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AN ANALYSIS OF ECONOMIC REFORMS IN FINANCIAL SECTOR IN THE CONTEXT OF INDIAN MONETERY SYSTEM

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Introduction:-

After Independence, the managers of the Indian economy found that the world has been sharply divided into two blocks: the one led by the capitalist economies and other led by the communist economies, primarily the then USSR. There was a cold war between these two blocs. Less developed economies had no option than to join either of the two and invite the ire of the opposite bloc. Especially those economies that were under the British Empire and won freedom during 1940's faced a difficult choice. India chose to keep a safe distance from both the blocks by inventing the idea of a mixed economy. In doing so, India invited as much favor as suspicion from both the blocks. Some economists hold the opinion that the Indian economy was pro-capitalism in its core that wore the façade of a socialistic economy. The state-managed economic endeavors facilitated capital formation in the private sector, often at the cost of the public sector and resources, preparing for a smooth transition to open capitalism in future when the conditions were ripe for such a transition.

Macro-economic imbalances characterized by high fiscal deficits and a growing revenue deficit have continued to remain a major source of concern for the Government during the past few years. These concerns have been compounded by the impact of the Gulf crisis during 1990-91. Aggregate resources of the Central Government including internal and extra budgetary resources of Central Public Enterprises were estimated to increase by 15.0 per cent in 1990-91. Aggregate disbursements, on the other hand, were estimated to increase by 9.4 per cent in 1990-91, thereby indicating some reduction in the relative size of the gap between income and expenditure of the Central Government. This also applies to the combined Budget Estimates (BE) of the Centre, States and Union Territories for 1990-91, which estimated a deficit of Rs. 8,999 crores compared with the Revised Estimates (RE) of Rs. 12,149 crores in 1989-90. Aggregate receipts were estimated to increase by 13.4 per cent while aggregate expenditure was expected to increase by 10.4 per cent.

REVIEW OF LITERATURE

A much more positive picture was drawn by Panagariya (2004), who argued that growth in the 1990s was more robust than that of the 1980s and that it was achieved through important policy changes. The main policy changes held responsible for accelerated growth are the liberalization of foreign trade, the reduction in industrial licensing and opening to foreign direct investment .

Das (2003) attempted such an assessment and computed effective rates of protection and import coverage as well as import penetration ratios for 72 three-digit industries for four sub-periods of the period 1980 to 2000. Although these ratios are useful they do not show the combined effect of tariffs and QRs on output prices. For that it would be necessary to estimate rates of protection based on

price comparison, as had been done in the 1980s by Pursell (1988). The author concluded that the Indian level of protection remained high in comparison with several South-East Asian countries . Pandey (2004) focused on the measurement of several trade reform variables, including the measurement of protection based on price comparisons. As to the impact of trade liberalisation on industry performance he concluded that this link appears to be weak, given the presence of other factors. Among these factors, government controls in form of industrial licensing and public sector investments are singled out, but the author also points to the well-known ambiguity between protection and growth: High protection tends to generate growth in the initial stages, but declining protection may also lead to growth through competition-induced gains in productivity and exports .

In a more recent paper Goldar (2005) examined to what extent India's commitments under the WTO have influenced the manufacturing sector and concluded that changes in production, imports and exports are largely not attributable to the commitments arising from WTO membership. He showed that for a number of consumer goods, especially in textiles and clothing, the increase in imports during the early years of 2000 were modest and largely matched by increases in exports .

Subramanian (2007) , after 1980, some clearer patterns become evident. It appears that two sets of factors played a role. First, different states had different pre-existing capabilities. But these remained latent and could not find expression until the economic environment changed. The trigger-the second set-was the liberalization begun in 1980, and especially the decentralization of economic power that was forced by the changing political landscape after 1980. Thus, it was the interaction between pre-existing capabilities and the twin triggers of liberalization and decentralization that explains how the different states fared.

After all, if the pre-1980s era was about the Centre deciding, for example, where and how much electricity capacity to install, there is little that the states could have done to affect economic performance within their borders. This is exactly what the evidence shows. For example, when state-level growth is related to state-level policies and institutions, the latter are found to have no role in explaining growth prior to 1980 but a robust role in explaining post-1980s, especially post-1990s, growth.

Financial Sector Reform in India

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks (Beck, Levin and Loayza 1999; King and Levin 1993; Rajan and Zingales 1998; Demirgüç-Kunt, Asli and Maksimovic 1998; Jayaratne and Strahan 1996). Many countries adopted a series of financial sector liberalization measures in the late 1980s and early 1990s that included interest rate liberalization, entry deregulations, reduction of reserve requirements and removal of credit allocation.

Reforms in the Capital Markets

Reforms in the capital market were the second leg of financial sector reforms and were initiated early in the process. India had a long experience with functioning stock markets—the Bombay Stock Exchange (BSE) was founded as early as 1875—but the state of the capital markets in 1991 was highly unsatisfactory. Financial repression was extensive. Companies needed government permission to access the capital market, and the government also had to approve the volume of resources to be raised, as well as the pricing of shares in the case of new equity issues and the interest rate in the case of corporate bond issues. While the government directly controlled the efforts of firms to raise resources from the markets, the supervision of trading practices was negligible. The stock exchanges were ostensibly self-regulating, but in practice cliques of brokers

managed stock exchanges under conditions of poor governance and low transparency, and price manipulation and collusive trading were rampant. The market was dominantly an equities market and the bond market, normally an important segment, was largely undeveloped.

The need for change had been recognized in 1987 when and the Securities and Exchange Board of India (SEBI) was established as a non-statutory body to evolve a framework for regulation of the stock market on modern lines, but it remained an advisory body with no statutory power. The process of reform began in 1992 when SEBI was given statutory status as the regulatory authority and government control was abolished. It has also put in place rules and regulations to govern the behavior of market participants, including stock exchanges, individual brokers, merchant bankers, and mutual funds. Rules have also been laid down governing insider trading and takeover bids with a view to protecting interests of minority shareholders.

The second half of the 1990s has also seen a rapid expansion in the market for government debt as a direct consequence of interest rate liberalization and other reforms in the banking sector. Earlier, the bulk of government debt was held by banks under high statutory-preemption requirements. Since the coupon rate on government securities was controlled and deliberately kept low, banks had no incentive to trade in the portfolio because trading would invariably involve taking a capital loss. The shift to market determined interest rates on government securities, and the requirement that banks apply mark-to-market practices on 75 percent of their securities holdings, created the basic requirement for banks to engage in active trading in the securities portfolio.

Strengthening financial systems has been one of the central issues facing emerging markets and developing economies. This is because sound financial systems serve as an important channel for achieving economic growth through the mobilization of financial savings, putting them to productive use and transforming various risks India's reform program included wide-ranging reforms in the banking system and the capital markets relatively early in the process, with reforms in insurance introduced at a later stage. Banking sector reforms included:

(a) Measures for liberalization, like dismantling the complex system of interest rate controls, eliminating prior approval of the Reserve Bank of India for large loans and reducing the statutory requirements to invest in government securities;

(b) Measures designed to increase financial soundness, like introducing capital adequacy requirements and other prudential norms for banks and strengthening banking supervision;

(c) Measures for increasing competition, like more liberal licensing of private banks and freer expansion by foreign banks. These steps have produced some positive outcomes. There has been a sharp reduction in the share of nonperforming assets in the portfolio, and more than 90 percent of the banks now meet the new capital adequacy standards.

India's banking reforms differ from those in other developing countries in one important respect, and that is the policy toward public sector banks that dominate the banking system. The government has announced its intention to reduce its equity share to 33.33%, but this is to be done while retaining government control. Improvements in the efficiency of the banking system will therefore depend on the ability to increase the efficiency of public sector banks. Skeptics doubt whether government control can be made consistent with efficient commercial banking because bank managers are bound to respond to political directions if their career advancement depends upon the government. Even if the government does not interfere directly in credit decisions, government ownership means managers of public sector banks are held to standards of accountability akin to civil servants, which tend to emphasize compliance with rules and

procedures and therefore discourage innovative decision making. Regulatory control is also difficult to exercise. The unstated presumption that public sector banks cannot be shut down means that public sector banks that perform poorly are regularly recapitalized rather than weeded out. This

obviously weakens market discipline, since more efficient banks are not able to expand market share. If privatization is not politically feasible, it is at least necessary to consider intermediate steps that could increase efficiency within a public sector framework, these include shifting effective control from the government to the boards of the banks, including especially the power to appoint the chairman and executive directors, which is at present with the government; removing civil servants and representatives of the Reserve Bank of India from these boards; implementing a prompt corrective action framework that would automatically trigger regulatory action limiting a bank's expansion capability if certain trigger points of financial soundness are breeched; and acceptance of closure of insolvent public sector banks .

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

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

In the period 1969-1991, the number of banks increased slightly, but savings were successfully mobilized in part because relatively low inflation kept negative real interest rates at a mild level and in part because the number of branches was encouraged to expand rapidly. Nevertheless, many banks remained unprofitable, inefficient, and unsound owing to their poor lending strategy and lack of internal risk management under government ownership. Joshi and Little (1996) have reported that the average return on assets in the second half of the 1980s was only about 0.15 per cent, while capital and reserves averaged about 1.5 per cent of assets. Given that global accounting standards were not applied, even these indicators are likely to have exaggerated the banks' true performance. Further, in 1992/93, non-performing assets (NPAs) of 27 public-sector banks amounted to 24 per cent of total credit, only 15 public-sector banks achieved a net profit, and half of the public-sector banks faced negative net worth .

The major factors that contributed to deteriorating bank performance included (a) too stringent regulatory requirements (i.e., a cash reserve requirement [CRR] and statutory liquidity requirement [SLR] that required banks to hold a certain amount of government and eligible securities); (b) low interest rates charged on government bonds (as compared with those on commercial advances); (c) directed and concessional lending; (d) administered interest rates; and (e) lack of competition. These factors not only reduced incentives to operate properly, but also undermined regulators' incentives to prevent banks from taking risks via incentive-compatible prudential regulations and protect depositors with a well-designed deposit insurance system. While government involvement in the financial sector can be justified at the initial stage of economic development, the prolonged presence of excessively large public-sector banks often results in inefficient resource allocation and concentration of power in a few banks.

The CRR requires banks to hold a certain portion of deposits in the form of cash balances with the Reserve Bank of India. In the 1960s and 1970s, the CRR was 5 per cent, but then rose steadily to its legal upper limit of 15 per cent in early 1991. The statutory liquidity requirement requires banks to hold a certain amount of deposits in the form of government and other approved securities. It was 25 per cent in 1970 and then increased to 38.5 per cent in 1991 – nearly to the level of its legal upper limit of 40 per cent. With respect to direct lending, the priority sector target of 33 per cent of total advances was introduced in 1974, and the ratio was gradually raised to 40 per cent in 1985. There were sub-targets for agriculture, small farmers, and disadvantaged sections.

Against this background, the first wave of financial liberalization took place in the second half of the 1980s, mainly taking the form of interest rate deregulation. Prior to this period, almost all interest rates were administered and influenced by budgetary concerns and the degree of concessionality of directed loans. To preserve some profitability, interest rate margins were kept sufficiently large by keeping deposit rates low and non-concessional lending rates high. Based on the 1985 report of the Chakravarty Committee, coupon rates on government bonds were gradually increased to reflect demand and supply conditions.

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

As a result of the reforms, the number of banks increased rapidly. In 1991, there were 27 public-sector banks and 26 domestic private banks with 60,000 branches, 24 foreign banks with 140 branches, and 20 foreign banks with a representative office. Between January 1993 and March 1998, 24 new private banks (nine domestic and 15 foreign) entered the market; the total number of scheduled commercial banks, excluding specialized banks such as the Regional Rural Banks rose from 75 in 1991/92 to 99 in 1997/98. Entry deregulation was accompanied by progressive deregulation of interest rates on deposits and advances. From October 1994, interest rates were deregulated in a phased manner and by October 1997, banks were allowed to set interest rates on all term deposits of maturity of more than 30 days and on all advances exceeding Rs 200,000. While the CRR and SLR, interest rate policy, and prudential norms have always been applied

with respect to the regulation that requires a portion of credit to be allocated to priority sectors. In 1993, foreign banks – which 3 In 1998, the Narashimham Committee II has recommended a convergence of developing financing institutions to with commercial banks or non-bank financial institutions and an adoption of the integrated system of regulation and supervision etc.

Drastic versus gradual privatization approaches

While India's financial reforms have been comprehensive and in line with global trends, one unique feature is that, unlike with other former planned economies such as Hungary and Poland, the Indian Government did not engage in a drastic privatization of public-sector banks. Rather, it chose a gradual approach toward restructuring these banks by enhancing competition through entry

deregulation of foreign and domestic banks. This reflects the view of the Narasimham Committee that ensuring the integrity and autonomy of public-sector banks is the more relevant issue and that they could improve uniformly to all commercial banks, the Reserve Bank of India treated foreign banks differently profitability and efficiency without changing their ownership if competition were enhanced .

Since this approach was introduced, some criticisms have been expressed (Joshi and Little 1996). First, public-sector banks continue to be dominant thanks to their better branch coverage, customer base, and knowledge of the market compared with newcomers. Second, public-sector banks would find it more difficult to reduce personnel expenditure because of the strong trade unions. Third, the government would find it difficult to accept genuine competition within public-sector banks. In response to these concerns, the government decided to gradually expand private-sector equity holdings in public-sector banks, but still avoided the transformation of their ownership. The 1994 amendment of the Banking Act allowed banks to raise private equity up to 49 per cent of paid-up capital. Consequently, public-sector banks, which used to be fully owned by the government prior to the reform, were now allowed to increase nongovernment ownership. So far, only eight public-sector banks out of 27 have diversified ownership. Meanwhile, a consensus is emerging that state ownership of banks is bad for financial sector development and growth. Based on data from the 10 largest commercial and development banks in 92 countries for 1970-1995, La Porta and others (2000) have found that greater state ownership of banks in 1970 was associated with less financial sector development, lower growth, lower productivity, and that these effects were greater at lower levels of income.

The insurance sector, was a public sector monopoly at the start of the reforms. The need to open the sector to private insurance companies was recommended by an expert committee (the Malhotra Committee) in 1994, but there was strong political resistance. It was only in 2000 that the law was finally amended to allow private sector insurance companies, with foreign equity allowed up to 26 percent, to enter the field. An independent Insurance Development and Regulatory Authority has now been established, and ten new life insurance companies and six general insurance companies, many with well-known international insurance companies as partners, have started operations. The development of an active insurance and pensions industry offering attractive products tailored to different types of requirements could stimulate long-term savings and add depth to the capital markets. However, these benefits will only become evident over time.

Reforms in the financial sector had to be implemented keeping in view not only the desirable directions and appropriate measures carefully sequenced, but also the emerging uncertainties, both in domestic and global arena. By all accounts, India has managed the uncertainties reasonably well. Recognizing that such uncertainties have a tendency to impact the exchange rate

it is instructive to briefly review the processes of management and drawn some tentative lessons. The Gulf crisis, which triggered the reform process was managed without any reschedulement of any contractual obligation, but with a recourse to stabilization measures and initiation of structural reforms. The current account convertibility in 1994 led to liberalization of gold imports and large capital inflows upto 1996. In 1997, the timely efforts to depreciate the currency warded off a possible crisis due to persistence of a relatively over valued rupee in the forex markets.

RBI and Government

During the early 1960s, Governor Iengar identified four areas of potential conflict between the Bank and the central government. These were interest rate policy, deficit financing, cooperative credit policies and management of sub-standard banks. It may be of interest to note that these four areas are still some of RBI's concerns.

During the post-reform period, the relationship between the central bank and the Government took a new turn through a welcome development in the supplemental agreement between the Government and the RBI in September 1994 on the abolition of the ad hoc treasury bills to be made effective from April 1997. The measure eliminated the automatic monetisation of Government deficits and resulted in considerable moderation of the monetised deficit in the latter half of the Nineties.

At the same time, with gradual opening up of the economy and development of domestic financial markets, the operational framework of the RBI also changed considerably with clearer articulation of policy goals and more and more public dissemination of vast amount of data relating to its operations.

In fact, during the recent period, the RBI enjoys considerable instrument independence for attaining monetary policy objectives. Significant achievements in financial reforms including strengthening of the banking supervision capabilities of the RBI have enhanced its credibility and instrument independence. It has been pointed out by some experts that the RBI, though not formally independent, has enjoyed a high degree of operational autonomy during the post-reform period.

In terms of redefining the functions of the RBI, enabling a movement towards meaningful autonomy, Governor Jalan's statement on Monetary and Credit Policy on April 19, 2001 is a landmark event. First, it was decided to divest RBI of all the ownership functions in commercial banking, development finance and securities trading entities. Secondly, a beginning was made in recommending divestiture of RBI's supervisory functions in regard to cooperative banks, which would presumably be extended to non-banking financial companies and later to all commercial banks. Thirdly, the RBI signalled initiation of steps for separation of Government debt management function from monetary policy. These measures would enable the RBI to primarily focus on its role as monetary authority and enhance the possibility of a move towards greater autonomy.

The emerging issues relating to autonomy of RBI can be addressed at different levels. First, at the level of legislative framework, several suggestions have been made to ensure appropriate autonomy and many of them are under consideration. In particular, proposed Fiscal Responsibility and Budget Management Bill and other amendments to Reserve Bank of India Act would cover significant ground. Several other suggestions relating to legal framework, as recommended by the Advisory Groups are yet to be taken up.

Second, at the policy level, there are three important constraints on the operational autonomy even within the existing legal framework. One, the continued fiscal dominance, including large temporary mismatches between receipts and expenditures of Government warranting large
involuntary financing of credit needs of Government by the RBI. Two, the predominance of publicly owned financial intermediaries and non-financial public enterprises, which has created a blurring of the demarcation between funding of and by Government vis-à-vis public sector as a whole. Three, the relatively underdeveloped state of financial markets partly due to legal and institutional constraints, which blunts the effectiveness of instruments of monetary policy. These issues need to be resolved to enhance genuine autonomy.

Third, at the operational and procedural level, there is a problem of "old habits die hard". In a deregulated environment, there is considerable scope to reduce micro-management issues in the relations between the Government and the RBI. At the level of degree of transparency, there is a temptation to continue, what has been termed as the "joint-family approach"; which ignores basic tenets of accounting principles in regard to transactions between RBI and Government.

Some Critical Elements for Progress in Financial Sector Reforms

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

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

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

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

Furthermore, monetary policy is increasingly focused on efficient discharge of its objective including price stability, and this no doubt would help poverty alleviation, albeit indirectly, while the more direct attack on poverty alleviation would rightfully be the preserve of fiscal policy. Monetary and financial sector policies in India should perhaps be focusing increasingly on what Dreze and Sen call "growth mediated security" while "support-led security", mainly consisting of direct anti-poverty interventions are addressed mainly by fiscal and other governmental activities.

Impact of foreign and private domestic banks

One interesting feature of India's banking sector is that some large public-sector banks appear to have been performing reasonably well in the post-reform period. This could be attributed to (a) the import of better risk management skills from foreign and private domestic banks, (b) intensified competition, (c) the diversification effect described above, (d) reorganization (for example, mergers and acquisitions), and (e) goodwill. In India, however, given the virtual absence of an exit policy, large-scale mergers and acquisitions among problematic banks have not occurred so far. It is generally thought that the entry of well-capitalized new banks is likely to improve the quality and variety of services, efficiency of bank management, and prudential supervisory capacity . The entry of foreign banks tends to lower interest margins, profitability, and the overall expenses of domestic banks. Further, Claessens, Demirgüç-Kunt and Huizinga have reported that the number of entrants matters compared with their market share, indicating that foreign banks affect local bank competition upon entry rather than after they have gained a substantial market share. Moreover, these banks may be able to provide a source of new capital for enterprises and thus reduce government restructuring costs, especially when the domestic banking sector is devastated in the aftermath of a crisis. Some studies also find that foreign banks tend to go for higher interest margins and profitability than domestic banks in developing countries, while the opposite is true in developed countries (Claessens, Demirgüç-Kunt and Huizinga 2000) .

Objectives

When a study has been carried out regarding some research, it has certain aims and objectives.

1. To survey the impact of economic reforms on the different macro indicators.
2. Financial sector reform and its critical appreciation.

Although these are the main objective of this study but beyond these objective, we have to study some other measures also. We have to study for elaborating the possibilities of establishing the agriculture sector reforms, impact of poverty alleviation programmes, labour laws, infrastructure sector reforms as well as power sector reforms in Indian economy

Hypothesis of Study

(1) Economic reforms have significant impact on such indicators of the economy as- Financial Sector: Capital Market, Money supply.

(2) Economic reform have significant impact on financial sector in India.

Methodology

This paper, mainly emphasized some critical aspects of financial economic reforms and impact of globalization. Where Capital market, LIC and some other areas has been analysed on the behalf of some statistical tools. Mainly growth of the financial sector has been represented with the help of diagrame. Study is based on secondary data which has been taken from National and International sources as well as agencies.

Reforms in Insurance Sector

The insurance sector, in many respects, was most in need of reforms in 1991, being completely nationalized at the time. The public-sector Life Insurance Corporation had a complete monopoly on life insurance and pension products while the General Insurance Corporation, operating through four subsidiaries, monopolized general insurance. The government not only owned the insurance companies, it also performed the role of regulator. As it happened, the pace of change in this area was much more gradualist than elsewhere.

The need to open the sector to private competition as part of the broader thrust of financial sector reforms was recognized relatively early and the Congress government that initiated the reforms appointed the Malhotra Committee in 1993 to recommend a future course of action. The committee submitted its report in January 1994 recommending the establishment of an independent regulatory authority for insurance and opening up the sector for competition from new private entrants. Although some preparatory work was done by the Finance Ministry in pursuit of these recommendations, decisions were postponed because of the impending general elections in 1996.
The first step towards insurance reform was taken by the successor United Front Government when it established the Insurance Regulatory and Development Authority as an independent regulator for the insurance sector. However, the government's proposals on opening the sector to competition was limited to allowing private insurance companies to enter the health insurance and pension area. Even this limited opening was opposed in Parliament and the necessary legislation could not be passed before the government collapsed in 1998. In retrospect, it is doubtful that the small window of operations proposed would have attracted credible investors and further amendments would almost certainly have been needed.

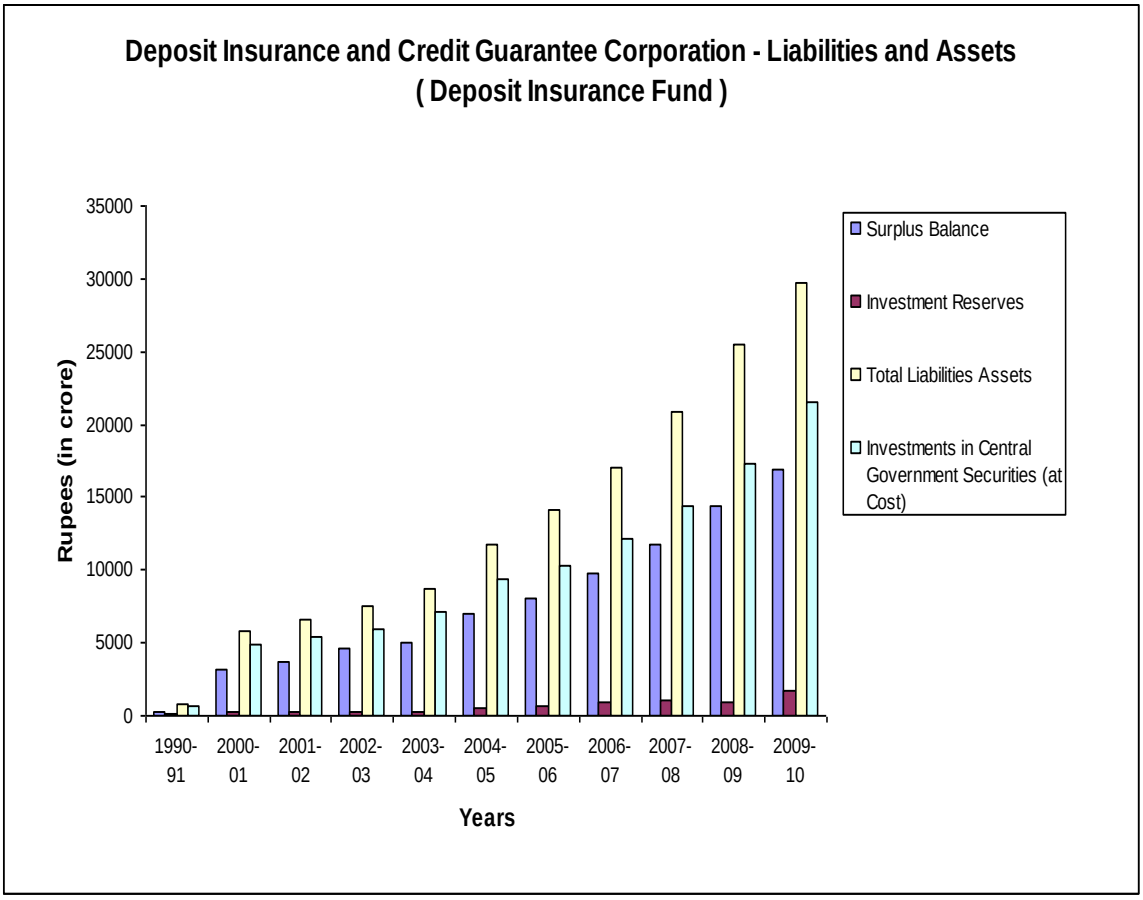
The opening of the insurance sector to new private insurers should in due course lead to the development of a competitive insurance and pension funds sector, providing a wide range of products tailored to different needs and circumstances. This should help mobilize long-term household savings in the form of insurance and pension funds. Traditionally, the financial resources mobilized through these channels have been directed disproportionately to the government because of high statutory requirements for investment in government securities, in the case of the life insurance fund, and the traditional preference of the government appointed Commissioners of the Employees Provident Fund to invest the Fund's resources with the government at an interest rate that has traditionally been kept at attractive levels. However, this pattern can be expected to change in future if the fiscal deficit is brought under control and government interest rates decline. One can expect that a substantial part of these resources would flow to the capital market, seeking higher returns, while adding depth to the capital market, especially for long-term corporate bonds.
As an integral part of the financial sector reforms, Insurance Sector was opened up based on the recommendations of Shri R.N. Malhotra Committee in March 2000. The passage of the Insurance Regulatory and Development Authority (IRDA) Bill lifted all entry restrictions for private players and allowed foreign players to enter the market with some limits on direct foreign ownership.

The basic objective of opening up was to tap the tremendous potential of the insurance sector in terms of increase in the number of insurance products in addition to players. It was aimed at throwing open more options for consumers in terms of products, price benefits and procedures. It was also aimed at generating long-term funds for giving a real push to the infrastructure sector. While fulfilling the objectives for which the sector was opened up, post-liberalization insurance sector joined the stream of service industry which experienced a boom in its growth. In a matter of nine years, the industry has brought about paradigm shift in the meaning and relevance of 'Insurance' to the common man. Insurance penetration has witnessed commendable increase from 1.77 in the year 2000 to 4 in the year 2007 in life insurance sector. Non-life penetration has increased from 0.55 percent to 0.60 percent during this period. Insurance industry has witnessed a business growth of more than 5 times from Rs. 44705 crore in the year 2000-01 to Rs. 253272 crore in the year 2008-09. Assets under management of the sector has grown more than 3 fold in matter of 8 years from Rs. 218471.63 crore in 2000- 01 to Rs.818321.69 crore in 2007-08 .

Table 1 : Deposit Insurance and Credit Guarantee Corporation - Liabilities and Assets (Deposit Insurance Fund)

(Rupees crore)

Year	Surplus Balance	Investment Reserves	Total Liabilities Assets	Investments in Central Government Securities (at Cost)
1990-91	271	76	**787**	678
2000-01	3205	261	**5749**	4874
2001-02	3687	261	**6600**	5453
2002-03	4683	261	**7584**	5999
2003-04	5037	259	**8740**	7079
2004-05	6942	475	**11797**	9363
2005-06	8077	641	**14102**	10284
2006-07	9767	954	**17008**	12194
2007-08	11809	1050	**20853**	14399
2008-09	14339	929	**25515**	17268
2009-10	16877	1661	**29682**	21532



This growth process in the sector has pioneered abundant opportunities in terms of employee generation both within the sector and in supporting services sector like Business Process Outsourcing (BPO) and Information Technology (IT). The growth is expected to be sustained in the coming years with dynamic changes in the insurance sector in terms of product innovation,

In the nine years since the Insurance sector was opened up in the year 2000, Insurance industry has witnessed a business growth of more than five times, from Rs. 44705 crore in 2000-01 to Rs. 253272 crore in 2008- 09. Ever since, there has been paradigm shift in the meaning and relevance of 'Insurance' to the common man. This growth process in the sector has pioneered abundant opportunities in terms of employee generation. In this scenario, Chartered Accountants (CAs) are thrust with responsibility to authenticate various information submitted to the Regulator by an insurance company. While insurance companies need experts to present their performance meaningfully to the public, stakeholders need professional advices for a meaningful interpretation of the same. Role of CAs, therefore, comes to the forefront in such a scenario.

Contribution of Insurance in financial sector

Insurance companies as mandated by the Insurance Act, 1938 are required to have their final accounts audited as required under the Companies Act, 1956. The relevant formats for preparation of financial statements have been prescribed separately for life and non-life insurance companies by IRDA (Preparation of Financial Statements and Auditor's Report of Insurance Companies) Regulations, 2002. Apart from the stipulations on preparation of financial statements and necessary formats, the said Regulations also indicate specific areas of concern like compliance with the legislation, directives, guidelines etc., on which the auditors are required to report, certify and/or

give their opinion. Apart from the year-end certification as specified in the Regulations, Auditors' certification is also called for on a periodic/adhoc basis on concerned areas. Professional Chartered Accountants (CAs) are, therefore, thrust with responsibility to authenticate various information submitted to the Regulator by an insurance company. CAs, with the mission to be valued trustees of world class financial competencies, good governance andcompetitiveness and with a vision to recognize the need to be known as world class advisor, are relied upon by the public for financial advisors and the Regulator for regulatory comfort.

Table 2 : Deposit Insurance and Credit Guarantee Corporation - Insured Deposits

Year	Total amount of insured deposits	Total amount of assessable deposits
1990-91	109316	156892
2000-01	572434	806260
2001-02	674051	968752
2002-03	828885	1213163
2003-04	870940	1318268
2004-05	991365	1619815
2005-06	1052988	1790919
2006-07	1372597	2344351
2007-08	1805081	2984800
2008-09	1908951	3398565
2009-10	2369483	4282966

Source: RBI handbook 2011

Long-term debt market: The development of a long-term debt market is crucial to the financing of infrastructure. After bringing some order to the equity market, the SEBI has now decided to concentrate on the development of the debt market. Stamp duty is being withdrawn at the time of dematerialisation of debt instruments in order to encourage paperless trading

The capital market

The number of shareholders in India is estimated at 25 million. However, only an estimated two lakh persons actively trade in stocks. There has been a dramatic improvement in the country's stock market trading infrastructure during the last few years. Expectations are that India will be an attractive emerging market with tremendous potential. Unfortunately, during recent times the stock

markets have been constrained by some unsavoury developments, which has led to retail investors deserting the stock markets.

The mutual funds industry is now regulated under the SEBI (Mutual Funds) Regulations, 1996 and amendments thereto. With the issuance of SEBI guidelines, the industry had a framework for the establishment of many more players, both Indian and foreign players.

The Unit Trust of India remains easily the biggest mutual fund controlling a corpus of nearly Rs.70,000 crores, but its share is going down. The biggest shock to the mutual fund industry during recent times was the insecurity generated in the minds of investors regarding the US 64 scheme. With the growth in the securities markets and tax advantages granted for investment in mutual fund units, mutual funds started becoming popular.

Private mutual funds permitted

The Depositories Act had given a legal framework for the establishment of depositories to record ownership deals in book entry form. Dematerialisation of stocks encouraged paperless trading. Companies were required to disclose all material facts and specific risk factors associated with their projects while making public issues.

With regard to wholesale investors such as Mutual Funds, Institutions and FIIs, their participation frequency is similar to that of long / short term delivery-based investors. Some FIIs are very active in the derivatives market. However, increasing volumes to make use of extra time is not prudent unless there is some money making opportunity, which is a function of price fluctuation and not length of time available for trading. The FIIs find cost of trading in India high due to Security Transaction Tax and Stamp Duty. They would thus prefer low cost markets rather than India. They also have the flexibility to issue exotic instruments based on derivatives, which is not possible in India.

This proposal will increase trade hours from current 5 hours and 35 minutes to 8 hours. This is roughly 43% increase from current 335 minutes. An increase of less than 43% on a daily basis on daily volumes will mean per hour volumes will be thinner than they were earlier. This will increase bid offer spread and consequently the transaction cost to all investors. This may also impact option prices as actual time value to be factored into the price of each of the options will go up due to increased time of trading. In short, a longer trading time works against the very definition of a market place.

The deficiencies of public-sector banks are well recognized in India, but there is little public support for privatization as a solution. Privatization is a politically sensitive issue in general, but it seems especially so in the case of banks. This is usually explained by the fact that public confidence in governance standards in the private sector is low and there is deep suspicion that privatization will lead to misuse of resources collected from the public. The policy response to this problem has been typically gradualist. Early in the reforms process, the law was amended to allow public-sector banks to raise private capital in order to meet the new capital adequacy standards, but the law provided that government equity would not be diluted below 51 percent. A dozen or so public-sector banks successfully raised private equity under this policy, and these banks now have private shareholdings ranging from 23 percent to around 44 percent. More recently, the government has introduced legislation to permit a further dilution of its stake to 33.33 percent, so that public sector banks can mobilize the additional capital needed to meet the requirements of expanded lending in the future. However, it has also stated that it will ensure that “the public-sector character” of banks will be preserved, implying thereby that the government intends to retain effective management control. Any strategy for improving the efficiency of the banking system must therefore deal with the problem of increasing efficiency in public sector banks which remain under government control.

Conclusions

India's financial market has been gradually developing, but still remains bank-dominated in the reform period. The extent of financial deepening measured by total deposits in GDP has risen only modestly from 30 per cent in 1991 to 38 per cent in 1999. Capital market development has also been quite sluggish. Outstanding government and corporate bonds as a share of GDP rose from 14 per cent in 1991 to 18 per cent in 1999 and from only 0.7 per cent in 1996 to 2 per cent in 1998, respectively, while equity market capitalization dropped from 37 per cent in 1995 to 28 per cent in 1999.The balance sheets of foreign banks appear to be more structurally sound than those of domestic and public-sector banks based on the following criteria: capital adequacy, asset quality, management and liquidity.

First, on the capital adequacy ratio proxied by equity plus reserves over total liabilities or total assets, the ratio of foreign banks increased from 7 per cent in 1993 to 20 per cent in 2000. While the ratios increased moderately for domestic banks, it still remains small. This suggests that foreign banks have greater incentives to lend prudently and remain well capitalized than the two other kinds of banks. This reflects the fact that foreign banks steadily reduced their deposit dependence ratio from 67 per cent of liability in 1993 to 47 per cent in 2000, while the two other types maintained their dependence ratio at about 85 per cent throughout the sample period.

Nevertheless, the IMF report (2001) indicates that the risk-weighted capital ratio has been comparable among all banks and has improved from 1996/97 to 1999/2000: from 10.4 per cent to 11.9 per cent for foreign banks, from 11.7 per cent to 12.4 per cent for old private domestic banks, and from 10 per cent to 10.7 per cent for public sector banks, while that of new private domestic banks declined from 15.3 per cent to 13.4 per cent.

Second, by contrast, the assessment on asset quality based on (a) the ratio of contingent liabilities to assets, (b) asset growth, (c) the ratio of investment in securities to assets, (d) the ratio of provisions for NPA to assets (PROV), and (e) the ratio of medium- and long-term credit to assets reveal mixed results. The first indicator reports that the ratio of foreign banks (at around 25-30 per cent) has been greater than that of domestic banks and public-sector banks. While this indicates that foreign banks are more exposed to high potential losses in cases of default, this outcome may simply show that foreign banks provide more complex and sophisticated services than the two other types of banks, given that their activities are concentrated on urban areas, wholesale markets and large clients.

The second indicator reports that foreign and private domestic banks faced rapid credit growth in 1993-1997, signalling some kind of risk-taking behaviour. However, this may be explained simply by their early stage of establishment. The third indicator shows that all three banks invested about 30-40 per cent of assets in securities in response to the SLR, indicating that all of them have a large cushion against NPAs. In particular, public-sector and private domestic banks increased their share of investment in government bonds in assets in 1993-2000 from 21 per cent to 23 per cent and from 21 per cent to 27 per cent, respectively. This may be due to their preference for more liquid, safe assets as the Basle Accord was applied. The fourth indicator reports that foreign banks generally allocated greater provisions for NPAs. Given that more stringent accounting and auditing standards of their mother countries are applied to foreign banks, the foreign banks are more resilient to adverse shocks. IMF (2001) has reported that foreign and new private domestic banks maintained small NPA ratios (about 2-4 per cent) during the period 1995-2000 – below the level of public-sector and old domestic banks, with the former declining from 9.2 per cent in 1996/95 to 7.4 per cent in 1999/2000 and the latter remaining at around 7 per cent. The final indicator reports that foreign and private domestic banks increased medium- to long-term credit in 1993-2000 from 7.5 per cent to 17 per cent and from 10 per cent to 13 per cent, respectively, suggesting their increased confidence in India's financial market .

Third, management performance is assessed based on two indicators: (a) the ratio of credit to deposits; and (b) the ratio of equity and reserves to debt (inverse of leverage). The first indicator reports that foreign banks attempt to improve their income by expanding their lending operations as compared with other domestic banks.

The ratio of foreign banks surged from 56 per cent in 1993 to 94 per cent in 2000, while the two other types of banks maintained the ratio at about 40 per cent over the same period. Given that **foreign banks' ratio of credit to assets is similar to other domestic banks (about 35 per cent of** assets), however, this simply suggests that foreign banks lowered the deposit dependence ratio. Based on the second indicator, foreign banks are generally less leveraged than domestic and public-sector banks. Fourth, all three types of banks maintain a similar liquidity position, accounting for about 15 per cent in terms of cash and balances with banks; and about 50 per cent in terms of the sum of cash, balances with banks, and investment. This reflects the CRR and SLR.

Suggestions

If outright privatization is ruled out, it is necessary to experiment with other changes in institutional structures and incentives that would enable public sector banks to improve their commercial performance. This is easier said than done since any such effort must balance two potentially contradictory considerations. On the one hand accountability requires the government to take responsibility for the actions of an entity in which it has a substantial stake but on the other there is need to avoid "interference" if the entity is to act commercially. There is no easy solution to this problem and it is necessary to experiment to find answers that are at least satisfactory if not perfect.

- If public-sector banks are to behave more like commercial organizations it is necessary to begin by empowering the boards of the banks as the key institutions for exercising oversight on management and to which the management must be responsible. An essential step in pursuit of this objective is for the top management of each bank to be appointed by the board, on the basis of recommendations made by a nominating committee of directors, and not by the Appointments Committee of the Cabinet, as at present. The board should then set monitor able targets which management should aim at and management performance should be judged on the basis of achievement in these dimensions.
- As long as government is an owner, it needs to be represented on the board, but it need not be represented by serving civil servants, as is the case at present. Civil servants cannot be expected to separate their role as board members from their accountability as civil servants to the government. Managements also tend to defer excessively to the perceptions of civil servants representing the Ministry of Finance, giving them a disproportional influence. The government could nominate, as its representatives, competent persons other than serving civil servants who could be given general directions to follow concerning the broad objectives they need to keep in mind.
- The RBI's powers to take corrective action vis-à-vis public-sector banks need to be equated with the powers it enjoys vis-à-vis private-sector banks. At present, the RBI has the power to remove the chief executive officer (CEO) of a private-sector bank and even to withdraw its banking license, but it does not have these powers in the case of public-sector banks. The law should be amended to give these powers to the RBI. This would greatly increase the accountability of the RBI in ensuring that public-sector banks comply fully with supervisory directions.
- The practice of the RBI nominating directors on the boards of public-sector banks is inconsistent with independence of the supervisory authority and should be given up.

- Hiring and promotion policies for managerial positions within the banks should be made much more flexible, giving much greater decision-making powers to bank managements to reward merit and to encourage commercial initiative. An important start has been made in this direction recently with the State Bank of India undertaking direct recruitment in select campuses instead of relying solely on competitive examinations. However, this initiative needs to be accompanied by flexibility in ensuring that promotions are based on merit if high quality entrants, successfully lured by direct recruitment, are to be retained.
- Wage negotiations should not be conducted, as they have been in the past, on the basis of an industry wide negotiation, but should be left to individual banks so that wage agreements in individual banks will reflect their performance and profitability. Unless this is done, it will be difficult to introduce appropriate incentive structures that give employees a stake in the performance of the bank. The salary structure for executives in public-sector banks should also be delinked from the present informal linkage to the government/public-sector salary structure.

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