Indian Economy: Some Contemporary Perspectives
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Lecture 19
Indian Economy – Financial Sector 1

Hi, everyone so we are now going to start the lecture 19 of this course which is Indian Economy: Some Contemporary Perspectives. Now we will be moving to financial sector and this sector is very important because it consists of… and it captures the whole landscape of what we call it as the financial sector development. And we will be spending some more time because this particular topic is going to take some more time in terms of covering place and developments. But, particularly lecture 19 and 20 will be focusing more on the earlier development and the banking sector.

Lecture 19 is mainly meant for understanding the developments in the banking sector, how since independence we have progressed and what kind of development we had to undertake, and we had to experience. And how government of India had to go for revisiting the model of the development that we have envisaged.

Now apart from the banking sector, maybe in lecture 20 will cover some aspects of the banking regulation because this is also one of the areas, we are looking for certain improvements and post 2008-09 global financial crisis, there is a whole lot of debated discussions on the marco potential role and the role of the central bank in devising certain regulatory norms so that we can avoid the uncertain situations in future. And those norms have now been stipulated in the form of the financial stability report. So, if you go on the RBI website, you will find a report called financial stability report and it captures or it provides a signal to the financial health of the financial system.

Now if you trace the history of India's financial system then it is basically based on the banking sector development. So, we are more into the banking sector led economic growth. There are some differences among the academicians and the researchers that whether it is grew up late, the financial development, or the financial development led economic growth development. So, those topics will be touching up and we will also be trying cover certain important developments in the history of Indian Banking sector and that is about the nationalisation process till 1991 developments and how banking sector was till 1991. And then we will be covering the periods of post reform periods.

And post reform periods, we have a lot to cover because it touches upon the recent period reforms also. So, I will try to give you as much background as I can in the next half an hour or 25 minutes. And then we will be moving to the further details of the banking sector that we have been regulating and experiencing. And also, towards the extend that how in 2016 we had to experience some kind of very awkward movement in the Indian Banking history when we had to go for or experience very downward movement in the asset prices of the banks and that resulted in complete chaos. And finally, government of India had to go for consultation of banks.

There is also an important committee that we have to specially mention here that is called the SINGAM committee report. And it has part 1 and part 2. In 1992 and 1998, this particular committee has recommended a lot in terms of changing the contours of the Indian banking sector. How banking sector should be, and whether we can incorporate new changes or not. Now keeping that in mind, I will be trying to cover as many topics as I can.

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So, here I have referred few materials that I have thought, I should be mentioning, and it is Rakesh Mohan, he is an authority in the area of monitoring system in India and he writes a lot and he has written in the past and he is still interested in this topic. So, if you are interested you can read the report on financial sector reforms in India, policies and performance analysis.

Then T.G Arun has written a good article, it is mentioned in financial sector reforms in developing countries, the Indian Experience and it highlights the role of financial sector development. Then I have referred, Twenty Years of Economic Reforms in India by Sury. I have also referred the Educate book of Ashima Goyal, Handbook of the Indian Economy in the 21st Century.

Then I found Shirai S, the Assessment of Indian Banking Sector reforms from the perspective of the governance of the banking sector. And this particular book also provides deep inside the India's regulatory framework of the banking and how evolution of the banking sector has taken place in India. So, these references might be useful for the people who are deeply interested and if they want to explore more about this particular topic that I am going to discuss.

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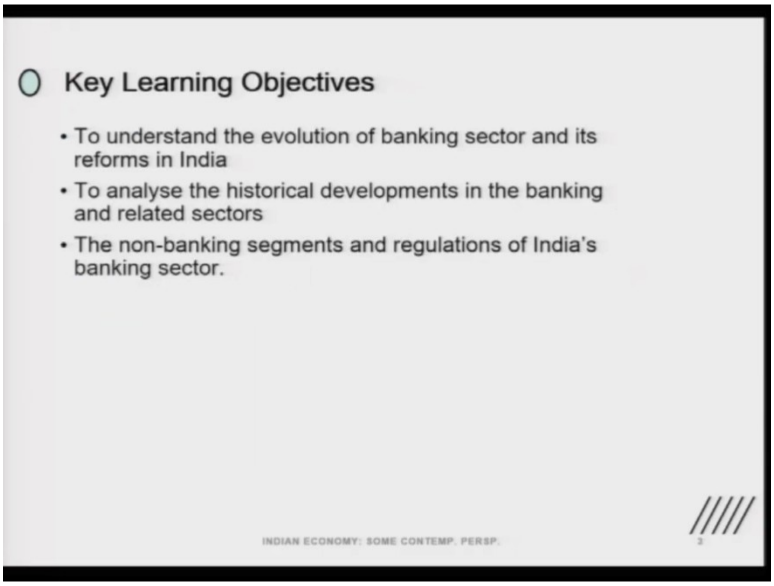

So, the key learning objective is that to understand the banking sector developments and how we can corelate with the historical developments and how they regulations in the banking sector have evolved over the period of time.

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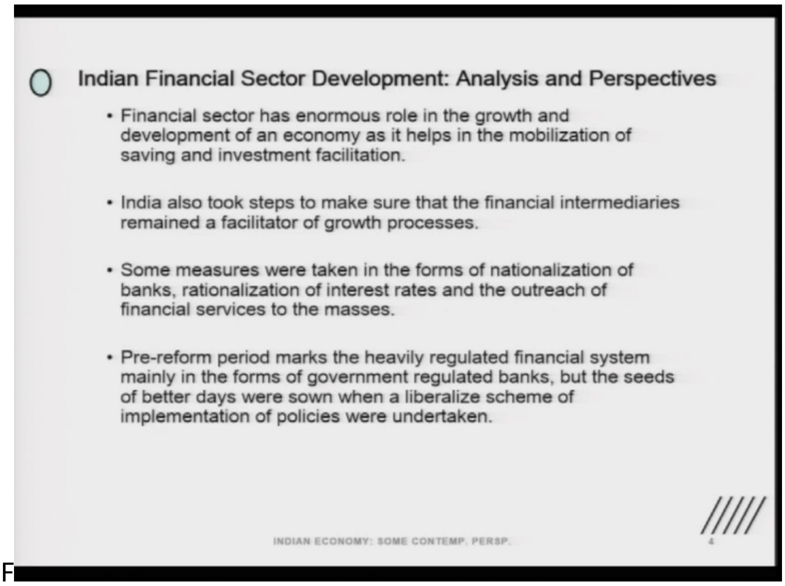

So, the debate in the field of economics starts with the role of financial sector development. So, whether the financial sector development leads to better economic growth and development or it is just the reverse. Which means that if the GDP is increasing then this leads to better financial services and fancy development in the country. Or in a way that first let us develop the financial sector and then once the financial sector is developed then it creates the extra opportunity, and that extra opportunity may translate into a better growth and development. So, there are either one-way cordial relationship between economic growth and financial development or both ways.

So, these two arguments are well argued by economists and there are differences with regard to the developed economy and developing economies. The king and Livian paper in 1993 gave the idea of how we can give importance to financial sector development in faster economic growth. And at that time idea was that, in the context of each and every country, the pattern of financial sector developments changes in the sense that most of the countries during 1950's which got independence in 1950's was influenced more by the socialistic pattern which means the regulated economy and a lot of hurdles with regard to the pursuance of the utilisation policies.

So, the economic development was not as quick or as fast as in some of the countries which are adopted the market, this economy experienced this. So, that is why the relationship between the financial sector development economic growth where… or it is dependent on the nature of the economy that we are considering.

So, in case of India it is the case that, in the beginning the banking sector scope was limited and then when we expanded the economy then we took major steps to revive the economy or to expand the economy. Then the financial sector expanded quickly and then it helped in sustaining the high growth. So, keeping those dimensions in mind we also thought that we should... knowing about the role of the financial sector and in the formative years of the economy in any country, the role of the financial sector normally, it is about mobilising the saving and translating that saving into an efficient investment.

So, those roles are important to understand, and India also took major steps in that regards. India also took steps to make sure that the financial intermediation remained facilitator of the growth process in the 50's and late 50's and even in 60's we had a DFI, development in financial institutions in India, which means that these institutions were interested in task to support the industrial growth process of the country and provide long term financing opportunities for more than 10 years, 15 to 20 years.

And DFI, development of financial institutions played key role because each and every country even in the west and even in Europe, these institutions played a role and India also took major steps. And development of financial institutions and those institutions later due to irregulated market system, when the economy was opened, the institutions filled the impact of the market-oriented system and then ultimately the institutions had to be adopted as any bank and they were further transformed into full time or proper commercial bank.

So, when the economy progresses it leads to certain changes in the economy and as a result the financial institutions also incorporate those changes and they also try to adjust with the new pattern in the economy. So, we also saw in case of India, in the 60's and late 60's and in the 80's we took major nationalisation so we had gone for nationalisation of banks because it was felt that, since the task for the government was to implement certain socio-economic objectives and even to go for the adapted industrialisation process, at that time the government took measures and they felt that the banking process was not completely oriented for such rapid industrialisation and that is why, some of the private banks were forced and that was nationalised.

Then the government of India took measures on the financing which means the credit facilitation, in terms of credit creation and in that case they had gone for rationalisation of interest rate, certain deposit ratios, liquidity ratios and ultimately it benefitted the sector in terms of giving sufficient supply for the credit.

Then we also, in the pre-reform period since the economy was regulated by most of the large forms and the large forms had a major say in terms of banking sector and the banking sector was also more obliged to the large banks and that is why we had to take the regulation measures and when in 1980's or in the mid of 1980's when the government of India took measures to go for the market oriented economy with more participation of the private sector, then the government had to accept the change and then they allowed the private sector to function, then we had a huge change in the composition of the financial sector in the country.

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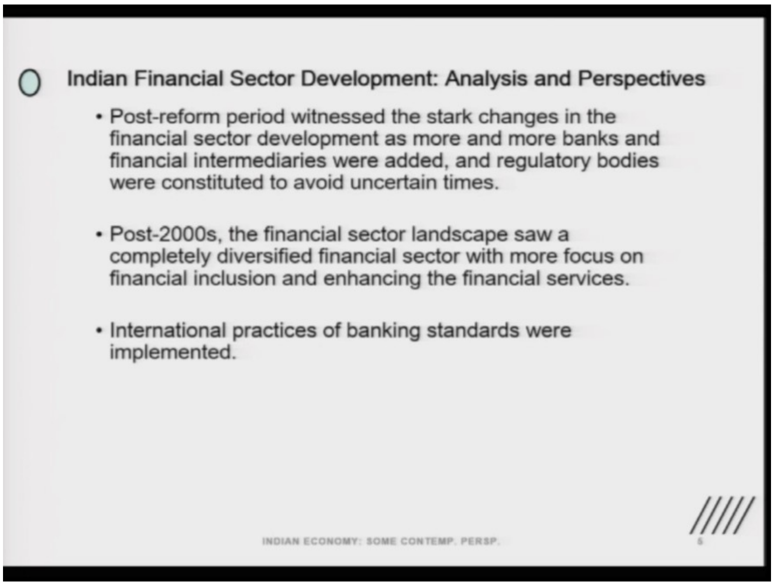

Then post reform period, saw complete start changes in terms of the financial sector development as we had not only banking sector in terms of public sector banks and private sector banks but also we allowed the non-banking financial companies to operate and then we had a different options given to investors for investments for example, we had gone for mutual then our capital market was developed and the capital market also provided incentives so post 2000, the financial sector of India was well diversified financial sector. And then we started focusing on whether we should focus on outreach of the financial services that we are providing to the urban masses.

And then we started focusing on expanding to the rural areas and unbanned population. Then during or post 2000 period, we also took major align our banking system with the international system and in that process, we took majors for the BASIL norms so international banks for settlement so there we had gone for implementation of certain norms for the banking regulation, for example BASIL 2 was implemented quite efficiently, BASIL 3 because of the pandemic we have postponed.

And it may be implemented in 2023. So, those regulatory changes market disciplines, supervising norms, disclosure requirement, calculative norms, implementation and even India had gone for adoption of higher level of calculative ratio compare to the other countries and that is why the strength of the banking sector was more on the mobilization of savings facilitating the financial services to the large populous.

So this aim gave a lot of boost to the banking sector as a result in the post 2010 era, you have seen India's banking sector as one of the most diversified in the world and we have enormous opportunity but the regulatory system or the regulated banks are failed in some aspects especially in terms of regulating the default sanction of loans and that resulted in 2016, twin balance sheet crisis. So, I will be discussing those topics again, but let us have the historical perspective.

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So, if you try and understand the financial sector, what all institutions are covered in this, you will find that it is the rural banks, so first is the commercial banks that we have both public and private. Then we have rural banks then we have cooperative banks, then we have credit institutions, then we have development of finance and then we have non-banking financial institutions that we call it as NBFC's and both have deposit taking and non-deposit taking, those who are in leasing and other business.

And then we have mutual funds, pension funds, and insurance companies. So, the whole land scape of the financial sector in India consists of these institutions and that is why it is important that we should be focusing on understanding each and every component and some components for example, rural banks, RB's which was set up in 1975, which we have already covered when we discussed about the agriculture sector and that is why even cooperative banks to some extent we have covered. Then we have credit institutions, development finance institutions will be covering today.

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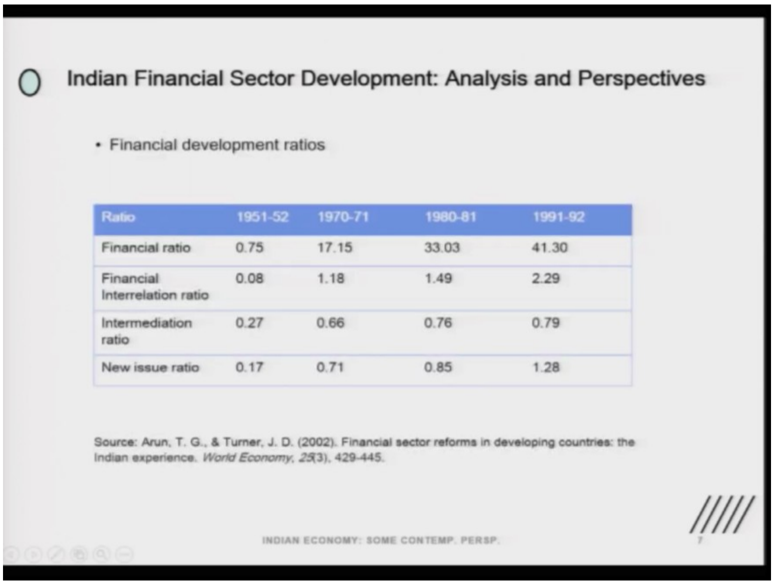

So, this table talks about the financial development so here is your financial ratio, what is the ratio? The ratio is in terms of the short term and the long term wise happening or the credit facilitation provided by financial institutions, so it depends on the financial growth. Then we find that it is higher, 3.75, it was in the beginning of 1951, 52 it was 0.75 then it raised to 17.15 and then we had 33 and then in 1991-92, it reached to 41. Similarly, financial inter-relation ratio, which means that financial development in terms of both money and capital and upon the physical investment.

And this also shows the increase in number, so this also shows the same and here again the intermediation ratio is increase in the number. So, this is also showing the same and here again the intermediation ratio means how much the money market and capital market contributed.

So, this also we have seen a complete intermediation means those institutions which are in the intermediate sectors so banks, NBFC and all the institutions. So, here also we are finding that the ratio is increasing continuously and new things in terms of the capital market in 1951-52 we had very limited scope for the capital market development and we find that from 1970 onwards we started experiencing something and till 1991-92 we had a value reached up to 1.82.

So, the overall picture looks promising because we have progress built and we have seen the changes in terms of build in financial services and financial ratios. And that is why it looks, or it may be called as better for the… as we have progressed in terms of GDP growth, financial sector was also proud. So, that is why it becomes really important to focus.

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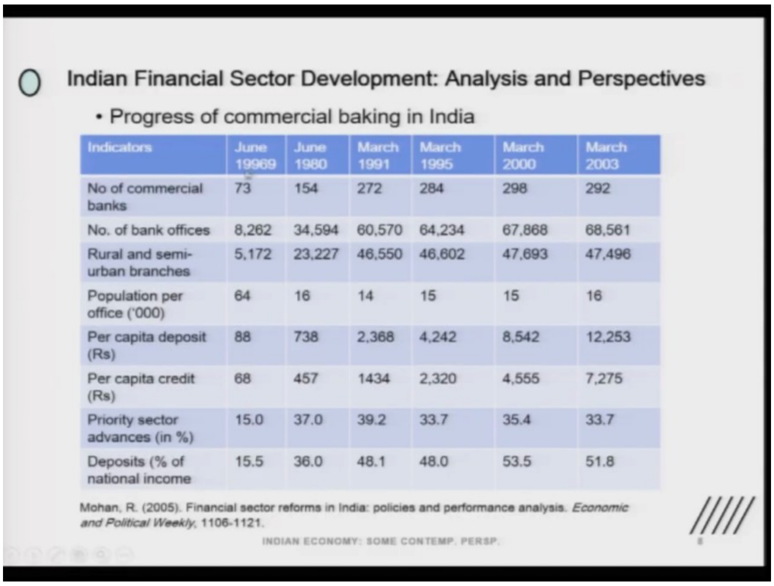

Indicators	June 19969	June 1980	March 1991	March 1995	March 2000	March 2003
No of commercial banks	73	154	272	284	298	292
No. of bank offices	8,262	34,594	60,570	64,234	67,868	68,561
Rural and semi-urban branches	5,172	23,227	46,550	46,602	47,693	47,496
Population per office ('000)	64	16	14	15	15	16
Per capita deposit (Rs)	88	738	2,368	4,242	8,542	12,253
Per capita credit (Rs)	68	457	1434	2,320	4,555	7,275
Priority sector advances (in %)	15.0	37.0	39.2	33.7	35.4	33.7
Deposits (% of national income	15.5	36.0	48.1	48.0	53.5	51.8

If you go for the analysis of the… I have got this from the Rakesh Mohan paper and just to give you some kind of background, here it is 1969, 9 is extra and here it is banking not baking. And here it is, June 1980 and then March 1991, March 1995, then March 2000 and March 2003. Here we can see in terms of the number of commercial banks in June 1969, when it had gone for nationalisation, it was 73, then it increased to 154 and then we had 272, then it was reduced to March 2003 to 92. Then here number of bank officers, that also you can see there is tremendous increase specially in March 1991, we see a bigger jump and that could be because most of the banks are having… there are a lot of reform initiatives undertaken at that time and might be it was the phase where it was just beginning of the major change happening.

And then out of this we have rural and semi-urban areas, out of 8262 we have 5172 and out of 34 it was 23 thousand and out of 60 thousand, we have 46 thousand here. So, this also was shown but after March 2000, it shows some kind of stabilisation but compared to 1980, we see almost double of the number of rural and semi-urban branches. Population per thousand office, this also we have seen the increase. Per capita deposit if you see, so this also has increased, it has gone to 12253. Per capita credit also has increased, 7275 which means there is a whole lot of financial deepening process that we see.

So, this we can call it as a healthy financial deepening process. In priority sector advances which means that we have agriculture and other sectors as priority sector, there also we see continuously… here we see some vibrations. For example, in 1969, it was 15 percent and then in June 1980 it reached up to 37 percent and then again it was mild increase. And then we see some kind of correction here, 33.7 and that could be because of, in March 1995, the scenario was quite different, and we were more focused on industrialisation process and the priority sector advances where quite low and this has realtor again in the basic relation.

In terms of deposit, the percentage in national income, this also we see an increase, though there is a modulation but March 2000 we had the increase. Now, this tables clearly shows that the banking sector in India has played a constructive role in terms of facilitating. But post 2005 or 2006 we have seen major change in the banking sector, and we saw huge amount of banking operations taking place in the remote area of the territory and that has changed the entire outlook of the banking sector.

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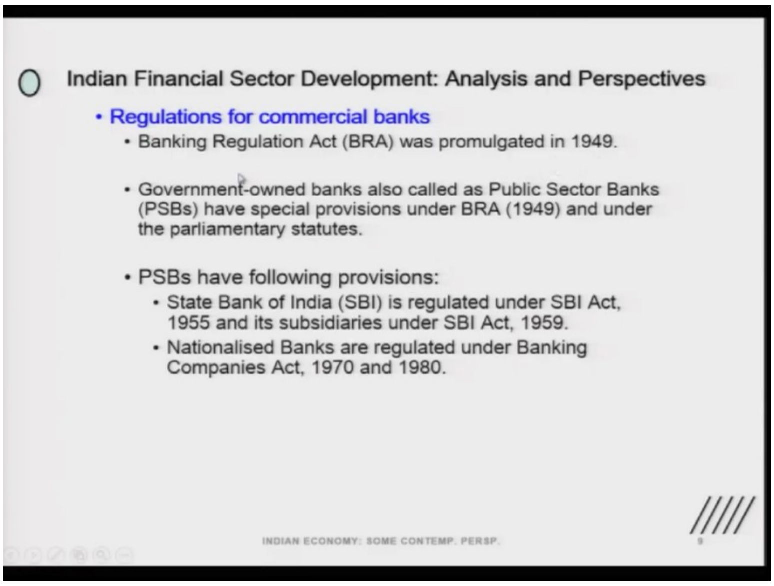

Now here Banking Regulation Act BRA was implemented in 1949, so this was the first banking revolution act that India have implemented. Government owned banks are called public sector banks, had special provisions in terms of not only just mobilisation of saving but also in terms of participation in industrial activities.

The public sector banks also had, basically SBI was regulated under the SBI act and its subsidiaries were regulated on 1959 Act but now most of the subsidiaries of SBI now merged with SBI and now it is just one entity. And nationalised banks are regulatory under the banking companies act, 1970's and 1980's. So, that give them different kind of regulatory firms compare to the State Bank of India.

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Now if you trace the history then I have already mentioned, at the time of independence we had a large number of banks and most of these banks had fragmented business activities. Most of the banks were owned by large business houses and these banks were simply serving the purpose of those houses or I would say business promoters.

But the government of India took majors in terms of rapid industrialisation and then at that time, it was filled that until and unless we have the proper banking structure that we support the or that will provide the sufficient question for the development of financial or that will help in expanding the in-term credit services then only it will be fruitful or the objectives of the planning process will be materialised otherwise it will be difficult.

So, in the Indira Gandhi government at that time, have nationalised 14 major commercial banks and it was also possible for some of the renewals of the researchers have argued that, one of the reasons was not just the planning process but it also one of the reasons that the country was devastated with wars with China and Pakistan.

And country was also going through a severe drought, higher inflation, inflation has reached 20 percent and that time it was also famine kind of situation in the country so that time the domestic scenario was not that much suitable and the government was also in the need of financing individual activities, financing the economic activities and that is why, it became really difficult for the government to work with the private banks that's why this drive was possible, that is 20th July 1969 nationalised 14 major commercial banks and these banks included these. So, one was Allahabad Bank, Bank of Baroda, Bank of India, Bank of Maharashtra, then we had Centra; Bank of India, Canara Bank, Vijaya Bank, Indian Bank, Indian Overseas Bank and then we had Punjab National Bank, Syndicate Bank, UKO Bank and Union Bank, United Bank of India so these banks were nationalised, and it became controversial subject because some of the bank promoters were not happy with the decision of the government. And finally, since this decision was from the Prime Minister, it was supposed to be accepted.

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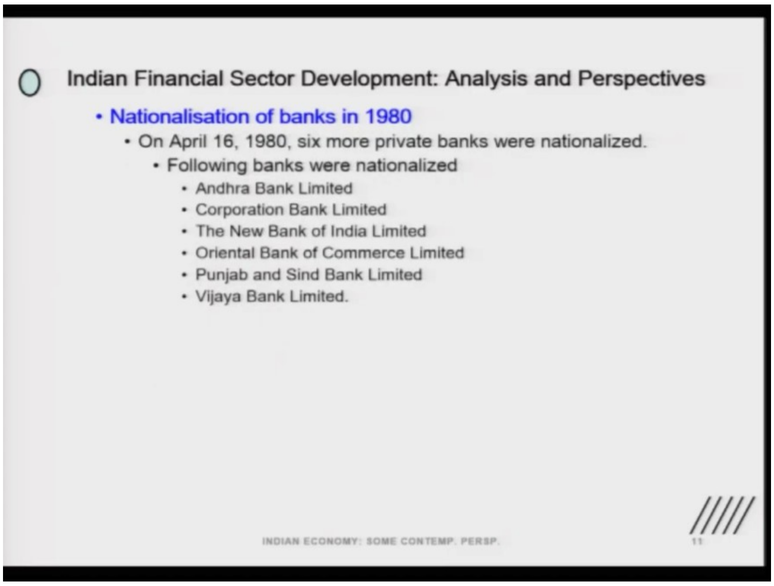

Then the second phase of nationalisation started, and this nationalisation phase was, it started on April 16th, 1980, 6 more banks were nationalised and these banks were Andhra Bank Limited, Corporation Bank Limited and then we also had New Bank of India Limited, Oriented Bank of Commerce, Punjab National Bank Limited and we also Vijaya Bank Limited. So, overall, what I would like to say is that in terms of the nationalisation of banks these 2 events are very much important for understanding the Indian Banking sector landscape.

So, let me summarise what we have done, so we just gone through the background of India's banking sector. We just covered the landscape that how and what are the components were there. And we started talking about the nationalisation process. In the next session we will be talking about the banking sector reform that we undertook and how it has helped in terms of developing the diversified banking sector. Thank you, thank you so much.