ports, power and highways. Public sector banks have already announced a separate package for home loans upto Rs.5 lakhs and between Rs.5 lakhs and Rs.20 lakhs. Cheaper home loans will boost the real sector industries, which would, in turn push up the demand for cement and steel. This fiscal stimulus package along with the monetary measures announced in December is expected to show some positive results.

Within a month, the Government has come up with a second stimulus package, along with considerably liberal monetary measures. Together these initiatives will help housing, exports, infrastructure and auto industry in particular, to obtain loan at cheaper rates. The corporate sector have access to cheaper rates in India and will

Within a month, the Government has come up with a second stimulus package, along with the considerably liberal monetary measures.

be able to raise loans from abroad without much hassle. IIFCL is allowed to raise Rs.30,000 crores through tax free bonds. Integrated townships are allowed to tap ECB, (external commercial borrowings). States have been asked to release land for low and middle income housing. Infrastructure NBFCs can access ECB from multilateral and bilateral financial institutions. States have been allowed to access market borrowings upto Rs.30,000 crore. FII investment limit in re-denominated investments has been raised to $15 billion. CVD exemptions on cement and TMT bars have been withdrawn. Both the fiscal stimulus packages announced by the Government as well as the monetary measures taken four times by RBI in about 2½ months should produce salutary effects on the economy. Together they can change the environment favourable to Indian economy.

Corporate Sector

A question often asked is - how the slow down in the last two quarters of 2008 (July - December) has impacted the corporate sector and further, how the steps taken so far would help improve the industrial scene?

The Index of Industrial Production (IIP) showed a remarkable recovery in November clocking a growth rate of 2.4 per cent, after it had dropped to a 15 year low of a negative 0.4 per cent in October. However, the industrial data for the April-November period show 3.9 per cent growth as against 9.2 per cent in the same period last year. The data further points out that output of petroleum refinery products, power generation, finished carbon and steel shrank in November while production of coal, cement and crude oil outspaced that in 2007. The impact of monetary and fiscal measures taken in December and January would certainly help improve the industrial scene further. The Petroleum Ministry has recently announced a cut in prices of petrol, diesel, gas and kerosene. This too will prove favourable to the industry.

Industries mainly dependent on exports are worst affected. IT and IT related services which have been recording a much faster growth rate average around 18 per cent is likely to decline in the current fiscal 2009-10. It is estimated that nearly 55,000 IT workers will be unemployed. With the fiasco of Satyam, the number may even grow further. Exports of gems and jewellery are equally hit hard. With the sharply falling demand from the USA and Europe, not only exports have gone down but management of receivables has become a big problem. With the emerging scenario in Western countries, the demand for polished diamonds and diamond jewellery may turn out very poor in the current fiscal year. Other worst hit sectors are exports of textiles, leather and leather products. In all these products, demand in the domestic market is very limited.

With the emerging scenario in Western countries, the demand for polished diamonds and diamond jewellery may turn out very poor in the current fiscal year.

During last October and November exports showed negative growth. They declined by 12 per cent in October and by 9.9 per cent in November. However, for April-November 2008, the growth works out to 19.14 per cent, amounting to $119.5 billion as against the target $200 billion for the year. Imports, however, continue to grow and may end up at over $300 billion. Rupee has been falling against the Dollar from February 2008 onwards. In February the exchange rate was 39.73 and it is hovering around 49 - 49.5 at present. The falling exchange rate has not helped exports at all because of the recessionary conditions in developed countries. On the other hand imports have become costlier. As a result, the trade balance is estimated to be negative at over $100 billion. Taking into account other receipts such as invisible earnings, foreign capital inflows, NRI deposits and FDI as well as servicing external debts, the current account balance widened to $12.5 billion in the quarter, July-September. Estimates vary widely as to how much further it would go up in the two quarters, ending March 09 and also in the fiscal 2009-10, if the domestic and global situation does not improve significantly. Steady withdrawals of FII and FDI investments, along with the widening trade imbalance, put lot of pressure on the exchange rate of rupee. Thanks

Price reductions and the excise duty cut across-the-board they have not helped the sagging demand.

to the RBI policy of buying over rupees and providing dollars against them, the pressure has somewhat eased. Another important factor which has come to our help is NRI deposits. At the same time forex reserves have been steady at around $250-55 billions. Taking into consideration the deteriorating global situation as also the falling exports and foreign investments, a close watch on the balance of payments situation is required so that in the event of the problem getting aggravated, timely and effective measures could be taken urgently.

Besides the problems / issues, issues discussed above, the corporate sector is faced with some basic weaknesses, which are undermining its robust health and competitive position, both domestically and internationally. First of all, demand for many products has been declining. For example, demand in the auto sector alone has declined by 18.2 per cent. Price reductions and the excise duty cut across-the-board they have not helped the sagging demand. Taking an optimist viewpoint, many companies were restructuring themselves to become more efficient and competitive. however, Mergers and Acquisitions (M&As) in India, for the first time in last few years has, witnessed a decline in M & As in 2008. Likewise, the cross-border buys by Indian companies has witnessed a 33 per cent fall to $15 billion in 2008. The liquidity crunch and high interest costs are still a major concern for companies faced with accumulated inventories and sagging receivables. This is particularly secure in the Small and Medium sector. Despite some liberalizations announced by RBI, banks are possibly reluctant to lend to companies perceived as high risks. The third quarter results of some of the banks show a marked jump in NPAs, both gross and net. As a result, adversely affected units have started reducing their employees as a cost cutting measure and worst affected among such units are closing down.

Although the fiscal and monetary measures taken so far are being monitored at the highest level, it is necessary to take into confidence business and trade union leaders, taking into account the gravity of the situation. There is a strong case for a small and compact group representing different interests, monitor the issues / growth independently and present its suggestions to the high-powered Review Committee. This group should act as the first sounding base, helping to implement policy measures effectively and suggesting from time to time flexibility and changes required in the context of the emerging situation. This kind of partnership among different groups will go a long way, not only for the short-term problems faced at present but also for faster growth in the future.

Capital Market

If any one sector has suffered most, it is the capital market. During the year, the BSE Sensex crashed from 20,301 on January 1, 2008 to 9,647 on December 31, 2008. The lowest level was 9,027 on November 26. The Sensex is moving around 9,000 at present. This is the lowest level during last 3 - 4 years. It is feared that not so satisfactory corporate results in the third quarter may further depress the market. This is evident from the fact that advance tax paid by companies in December quarter was down by 22 per cent by Rs.42,600 crores. Volatility in the market is very high, making it is difficult to foresee which way it would go. As a result, market capitalization has fallen by 65 per cent for BSE, from $1,472 million to $562 million till November, 2008 and by 64 per cent for NSE from $1,345 million to $512 million. Further, the average turnover of BSE and NSE combined was working out at Rs.1,20,000 crores in January 2008 has come down to Rs.40,000 crores towards the end of December.

FIIs continued to pull out money from the equity market from June onwards. The net amount withdrawn by FIIs upto December 2008 works out to Rs.52,723 crores. The primary market is almost non-existent during last six months. The total amount collected in 2008 was Rs.17,977 crores, down by 63 per cent compared with Rs.45,137 crores collected in 2007. In all 38 IPOs came to the market, compared with 106

Investors in the capital market include a large number of middle income groups.

in 2007. Prominent among the issues in 2008, were Reliance Power (Rs.10,123 crores) and Rural Electrification (Rs.1,639 crores). Fees earned by lead managers and merchant bankers dropped sharply from Rs.771 crores in 2007 to Rs.230 crores in 2008. Likewise, share prices of brokerage companies have dropped by 60 - 70 per cent.

GDR and ADR issues of Indian companies listed abroad show an equally alarming drop in their values during the year. Scindia Index dropped by 65 per cent, falling during the year from 2,361 to 1,279. For example, GDR price of Reliance Industries came down by 64.8 per cent, from $95.85 to $51.9; similarly GDR price of L&T came down by 84.3 per cent, from $105.25 to $88.75. Equally alarming is the fall in ADR prices.

Investors in the capital market include a large number of middle income groups. Their position is different from that of day traders and speculators. Retail investors buy shares of well-known companies. It is estimated that such investors have lost, over the year anywhere between 60-65 per cent. Their investments in mutual funds have suffered a worse fate. Those who invested in shares after borrowing from banks had to pay high margins, thus liquidating such shares either on their own or banks sold them for margin adjustments. All the fiscal and monetary measures taken so far have no positive impact at all on the markets. It is anybody's guess how long this situation would last. At present it is an exercise in fire-fighting.

It is seen that of other countries have taken various measures to ward off the adverse impact of the slowing growth rate, slipping into recession. India has to study them and take additional measures where required and implement the measures already taken in flexible and purposeful manner.

Fire fighting is undoubtedly critical at present to minimize the impact of the global financial crisis and the impending fear of recession. But a long term plan should be put in place such that those who are entrusted with the critical task should move fast and effectively, over-coming the political and other uncertainties which may crop up during the first two quarters of the fiscal 2009-10.

Simultaneously efforts should be made to give equal priority to correcting the chronic weaknesses of the economy so that not only is the growth rate accelerated but also help reduce sharp regional and rural urban imbalances as well as minimize the widening gulf between the rich and the poor.

There is a need to reshape the economy to meet the challenges from within and from the world. In fact, this is the direction in which even advanced economies are moving accepting the positive role of the state along with private enterprises.

Principles for the Supervisory Review Process

The Basel Committee has defined the following four basic principles for the supervisory review process.

Principle 1 : Banks should have a process for assessing their overall capital adequacy in relation to their risk profile and a strategy for maintaining their capital levels.

Principle 2 : Supervisors should review and evaluate banks internal capital adequacy assessments and strategies, as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the result of this process.

Principle 3 : Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4 : Supervisors should seek to intervene at an early stage to prevent capital from failing below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained or restored.

Essentially, these include evaluations of the banks' internal processes and strategies as well as their risk profiles, and if necessary taking prudential and other supervisory actions.

Source : RBI's Report on Currency and Finance, 2006-08

Subprime Crisis and the Liquidity Crunch

Dr. Rupa Rege Nitsure *

The global banking system has been passing through a major liquidity and credit crisis since July, 2007. Losses from sub-prime mortgages (i.e. the mortgages normally provided to borrowers with lower credit rating) have created a liquidity and credit crunch, which, in turn, have triggered a global slowdown. According to the International Monetary Fund's (IMF) latest Outlook on World Economy (Jan 28, 2009), world economic growth is projected to fall to 0.5% in 2009 when measured in terms of purchasing power parity and turn negative when measured in terms of market exchange rates. Advanced economies (US, Euro Area, UK, Japan, etc.) are suffering their deepest recession since World War-II and their output is projected to contract by 2.0% in 2009. Growth in 'emerging and developing economies' (which include China, India & countries from Africa, Latin America, etc.) is expected to slow sharply to 3.25% in 2009 under the drag of falling export demand and tighter financing constraints.

The IMF Report says that the continuation of the global financial crisis, as policies failed to dispel uncertainty, has caused asset values to fall sharply across all countries, decreasing household wealth and thereby, putting downward pressure on consumer demand. Moreover, widespread disruptions in credit are constraining household spending and curtailing production and trade. In nutshell, the liquidity or credit crunch following the outbreak of subprime crisis has been a major trigger for the present global slowdown.

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Reasons for Liquidity Crunch

To understand the reasons behind the liquidity or credit crunch that surfaced during the current crisis, it is necessary to understand the roots of the present crisis.

Before the crisis erupted in developed economies, their economic systems were characterized by booming stock and real estate (housing) markets, ample liquidity, low interest rates, narrow credit spreads and lesser volatility in financial markets. Against this backdrop, the lenders to subprime borrowers (i.e. borrowers with poor credit histories) in these countries, especially in the U.S. (the epicenter of the crisis) increased their exposure to subprime segment on strong conviction that they have means to mitigate their risks, while still making a profit. They tried to manage the risk by packaging up the loans and selling them (i.e., the process of asset securitization) to hedge funds, mutual funds, private equity firms, etc. who were looking for quick returns. The buyers of these packaged loans, in turn, made use of borrowed funds to facilitate these purchases and thus added another layer of debt to the original transaction in subprime mortgages. The shares of these companies were then bought by pension funds and insurance companies whose risk management practices otherwise would not have allowed them to buy the risky mortgages outright.

Thus, layers of risky debt were built upon each other to facilitate quicker gains and when the borrowers at the foundation of this structure (i.e. the subprime borrowers) started defaulting, the entire structure started collapsing resulting into the subprime crisis. What began as a bursting of the U.S. housing market bubble soon spread to other advanced countries that too were having their own home-grown real estate bubbles. Moreover, in a globalised world, the balance sheets of individuals, banks, corporations

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Liquidity crunch is a situation when the price system does not work any more to make supply of loans equal to demand for loans.

and governments are all interconnected through the international markets. So even though the immediate problem started with the defaults on U.S. mortgages, the U.S. and other international banks suffered about equally due to their interconnected balance sheets. Even developing countries like India suffered from the knock on effects on their money, capital and forex markets due to capital flow reversals, sharp widening of spreads between sovereign and corporate debt and abrupt currency depreciations.

The collapse of large banks and financial institutions (FIs) in most of the advanced countries shook the confidence of banks to freely lend to each other. As a result, many banks and FIs that relied on short-term wholesale funds from other banks started finding it difficult to raise such funds any longer, leading to a liquidity crunch. The inter-bank markets which are known as the deepest and the most liquid of all markets almost froze world over.

Thus, roots of the present crisis can be traced to securities invested by banks that were backed by subprime mortgages. Sharp erosion in the value of such securities and lack of transparency (about the quantum and nature of such toxic assets that still remain in various banks' books) have been the main reasons behind the crisis of confidence and liquidity crunch in global markets.

Understanding Liquidity Crunch

Liquidity crunch is a situation when the price system does not work any more to make supply of loans equal to demand for loans. Zarazaga (2007) explains this phenomenon as follows. The crisis of confidence that gives rise to such situation results from serious information problems. The banks are not in a position to distinguish prudent from imprudent borrowers. For example, in the present crisis, due to the complexity and opacity of securitized assets, the banks were unable to know who was exposed to subprime mortgages and who is not? Under such circumstances, banks tend to become risk averse out of the fear that only imprudent borrowers would approach them for loans. Subsequently, higher interest rates stemming from higher risk premium introduce “adverse selection” problem. Prudent borrowers tend to withdraw applications while imprudent borrowers tend to apply for more. Loan composition by tilting in favour of imprudent borrowers exposes banks (who might have continued with lending even during the liquidity tightness) to heavy losses. This discourages lending further and a proper credit crunch develops. Something like this happened in the real world after the outbreak of subprime crisis.

An IMF working paper by Nathaniel Frank, Brenda González-Hermosillo and Heiko Hesse (2008) shows how the interaction between market and funding illiquidity increased sharply during the financial turbulence created by the subprime crisis in the U.S. It was not just the credit that dried up, it was trust - the whole basis of inter-bank money markets that collapsed. Banks were unwilling to trust the disclosures or assurances of their counterparties. As a result, central banks had to pump hundreds of billions into financial markets to address the liquidity crisis and to ensure the solvency of key financial institutions. According to Frank *et al*, increasing financial integration and innovation can make market and funding liquidity pressures readily turn into issues of insolvency.

Policy Response to Liquidity Crunch : An International Perspective

Liquidity crisis or credit crunch resulting from the loss of confidence by investors in the value of securitized mortgages in the advanced nations during 2007-2009 prompted a substantial infusion of capital into financial markets by the U.S. Federal Reserve (Fed), Bank of England (BOE) and the European Central Bank (ECB). Globally, the central banks' lending to their respective banking systems combined with rescue packages has totaled almost U.S. $3 trillion to date.

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Fortunately, Indian banking system has not had direct exposure to the subprime mortgage assets or to the failed institutions.

There has been a substantial easing of the policy interest rates also. For instance, the U.S. Fed has reduced policy rates aggressively by 500 basis points since the beginning of the crisis to close to the zero bound. The ECB and BOE too have reduced their official rates though at a somewhat slower pace than the U.S. Fed. There was an unprecedented coordinated cut in policy rates of 50 basis points by six major central banks of the world in October 2008, followed by a further lowering of rates by individual central banks in November, December and January.

Australia's central bank slashed short-term borrowing costs by a full per centage point and its government announced that it was more than doubling the size of an initial stimulus, bringing the total package to more than $49 billion, or nearly 8.0% of the economy's annual output.

Between December, 2007 and February, 2009, the U.S. government allocated $11.5 trillion by way of bailouts, tax cuts, spending on economic activities, etc., out of which $2.2 trillion has been spent so far. Public debt has been rising at its fastest pace across the globe since the World War-II, as the governments of different countries fight out financial crisis and recessions. According to The Economist (2009), weighted by their economies' size, the plans of 11 large advanced and emerging economies are worth an average of 3.6% of GDP - though spread over several years. The IMF expects tax cuts and spending worth 1.5% of global GDP to kick in during 2009.

Indian Experience in Liquidity Crunch

Fortunately, Indian banking system has not had direct exposure to the subprime mortgage assets or to the failed institutions. Also, the off-balance sheet activities of Indian banking industry are quite limited. Moreover, in India, complex structures like synthetic securitization have not been permitted so far.

However, India's increased integration with the western world through trade and investment channels during the last 15 years and the fact that Indian corporates have significantly increased their dependence on external financing during the last five years exposed India to a few knock on effects of the subprime crisis through the financial, the real and the confidence channels.

As a consequence of the global liquidity squeeze, overseas sources of funds dried up for Indian banks and corporates forcing corporates to shift their credit demand to the domestic banking sector. Besides, the scarcity of external funds forced Indian corporates to withdraw their investments from domestic money market mutual funds (MFs) putting redemption pressures on these funds. The NBFCs (non-bank financial companies), in turn, suffered as MFs had invested a significant portion of their funds with NBFCs. Thus, the substitution of overseas financing by domestic financing brought liquidity under pressure in both the money and credit markets of India in Sept-Oct, 2008. The forex markets came under pressure due to the reversal of portfolio capital flows. Also, the corporates kept converting rupee liquidity into dollar liquidity to meet their external payment obligations. Both these factors have put substantial downward pressure on the rupee. The Reserve Bank of India's (RBI) efforts to prevent sharp fluctuations in the value of rupee through intervention in the forex market also added to liquidity tightening in India.

The real sector effects on India are primarily felt through the exports channel due to the slackening of global demand for Indian products. This has significantly affected the export earnings.

The remittances coming from the migrant workers are also expected to slow down significantly as the Middle East has been struggling to adjust to lower crude prices and advanced economies are in the grip of severe recession.

The last but most important factor affecting the credit availability within India was the crisis of confidence that got transmitted to our financial markets due to faster modes of communication. The tightened global liquidity situation and credit crunch following the **Lehman Brothers'** failure in mid-September, 2008 considerably increased the risk aversion of the Indian banking industry -

especially of the private and foreign banks that became extra cautious in their lending strategies.

Reserve Bank of India's Response to Liquidity Crunch

The RBI - the Central Monetary Authority of India - responded in timely manner to control the effects of “contagion” coming from the external markets and ensured normal functioning of the India's money and credit markets during the turbulent times. For this purpose, the RBI made use of both the conventional and unconventional measures.

The conventional measures included aggressive reduction in policy rates, a massive cut in the quantum of bank reserves impounded by the RBI and expansion & liberalization of refinance facilities for export credit. To enhance forex liquidity, the RBI introduced an upward adjustment of the interest rate ceiling on the foreign currency deposits by non-resident Indians, relaxed the external commercial borrowings (ECB) norms for corporates, and allowed NBFCs and HFCs (housing finance companies) access to foreign borrowings.

The unconventional measures included introduction of a rupee-dollar swap facility for Indian banks to enable them to manage their short-term foreign funding requirements well, introduction of an exclusive refinance window and a special purpose vehicle for NBFCs and expansion of the lendable resources available to apex financial institutions for refinancing the credit requirements of small industries, housing projects and exports - the sectors particularly under stress as a fallout of the subprime crisis.

As a result of the RBI's timely measures since early October, 2008, the cumulative liquidity potentially available to the Indian financial system increased to over $75 billion or 7.0% of GDP. This substantial easing in liquidity triggered a fall not just in money market rates but also in the prime lending rates of Indian banks - especially that of public sector banks (PSBs) in the range of 150 to 200 basis points. The bank credit to commercial sector too expanded at a faster pace during April-December, 2008 as against its pace of growth in the previous year.

The PSBs played a major role (due to a more pronounced risk aversion on the part of private and foreign banks) in financing the credit requirements of the productive sectors during April-December, 2008 without compromising the credit discipline. While the aggregate advances of entire banking industry grew by 12.6% during the first nine months of 2008-09 (i.e. Apr-Dec, 2008), the advances of PSBs grew by 17.2%. The PSBs' credit to critical employment generating sectors like agriculture and MSMEs (Micro, Small & Medium Enterprises) expanded by 14.1% and 15.4%, respectively, during the first nine months of 2008-09. Despite challenging economic conditions, the credit-deposit ratio of PSBs remained at the healthy level of 74.74% at end-December, 2008. The PSBs achieved this performance by maintaining a reasonable asset quality as reflected in their gross NPL ratio of 2.03% and net NPL ratio of 0.88% at end-December, 2008.

Yet, the overall flow of resources to the commercial sector is less than what it was last year during the first nine months of 2008-09. This is because even though the bank credit has expanded decently, it has not fully compensated for the decline in non-bank sources of funds to the commercial sector. It also partly reflects the slowdown in credit demand due to weaker market conditions.

Government of India's Response to Liquidity Crunch

Given the depth and the exceptional nature of the present crisis, the Government of India invoked the emergency provisions of the FRBM (Fiscal Responsibility and Budget Management) Act to seek relaxation from the fiscal targets and came out with two stimulus packages in December and January of 2008-09, which together amounted 3.0% of GDP. The stimulus packages included additional capital spending, government guaranteed funds for infrastructure spending, cuts in indirect taxes, expanded guarantee cover for credit to micro and small enterprises and additional support to exporters. As the economic slowdown in India has assumed serious dimension since Q3, 2008-09 onwards, the government further reduced factory gate duties and service taxes on February 24, 2009 taking an additional hit of Rs.30,000 crore to its revenues. On the same day, Standard and Poor's cut its outlook on India's long-term sovereign credit rating to 'negative' from 'stable' citing worsening government finances.

Analysis of 'Policy Response' in the Global Context

World over, the policymakers have responded to the present crisis by undertaking stabilization as well as stimulation measures. Hannoum (2009) argues that 'stabilization policy' accepts the fact that the adjustment is inescapable while it endeavours to mitigate the pain and promote an orderly adjustment. In our opinion, the RBI's measures in the Indian context have precisely been 'stabilization' measures that have succeeded in ensuring the orderly functioning of money, government bonds and forex markets since the onset of global financial crisis.

Hannoum (2009) describes 'stimulation policies' as the ones that generate a stimulus to demand, say in the form of new spending or tax cuts or both. These policies have potential to generate serious fiscal stresses if taken to an extreme end. In addition to these, many developed countries (directly affected by the subprime crisis) have undertaken huge public programmes to rescue financial institutions under trouble. These are unprecedented and large-scale adjustments that have significantly increased the ratio of public debt to GDP in a number of large economies. For instance, in 2009, the Gross Public Debt to GDP ratio for the U.S. is estimated to be 78.0%, for Germany 70.0%, for U.K. 63.0% and for Japan 174%.

Hannoum (2009) argues that measured stabilization policies are not controversial in today's context given the extent of systemic threats. These are essential to get the financial system working again and overcome the liquidity or credit crunch caused by extreme and irrational “risk aversion”. However, there is a much larger question concerning whether demand stimulation policies should be activated on a larger scale. Such policies are likely to lead to a vicious circle of “serial stimulus packages” that would temporarily stimulate demand but may fail to place the global economy on a sustainable path. He cites the example of Japanese economy in the 1990s where the adoption of successive expansionary supplementary budgets in the early 1990s resulted in a sharp deterioration in the government balances and limited the flexibility of the authorities to address the situation of its banking sector in more depth.

At present there is comfortable liquidity in the system. Inflation has eased substantially from close to 13.0% in August, 2008 to 3.36% in the second week of February, 2009 thanks to sharp reduction in global fuel and other commodity prices.

Thus, from a medium term perspective, a key risk involved in the excessive demand stimulation packages is the tendency to perpetuate or even exacerbate the current economic imbalances.

Evaluation of the Indian Case

As discussed earlier, India suffered primarily from the knock-on effects of global financial crisis, as its banking industry did not have any direct exposure to the subprime mortgage assets or globally failed institutions. However, it indeed faced the pressures on “liquidity” due to the drying up of external sources of funds, reversal of portfolio capital flows, rapid rupee depreciation and the consequent RBI intervention into the forex market. Another important factor was the transmission of the “crisis of confidence” from global markets that made our banks and FIs more risk averse and extra cautious in lending, which resulted into a kind of credit crunch. This credit crunch continued even after the RBI acted promptly and swiftly to infuse more liquidity into the system.

At present there is comfortable liquidity in the system. Inflation has eased substantially from close to 13.0% in August, 2008 to 3.36% in the second week of February, 2009 thanks to sharp reduction in global fuel and other commodity prices. The prime lending rates of banks (mainly the PSBs) are down by 150 to 200 basis points since November, 2008 onwards. Yet the demand for bank credit has been slackening on a continuous basis. Uncertainty surrounding the global crisis and dampened domestic demand (especially the leveraged part of it) have adversely affected business confidence. The corporate sector has been continuously shelving its major investment projects.

As the monetary policy works with a lag and as uncertain economic environment has made banks more cautious in credit operations, the Government of India is trying to stimulate the domestic demand through indirect tax cuts and direct developmental spending. This is on top of an already announced expanded safety net for rural poor, a farm loan waiver package and salary increases for government staff - the measures which primarily reflect the political motives in an election year. As a result, the government's finances have deteriorated sharply in 2008-09 after having made decent strides towards fiscal consolidation during the past few years.

Unfortunately, India had to pay the heavy price for this lapse, as on February 24, the international rating agency - Standard & Poor's (S&P) reduced its outlook on India's long-term sovereign credit rating to negative from stable. The S&P expects India's general deficit (that includes off-budget items like fertilizer & oil bonds) to increase to 11.4% up from 5.7% last year. Moreover, it expects a fiscal deficit of 11.1% in 2009-10 - more than double the government's estimate of 5.5%. The ratings agency called India's weak fiscal position "the single largest negative factor for the sovereign ratings".

Another rating agency Fitch has also described deteriorating fiscal position its main concern for India. It currently has BBB-minus ratings, with a negative outlook on the local currency rating and a stable outlook on the foreign currency.

This naturally raises the question which Hannoum (2009) has raised in the global context - "In its attempt to stimulate demand in the near term whether India's government has been sacrificing long-term sustainability?"

At present, due to a low business sentiment, not many Indian companies are tapping the ECB market, but in the medium term they would certainly find it difficult to raise capital in the overseas markets due to higher borrowings costs - a necessary side effect of the recent S&P's downgrade of India's sovereign credit rating. Even the rupee will come under increasing pressure going forward.

Concluding Remarks

Liquidity or credit crunch following the outbreak of subprime crisis primarily reflected the crisis of confidence in the global financial system. It occurred because risk management and supervisory practices in the U.S. and many other developed nations could not keep pace with new financial innovations and business models. Inadequate oversight and distorted incentives structure of Credit Ratings Agencies were also equally responsible for misleading the market players.

The subprime crisis has proved that the current global financial system is not sustainable and there is a need to strengthen its capital and liquidity rules and improve prudential regulation. This includes the introduction of better disclosure requirements with closer supervision of the measurement and management of firm-wide risks, steps to increase the transparency and resilience of the financial structure and improvements in the assessment of systemic risks. There is also a need for reassessing the appropriateness of various structured products like credit derivatives and their implications for financial stability.

So far, the government bailout plans or short-term stimulus packages across various countries have focused on treating the immediate symptoms of the crisis without attacking the roots of the disease. Just by giving more money to banks or increasing public debt, the problem of "crisis of confidence" cannot be solved effectively.

While Central Banks need to respond to short-term liquidity pressures in a swift fashion, they also need to avoid large-scale pumping in of liquidity, which encourages the relentless risk-taking that has led to the sub-prime collapse. Similarly, large-scale stimulus packages focusing unduly on sectors that have come under trouble due to 'moral hazard' and 'adverse selection' would encourage these sectors to take on more and more risk in the future. The large-scale fiscal stimulus also has potential to trigger inflationary pressures, once the conditions improve, and, thus, create a strong upward bias in interest rates - a major deterrent to growth.

In short, the "size" of the fiscal stimulus should not give rise to the concern of medium-

To summarise, the policy response to the crisis has to balance the country's short-term needs with its long-term macroeconomic plan and a plan for financial and regulatory reforms.

term fiscal sustainability, which can have adverse repercussions on financial markets, inflation, interest rates and consumer spending. Rather, fiscal measures should focus on improving the role of automatic stabilizers like certain types of taxes, transfers, purchases, etc. that by nature are countercyclical and temporary.

To summarise, the policy response to the crisis has to balance the country's short-term needs with its long-term macroeconomic plan and a plan for financial and regulatory reforms. This alone can revive the confidence of all economic agents, notably, consumers, entrepreneurs and banks in the economic system and ensure a path for long-term sustainable growth.

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Growth of Deposit Insurance Systems

The first national deposit insurance system in the world was the Federal Deposit Insurance Corporation (FDIC), U.S., which was created in 1933 during the Great Depression to restore public confidence in the U.S. financial system and to protect small depositors. At the time of its creation, the U.S. was in the midst of the largest financial crisis in its history. During the first few months of 1933, 4,000 U.S. banks suspended operations and bank runs had become commonplace. The issue then was how to restore confidence in the US banking system. Without a doubt, the FDIC helped restore public confidence in the U.S. financial system. In 1934, the year after the FDIC was created, only nine banks failed compared to 4000 bank closures during the nine months prior to its creation. Deposit Insurance effectively ended bank runs in the U.S. The FDIC is widely viewed as one of the most successful legacies of that era.

The adoption of explicit deposit insurance systems around the world has steadily increased since the 1960s. The number of countries adopting explicit deposit insurance increased to 10 by 1970, 18 by 1980, 36 by 1990 and 70 by 2000. According to the International Association of Deposit Insurers (IADI), as on May 1, 2008, 119 countries either have, or are considering or planning, deposit insurance schemes, i.e., 99 in operation, 8 pending, 12 planned or under serious study. The pace of adoption of explicit deposit insurance systems around the world has accelerated in recent years, as many countries moved to establish systems after experiencing financial crises, or witnessing crises in other countries. The Mexican peso crisis in the early 1990s served as an impetus to the adoption of deposit insurance systems in Central and South America. The Asian financial crisis in 1997 led to the establishment or strengthening of deposit insurance systems in Asia. A number of African countries established deposit insurance systems to strengthen financial stability and depositor protection. In1994, the European Union adopted a directive requiring the establishment of deposit guarantee schemes in its member countries. The fall of the Soviet Union led many countries in central and eastern Europe to establish deposit insurance systems as part of their financial regulatory reform programs, China, for example, has been working for some time to establish a deposit insurance system as part of efforts to strengthen its banking sector. Other countries with deposit insurance systems under study, planned or pending include South Africa, Thailand, Egypt, Bolivia, Costa Rica, and New Zealand.

Furthermore, there are a number of countries with more than one deposit insurance systems in operation (for instance, Austria, Canada, Germany, Italy and the United States). On the other hand, one deposit insurance system can cover more than one country (for instance, the Marshall Islands, Micronesia and Puerto Rico are insured by the U.S. FDIC; and Cameroon, Central African Republic, Chad, Congo, Equatorial Guinea and Gabon will be covered by a single system).

Source : RBI's Report on Currency & Finance, 2006-08.

Indian and US Banking : Yogi and the Capitalist

Dr. Brinda Jagirdar *

Global Financial Crisis

The global financial situation continues to remain uncertain. What started off as a sub-prime crisis in the U.S. housing mortgage sector has turned into a global banking crisis, global financial crisis and now a global economic crisis. The world has not seen anything of this magnitude since the Great Depression that originated in the advanced economies and rapidly engulfed the whole world, which shows the depth and sweep of financial globalisation. One view is that this was caused by economic and financial sector deregulation. But a dispassionate analysis would suggest other factors including lax regulation, oversight by rating agencies, excessive leverage, loose monetary policy, global imbalances, etc.

Despite strong and co-ordinated intervention, the economic situation continues to deteriorate and 2009 will remain a challenging year. IMF scaled down estimates for global growth in 2009 to 0.5%, weakest expansion since WW-II, from earlier estimates of 2.2% (Nov08), 3.75% (Apr08) and 5% in 2007. Global growth is expected to touch 3% in 2010. The U.S.[1] is projected to contract 1.6% in 2009 and grow 1.6% in 2010, Eurozone to shrink by 2% and grow 0.2% in 2010. For Japan, the IMF forecasts a contraction of 2.6% in 2009 and growth of 0.6% in 2010.

Asian economies face headwinds as manufacturing, exports and domestic demand fall. IMF has lowered Asia's growth forecast for 2009 to 2.7% with further downside risks. Developing Asia will grow 5.5%, the slowest pace since 1998 and expand to 6.9% in 2010. Given high trade and financial linkages, Asia will recover only when global recovery begins. But IMF points out that fundamentals are strong and there is considerable room for counter- cyclical policies. The silver lining is that China is likely to grow at 6.7% in 2009 and 8% in 2010 (vs. 13% in 2007) and India's GDP growth has been projected at 6.7% in 2009 and 6.5% in 2010 (vs. 9% in FY08). What is worrying is that slower growth will push more people out of jobs: 18 million people in 2009 which could rise to 30 million workers; some 200 million workers, mostly in developing economies, could be pushed into extreme poverty if the situation worsened (IMF forecast).

> **Despite strong and co-ordinated intervention, the economic situation continues to deteriorate and 2009 will remain a challenging year.**

The IMF now expects total write downs on U.S. originated assets to reach at least $2.2 trillion from $1.4 trillion estimated in October, 08. This global capital shortfall of $500 bn could force banks globally to contract credit sharply. So half a trillion dollars in fresh capital is required just to prevent banks' capital position from deteriorating further and more measures will be needed to clean up banks' balance sheets of troubled assets to unclog the system and revive confidence in the banking system. However, the problem could be far worse: according to U.S. economist Nouriel Roubini, total loan losses and securities writedowns on U.S. originated assets are expected to reach about $3.6 trillion. The U.S. banking sector is exposed to half of this figure, or $1.8 trillion (i.e. $1.1 trillion loan losses plus $700bn write downs.) FDIC-insured banks' capitalization was $1.3 trillion as of Q3 2008; investment banks had $110bn in equity capital in Q3 2008. Against this, recapitalization via TARP 1 funds is only $230bn and private capital of $200bn.

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Country	Policy rate Change	Total Easing	Since	Duration of easing
USA	5.25% to 0.00%	525bps	Sept.-07	17 months
UK	5.75% to 1.00%	475bps	Dec.-07	14 months
Euro Area	4.25% to 2.00%	225bps	Oct.-08	4 months
Canada	4.50% to 1.00%	350bps	Dec.-07	14 months
Australia	7.25% to 3.25%	400bps	Sept.-08	5 months
New Zealand	8.25% to 3.50%	475bps	Jul.-08	7 months
Japan	0.50% to 0.10%	40bps	Oct.-08	4 months
Korea	5.25% to 2.00%	325bps	Oct.-08	4 months
China	7.47% to 5.31%	216bps	Sept.-08	5 months
India	9.00% to 5.50%	350bps	Oct.-08	4 months
Indonesia	9.50% to 8.25%	125bps	Oct.-08	4 months
Malaysia	3.50% to 2.50%	100bps	Dec.-08	2 months

Faced with a quickly deteriorating outlook and subsiding inflation pressures, central banks in several countries including the U.S. Fed, ECB, BoE and RBI, have slashed interest rates (table above). On February 5, Bank of England cut the benchmark interest rate 50bps to 1.0% the lowest since the bank was formed in 1694.

Impact on India

The impact of the global economic turmoil is expected to be limited, though not insignificant.

Economic activity has slowed down across sectors. After growing at 7.8% in H1FY09, GDP growth may now average 6.4% in H2 FY09 (or less if the Q3 data are any indication) and with global recession and sharp declines in asset prices affecting India's growth momentum, GDP growth could slow further to 6-6.5% in FY10. A recent report released by the Ministry of Labour shows over 500,000 job losses during Oct.-Dec. 08 with export-oriented sectors such as gems and jewellery, autos and textiles, being most impacted.

- Foreign Trade has decelerated against the backdrop of global economic slowdown, with exports falling for four straight months in a row. After falling -12.1% in October 08 and -9.9% in November 08, exports fell by -1.1% in December 08 and by -15.9% in January 09 due to weak foreign demand and falling commodity prices. India's imports fell for the first time this fiscal by -18.2% in January 2009 against +8.8% growth seen in December 08, due to fall in imports of crude oil and petroleum products, capital goods, iron and steel and chemicals. In January 09, while oil imports fell by -24% yoy due to sharp decline in crude oil prices, non-oil imports declined by -0.5% yoy, due to low demand for capital goods indicating continuing sluggishness in investment activity. Falling commodity prices of metals and minerals also led to the decline in imports.
- In 2008-09 so far (Apr-Dec), the Index of Industrial Production (IIP) at 3.2% was substantially lower than the 9.0% recorded in the same period last year. In December 08, industrial production declined 2%, following the -0.3% decline in October, the first fall in 15 years; in November IIP rose by 1.7%. What is of concern is that manufacturing sector declined 2.5% in December after registering a growth of 1.8% in November, with marked declines in rubber, plastic, petroleum & coal products, food products, machinery & equipment, wood and chemicals. Electricity decelerated to 1.6% in December from 2.6% in November while mining accelerated to 1% against 0.3% in the same period. Sectors such as automobiles, auto ancillaries, paper, edible oils, metals, hotels and telecom are expected to see their profits decline according to CMIE.
- Risk aversion in the global financial markets has resulted in a sharp reversal in capital inflows into India with net outflow by foreign institutional investors (FIIs) of around US $10.2bn in calendar 2008 compared with an inflow of US $19.5bn in 2007. In 2009 so far (upto 10th Feb.) there was net outflow of $899 mn; in equity alone there was a net outflow of $1bn and $107mn inflow in debt. During FY09 so far (upto Nov. 08) FDI inflow at $23.3 bn was higher than that in FY08 ($16.1bn upto Nov. 7). However, FDI in October slipped to $1.4bn and further to $1.08bn in November, after maintaining robust inflows till September with a monthly range of $2.5-3bn. Falling capital inflows, reduced access to liquidity, slowing economic growth, rise in non-performing loans, and increased risk aversion in the financial system are matters of concern, going forward.
- The fiscal stimulus packages, additional expenditure on food and fertilizer subsidies, debt waiver, Sixth Pay Commission, etc., have led to a ballooning in India's fiscal deficit and the Centre's

expenditure is set to rise further in FY 2009. In fact, the increase in expenditure in FY09 over FY08 is the highest-ever annual increase since 1980-81. At the same time, Government's tax collections have slowed. Consequently, against the target of 2.5% of GDP for 2008-09, the Centre's fiscal deficit could cross 6% of GDP by March 09, with the combined fiscal deficit of Centre and States exceeding 10%.

- With FIIs pulling out of equity, India's SENSEX has fallen. Like in other countries, the stock market valuation losses have been significant as shown below. Total loss of wealth in stock markets for these 56 countries amount to US $28.2 trillion in 2008 :

	US $ Bln.	US $ Bln.	% Change	
	End 2008	End 2007	In US $	In Local Currency
NYSE Group	9209	15651	-41.2%	- 41.2%
Tokyo Stock Exchange	3116	4331	-28.1%	- 41.4%
NASDAQ	2396	4014	-40.3%	- 40.3%
Euronext	2102	4223	-50.2%	- 47.8%
London Stock Exchange	1868	3852	-51.5%	- 33.4%
Shanghai Stock Exchange	1425	3694	-61.4%	- 64.0%
Hong Kong	1329	2654	-49.9%	- 50.2%
India (NSE)	606	1660	-63.5%	56.8%
Members of WFE (56)	32584	60833	-46.4%	-
Source : World Federation of Exchanges (WFE)				

But the silver lining is that domestic demand will drive Indian economy despite global slowdown. Also, the Central Government has announced $4 bn for infrastructure projects, which would take off in the next couple of months, which will create domestic investment, consumption demand and employment.

India Banks Show Robust Performance

At a time when corporate India has seen its net profits shrink by 24%, banks have reported a 43.83% net profit growth in the quarter ended December 2008. In particular, the net profit of public sector banks (PSBs) surged by 50% compared with the 26% growth reported by private banks as shown below :

Performance in quarter ended December, 2008						
	PSU Banks		Private Banks		Aggregate	
	Dec. 2008	% change	Dec. 2008	% change	Dec. 2008	% change
Interest earned	72171	37.54	20663	25.82	92834	34.75
Other income	11861	35.03	5260	22.69	17120	30.98
Interest expended	50166	36.37	14143	27.17	64308	34.23
NII	22005	40.29	6521	22.99	28526	35.92
Net profit	10810	49.89	3185	26.45	13995	43.83
Growth over December 2007						
Source : Business Standard 5.02.09						

In fact, PSBs have outperformed private banks and have maintained their lead over private banks in recent times despite pressures of global meltdown. According to a study by Assocham[2], not only have they succeeded in lowering lending rates with maintaining record growth of net profits, but also drastically reduced their non-performing assets (NPAs) compared with private banks.

- The public sector banks have emerged strong across all key indicators as the global financial turmoil and slowing domestic economy put the banking sector to a test. Public banks have not only reduced the lending rates but have also managed to record higher average net profit and lower NPA level than their private sector counterparts.
- While they reduced their prime lending rates by 75-125 basis points, higher than the 50-75 basis points cut made by private banks, their credit growth has surpassed the latter at 28.6% against 11.8% growth registered by private banks, as shown below :

Credit Flow From Scheduled Commercial Banks (Rs. cr)					
	O/s as on 2 Jan 09	Variation year-on-year			
		As on 4 Jan, 2008		As on 2 Jan, 2009	
		Amount	%	Amount	%
Public Sector	19,23,953	2,47,633	19.8	4,28,302	28.6
Foreign Banks	1,73,451	34,834	30.7	25,016	16.9
Private Sector	4,98,107	86,731	24.2	52,375	11.8
ASCB	26,58,997	3,77,855	21.4	5,14,980	24.0
Source : RBI					

2. *"Performance Analysis of Indian Banking Sector", which tracked quarterly results of 15 public and 10 private sector banks, in Business Standard, 5 February 2009.*

- Despite lower lending rates, the net interest income growth of the PSBs was much higher at 50 per cent as against the 32 per cent witnessed by private banks, which fuelled the bottom line growth of public banks. The net profit of public banks jumped by 57 per cent compared with the 44 per cent rise in the bottom line of private banks.

In general, India's banking sector, characterised by dominance of public sector banks (70% share in assets) has inspired confidence among the public in these troubled times and customers are seeking the comfort and reassurance of PSBs. PSBs have also restructured and reoriented themselves and offer service and products comparable with the best: Core banking, ATMs, anytime anywhere banking, demat accounts, wide range of services (insurance, credit cards, asset management, etc.) branch ambience.

India's Banking System vs. U.S. Banking System

The Indian banking system is not directly exposed to the sub-prime mortgage assets and has very limited indirect exposure to the U.S. mortgage market, or to the failed institutions or stressed assets. Indian banks, both in the public sector and in the private sector, are financially sound, well capitalised and well regulated. The average capital to risk-weighted assets ratio (CRAR) for the Indian banking system, as at end-March 2008, was 12.6%, as against the regulatory minimum of 9% and the Basel norm of 8%.

1. One reason why Indian banks have been able to weather the downturn better than U.S. banks is cultural. Indians culturally are not attracted to debt and the savings rate is at a high of 37.7% (35.7% in FY07) against 5-6% in the U.S. In fact American household saving was negative till recently and the average number of credit cards per person was at least 10.
2. Another reason is the steady pace of expansion of the banking sector in India as shown by the credit-GDP ratio which rose from around 20% in 1990-91 when the banking sector was liberalized, to around 50% at present. In contrast, the pace of growth of the US banking sector has been mind boggling: total credit outstanding was 160% of GDP in 1929 and rose to 260% in 1932; U.S. entered the crash of 2008 at 365% and the ratio is bound to rise to 500%[3].
3. A recent paper by the World Bank[4] has pointed out that the risks of contagion from the global financial markets on India are countered by, among others, 'solid financial sector health'. In the current context of turmoil in global financial markets, RBI's proactive policies have only reinforced the safety and stability of India's banking sector :
   - To discourage banks from aggressively lending to the real estate sector, RBI increased the risk weight on banks' exposure to commercial real estate from 100% to 125% in July 2005 and 150% in April 2006.
   - In December 2004 the risk weight on housing loans to individuals against mortgage of properties was increased from 50% to 75% (relaxed thereafter for housing loans up to Rs.30 lakh).
   - The risk weight for consumer credit and capital market exposures were increased from 100% to 125%.
   - The provisions for standard assets were also progressively raised from November 2005 to 2% (which were subsequently relaxed).
   - To strengthen systemic stability, banks are not allowed to borrow more than 200% of their net worth or capital and reserves from other banks; for well-capitalized banks the limit is 300% of their net worth.
   - A cautious approach has ensured that banks and financial institutions are not encouraged to recklessly securitise their exposure and create more liquidity.
   - Risk management in banks has been continuously strengthened, unhedged foreign currency exposures are closely

3. George Soros, The New Paradigm for Financial Markets The Credit Crisis of 2008 and What It Means.
4. Global Financial Crisis: Implications for South Asia, World Bank, October 2008: "Yet these risks are countered by a fundamentally strong macro economy including prudent foreign debt management, high savings rate, solid financial sector health, and a proactive monetary policy management that will likely allow India to ride the crisis without destabilizing the financial sector".

monitored and compliance with prudential norms insisted upon at all times.

- An up-to-date technology platform has facilitated the modernization and growth of the banking and financial sector.
- More recently, Government announced that it will inject Rs.30 billion into seven public sector banks to raise their capital adequacy to 12%; CAR to be maintained at 12% for all banks, thus improving market confidence in the banking sector. On 11 February 2009, the Cabinet approved capital infusion of Rs.3,800-cr into Central Bank of India (Rs.1400 cr), UCO Bank (Rs.1400 cr) and Vijaya Bank (Rs.1200 cr) by March-end 2010. The infusion of fresh capital would raise the capital adequacy ratio of these banks to at least 12% and facilitate lending.
- Provisioning requirements for derivatives : credit exposures on account of the interest rate and foreign exchange derivative transactions and gold attract provisioning requirements.
- Liberalisation of hedging facilities by permitting domestic oil companies to hedge their freight risk with overseas exchanges / OTC markets.
- Receivables in respect of derivative transactions, which remain unpaid for a period of 90 days, are classified as NPAs, in line with global practice.

4. Even as the regulator remained vigilant and pro-active, Indian banks did not indulge in reckless lending of the subprime kind. All lending to individuals was based on their income and unlike in the U.S., additional loans were not given to borrowers just because the value of the house had gone up. Even as the price of land was skyrocketing, RBI recognized the bubble and banned the use of bank loans for the purchase of land. Only when the developer was about to commence building could the bank get involved and only loans for construction of the building were permitted. More importantly, Indian banks are not leveraged like American banks and capital ratios are 12-13 percent, instead of 7-8 percent.

The system of compensation in India remains conservative unlike in the U.S. where enormous bonuses were paid for 'performance.'

5. Weaknesses of structured products and derivatives including the originate-to-distribute model was recognized by RBI. Even as securitizations and derivatives gained increasing prominence in the world's financial system, RBI sharply curtailed their use. In this context, it may be mentioned that the Basel Accord created incentives to hide risky assets off the banks' balance sheets as banks would otherwise be required to set aside more capital if they held these subprime securities. Therefore, they created complex special investment vehicles, which were not understood by regulators also. The off-balance-sheet Special Investment Vehicles being set up by American banks hid their debt but RBI's immense caution and conservatism led to curbs on such practices in India. Therefore, in India loans continued to remain on their books and banks remained in touch with their customers unlike banks in USA. This meant that Indian banks could not expand loans at a frenzied pace like their American counterparts because they could not sell off the loans in securitizations, but as the accounts remained on their books, the responsibility to recover these loans also remained with them.
6. The system of compensation in India remains conservative unlike in the U.S. where enormous bonuses were paid for 'performance.' For many years, subprime traders were making huge profits for which they were paid large bonuses. By the time the crisis broke, the people who fueled it had sold their subprime assets to someone else, helped by assurances from the rating agencies[5].
7. In stark contrast to the Indian scene, deregulation in the U.S. was fuelled by vested interests and accompanied by lax regulation. As U.S. banks

5. Not surprisingly, U.S. Treasury Secretary Geithner and President Obama have been very critical of bankers and their compensation schemes and clearly angered by their arrogant bonuses: "These banks need to understand that access to government resources is a privilege, not a right. Its not for the banks. Its for the people, and companies that depend on that".

became healthy and powerful, the demand for greater deregulation increased. Pragmatic banking regulations following the devastating financial collapses of the Great Depression had for decades strengthened U.S. banks and capital markets, but these began to be systematically dismantled from 1980[6] by greedy bankers :

(i) The Depository Institutions Deregulation and Monetary Control Act of 1980 lowered the mandatory reserve requirements for banks, federal interest rate ceilings on deposit accounts were phased out over a six-year period, deposit insurance was raised from $40,000 to $1,00,000, savings and loans institutions were allowed access to the Federal Reserve Discount Window for credit advances and ceiling on the rates lenders could charge on residential mortgage loans were removed.

(ii)The Garn-St. Germain Depository Institutions Act 1982 allowed S&L institutions to make commercial, corporate, business or agricultural loans of up to 10% of their assets. It authorized a capital assistance program - the “Net Worth Certificate Program” - for dangerously undercapitalized banks, under which the Federal Savings and Loan Insurance Corp. (FSLIC) and the FDIC would purchase capital instruments called “Net Worth Certificates” from savings institutions with net worth / asset ratios of less than 3.0%, and would theoretically later redeem the certificates as these shaky banks regained financial health. The ceiling on direct investments by savings institutions in non-residential real estate was raised from 20% to 40% of assets.

(iii)The Glass-Steagall Act of 1933 mandated the separation of banks according to the types of business they conducted. Investment banks, whose securities related activities resulted in relatively large risks, were to be separate from commercial banks, whose depositors needed greater protection. In 1999 the Gramm-Leach-Bliley Financial Services Modernization Act did away with Glass-Steagall Act as well as the Bank Holding Company Act of 1956.

India has increased its footprint in the global economy : India Inc has scaled global ranks across sectors, India is the largest recipient of remittances in the world and notwithstanding the current slowdown India's underlying medium term growth momentum remains on track.

(iv)In 1988 the Basel Accord established international risk-based capital requirements for deposit-taking commercial banks. In a by-product of the calculations of what constituted mortgage-related risk (by nature of the loans' long maturities and illiquidity) lenders were expected to set aside substantial reserves; however, marketable securities that could theoretically be sold easily would not require significant reserves. To obviate the need for such reserves, and to free up funds for more profitable lending, banks shifted from originating and holding mortgages to packaging them and selling them. This led to a disconnect between asset-quality considerations and asset-liquidity considerations.

(v)On April 28, 2004, the SEC ruled that investment banks could essentially determine their own net capital. While the SEC in turn demanded greater scrutiny of their books and records, in reality, the SEC never used its new powers to examine the banks. The idea was that Consolidated Supervised Entities (CSEs) could use internal models to determine risk and compliance with net capital requirements.

Conclusion

India has increased its footprint in the global economy : India Inc has scaled global ranks across

6. *“U.S. Bank Deregulation in Historical Perspective” by Charles W. Calomiris, Columbia University, New York, and “How Deregulation Eviscerated the Banking Sector Safety Net and Spawned the U.S. Financial Crisis”, by Shah Gilani, Contributing Editor Money Morning/The Money Map Report*

High tech industry will receive billions of dollars in subsidies to expand broadband access to rural and other underserved areas.

sectors, India is the largest recipient of remittances in the world and notwithstanding the current slowdown India's underlying medium term growth momentum remains on track. But this needs to be supported by a robust financial system, going forward. So the lesson is not to lose sight of the role of the financial system in the economy's growth and development and to continuously upgrade skills and instruments for financial regulation and supervision. According to Prof. Allan Meltzer, capitalism without failure is like religion without sin - it just doesn't work. So, as pointed out by the RBI Governor Dr. Subbarao, the right lesson is not that markets and competition do not work, but that markets and institutions occasionally succumb to excesses, so that regulators have to be vigilant.

Annexure

Global efforts to stimulate the economy

- Stimulus packages announced by Governments across the world.
- Sharp cuts in interest rates by central banks : U.S. Fed, ECB, BoE, RBI. BoE benchmark interest rate at 1.0% lowest since the bank was formed in 1694.
- U.S. $789bn second stimulus package to boost business confidence (tax breaks), low incomes / unemployment aid (benefit cheques, food stamps, health insurance), consumer spending (tax breaks), job creation (infrastructure spending, aid to States), economic growth (spending, tax breaks; $282 bn (35%) dedicated to tax cuts).
  - High tech industry will receive billions of dollars in subsidies to expand broadband access to rural and other underserved areas. Funds to computerise health care records.
- Asian nations from China to Singapore and India have pledged more than $685 billion on their own spending programmes.

U.S. Treasury support for weak banks

- The Treasury Department created the Capital Purchase Program, a part of the Troubled Asset Relief Program, to help to stabilize and strengthen the U.S. financial system. Treasury allocated $250 billion under TARP's Capital Purchase Program to invest in U.S. financial institutions.
- To buy stock in banks to strengthen their balance sheets and stimulate the banks to increase lending in an effort to unfreeze credit markets and prevent further deterioration in the U.S economy.
- Additional $4.7 billion to recapitalise 92 banks as part of the government's $700 billion rescue package : So far 165 banks have received $170.55 bn in capital.
- Capital allocation for weak banks under the second $789 bn stimulus package to be announced.
- U.S. Budget deficit at $1.9 trillion would be 13.5% of GDP. The U.S. President called a Fiscal Responsibility Summit on 23 Feb to pressurise politicians to address the country's long term debt crisis.
- The U.S. Treasury's $250 billion towards Capital Purchase Program to help stabilize and strengthen the U.S. financial system was initially for 92 banks; the list now covers 165 banks.
- Government bought stock in banks to strengthen their balance sheets and stimulate increased lending by banks.

	Banks Recapitalized (Top 15)	Capital Infused ($ bn)
1.	Citigroup Inc., New York NY	25.00
2.	Wells Fargo & Company, San Francisco CA	25.00
3.	JPMorgan Chase & Co., New York NY	25.00
4.	Bank of America Corporation, Charlotte NC	15.00
5.	The Goldman Sachs Group Inc., New York NY	10.00
6.	Morgan Stanley, New York NY	10.00
7.	Merrill Lynch & Co. Inc., New York NY	10.00
8.	U.S. Bancorp, Minneapolis MN	6.60
9.	Capital One Financial Corporation, McLean VA	3.56
10.	Regions Financial Corp., Birmingham AL	3.50
11.	SunTrust Banks Inc., Atlanta GA	3.50
12.	BB&T Corp., Winston-Salem NC	3.13
13.	Bank of New York Mellon Corporation, New York NY	3.00
14.	KeyCorp, Cleveland OH	2.50
15.	Comerica Inc., Dallas TX	2.25

"Building Indian Infrastructure : Financing of Public Private Partnership Project"

Narinder Kumar Bhasin *

Introduction

The Indian economy is today the world's second fastest growing economy after China. Real GDP growth has averaged more than 8 percent in the three year period ended 2005-2006. In terms of purchasing power parity GDP, India is the world fourth largest economy after the U.S., China and Japan. India's share in the world GDP has increased from 4.3 percent in 1991 to almost 6.0 percent in 2005. Indian economy moves closer towards becoming a robust, vibrant and mature economy; therefore, it is the right time to get real and start scripting success stories in building infrastructure. The role of infrastructure in economic development cannot be over emphasised. It is infrastructure that provides the framework for progress. World Bank development Policy Review 2006 report focusses on Indian infrastructure to sustain the rapid overall growth of the Indian economy which is at risk if modernization of economic infrastructure cannot keep pace with the demands - improvements in airports, ports ,power and transport are a potential constraint to sustained, job creating growth.

India needs to invest an additional 3 - 4 percent of GDP on infrastructure to sustain current levels of growth and to equalize its benefits. Although this will clearly require a governmental role, the relative roles of the government and private sector need to be defined. Infrastructure is critical to improved productivity across all sectors. World class infrastructure is the key to a globally competitive economy and India's objective of sustained double digit growth can only be achieved through a quantum growth in the

The Indian Economy is today's the world second fastest growing economy after China.

The quality of our infrastructure at present simply will not allow the economy to reach the level of competitiveness needed to achieve 9% growth in an open economy.

infrastructure sectors. This, in turn would lead to improved opportunities and progress towards the elimination of poverty. The PM during an infrastructural conference meet on 7th Sept, 2006 said "It would be difficult to step up the growth rate to 8 - 10% without investing $320 billion about Rs.1,450,000 cr, in upgrading infrastructure for road, rail, air and water transport, electric power, telecommunicaions, water supply and irrigation in the next five years during the 11th plan period (2007-2012). We will need to run to stay where we are ."

New recipies for improving the quality of roads, airports, railways and ports involves greater play for the private sector along with regulatory set up. It will require setting up an independent and transparent policy and regulatory and institutional frame work for private public-partnerships (PPPs) in infrastructure.

Need for Building Infrastructure : Challenge and Opportunity

There is today a broad consensus that a sustained growth rate of 9 per annum is the minimum required if India is to eliminate poverty and achieve a quantum jump in the quality of life of its citizens. One of the preconditions for sustaining such a growth rate is the creation of the world class infrastructure. The quality of our infrastructure at present simply will not allow the economy to reach the level of competitiveness needed to achieve 9% growth in an open economy. The Government of India's justifiable concern with inclusiveness of economic growth can be addressed by focussing on

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To help India develop, the government is investing US$150 billion, of which US $50 billion is going into airports, seaports and surface transport.

expanding the regional scope of economic growth, expanding access to assets and thriving markets and expanding equity in the opportunities for the next generation of Indian Citizens no matter who they are or where they live. While reforms that are growth accelerators are important, even more pressing is the need for equalizing accelerator actions that promote more rapid growth in those areas, sectors, and groups where it is needed the most. Infrastructure has impact on economic growth of both types. Some investments in infrastructure are needed to maintain rapid growth - ports and airports, modernization, improved highways. But infrastructure is also important to equalize growth investments that help jobs move to people as well as the infrastructure that is needed to connect rural India with the benefits of a growing economy.

Infrastructure : Potential Binding Constraint

A major concern for rapid growth in India is the availability of adequate infrastructure as there are some suggestions that while the high skill service sector will continue to thrive, a greater ability of India to engage in manufacturing that is intensive in semiskilled in labor is desirable. Services, are to a large extent, either, reliant, on the infrastructure that has made the most progress (telecommunications) or able to cocoon themselves from service inadequacy. But engagement in manufacturing, particularly, export oriented manufacturing that typically requires integration of supply chains or in higher value added agriculture will require substantial improvements in basic transport infrastructure (roads, ports, airports, railways) and more reliable power and water. This emerging infrastructure constraint requires systemic reforms that not only the "fix the pipes" but also "fix the institutions that fix the pipes."

Core Concerns

To help India develop, the government is investing US$150 billion, of which US $50 billion is going into airports, seaports and surface transport.

A new phase of infrastructure development is underway in India in the form of widening existing roads, building new roads, ports, airports, dams and waterways, and the boom in urban infrastructure. The Indian infrastructure industry is now ready to make effective use of technologies and systems being implemented elsewhere in the world. These technological advancements are being driven by factors such as improving worker safety, enhanced operator control, increasing cost of fuel, and the need to reduce fleet size at the construction site.

To lay the foundations for this level of construction activity there is a pressing need for aggregate production that meets global standards. India's average per capita consumption of aggregates stands at 0.8 tons, which is way below some of the European countries. Spain, for instance, has an average per capita consumption of five tons.

Roads

An investment of Rs.4000 cr will be needed for six - laning of the Golden Quadrilateral on a BOT basis. Only 15% will come from budgetary support. By 2012 an investment of Rs.2,20,000 cr will be required for modernization and upgrading of high ways.

India's road network, the third largest in the world, covers 2.9 million kilometres but more are needed. The Government is looking for private and foreign investment to build and maintain national highways, allowing duty free imports of road building machinery and 100% foreign equity. India's National Highway Development Authority estimates investment in national and state highways in 2005-6 at US $11.5 billion.

Civil Aviation

The civil aviation traffic in the country is increasing at unprecedented growth rate. The traffic trends during the first quarter of the current financial year *i.e* April June 2006-2007 have registered a growth of 48% in respect of domestic passenger traffic and 16.3% in respect of international passenger as compared to similar period of the last year *i.e.* an investment of Rs.40,000 cr by 2012. A new civil policy will be announced soon.

Ports :

An investment programme of Rs.50,000 cr by 2012 is envisaged, in which PPPs are expected to play

a dominant role. The government is planning to develop 76 new berths by 2012 of which 53 are to be undertaken through PPPs.

Railways

Indian Railways is preparing an investment of programme of Rs.300000 crore of which almost 40% is expected to come from the private sector through PPPs. Indian Railway with 63221 route kms of network, 1.42 million employees, 440 BTKms and 615 BPKms of traffic is one of the largest networks of the world.

In the railway sector, the National Rail Development Programme has received an investment of US $3.5 billion for the construction of four mega bridges. It also intends to construct a new railway line to the Kashmir Valley and expand the rail network with additional broad gauge lines, strengthening the “Golden Quadrilateral”, enhancing safety and increasing asset utilisation through the introduction of modern wagons and signalling and telecommunication systems.

Companies involved in the construction of dams, roads and highways, port and airports and other allied constructions, continually evolve methods and optimise their execution modalities. Aggregate processing technology stands at a point where crushing plant owners are redefining their needs to increase operational flexibility and achieve a better return on investment.

Role of Private Sector in Infrastructure Development

India must invest around 3 - 4% more of GDP on infrastructure to sustain growth of around 9% to address existing gaps and meet policy driven coverage goals. The private sector can play an important role in providing such level of resources, including through PPPs although improving implementation capacity and the quality of investment will be as or more important than increasing the quantum of funds available. A greater emphasis must be placed on the actual delivery of services rather than completion of infrastructure : this will include shifting resources to maintain existing assets and making service providers more accountable to consumers and their owners.

Public Private Partnership is a system in which a government service or private business venture is funded and operated through a partnership of government and one or more private sector companies.

Public Private Partnership Format

Public Private Partnership is a system in which a government service or private business venture is funded and operated through a partnership of government and one or more private sector companies. These schemes are sometimes referred to as PPP or P3. It is a process where the public sector contracts with the private sector to deliver services on its behalf. PPP are initiatives sponsored by the Government and public and private sector organisations work together to achieve a common goal. In some types of PPP, the government uses tax revenue to provide capital for investment with operations run jointly with the private sector or under contract. In other types, capital investment is made by the private sector on the strength of a contract with government to provide agreed services. Government contributions to a PPP may also be in kind (notably the transfer of existing assets). Typically, private sector consortium forms a special company called a “special purpose vehicle” SPV to build and maintain the asset. The consortium is usually made up of a building contractor, a maintenance company, and a bank lender. The investment requirement for meeting he infrastructure deficit is such that it cannot possibly be met by relying on the public sector alone. It is necessary therefore, to explore the scope for building infrastructure through Public Private Partnerships. PPPs have the added advantage that they lend themselves to a clear specification of levels of service quality based on bench marks that have been achieved elsewhere.

Basic principles of PPP are :

- Contracts for works and performance of services
- Payment of fees based on the standards of performance of services

Building enduring relationships.

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- Payments commence only when service commence
- Pricing risk transferred to private sector with in built contractual mechanisms for variations

In India, the Prime Minister has established a Committee of Infrastructure under his chairmanship to systematically review policy issues in each of the infrastructure sectors and to determine an agenda for policy change and also to monitor implementation. Private sector participation in infrastructure development is not, however, a simple matter. It requires a framework that can enable the private investor to secure a reasonable return at manageable levels of risk, assure the user of adequate services quality at an affordable cost and help the Government in getting value for public money. These preconditions are more difficult to fulfill than is commonly realised. Because of the multiplicity of stakeholders pursuing conflicting interests, risk mitigation arrangements are usually complex.

Emphasizing the role of Public Private Partnerships in the creation of infrastructure, the Prime Minister, Dr. Manmohan Singh while inaugurating the Conference on infrastructure emphasized that PPP projects should be awarded on the basis of transparent competitive bidding with a standard concession agreement to the extent possible. Referring to the critical role of State Governments in this regard, Dr. Singh urged them to promote PPP projects in a transparent and efficient manner. Most importantly, our growth potential will be realized only if we can ensure that our infrastructure does not become a severe and critical handicap.

Among these, the PPP approach is best suited for the infrastructure sector. It supplements scarce public resources, creates a more competitive environment and helps to improve efficiencies and reduce costs. Our experience shows that competition and Public Private Partnerships can help in improving infrastructure. The opening of the telecom sector is a case in point. Opening up the sector has led to massive investments and expansion in supply coupled with improvements in quality. The target of 15% teledensity set for the year 2010 will be realised this very year itself.

Viability Gap Funding Scheme

Financing of public private partnership project especially making high investment, long duration of implementation and recovery of principle and return on investment does not make many of the projects “bankable” or of investment grade. Government of India, Ministry of Finance, Department of Economic Affairs, Infrastructure section has introduced “Scheme for Financial Support to Public Private Partnerships in Infrastructure” to bridge the viability gap of infrastructure projects undertaken through PPPs. The Government of India recognizes that infrastructure projects may not be always viable because of long gestation period and limited financial returns and that financial viability of such projects can be improved through Government support. Viability gap funding or Grant means a grant one time or deferred provided under this scheme with the objective of making a project commercially viable. The total viability gap funding under this scheme shall not exceed twenty percent of the total project cost; provided that the Government or statutory entity that owns the project may, if it so decides, provide additional grants out of its budget, but not exceeding a further twenty percent of the project cost. Viability gap funding under this scheme will normally be in the form of a capital grant at the stage of project construction. Viability gap funding upto Rs.100 crore for each project may be sanctioned by the Empowered Institution subject to the budgetary ceilings indicated by the finance ministry. Amounts exceeding Rs.200 crore may by sanctioned by the Empowered Committee with the approval of Finance Ministry .

Role of the Banks in financing Infrastructural Projects : Experience and Solutions

A concentration on finance may detract from an appreciation of the real value of PPP, which is about better procurement, reforming the public sector and delivering better services to the public. These factors are largely unaffected by the financing method and indeed it would be quite possible to use a PPP structure, focussing on the delivery of output based services with all the finance being provided by the government. The role of the banks (rather

than the source of finance) is important in some areas of PPP. However, given the interest, role and skills, banks may assist government in their analysis and control of PPP projects .The majority of PPP projects are financed by banks or other political institutions and as such, they will be regularly monitored by these organizations. Before agreeing to lend a money to a PPP project the banks will insist on an independent confirmation of all the technical, environmental, economic and commercial studies on the project.

With a PPP, they will expect a frequent and regular reports on the project's progress. This will include a review carried out every 3 or 6 months with forward looking financial ratios to check on how well the project is doing. These analyse the cash flow of project to see how well it can cover obligations to service and repay debts, as well as meet the essential running costs of the project. If the project is not demonstrating the strength that is required in these ratios, then the banks will expect early action to restore the project to good health. This is an important benefit for the public sector as the financing institutions will be as keen as to ensure the project succeeds. They will also ensure that they have “step in” rights to enable them to take prompt remedial action when a projected problem is identified. Hence there can be no “straight jacket” method of financing infrastructure projects like other projects .

Over 70 countries around the world are looking at using PPP. Just announcing a PPP programme is not enough to attract investment. The international market is looking for :

- Deal Flow - a reasonable number of potential projects in pipeline to make investing time and money in building understanding of the local environment worthwhile.
- Bankability - Unless projects are bankable the international financial community will not invest in them.
- Good credit ratings - for the country or (even more critical) the municipal or regional government concerned.
- Manageable political sensitivities : Given the sensitive nature of private sector provision of some services (such as health and education), the private sector will want reassurance that the client is able to manage this element of the process.
- Local capability - is there an experienced construction industry, banking market, good law firms and service companies?
- Strong local financial structures - ideally there should be a long term finance market or at least the potential to develop one. Indeed a PPP programme can be a great stimulus to a long term financial market.
- Projects which offer scope for innovation in design - if the private sector is to add value and reduce cost or increase quality, they must be capable of providing innovation in design, particularly in obtaining synergy between design and operations.

PPP policy is a long term solution. A real PPP project is going to deliver long term value for money; it does not take time because part of what is being done is investing the effort in understanding those long term objectives and risks for both sides, public and private.

There are few lessons and experience worth emphasising in developed PPP Markets such as the UK, Ireland, Netherlands, etc .

ESSENTIAL INGREDIENTS NEEDED FOR A PPP PROGRAMME

1. High level Political Commitment.
2. Public and Private Sector Champions.
3. Skilled central support from a PPP Task Force with authority over all PPP projects.
4. The involvement of high quality private firms.
5. Availability of long term private capital.

ESSENTIAL PREPARATION FOR A PPP PROGRAMME

1. An appropriate legal framework ensured at National, Regional and Municipal level.
2. Sound Financial Structure.
3. Guidance from experienced advisors.
4. Training at all level for public sector employees.
5. Standardised Contract Documentation.
6. Full time in house expertise in government bodies undertaking projects.

7. Identify and prioritise pilot projects.

PROJECT SUCCESS CRETRIA

1. The project must be bankable.
2. It must offer a service (output) driven solution.
3. There must be scope for innovation in design.
4. There needs to be committed public sector management.
5. The government needs to ensure there are manageable political sensivities.

LESSONS FROM THE UK AND ELSEWHERE

1. The Single Objective is better service for the public.
2. It is a Partnership. Think conflict limitation.
3. It is affecting the way the public sector delivers non PPP Services.
4. Have realistic expectations on time.
5. Focus on realistic risk transfer to private sector.
6. Prioritise projects.
7. Address public concerns : Involve all parties in discussions and ensure objective evidence of performance and value for money.
8. It is not a quick fix.
9. PPP does not make a bad project good.
10. UK experience proves that it works.
11. Other nations agree.

High legal and Political Risks in PPP model

The PPP model is of recent origin and not fully accepted by all the political parties especially the acquisitions of land for airports, roads, ports and SEZ are not only long drawn affairs but also have a high legal and political risk apart from environment clearance. Political risks have strong impact on opportunities in PPP. The level of perceived political risks determines the costs in PPP projects. With increasing political risks, PPP opportunities become less and the cost of PPPs increase as well. Survey conducted by Tillman Sachs and Dr. Robert LK Tiong on the impact of political risks on PPP across 14 Asian countries and 14 PPP sectors surveyed suggests that political risks are key risks in the public private relationship and some political risks are insurable (A to D) by public and private insurers while others (E and F) are not :

A. Currency inconvertibility and transfer restriction (CI / TR)

B. Expropriation

C. Breach of Contract

D. Political Violence

E. Legal, regulatory, and bureaucratic risks

F. Non Government Action Risk

The survey covers PPP opportunities in Bangladesh, Cambodia, India, Indonesia, Japan, Korea, Malaysia, Pakistan, Philippines, Singapore, Taiwan, Thailand and Vietnam. For all Asian countries, except Korea, Japan and Singapore, Legal, regulatory, and bureaucratic risks are perceived as having the strongest negative impacts on PPP opportunities. These are followed by currency inconvertibility and transfer restrictions, breach of contract, non governmental action or outside risks and expropriation. The least risky factor is political violence.

With increasing political risks, investment appetite decreases. Also with the increasing political risks, the expected minimum internal rate of return (IRR), minimum required debt service coverage ratio (DSCR), the risk margin on loans and the insurance premiums increase. Investment appetite, loan spread, and insurance premium are chosen to best show the effect of political risks on the PPP project participants objectives.

Guidelines on Financial Support to Public Private Partnership

Secretariat for the Committee on Infrastructure issued these guidelines in which the scheme aims at supporting infrastructure projects that are economically justified but fall short of financial viability. The lack of financial viability usually arises from long gestation periods and the inability to increase user charges to commercial levels. Support under this scheme will be viable only for infrastructure projects where sector sponsors are selected through competitive bidding. Apart from the financial support to be made available under this scheme, an additional grant of up to 20% can be provided by the sponsoring ministry or State Government.

> **Public Private Partnerships are useful only if they assure quality supply at reasonable cost.**

Guidelines on Formulation, Appraisal and Approval of Public Private partnership

These guidelines articulate the need for due diligence in the formulation, appraisal and approval of Public Private Partnership (PPP) projects of the Central Government. PPP infrastructure projects typically involve transfer of public assets, delegation of governmental authority for recovery of user charges, private control of monopolistic services and sharing of risks and contingent liabilities by the Government. Protection of user interests and the need to secure value for public money as such demand a more rigorous treatment of these projects.

Predictability and risk mitigation are key to successful PPPs. They require a framework that can assure the private investor of a market driven return at reasonable levels of risks and the user of adequate service quality at an affordable cost. Under this arrangement, administrative ministries can adopt a proactive developmental approach while the Planning Commission would focus on due diligence, consistency with processes in other sectors and consideration of best practices. The finance ministry would examine the extent of direct and indirect Central Government exposure and also act as an arbiter. Standardisation of the approval process will also ensure that planning, approval and execution of PPP projects is expedited, thus, restricting the tendency to re invent the wheel with each PPP transaction.

Policy Frameworks for PPP

While there are important advantages, it must also be recognised that attracting private capital through the Public Private Partnerships or any other route is neither easy nor is it automatic. A key pre-requisite is to lay down a policy framework that assures a fair return for investors provided they attain reasonable levels of efficiency. But the policy must also protect the interests of users, especially the poor. Public Private Partnerships are useful only if they assure quality supply at reasonable cost.

Balancing all these interests is difficult. But it needs to be done. Tariffs and service quality need to be regulated and consumer access protected. Since a large part of investor risk stems from uncertainty about government actions, we must ensure clarity in the policy and regulatory framework that governs private participation in any areas - both the Central Government and State Governments have, therefore, their tasks cut out in this regard. Sanctity of contracts must be observed, and dispute resolution mechanisms need to be speedy and effective. This is necessary if we are truly a country governed by rule of law.

India Infrastructure Finance Company (IIFC) :

IIFCL was incorporated on January 5, 2006 as an apex financial intermediary for the purpose of development and financing of infrastructure projects and facilities in the country. Setting up of IIFCL is aimed at the bridging gap and to address the need for providing long term debt for financing infrastructure projects that typically involve long gestation periods. Debt finance for such projects should be of a sufficient tenure that enables cost recovery across the project life. Indian capital markets, however, are deficient in long term debt instruments. Underdeveloped pension and long term debts markets have restricted the tenure of the project finance of India. Most of the available debt is of seven to twelve years maturity whereas infrastructure projects requires a longer pay back period. This constraint leads to front loading of tariffs during the initial years of the project cycle with a view to ensuring repayment of debt. Besides affecting the users, this handicap also affects competitiveness of infrastructure projects.

The ministry of finance evolved this scheme after extensive deliberations with the planning commission, financial institutions, experts and other stakeholders. The scheme thus formulated was considered and approved by the Committee on Infrastructure, chaired by the Prime Minister and subsequently endorsed by the Union Cabinet. The Scheme will be called the Scheme for financing Viable Infrastructure Projects. IIFCL has since been corporatised and operationlised. It will provide assistance through long term debt either by way of refinance to banks and financial institutions or by direct lending to project

Our government has made substantial headway in giving a push to all areas of infrastructure.

companies. It will lend up to 20% of the capital costs of a project. IIFCL would rely on the lead banks associated with the respective projects. Built into this scheme is a preference for Public Private Partnership (PPP) projects that are awarded to private companies selected through a competitive bidding process. Such projects will be eligible for direct lending by IIFCL, and will also receive overriding priority.

Road Ahead

Our government is paying focused attention to infrastructure through a Committee on Infrastructure which meets regularly to discuss and finalise policy initiatives. It has developed a sound framework for Public Private Partnerships in infrastructure sectors including roads, railroads, ports and airports with sector-wise arrangements and financing plans. Our government has made substantial headway in giving a push to all areas of infrastructure. In the roads sector, the four-laning of the Golden Quadrilateral has not only been nearly completed, but a programme for six-laning the entire Golden Quadrilateral on a BOT basis has been approved. This alone would cost over Rs.40,000 crores of which only 15% would come from budgetary support. A program for developing 1,000 km of expressways has also been initiated. We anticipate investments of Rs.220,000 crore by year 2012 in the modernisation and upgrading of our highways in the country.

Conclusion

India's economic performance in the past few years - particularly in the last three years - has been commendable on many counts. Economic growth has accelerated and we are now averaging an annual growth in excess of 8%. A fascinating story is unfolding before our eyes and the entire world is watching with wonder the emergence of India as a major economic force in the evolving global economy. However, the growth has not been without limitations. While a growth rate averaging 8% is certainly a matter of considerable satisfaction, I do believe we can and we must do even better. If we have to make a decisive impact on mass poverty and provide productive employment for our young population, we must further accelerate the pace of growth to 9 and 10% per annum. The broad goal of the Eleventh Five Year Plan will be to achieve this ambitious objective.

A growth rate in the vicinity of 10% is not impossible to achieve. Most independent observers believe that the Indian economy has the unique potential to grow at this rate. But, this will not happen automatically. We will need to run hard just to stay where we are. Maintaining a growth rate of 8% would need continual improvements in our policy regime. To raise it further to 9 and 10% would require additional sustained efforts to boost our agricultural and manufacturing growth. Most importantly, our growth potential will be realized only if we can ensure that our infrastructure does not become a severe and critical handicap. The quality and capacity of our infrastructure is certainly a matter of concern to one and all. We must deal with this deficit without any further loss of time.

Indian Financial Reforms : National Priorities Amidst An International Crisis

- Purushotamdas Thakurdas Memorial Lecture

Dr. Ashok K. Lahiri *

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. Consequently, there is a tendency to blame all crises on liberalization[1], 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.

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

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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".

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].

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 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.

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

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.

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

No.	Name of the Committee	Chairman	Year Set up	Year Submission	Set up by
	Initial burst 1991-1996				
1	Committee to Review the Working of the Monetary System (Chakravarty Committee)	Sukhamoy Chakravarty	Dec. -1982	10-Apr. -1985	Reserve Bank of India
2	High Powered Committee on Financial System (Narasimham-I)	M. Narasimham	14-Aug. -1991	Nov. -1991	Government of India
3	High Level Committee on Balance of Payments (Rangarajan Committee)	C. Rangarajan	19-Feb. -1991	26-Apr. -1993	Government of India
	Troubled second round 1997-2006				
4	Committee on Capital Account Convertibility (Tarapore-I)	S. S. Tarapore	28-Feb. -1997	30-May -1997	Reserve Bank of India
5	Committee on Banking Sector Reforms (Narasimham-II)	M. Narasimham		Apr. -1998	Government of India
	Third round with untapped potential				
6	Committee on Fuller Capital Account Convertibility (Tarapore-II)	S. S. Tarapore	20-Mar. -2006	31-Jul. -2006	Reserve Bank of India
7	High Powered Expert Committee on Making Mumbai an International Financial Centre (PM Committee)	Percy Mistry[8]	28-Nov. -2005	10-Feb. -2007	Government of India
8	Committee on Financial Sector Reforms (Rajan Committee)	Raghuram Rajan	17-Sep. -2007	07-Apr -2008	Planning Commission

sectors. Reforms recommended 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

8. Mistry resigned a few days before the submission of the report.ilton Young.

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.

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 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. 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.

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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.

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(g) Strengthening of the financial system -- 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 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;

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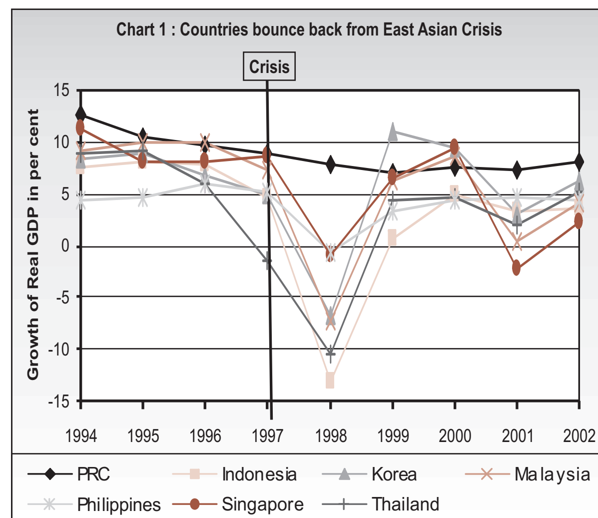
- progressively raise the statutory minimum net worth requirement for registration of NBFCs from Rs.25 lakh to Rs.2 crore, and withdrawing deposit insurance from NBFCs;
- move from a flat to a risk-based or variable rate premium for deposit insurance;
- reduce the legally required public shareholding 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.



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.

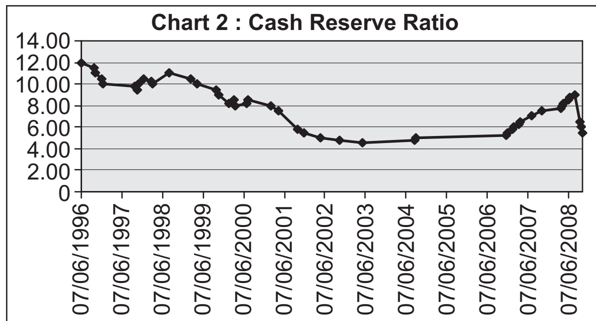
In the short-term firefight, initially, the strategy was that of sterilized intervention. First, the RBI bought the foreign currency by releasing rupees, and then sterilized it by selling bonds and mopping up the rupees released. The RBI could only sell Government bonds that it had in its kitty, and 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 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

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,

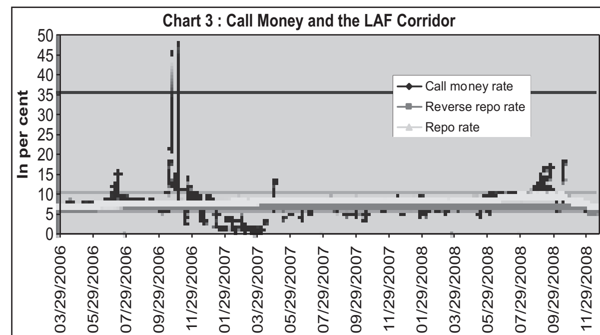
announced that it "….continues to pursue its medium-term objective of reducing the CRR to the statutory minimum level of 3.0 per cent."[16] In the event, this medium-term objective became a victim of short term exigencies.

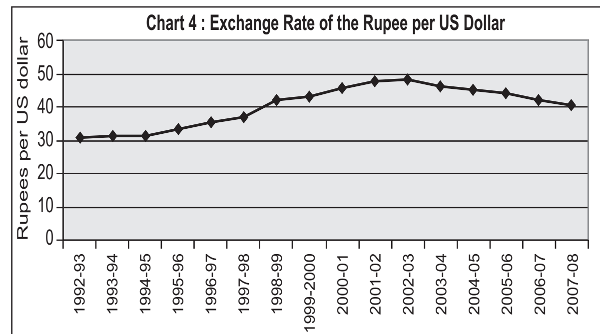


Third, following the recommendation of Narasimham-II, to stabilize short-term interest rates through an informal corridor, a Liquidity Adjustment Facility (LAF) was introduced on June 5, 2000. LAF is a daily exercise, in which only banks and Primary Dealers (PD) participate[17]. Acting as a banker of 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 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.

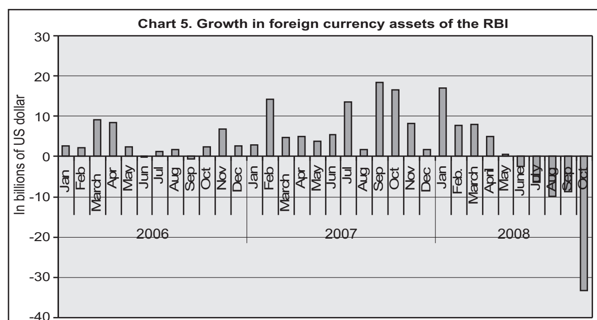
16.See RBI (2005), Part II, Chapter 3, para III.9.

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.

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.



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, 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-registeredentities;

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

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.

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- 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.

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]

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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).

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.

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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 1824 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.

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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 :

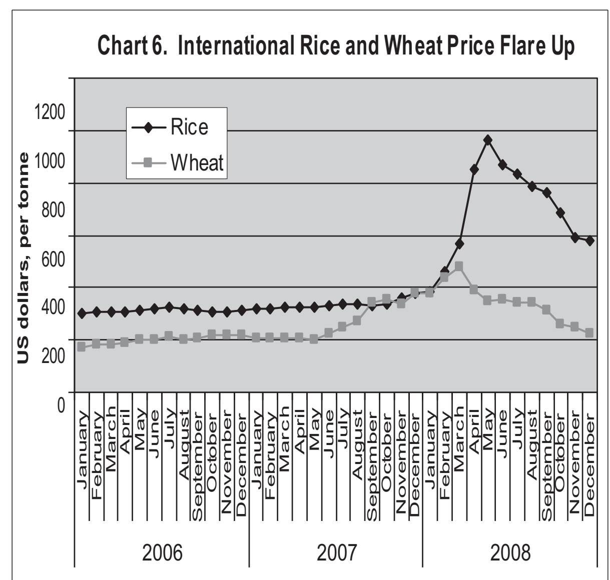
1. Moving to an inflation-targeted monetary policy regime;
2. Modernising the delivery of financial services to the priority sectors and the vulnerable and weaker sections;
3. Introducing capital account convertibility;
4. Moving from a rules-based and fragmented regulatory architecture to a principles-based 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.

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.

Chart 6. International Rice and Wheat Price Flare Up



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.

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. 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 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.

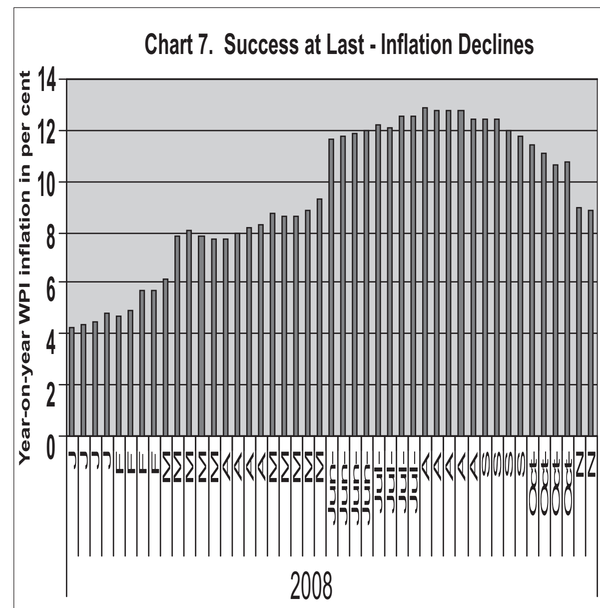


Chart 7. Success at Last - Inflation Declines

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]

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

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," 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.

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.

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.

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 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.

35.Noble laureate Gary Becker (2008) has emphasized that "it is paramount to distinguish between the immediate steps needed to ope 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."

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 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.

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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.

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. .

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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 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 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.

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.

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]. 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

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.
53.See Vittas and Cho (1995)

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. 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[58]. 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 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;

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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)

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- 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.

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

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).

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 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.

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 the same time,

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

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

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, 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

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

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; (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

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.

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).

74. See PM Committee, p. 132.

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 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

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.

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.

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 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

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.

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, 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.

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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Financial Inclusion : The road ahead **

Dr. J. Sadakkadulla *

It gives me great pleasure to be at this State level seminar on financial inclusion being hosted by the Indian Institute of the Banking and Finance, Mumbai in collaboration with RBI and NABARD. I congratulate the Institute for organizing such a timely seminar which aims at providing in-depth knowledge on financial inclusion, the role of various agencies like State Government, banks, NGOs and also to pin point the road ahead. Himachal Pradesh having the distinction of achieving the 100% financial inclusion, first in the country, is the right venue for holding such a seminar. The State has also taken upon itself the ambitious target of achieving credit inclusion as well by March 2009. I really compliment the banks and State Government for their continued endeavour for making the financial inclusion and thereby inclusive growth a reality.

Magnitude of the problem and efforts to outreach

Inclusive growth is the talk of the day and financial inclusion is the road to achieve inclusive growth. It is worth recollecting from the speech of Madam Thorat (DG, RBI), "If all stakeholders realize that inclusive banking is good business then regulatory and policy frameworks that promote accessibility and responsible banking can definitely lead to the desired outcomes", which aptly summarises the importance of financial inclusion not only as a social commitment but also as a viable business proposition.

Financial inclusion is not a new concept and there were initiatives since the very beginning of development planning in India. In fact, Reserve Bank of India started its Agricultural Credit Department way back in 1935 as a unique initiative. That way, there are very few Central Banks in the world such as Malaysia which evince such direct interest in agricultural / rural credit. The erstwhile ACD along with the Agricultural Refinance and Development Corporation (ARDC) has been merged to become NABARD in 1982.

Inclusive growth is the talk of the day and financial inclusion is the road to achieve inclusive growth.

The very introduction of the Lead Bank Scheme coinciding with the nationalization of the major commercial banks in the country in 1969, establishing of RRBs in 1975 (originally numbering 196 and recently amalgamated into 88) till the recent initiative on micro-finance (through SHGs) are the steps in this direction. Banks and development are so inter-related that even advanced countries like USA and several countries in middle east evince interest in micro credit mechanism for achieving social equity and thereby inclusive growth. There is a recent World Bank study that shows a very interesting relationship that countries with large proportion of population excluded from the formal financial system also show higher poverty ratio and high in equality. For instance,

Sr. No.	Country	Composite index subject to financial inclusion (% of population with access to financial services)	Poverty (% of population below poverty line)
1.	India	48	28.6
2.	Bangladesh	32	49.8
3.	Malaysia	60	15.5

Source : World Bank

The financially excluded sections largely comprises marginal farmers, landless labourers, oral lessees, self-employed and unorganized sector enterprises, urban slum dwellers, migrants, ethnic minorities and socially excluded groups, senior citizens and

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** *Keynote address delivered at the State level seminar at Shimla on 20th October, 2008.*

women. Some of the reasons for the financial exclusion from the demand side are lack of awareness, low incomes, illiteracy, etc. and from supply side unsuitable products, language, staff attitudes, etc. The problem gets further aggravated going by the continental dimension of our country spreading over geographical area of 328 million hectares some of which are hilly and remote and are difficult to access and poor in infrastructure.

The Indian economy is growing at around 8-9% though of late due to global economic turmoil there is a little bit of a slow down in the recent past. The Services Sector has been the key driver to these growth processes with agriculture largely left out with a growth rate of a little over 2%. Indian agriculture is also a success story with the Green Revolution of seventies resulting in food self-sufficiency and also bringing down substantially the dependence of the economy on the agriculture sector by way of reducing the share of national income from agriculture from 52% in 1950 to 18% today. However, the area where we have failed perhaps is our inability to reduce the excess people depending on agriculture on a very unviable land holding. This is where the role of non-farm sector comes wherein bankers with their innovative entrepreneural ventures such as RUDESETI, Farmers Club, SHG-banks linkage programme etc. have a very crucial role and all of these will result in financial inclusion. India being agrarian economy, Reserve Bank of India continues to play its vital role in rural credit dispensation.

RBI initiatives on financial Inclusion :

Now, I would like to highlight some of the initiatives taken by the RBI in general on financial inclusion and literacy and also the Regional Office, Chandigarh / sub-office Shimla, in particular.

- The Reserve Bank of India has taken a number of measures in recent years to effectively address issues relating to financial inclusion. At the highest level both the Union Finance Minister and RBI Governor through their addresses in various forums have tried to sensitise the bankers for the cause.
- In November 2005 banks were advised to make available a basic banking (No-frills) account with low or nil minimum balance and charges, to expand the outreach of such accounts to all sections of the population.
- In order to ensure that persons belonging to low income groups both in urban and rural areas to open bank accounts the KYC procedures have been simplified for those persons with balances not exceeding Rs.50,000 and credit in the accounts not exceeding Rs.1,00,000 in a year.
- Credit counseling and financial education centres have to be set up by the banks at least one in a district and an approach paper is put in the public domain for comments.
- In January 2006 banks were advised to utilize the services of NGOs / self-help groups to provide micro-finance through use of business facilitators and business correspondent.

As a parallel initiative to facilitate financial literacy a multi-lingual website in 13 Indian languages on all matters concerning banking and the common person has been launched by the Reserve Bank of India on 18 June 2007.

- To take the benefit of last mile support to reach the unreached, pilot projects have been initiated for IT enabled financial inclusion using smart cards for operating bank accounts through bio-metric identification, use of mobile or other connectivity devices, etc.
- State Governments are encouraged to route social security payments as also payments under the National Rural Guarantee Scheme through such smart cards. The same delivery channel can be used to provide other financial services like low cost remittances and insurance.

The success story of Himachal Pradesh

Himachal Pradesh has become the first State in the country to achieve 100% financial inclusion as early as in March 2007. It has taken upon itself the ambitious goal of achieving 100% credit inclusion as well for March 2009. Reserve Bank of India on its part has fulfilled its promise of opening a sub-office exclusively for Himachal Pradesh at Shimla on 1st July, 2007.

The working group set up by RBI (under the Chairmanship of RD, Chandigarh) has undertaken a very detailed study of the measures for enhancing

the outreach of the banking system in Himachal Pradesh and submitted its report in October 2007. All its recommendations have been accepted by the Reserve Bank of India. I am happy to say that 54 out of 60 recommendations have already been implemented enthusiastically by the banks in Himachal Pradesh and also by the various departments of the State Government and the remaining recommendations are in the process of getting implemented.

Very recently, Reserve Bank of India has commissioned an independent study by experts from the University Business School, Panjab University, Chandigarh to validate the claim relating to 100% financial inclusion in Himachal Pradesh. I am very happy to share the findings of the study in this august forum with as high as 97.8% of the claim by the State Government and the banks regarding financial inclusion in the State of Himachal Pradesh is found to be true by that study. The left out were largely the migrant labourers and such other isolated groups. The study has gone further to say there are certain qualitative improvements in the outlook of the people, their sources of the information relating to banking facilities and has also given suggestions for further taking the financial inclusion forward.

By way of conclusion, I would like to say that opening the no-frill account is just a beginning of the long journey in financial inclusion and thereby to pave way for inclusive growth. Credit inclusion is obviously the next logical step but should not stop with and further get extended to micro-insurance and such other total financial solution of the common man. We can take as to have reached the destination “the day when there is no longer a need to look for money lender by anyone even in the remotest part of the country”. I would like to conclude with the quotation from Dr. Rangarajan in his report on the Committee of Financial Inclusion, January 2008, “Financial Inclusion is not an option but a compulsion”.

I thank the organizers for giving me the opportunity to participate in this important seminar.

Adoption of Capital Charge for Market Risks in India

The major focus of prudential regulation in India as in other developing countries has traditionally been on credit risk. While banks and their supervisors have grappled with non-performing loans for several decades, interest rate risk is a relatively new problem. The easing of financial repression that took place in many countries in the 1980s and the1990s generated some experience with interest rate volatility in these countries compared with administered interest rate regime with near-zero volatility. In India, administrative restrictions on interest rates have been steadily eased beginning 1993, leading to increased interest rate volatility. Low inflation, opening up of financial markets, and falling international interest rates resulted in a significant decline in interest rates in India during 2001-04.The drop in interest rates generated substantial trading profits for banks that had a large investment portfolio. This tendency, as well as difficulties in creating sound processes for handling credit portfolios, led some banks to hold Government securities in excess of reserve requirements. However, when the interest rates began to rise beginning October 2004, some of these banks were exposed to high interest rate risk.

This concern was reinforced by the relatively large share of Government securities in assets held by Indian banks. At end-March 2001, Government bond holding of banks in India stood at 27.2 per cent of assets as against only 4.6 per cent in the United States, a mere 0.3 per cent in the United Kingdom and at 6.9 per cent in the Euro area (Study Group on Fixed Income Markets, 2001). In addition to the cash reserve ratio, banks are required to hold a part of their deposits in the form of liquid assets, comprising mostly Government securities. The statutory liquidity ratio (SLR) has remained unchanged at 25 per cent since October 1997.

While the duration mismatches between loans and advances on the asset side and deposits on the liability side are typically not very large, the bulk of Government bonds are fixed-rate products and have a higher duration than the typical credit portfolio. Movement of interest rates, thus, normally has a bigger impact on the investment portfolio of a bank.

Internationally, banks routinely use interest rate derivatives to hedge interest rate risk. In India, while the Reserve Bank allows banks to use forward rate agreements and interest rate swaps to hedge interest rate risks, these markets are not very liquid.

Interest rate risk, thus, became an important issue for banks in India and for the Reserve Bank. In India, as an initial step towards prescribing capital charge for market risks, banks were advised to: (i) assign an additional risk weight of 2.5 per cent on the entire investment portfolio; (ii) assign a risk weight of 100 per cent on open position limits on foreign exchange and gold; and (iii) build up investment fluctuation reserve up to a minimum of five per cent of investments in HFT and AFS categories in the investment portfolio. The Monetary and Credit Policy Statement announced in April 2002 that it would be appropriate for banks to adopt the BCBS norm on capital charge for market risk. Accordingly, the Reserve Bank through consultative process issued the final guidelines in June 2004, wherein banks were required to maintain capital charge for market risks in a phased manner over a two-year period. Banks were required to maintain capital for market risks on securities included in the HFT category, open gold position limit, open foreign exchange position limit, trading positions in derivatives and derivatives entered into for hedging trading book exposures by March 31, 2005. In addition to above, banks were required to maintain capital for market risk on securities included in the AFS category by March 31, 2006.

Source : RBI's Report on Currency and Finance, 2006-08.

Financial Inclusion **

Elaben Bhatt *

Financial Inclusion is no less important than social inclusion. As we see in our society, millions of people not considered for a fair treatment either from the social institutions or from the financial institutions. It is commendable that, of late, the policy makers and banking institutions have come forward to address the issue of banking exclusion.

It is estimated that globally over two billion people are excluded from access to financial services, of which one third is in India. The Committee on Financial Inclusion (Rangarajan Committee 2006) observed that in India 51.4% of farmer households are financially excluded from both formal and informal sources and 73% of the farmer households do not access formal sources of credit. To be specific, those excluded are marginal farmers who happen to be women who are further excluded right from the first stage of perception.

Financial inclusion is a complex issue, not simple. There are issues in our approach. When the excluded sections approach formal financial institutions they are confronted with problems of accessibility, timeliness, inadequacy of credit. For one reason or other, they are compelled to approach the informal agencies to meet their credit demands as we all know. An all out effort has to be taken to address these problems that are not simple.

In Gujarat, the commercial banks are doing their best in providing banking services to the general public. I learn, out of 5600 bank branches in Gujarat, more than 4000 are in rural and semi urban areas. The credit deposit ratio of banks in Gujarat is 72% which is an indicator of channeling credit to the needy sectors from the deposit resources banks raise from the public. While this is a good indicator, I am not sure how balanced or evenly spread it is districtwise, incomewise, genderwise, in Gujarat.

It seems, on lending to weaker sections, the banks in Gujarat have to go a long way. Against the targeted lending of 10% of total lending, the outstanding lending of banks has reached only half way (5.21%). Under the Differential Rate of Interest (DRI) scheme (wherein banks are required to give loans to the people below poverty line at 4% interest) the banks in Gujarat, against the target of 1% of total lending, Gujarat has not achieved even 0.01%. I hope my information is wrong.

As we know, credit linkage of SHGs in Gujarat is very slow. I think, there are around one lakh SHGs in the state and around one fourth of them are credit linked. Banks should come forward to lend to the SHGs so that the members of the group get benefited with and ensure the asset creation as well as asset ownership of assets by women of SHGs. This process is an engine of social change rather than credit allocation.

The decision of the ministry of rural development, Government of India to start training institutes in every district to train the youth all over the country, is welcome. This is under the scheme of RUDSETI - Rural Development & Self Employment Training Institute. I understand that NABARD is supporting conduct of rural entrepreneurship development programmes and skill development programmes to rural unemployed youth. We need many such RUDSETI in every district of Gujarat to build up the professional local capacity to use and manage and own their own markets and finances. Such institutes should be sustainable and serve the needs of the lives and livelihoods of the poor so far excluded.

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* *Chairperson, SEWA.*

** *Inaugural Speech given during the seminar on 'Financial Inclusion' organized by Indian Institute of Banking & Finance on 22nd January, 2009 at Ahmedabad.*

As I know, NABARD Rural Innovation Fund has been set up in 2005 to support innovative, unconventional pro poor experiments in farm, non farm and micro-finance sector. Since the focus of the Fund is on the rural poor, I urge the community organizations, commercial banks and other agencies to make use of the effective and production utilization of the Fund support.

Moreover, recently banks have come up with strategies to reach the excluded through Banking Correspondents and Banking Facilitator Models. This strategy to make use of the informal channel to reach the poor is very encouraging for a larger outreach. I urge the banks and NGO community to make the schemes to work the best way in achieving financial inclusion.

My ardent appeal to Banks is to shed away the targeted approach and understand the true needs of the poor and view financial inclusion as a vehicle to empower them through meeting their financial needs in a holistic way, motivating them to save and educate them in financial literacy. Mere opening of a savings bank account is not financial inclusion. They need to be treated as clients, not as beneficiaries.

I do realise that when business model in MF sector is gaining precedence, it necessitates the economies of scale. Yes, however, as it is important for the 'suppliers of financial services' to be sustainable, it is also important for the poor households to become financially sustainable. Unfortunately we often see that upscaling tends to become a number game, and, where 'Inclusion' is the magic word.

Our own humble experience has been that 'inclusion' entails understanding the poor, and their lives, their needs, their productivity, their vulnerability. With the banking interventions, after opening a bank account, they graduate (or are supposed to be graduated) through stages : First, stabilization i.e. minimizing their risks; second, maintenance, i.e. the stability attained so far is maintained and preferably move towards higher earnings and ownership of assets; third, self sufficiency i.e. the household has become more resilient and started reaping the benefits of loans taken and assets owned.

The financial inclusion mandate of Government is commendable. But even that process can remain at a mere transactory level where only outreach is addressed. Unless financial inclusion also builds in processes of reaching out and particularly to women in poor households it will not be able to transform and move them out of poverty.

In fact, the inclusion is a continued banking relationship which cannot rest until the poor households become environmentally sustainable, financially sustainable and gender sensitive. We all have significant roles to play to reaching out to those excluded. It is a long term process of Inclusive Growth.

Financial Inclusion currently is seen as at least one member of a family having a bank account. It is a drive that wants the poor to get linked with formal banking institutions, however, there are several issues that need attention : Opening a bank account is only the beginning and not the end of financial inclusion. It will be better for the household if that one member with formal access to the bank account is a woman. Mere opening an account is not enough. The account has to be operational. The use of technology to increase access is invaluable and if this involves women then there are definite empowerment outcomes. The paper that the MF School is currently doing 'State of Practice Report on ICT in Microfinance' may throw more light on the subject. Financial Inclusion has to go hand in hand with financial literacy. The MF School's experience with this regard in different parts of the country has been quite stimulating. Again, it should be women's participation that is ensured. Financial Inclusion can be a powerful tool for inclusive growth and participatory development. But there is also a danger of it remaining a mere tokenism if attention is not paid to the outcomes of financial inclusion. Microfinance institutions and banks have always been vary of each other. The current Business Correspondent and Business Facilitator mechanisms should bring the synergies of both sides together so that ultimately it will be poor households and poor women who benefit. Providing full range of financial services, not just micro-credit

has to be considered. Enabling poor people to participate in the growth economy requires ensuring that they get access to a whole range of financial services (payments / remittances, savings, insurance), not just credit. Thus the emphasis on micro-credit is misplaced, though eventually it should come as a part of all financial services. Similarly, microfinance institutions (MFIs) by themselves are an inadequate solution to the issue of financial inclusion and we need to focus on building an inclusive financial sector, as stated in the report of the Raghuram Rajan Committee on Financial Sector, and as stated in the Raghuram Rajan Committee Report on Financial Sector Reforms.

Nationwide electronic financial inclusion system (NEFIS) is another suggestion. India needs a NEFIS to enable small, personal transactions to happen in an affordable and secure manner. NEFIS needs to be treated as a public good. Why not? And worthy of an IBRD financial infrastructure plan. We can also use the Rs.1000 crore of the Financial Inclusion Fund announced by the Finance Minister, based on the recommendations of the Ragarajna Committee on Financial Inclusion for the purpose of NEFIS. In this vast country, we need technological intervention as well, along with personal contacts.

Let poor people build a financial history using NEFIS : All government payments like the NREGA and old age pensions, as well remittances from family members who have migrated to cities, can be made using NEFIS into "no-frills" bank accounts that are opened for hitherto excluded households. In the meanwhile, all no-frills account holders can get group life and group health insurance. Once the cashflow history and savings balances builds up in the accounts, banks can initially even give overdrafts and then extend term loans. Future loan can be based on repayment history, all available through the NEFIS to any lender.

While appreciating the support by the GOI and the RBI to the financial inclusion agenda, nearly three quarters of all Indians do not have access to basic financial services. Moreover, the gap between pronouncement of intent and the actual practice has to be filled. Where financial services to the poor are pushed either to the public sector banks (with an expectation that they will cross subsidised services to the poor) or to non-profit NGOs, who have to raise money from donors to serve the poor. In either case, private, for-profit actors are discouraged, both by specific bar / restrictions on their entry / operations (*e.g.* Business Correspondents) and by restrictions on interest rates / fees. This leaves the poor to mercies of unregulated actors - money lenders, deposit collectors, hawala remitters. Anyway, these are practical difficulties, not difficult to reform.

But the ultimate question is, what do we do with our finance inclusion?

We build economies that encourage self-reliance and self development of communities. We build economies that conserve natural resources, restore balance of global eco system and social-political systems. We assure power and resources, decentralized and inclusive. We recycle our flow of food, water, energy, naturals, wastes. We maintain our structures and systems autonomous, interdependent, and that enrich others - so as to be self reliant and conserving. We create and recreate productive work for everybody that enhances human dignity. We regard women's way of inclusive, collective practices of reaching out to the needy.

If not, world is left with hunger and violence.

Glimpses of changing Banking Scenario

Author : P. N. Joshi
Publisher : Mehta Publishing House, Pune
Pages : 295
Price : 295/-
Reviewed by : **Prof. R. D. Pandya**

Shri P. N. Joshi who worked as a banker in the public sector as well as private sector of banking apart from his working in Reserve Bank of India (RBI) for over a period of nearly 40 years, Shri P. N. Joshi has experienced and seen a large number of changes in the banking sector in India. These experiences in the banking sector are recorded in this book called “Glimpses of Changing Banking Scenario”. What emerges form the study of this book is that the book is partly autobiographical and partly historical in nature.

He has worked in RBI, then in a nationalized bank *i.e.* Bank of India (BOI) and then in a private sector bank with a regional focus *i.e.* United Western Bank (UWB). He worked in RBI under eminent Central Bankers such as Shri A. Raman, Shri N. Narasimham and that helped him in getting a deep insight into the working of not only central banking but also banking system in general. His work in RBI helped him to work more effectively and efficiently in BOI. Because of the sound grounding he got in RBI, he moved away from BOI to a Private Sector Bank *viz.,* United Western Bank. The bank was in difficulties when he took over as its Chairman. But he followed appropriate policies to strengthen the Bank but it must have been a sad day for him when UWB collapsed. Shri P. N. Joshi talks not only about his experiences as a banker and economist but also deals with several issues relating to non-performing assets, financial sector reforms, and national banking policy to provide what he calls “a sustainable banking structure”.

The chapter on nationalized banking policy is indeed very interesting and needs to be read with great interest for he indicates revolution for national banking policy over a period of years and then suggests a banking policy which can provide a sustainable banking structure. The book is full of interesting anecdotes which are referred to with a sense of humour. He explains in the book what should be the role of a Chairman as a leader in a bank. It comes out very clearly that Shri P. N. Joshi is more than satisfied with his work in RBI, BOI and UWB.

This book should be read by all those who are interested in the working of the banking system in our country, more particularly after nationalization of banking in 1969. One would be greatly interested in studying the Bank Nationalization case in the Supreme Court of India, the details of which have been given. In short, this book shows “Glimpses of Changing Banking Scenario” and a plea for national banking policy. This book would be useful not only to students of banking and finance but even to policy makers in RBI, Commercial Bank and Government of India. Shri P. N. Joshi deserves congratulations in publishing such a useful book.

Bank Marketing - Concepts and Applications

Author : K. K. Saxena
Publisher : Skylark Publications
Edition : 2nd Edition (Revised)
Pages : 215
Price : 150/-
Reviewed by : **Dr. K. M. Bhattacharya**

Entry of new private sector banks in the wake of globalization and deregulation of the banking sector coupled with technology revolution and competition has brought about a sea change in the approach and business strategies of the Indian banks towards customers and market. The new private sector banks have rapidly increased their market share by using technology enabled channels to offer world class services to customers. These banks are better informed about business opportunities and are able to act fast in finding out tailor-made solutions for customer because they are in close touch with customers and market. The public sector banks and old private sector banks have realized that in the backdrop of heightened competition because of the entry of new players and multiple channels, customers have become more demanding and less loyal to banks. The major challenge before these banks today is how to retain the existing customers and attract new customers.

It is in this context that the book titled "Bank Marketing" by Shri K. K. Saxena has became extremely significant to the bankers. Shri K. K. Saxena is a seasoned banker with three decades of rich and versatile experience in State Bank of India. He came out with his treatise on bank marketing first in the eighties and now he has brought out the revised second edition of the book.

During the intervening period banking has undergone a metamorphosis. To take care of the requirements for marketing in the changed environment, he has incorporated in the revised edition, certain new topics *viz.,* evolution of marketing in India, technology, competition, customer service, cross selling, avenues of savings and changing profiles of Indian savers, etc.

The book has been divided into fifteen chapters and has covered almost all the important concepts of marketing like Buyer Behavior, Market and Market Segmentation, Marketing Mix, Environment Analysis, Market Planning, Personal Selling, Public Relations, Image Building, Competition and Customer Service, etc.

What is significant and makes this book distinct from other books on the subject is the author's sharing of his personal experiences in the application of many of the marketing concepts. He has also tested the validity and effectiveness of many marketing concepts from the experience in application of these concepts in State Bank of India. The author has also added three chapters for the guidance of the bank branch managers *viz.,* Environmental Analysis at Branch level, Marketing Planning at Branch level and Profitability of Branches.

All these unique features have made the book a must-read in the present day bank management especially for bank branch managers who wish to survive and grow with better profitability in the fiercely competitive banking environment prevailing in India today.

Mr. Saxena deserves to be congratulated for coming out with the revised edition of the book at this juncture. It will serve as a very useful guidance to the bankers for making their marketing plans and policies more realistic and effective.

Banking Principles and Banking Operations

Author : M . N. Gopinath
Publisher : Snow White Publications (P) Ltd.
Jer Mahal, 532, Kalbadevi Road,
Mumbai - 400 002.
Pages : 632
Price : 595/-
Reviewed by : **V. Raghuraman**

With the onset of financial and banking reforms, there has been a virtual sea change in the banking arena. The proof of this, if need be, could be seen from the fact that both public and private sector banks are found vying with each other in offering newer and newer products and improving their customer service. In such a scenario, there is a crying need for all bank employees to know not merely the basic banking principles / procedures but also the various products and services offered by them. And, not many publications have come out covering both these aspects in a very comprehensive fashion.

The book under review mainly aims to fill in this void. For, not since M. L. Tannan's publication, "Banking Law and Practice", there has been no such exhaustive book on the subject. Hence, the author, M. N. Gopinath, a seasoned banker with over 3 decades experience in both leading public and private sector banks and presently on the board of Bank of India, has done a commendable job in bringing out this book. His objective in writing the book is clear - to give banking students a through grounding in all products and services offered by commercial banks together with all the relevant theoretical and legal inputs. The purpose has been to develop a course for equipping students to confidently manage the work in the front office of the bank, within a week of joining, i.e. after the usual familiarization course.

While thus the book has been designed primarily to serve as an authoritative text book, some of the topics touched upon by him are sure to be of immense interest even to the general reader. For instance, the chapters on Retail Credit, Marketing and Customer Service are written in such a simple and effective way that they would be appealing to one and all. M. N. Gopinath, who was with Bank of India at its New York office, has put to good use the valuable experience gained therein, particularly regarding modern banking practices. His later stint with ICICI Bank helped him further to reinforce the ideas while formulating the various chapters.

His emphasis has been more on the operational and customer service aspects rather than the legal angle. Nevertheless, he has taken pains to provide the necessary legal and regulatory provisions at the appropriate places for the benefit of readers. Realising the need for the present-day banker to have sound knowledge of financial accounting and business mathematics, he has devoted two chapters on the same. Similarly, the chapter on Monetary Policy is expected to help even the general reader to understand and appreciate news and events relating to price, liquidity and interest rate and their impact on economic growth. In the chapter on Financial Services, he has discussed, among others, the insurance scene and its regulatory body, Insurance Regulatory Development Authority (IRDA) and how banks are also providing insurance services.

One other chapter on the Regulatory Environment spells out RBI's role in regulating the banking system. The author has done well in highlighting, among others, the importance of Know Your Customer (KYC) norms and the need for banks to follow them scrupulously. Also, the Anti Money Laundering (AML) guidelines of RBI are, according to him, mainly to prevent the misuse of banking channels for laundering illegal or black money. He has rightly emphasized that banks should educate the customers and enlist their support and cooperation so as to follow the KYC norms and AML guidelines in the true spirit.

Going through this extremely absorbing book, one cannot but agree with the words of K. V. Kamath, CEO and Managing Director, ICICI Bank : “We need to equip our young people with skills related to this new economic reality, by providing vocational training, by expanding the availability of higher education and through curriculum change. Only then can India's demographic advantage be truly realized”.

This book is sure to go a long way in the above direction and would benefit not only banking students and bankers but also the general public at large. A study of the book is expected to help the readers to become “productive employees of banks” with the minimum of on-the-job training, resulting in greater job satisfaction for the employees and higher productivity, lesser errors and greater customers satisfaction.

In fact, this book is ideally suited for students aspiring for a banking career, bankers as well as the general public.

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I, Shri R. Bhaskaran, hereby declare that the particulars given above are true to the best of my knowledge and belief.

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5.	Bank Marketing : Concepts & Applications, 2nd edn.	K. K. Saxena	Skylark, 2008
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